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The Surety Company's Guide To Mitigating False Claims Act Risks

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Commentary

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On July 29, 2019, motions for summary judgment are due in *United States ex rel Scollick v. Narula*,[1] a case that has shown a spotlight on the potential FCA (FCA) risks that sureties can face when issuing Miller Act bonds[2] to construction contractors that have fraudulently claimed eligibility for set-aside awards through the federal small business contracting programs.

Scollick has become a closely-watched test case that has forced sureties to reevaluate their underwriting practices and better understand their potential FCA exposure when bonding participants in federal preference programs such as Historically Underutilized Business Zones (HUBZone) contractors, 8(a) business development participants, and Service Disabled Veteran Owned Small Businesses (SDVOSB).

In *Scollick*, a former employee of a construction company filed an FCA lawsuit against several companies, their principals, and the sureties who bonded the federal construction projects. The complaint alleges that the principals established shell companies to obtain HUBZone, 8(a), and SDVOSB status in order to win set-aside government contracts. The court determined that the allegations against the sureties were sufficient to survive a motion to dismiss. Specifically, the amended complaint alleged that the sureties had obtained information through the underwriting process that should have tipped off the sureties that the principals they were bonding were violating government contracting requirements.

At its core, the *Scollick* ruling demonstrates that the underwriting process itself can expose sureties to FCA risk when bonding federal construction projects whether or not the underwriters or the surety itself understood the particulars of relevant government procurement laws and regulations that the principal was supposed to follow. This is because an underwriter's normal diligence and documenting of the file might create evidence that would lead a regulator to decide that the principal had failed to comply with government contracting requirements.

As the *Scollick* case awaits decision, the surety industry finds itself in an uncertain position. The law is unsettled, and the government can use the routine documentation of the underwriting file as evidence of a

surety's knowledge of the principal's potential violations of government contracts laws. This supposed knowledge can bring the surety company within the ambit of FCA enforcement. Until the law is settled, surety companies should consider (a) how to defend themselves against potential FCA investigations and inquiries; and (b) how to adjust ongoing underwriting operations to minimize risk. This article addresses both topics.

I. Overview of the FCA

The first line of defense for surety companies is understanding how FCA inquiries typically begin. The general avenues are: whistleblower-driven *qui tam* suits filed under seal; affirmative civil enforcement driven by the government; and, hybrid enforcement actions that the government begins after seeking third party discovery from a surety company before pivoting to investigate the surety after finding evidence of potential noncompliance by the surety in its responses.

Whistleblowers may bring FCA suits in the government's name under the statute's *qui tam* provisions. *Qui tam* is short for a Latin phrase that roughly translates to "he who brings an action for the king as well as for himself" and these provisions provide strong incentives for whistleblowers (referred to as relators under the statute) to file suit in light of the statute's treble damages combined with a provision allowing relators to receive a share of up to 30% of any recovery. *Qui tam* suits are filed by private plaintiffs under seal, where the Department of Justice (DOJ) can take months or even years to investigate the matter before deciding whether to intervene in the litigation.

When investigating allegations of small business fraud in the construction industry, the DOJ will typically seek evidence of FCA violations by, among other things, reviewing the government's contracting files, interviewing witnesses, and compelling production of documents from the principal and the surety. Because the *qui tam* suit remains sealed, the government may not inform the surety why they are seeking information. After reviewing the case and deciding whether it has merit, the DOJ may decide to take over the prosecution of the case. Alternatively, the DOJ may decline to intervene, leaving the relator to prosecute the case on their own.

At the point of the intervention decision, the case is unsealed and the complaint becomes publicly available. Unless the government previously requested from the court a partial unsealing of the case to provide a copy of the complaint to the defendant, this will be the first time the surety will have an opportunity to see what it is facing.

Although *qui tam* initiated enforcement is the most common way for an FCA case to begin, the government can also initiate a case on its own, through a process known as affirmative civil enforcement. This process involves the DOJ agreeing to begin a case after being presented with sufficient information and evidence of a FCA violation. This requires the government, typically through an agency inspector general (IG), to collect enough evidence to convince the DOJ to begin a FCA case. This process is comparatively less common than either a *qui tam* case or a case that begins following third party discovery.

