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Being Mindful Of The False Claims Act

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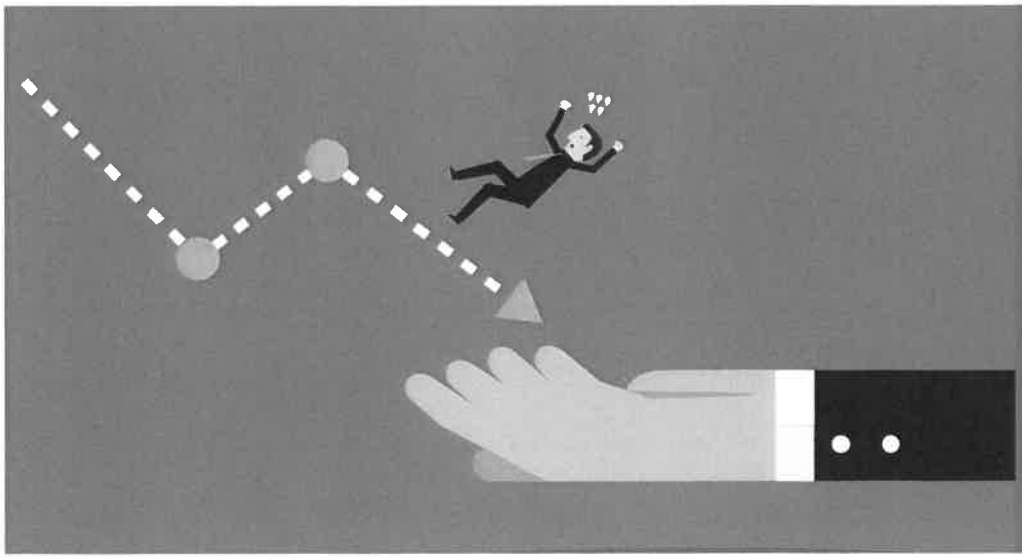
All sureties knew that because of the False Claims Act ("FCA" or the "Act")[1], a surety needed to be very careful about certifying an affirmative claim against the government. However, a few years ago, the surety world was jolted when an FCA case was filed against two sureties and a broker. The case essentially alleged that the sureties were liable under the FCA because they continued to bond a principal, allegedly with knowledge or under conditions in which they should have had knowledge, that the principal was not a properly certified disabled veteran-owned business. In an unrelated case, in September 2019, a settlement was announced between the United States Attorney's Office for the Western District of North Carolina and a surety whereby the surety agreed to pay $1 million dollars to resolve an FCA claim that the surety should have known the principal it was bonding was not a proper U.S. Small Business Administration Section 8(a) contractor. In that matter, the U.S. Attorney stated:

> By enabling fraudsters, these companies play a key part in unlawfully usurping government contract opportunities from socially and

Read more on page 15

1 31 U.S.C.A. § 3729 (West 2019) *et seq.*



In This Issue

Being Mindful... continued from page 1

> economically disadvantaged individuals who the 8(a) Program is intended to assist...My office will pursue vigorously bonding companies and other entities that, by turning a blind-eye or willfully ignoring blatant indicia of program fraud or abuse, enable the submission of these false claims and cause harm to the government program.[2]

As a result, sureties are starting to awaken to the fact that the FCA can have much wider application than previously understood. While we believe that such cases are a misapplication of the FCA as to sureties, until the surety industry can lobby Congress to change the laws or sureties can obtain favorable results in court, the FCA will continue to darken the industry's door. Accordingly, regardless of what your views are on the applicability of the FCA to the ordinary activities of sureties (underwriting, issuing bonds, satisfying claims), it is nevertheless prudent for a surety to review its normal processes and protocols, including claims handling activities, to see if there may be exposure to FCA claims. Awareness now of potential issues can help the surety avoid FCA exposure altogether later. In this article we will look at the FCA generally and discuss some scenarios where potential FCA claims may be lurking.

False Claims Act - History

The federal civil FCA was first enacted in 1863 to impose liability for presenting false claims to the government in order to prevent fraud by government contractors during the Civil War.[3] Congress intended that the False Claims Act, and its *qui tam* action, would help the government uncover fraud and abuse by unleashing a "posse of ad hoc deputies to uncover and prosecute frauds against the government."[4] Leading up to the enactment of the FCA, "a series of sensational congressional investigations" prompted hearings where witnesses "painted a sordid picture of how the United States had been billed for nonexistent or worthless goods, charged exorbitant prices for goods delivered, and generally robbed in purchasing the necessities of war."[5] Accordingly, Congress responded by imposing civil and criminal liability for various types of fraud on the government, subjecting violators to double damages, forfeiture, and up to five years' imprisonment.[6] The FCA originally allowed for "relator" or whistleblower actions by private citizens, but the Act was later amended to bar such actions. However, in the late 1980s, Congress amended the FCA to once again permit

2 Andrew Murray, United States Attorney, United States Attorney's Office for the Western District of North Carolina (Sept. 4, 2019).

3 *See* Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 784 (4th Cir. 1999).

4 *Id.* (quoting U.S. *ex rel.* Milam v. Univ. of Texas M.D. Anderson Cancer Ctr., 961 F.2d 46, 49 (4th Cir. 1992)).

