CLIENT ALERT

Increased False Claims Act Risk for Sureties

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United States ex rel. Scollick v. Narula, et al, a lawsuit that could have a profound impact on the surety industry, continues to proceed towards trial, with the parties exchanging their initial disclosures in the time since the U.S. District Court for the District of Columbia denied a motion to dismiss in late August. Having made it past the pleading stage, *Scollick* will be a closely-watched test case for potential FCA liability for sureties of government contractors that engage in small business fraud.

A novel theory of liability

In *Scollick*, a former employee of a construction company filed a lawsuit as a whistleblower (referred to as a "relator" under the statute) against 18 defendants, including construction companies and their principals, as well as sureties and a bond producer ("Bonding Defendants"). The complaint alleges that several contractors set up shell companies to obtain status as HUBZone, 8(a), and service-disabled veteran-owned small businesses (SDVOSB) in order to win set-aside government contracts.

Historically, FCA suits alleging set-aside fraud have been filed against general contractors, individual owners, and subcontractors. In *Scollick*, the relator seeks to expand the reach of FCA liability by alleging that the Bonding Defendants enabled the fraudulent small businesses to obtain work for which they were ineligible.

The district court initially granted a motion to dismiss for failure to state a claim on the ground that the relator had not alleged that the Bonding Defendants had knowledge of the fraud. The relator sought leave to amend the complaint to address this deficiency, and the Bonding Defendants opposed the motion to amend.

In its opinion granting leave to amend, the district court found that the amended complaint sufficiently alleged that the bonding defendants had knowledge of the fraud. *Scollick*, 2017 WL 3268857 (D.D.C. July 31, 2017). Specifically, the amended complaint alleged that the bonding defendants obtained facts through the underwriting process that the Bonding Defendants "knew or should have known violated the government's contracting requirements, but the Bonding Defendants not only concealed those facts from the government, they also issued surety bonds…" *Id*. at *14. By allowing the case to continue, the court's ruling indicates that the Bonding Defendants face the potential for liability under the False Claims Act for the submission of claims violating the government's contracting requirements.

Having survived the motion to dismiss, the case will now proceed into discovery. Unless the case settles, the effort to expand FCA liability to sureties will be tested on summary judgment or at trial.

No good deed goes unpunished

In addition to the risk presented by whistleblower lawsuits like the one in *Scollick*, the government is currently investigating sureties through the Small Business Administration (SBA) Office of Inspector General and other enforcement agencies, pursuing a similar theory of liability.

This is a troubling trend considering that the SBA actively encouraged sureties to extend bonding to smaller government contractors in the aftermath of the financial crisis. Under the Miller Act, bonding is an essential precondition for federal construction work. The SBA has encouraged sureties to bond small and disadvantaged businesses. Now it suggests that sureties could face potential liability if a contractor to whom they issued bonds was not eligible for the government contracts it bid for and obtained.

In-depth government contracts compliance expertise is not a skill set that is necessarily present at most sureties. Instead, sureties focus on writing profitable bonds where their risks are appropriately managed. But the underwriting process can contribute to the potential for FCA exposure when the contractor in question has set-aside status—*e.g.*, 8(a), SDVOSB. Information learned while performing diligence about the operational and financial support available to the contractor can reveal affiliation concerns that would render the client ineligible for special government contracting status and access to "no bid" contracts.

Navigating a changing landscape

Properly understanding the risk of liability –and defending any future FCA or other enforcement actions–requires an in-depth understanding of both the surety business and government contracts law. Sureties that regularly bond government contractors should evaluate the potential for exposure should the *Scollick* line of reasoning become the "new normal" in the industry.

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