Another way that an FCA investigation against a surety could arise is when the government is investigating a principal—such as one who defaulted on their performance and requires bond funds to cover the balance of construction or where a *qui tam* case or other investigation is ongoing—and seeks discovery from a principal. The resulting documents (and, potentially, testimony) may provide the government with sufficient evidence to cause the government to begin an FCA investigation of the surety.

Until the scope of surety liability under the FCA is settled, any of these three avenues of FCA suits are possible. And surety companies are well advised to treat any government inquiry as the potential beginning of an FCA action and protect themselves accordingly including by engaging counsel fully versed in the rules and norms of government contracting as well as the surety underwriting process.

II. FCA Risks Present in Underwriting Files

A trained underwriter will record his observations about a principal in the bonding file. These notes may include conversations with the bond producer or principal, and there will often be notes from meetings with the principal and business partners. To be sure that a principal does not present a financial risk, these notes will often be focused on the "three C's" of surety underwriting—character, capital, and capacity. The underwriter's focus on character considers whether the principal lives up to its commitments, keeps its promises, and has a track record on honest and fair dealings. Capital

and capacity refer to whether or not the business has the resources and experience to perform the work it is bidding on and for which the surety company is providing standby credit.

But each of the "three C's" also raise potential risk for surety companies when bonding federal construction projects. Many federal construction projects are awarded at fiscal year-end, using funds available after all other needs are met, and requiring relatively rapid contracting activity. Because of the uniqueness of federal contract rules and regulations, businesses with contracting preferences often receive the bulk of federal construction contracts. The federal acquisition rules generally require that these businesses be small (as defined in regulation) and play a leading role in the construction project including performing a significant portion of the work. It is not difficult to imagine underwriters evaluating "capital" and "capacity" in such a manner than they inadvertently describe the principal as either having access to more capital or other construction resources than they are permitted under government contracting rules. Similarly, underwriters may also explain relationships with key financial backers and subcontractors in a way that makes sense for the underwriting context, but in the eyes of government contracts-trained law enforcement agents, seems to explain a business that is over-reliant on another (perhaps larger) company for "capital" and "capacity" in a manner that violates federal acquisition regulations.

Accordingly, bond and underwriting files that appear perfectly normal to the surety may inadvertently provide ample evidence of FCA violations by the principal to a trained government contracts investigator. The problem is not that sureties are purposefully "looking the other way" while principals commit procurement fraud. Rather, it is that the underwriting process seeks principals that are low risk and good bonding investments. This necessarily involves discussions of business relationships and sources of funding that explain how smaller government contractors are supported by larger, better known (and therefore lower risk) construction companies. But the government contracting rules themselves discourage some types of business relationships and ties. Federal investigators and the DOJ may attempt to infer that the surety company understood the rules (even when they did not), but sat idly by collecting premiums while the principal operates its business in violation of government procurement rules.

For the near-term future, what a surety knew or suspected as the underwriting process unfolded is at the center of potential FCA liability for these companies. This can be challenging for surety industry counsel to navigate because doing so requires a fundamentally different thought process than the documentation-rich underwriting process necessitates. FCA defense lawyers well versed in government contracting rules, regulations, and practices can help sureties respond to government inquiries about principals engaged in the federal contracting business.

III. Theories of FCA Liability

In general, to prevail on a FCA cause of action, a plaintiff carries the burden of proving: (1) whether there was a false statement or fraudulent course of conduct; (2) made or carried out with the requisite scienter; (3) that it was material; and (4) that caused the government to pay out money or to forfeit moneys due (*i.e.*, that involved a "claim").[3] While sureties do not themselves submit invoices (*i.e.,* claims) directly to the government, the primary risks for sureties arise under § 3729(a)(1)(A) (establishing liability for any person who knowingly presents or *causes to be presented* a false or fraudulent claim for payment or approval) and § 3729(a)(1)(C) (establishing liability for conspiring to commit a violation of the statute).

Outside of the surety context, courts have found that a party caused the submission of a false claim in four scenarios where the non-claim-submitting party:

1) Takes advantage of an unwitting intermediary, thereby causing the party to submit a false claim;
2) Is the driving force behind an allegedly fraudulent scheme;
3) Agrees to take certain critical actions in furtherance of the fraud; or,
4) Continues to do business with an entity upon becoming aware that the entity was submitting false claims.[4]

Surety companies need to take special care with the third and fourth scenarios. It is possible that a court might find that issuing a surety bond (which is a necessary precondition to receipt of a federal construction contract) is a critical action in furtherance of the principal's alleged small business fraud. The fourth prong is

similarly challenging because of the disconnect between the manner that sureties memorialize the underwriting process and government contracting regulations. Accordingly, it is possible that a court might find that the surety had "knowledge" that a principal was committing procurement fraud, and yet continued to issue the principal bid and performance bonds.

IV. Potential Defenses for Sureties

Alarming though those theories of liability may be—all is not lost for sureties. Relevant government contracts case law offers ample opportunities for surety companies to argue that they lacked knowledge that a principal was allegedly committing procurement fraud. But this necessitates a deep dive into the sometimes arcane history of government contracts administrative decisions. Proving a conspiracy or that a surety knowingly caused the submission of a false claim requires proving that the surety company knew that the principal's conduct was unlawful. While federal agents trained in procurement fraud investigations might believe that a particular set of facts is evidence of procurement fraud, government contracts case law is by no means that clear cut—a principle recognized by a court when deciding *United States ex rel. A1 Procurement, LLC v. Thermcor, Inc.*[5] In granting the defendants' motion to dismiss, the court in *A1 Procurement* found that the Small Business Administration (SBA) alone is the arbiter of what conduct is material enough to cause the loss of eligibility for federal set-aside contracting. The decision notes that "[b]ecause the SBA has discretion both in certifying and graduating or terminating 8(a) companies, the court cannot determine, through simple application of one interpretation of the regulatory scheme, whether misrepresentations by Thermcor would be material to the SBA's decision [to remove the company from eligibility for further awards.]"

Indeed, there are decisions that find many (or even all) of the following elements insufficient to remove a contractor from eligibility for set-aside contracting:

- 51% ownership by the set-aside contractor, 49% ownership by another, larger company;
- The larger company is located in the same building and made a significant capital contribution to the set-aside contractor;
- Both companies use the same logo and similar names;
- The larger company provides accounting, information technology, and human resources support;
- Shared employees;
- Shared business licenses;
- Management fees paid by the set-aside contractor to the larger business; and,
- Capital contributions from the larger business to the set-aside business.

While some government investigative, audit, or procurement fraud related manuals consider these elements potential indicia of procurement fraud, administrative decisions by the SBA suggest these factors are insufficient evidence of government contracting misconduct. Because of this dissonance, surety companies may be able to argue that they could not possess the requisite knowledge that the principal's business conduct violated federal procurement law. Doing so, however, requires a deep dive into government contracts administrative decisions and the vagaries of government contracts rules and regulations.

A. Lack of Surety Company Duty to Inquire

In defending FCA allegations, sureties may need to remind government regulators of the legislative history of the Miller Act which described why bonding is required on federal construction projects. There is no indication in the legislative history or within industry practice to suggest that sureties have a duty to inquire as to the eligibility of their principals for set-aside contracts in the federal marketplace. Sureties do not guarantee a contractor's eligibility for set-aside contracts when issuing performance bonds on federal projects. By issuing a performance bond, the surety is agreeing to complete the construction or to pay the obligee the reasonable costs of completion if the contractor defaults on its construction obligations (*e.g.,* if the building remains unfinished). Indeed, the Miller Act legislative history says nothing about guaranteeing contractor eligibility for set-aside work. The Miller Act's intent was to ensure that buildings are properly constructed and that subcontractors are paid for their work.

When applying common law principles, courts have rejected efforts to find sureties liable under causes of action such as aiding and abetting (a concept closely related to conspiracy) in connection with information learned during the underwriting process. A recurrent theme in those cases is that the surety is under no

obligation to inform the obligee of infirmities learned during the underwriting process because the underwriting process is done solely for the benefit of the surety that risks paying if the principal defaults. This is consistent with longstanding common law principles that a defendant cannot breach a duty of disclosure unless a duty exists in the first place.[6]

For example, in a case in Florida, the obligee brought suit against a surety that issued performance bonds to a general contractor. The obligee alleged that the surety should not have issued the bonds because the surety should have discovered that the contractor was a "sham construction contractor" based on facts that the surety supposedly should have learned during the underwriting process. Despite significant evidence that the general contractor was not prepared for the job, the court found that "a performance bond is not designed or intended to protect an owner from his own folly or lack of due diligence. It is issued for the purpose of assuring that the project will be completed in the event that the general contractor fails to do so."[7] Likewise, in the context of bonds issued on federal projects, if there is no duty to inquire as to eligibility, then sureties should not be found liable under the FCA on the basis that the surety gained constructive knowledge of a principal's fraud during the underwriting process.

The *Scollick* case has led some government investigators to believe that merely filling out a Federal Standard Form 25, in connection with a performance bond, obligates sureties to cover losses when the wrong category of contractor completes a project, even if the project is correctly completed because of the expansive language of the standard form. However, in light of the above, a more reasoned reading is that the Federal Standard Form 25 used in connection with federal performance bonds limits the surety's performance obligation to reimbursing the obligee up to the penal sum of the bond for any cost of completion of construction work on the bonded contract in excess of contract funds remaining unpaid at the time of contract termination. In short, the surety is only agreeing to complete the construction or to pay the obligee the reasonable costs of completing the construction if the contractor defaults on its construction obligations.

B. Sureties are Entitled to Rely on the Representations of their Principals

Surety underwriters have historically given a lot of weight to the fact that a contractor has been certified by the SBA in the programs such as the 8(a) business development program where there is a formal certification process. This reliance is reasonable especially given that underwriters lack the training needed to perform the complex affiliation or control analysis required under SBA regulations. The view that a surety should be able to rely on the SBA's certification as proof of eligibility is consistent with the reasoning behind the SBA's small business subcontracting program.[8] In that context, as long as the prime contractor acts in good faith, it can rely on a subcontractor's representations as to size and status, and the prime is not expected to perform its own assessment of set-aside program eligibility. The legislative history of the Small Business Act of 1978 indicates the Congressional intent for allowing prime contractors to rely on these representations:

> The conferees recognize the difficulty that prime contractors may have in determining whether a firm is owned and controlled by a socially and economically disadvantaged person. Contractors may therefore rely on written representations by their small business subcontractors that they are either a small business or a small business owned and controlled by a socially and economically disadvantaged person.[9]

If a prime contractor can rely on certifications concerning the status of small business subcontractors, it stands to reason that a surety should also be able to rely on the certifications of a contractor that it is bonding. Indeed, holding sureties responsible for the eligibility of the principal may frustrate the purpose of the small business contracting programs themselves. Sureties may decide to exit the federal construction marketplace entirely, leaving the federal government to be the guarantor of federal construction projects, or sureties may make their own subjective determinations of a principal's eligibility for government contracting set-aside programs. And that is what Congress sought to avoid in the small business subcontracting context:

> The myriad of differing fact patterns would lead to a host of varying interpretations at best, and an extreme potential for abuse at worst. . . . [P]rime contractors should be allowed as much certainty in dealing with the Government as practicable. A definitive statement as to the

> status of their subcontractors permits them to calculate the consequences of their actions with reasonable certainty.[10]

When FCA liability for sureties is settled, we are hopeful that sureties, which by necessity are outside of the performance chain of a government contract, will not be held to a higher standard than a prime contractor performing on that contract. But, for the foreseeable future, sureties face added risk from the government and from *qui tam* relators who are attempting to broaden the reach of the FCA. This may mean that surety companies have to defend against a spate of FCA cases in the coming years. To help mitigate against this risk, the following section discusses some potential enhancements that sureties can make in the near term to reduce risk while the law is resolved in the courts.

V. Internal Controls and Process Changes to Reduce FCA Risk

Even if the *Scollick* case is resolved without liability for the surety defendants, the decision received substantial attention and relators' counsel have taken notice. Similar *qui tam* suits may very well be under seal while the DOJ investigates—a process that can take years. While the process unfolds, sureties should consider some of the following process changes that might help them avoid possible FCA risk.

➢ Conduct Government Contracts and FCA Refresher Training

Underwriters need not be experts in government contracting, but sureties that bond federal construction projects are well advised to help underwriters understand the current risk landscape. That includes teaching underwriters about government contracting set-aside programs, the rules that principals are required to adhere to, and how to spot "red flags" that government investigators might believe are indications of potential procurement fraud. This training should help underwriters understand why the language they use in the normal course of documenting the underwriting file might be misinterpreted by government investigators.

➢ Teach Underwriters "Red Flags" From the Government Contracts Perspective

The bodies charged with investigating procurement fraud, such as the agency inspectors general, maintain robust lists of indicia of procurement fraud. Non-federal entities are often surprised at some of the factors that the government considers to be indicia of control or affiliation. Teaching underwriters about the federal perspective can help them think twice when the see red flags and ask for home office support in their decision making.

➢ Confirm Eligibility for Set-Aside Contracts From Principals or Producers

A primary thrust of FCA cases against surety companies involve government allegations that the surety had superior knowledge of the true state of affairs in a set-aside contractor and failed to inform the government. For example, FCA investigations can begin where the government perceives that a principal hid its true organization and business practices from the government through the set-aside program application process or falsely self-certified their eligibility when the company is not actually eligible. And where the surety has superior knowledge and knows or should have known that the principal was ineligible, the government may try to proceed against the surety as well. To help mitigate this risk, sureties should confirm the principals' eligibility for set-aside programs either from the principal, the producer, or the authoritative federal database. And sureties should also consider asking sureties to represent that they have provided the government with all relevant information necessary for the government to confirm their eligibility.

➢ Escalate Red Flags for Home Office Review to Aide Consistent Decision-Making

Inconsistent bonding decision making can prolong potential government investigations and may increase potential defense costs. The fact that agents, underwriters, and home offices may all have delegated authority to bind sureties increases the risk of inconsistent decision making. In an environment where the government increasingly investigates whether sureties "looked the other way," thereby permitted principals to perform federal construction projects notwithstanding their ineligibility for those programs, inconsistent business decision making offers substantial avenues for inquiry. Deciding on a set of red flags that require elevation for purposes of consistent evaluation and decision-making, training underwriters and their managers on that process, and following through on that process, can reduce a surety's company's risk profile.

➢ Define Risk Tolerance for Bonding Accounts with Red Flags

The safest course of action in the current enforcement action is to decline to bond accounts that the business

terms "too risky," or has too many red flags for a given surety company's risk tolerance. Surety companies should define for themselves how much risk they are willing to accept, and whether and how many unaddressed red flags may exist before a principal is no longer an acceptable risk. This may require assistance from government contracts lawyers who can advise what the red flags are, and their approximate levels of severity.

Surety companies should note, however, that merely declining to bond may not be enough to satisfy aggressive federal investigators. These enforcement officials expect government contractors to comply with the "Mandatory Disclosure Rule" at Federal Acquisition Regulation 52.203-13 which, among other things, requires contractors to disclose "credible evidence" of certain violations of law and regulations, including the civil FCA. This can cause enforcement officials to believe, as a matter of course, that credible evidence of any sort of FCA-related misconduct anywhere in the government contracts supply chain must be disclosed to the government. We have yet to uncover a requirement that surety companies disclose evidence about its principals or prospective principals, but surety companies should be prepared to convince skeptical government investigators of this fact.

VI. Conclusion

Surety companies will face increased risk of FCA suits in the coming years. This article explains the risk, how to defend against the risk, and how to reduce that risk. Above all else, practical defense and mitigation efforts require familiarity and experience with complex federal government contracts rules and regulations, and the ability to apply that knowledge to the surety industry. And certain common-sense steps that surety companies can take now to help underwriters and their managers understand the evolving risk landscape might help to reduce enforcement risk in the future.

Endnotes

1. 1:14-cv-01339 (D.D.C.).
2. 40 U.S.C. § 3131.
3. *See, e.g., Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 788 (4th Cir. 1999).
4. *United States ex rel. Tran. Computer Scis. Corp.* 53 F. Supp. 3d 104, 126-27 (D.D.C. 2014) (citations omitted).
5. 173 F.Supp. 3d 320 (E.D.Va. July 2017).
6. *See, e.g., Dorsey v. Portfolio Equities, Inc.*, 540 F.3d 333, 341 (5th Cir. 2008) ("for there to be actionable nondisclosure fraud, there must be a duty to disclose").
7. *ZP No. 54 Ltd. P'ship v. Fid. & Deposit Co. of Maryland,* 917 So. 2d 368, 373 (Fla. Dist. Ct. App. 2005). Similarly, in *Abbott v. Equity Group*, investors sued their surety, alleging that the surety violated the Securities Act by continuing to participate in a fraudulent investment transaction after receiving a memo indicating the transaction was fraudulent. 2 F.3d 613 (5th Cir. 1993). The Fifth Circuit granted summary judgment for the surety and found no duty to disclose arose from the underwriting process. *Id.* at 624.
8. 13 CFR § 121.108.
9. H.R. CONF. REP. 95-1714, 26.
10. H.R. No. 95-959. ■

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