5 United States v. McNinch, 356 U.S. 595, 599 (1958).

6 Universal Health Servs., Inc. v. United States, 136 S. Ct. 1989, 1996 (2016).

qui tam actions by private individuals. Later amendments by Congress have steadily increased the scope of FCA coverage.

The False Claims Act – In Practice/Procedure

In December 2018, the United States Department of Justice ("DOJ") announced that it obtained more than $2.8 billion in settlements and judgments from civil cases involving fraud and false claims against the government in the 2018 fiscal year.[7] 2018 was the ninth consecutive year that FCA settlements and judgments have exceeded $2 billion.[8] The DOJ stated that it "has placed a high priority on rooting out and pursuing those who cheat government programs for their own gain."[9]

Typically, whistleblower actions comprise a substantial percentage of the FCA cases that are filed each year.[10] In 2018, for example, whistleblowers filed 645 *qui tam* suits and recovered over $2.1 billion of the $2.8 billion total.[11] The government paid out $301 million to the individuals who exposed the fraud and false claims by filing the whistleblower actions.[12] The threat of FCA exposure is always present and can come from multiple sources, including disgruntled current or former employees, customers, vendors, or even "professional" whistleblowers who target certain industries and review publicly available information to generate claims. Any individual with knowledge of fraudulent activity against the government may file a claim as the plaintiff/relator, and the relator need not have been personally harmed by the defendant in order to bring a *qui tam* suit.[13]

Procedurally, an FCA "relator" must cooperate with the government in filing its action.[14] *Qui tam* plaintiffs are required to file their claims under seal and to leave them under seal for at least sixty days.[15] Upon receiving notice of the complaint and a disclosure statement from the relator, the DOJ is required to investigate the relator's allegations of fraud.[16] Upon completing its investigation, the DOJ may elect to: (1) intervene in the case, [17] (2) decline to intervene, [18] or (3) move to dismiss the case.[19]

7 *Justice Department Recovers over $2.8 Billion from False Claims Act Cases in Fiscal Year 2018*, Dep't of Justice (Dec. 21, 2018), https://www.justice.gov/opa/pr/justice-department-recovers-over-28-billion-false-claim-act-cases-fiscal-year-2018.

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

13 *See* 31 U.S.C.A. § 3730 (West 2019).

14 *Id.*

15 31 U.S.C.A. § 3730(b)(2).

16 *See* 31 U.S.C.A. § 3730(a).

17 31 U.S.C.A. § 3730(b)(2), (4)(A).

18 31 U.S.C.A. § 3730(b)(4)(B).

19 31 U.S.C.A. § 3730(c)(2)(A).

There are similar false claim statutes in various states and other jurisdictions. Many are patterned on the federal FCA and courts in those jurisdictions look to federal law in applying and interpreting the state FCAs. There is also a federal criminal False Claims Act at 18 U.S.C.A. § 287 (West).

The False Claims Act – Legal Overview

Broadly speaking, a violation of the FCA occurs when there has been: (1) a false statement or fraudulent course of conduct; (2) made or carried out with knowledge of the falsity; (3) that was material; and (4) that involved a claim.[20] The FCA statutory language requires a claim to be false, but does not define falsity.[21] Courts have accordingly established definitions of false or fraudulent claims as those claims aimed at extracting money from the government that it otherwise would not have paid or owed. Courts have further defined two general categories of falsity—"factual falsity" and "legal falsity."[22] "Factual falsity involves 'an incorrect description of goods or services provided or a request for reimbursement for goods or services never provided.'"[23] "Legal falsity is where a claim is 'predicated upon a false representation of compliance with a federal statute or regulation or a prescribed contractual term.'"[24] Legal falsities include cases where a contractor has either expressly or impliedly certified compliance with some statutory, regulatory, or contractual requirement.[25] In an "express false certification," the defendant signs or otherwise falsely certifies to compliance with some law, rule, or regulation in connection with the claim submitted.[26] The payee's "certification" need not be a literal certification, but can be any material false statement that was made with scienter and caused the government to pay or forfeit money.[27] An "implied false certification" arises from the notion that when a defendant submits a claim it is impliedly certifying compliance with all conditions of payment.[28] For liability to exist under "implied false certification," two conditions must be satisfied: first, the claim must not merely request payment, but also must

20 31 U.S.C.A. § 3729(a)(1).

21 31 U.S.C.A. § 3729(b).

22 United States *ex rel.* Daugherty v. Tiversa Holding Corp., 342 F. Supp. 3d 418, 424 (S.D.N.Y. 2018).

23 *Id.* (quoting Mikes v. Straus, 274 F.3d 687, 697 (2d Cir. 2001), *abrogated by* Universal Health Servs., Inc. v. United States, 136 S. Ct. 1989 (2016).

24 *Id.* (quoting *Mikes*, 274 F.3d at 696).

25 *See Universal Health Services, Inc.*, 136 S. Ct. 1989.

26 United States *ex rel.* Lorona v. Infilaw Corp., No. 3:15-CV-959-J-34PDB, 2019 WL 3778389, at *16 (M.D. Fla. Aug. 12, 2019) (citing U.S. ex rel. *Keeler v. Eisai, Inc.*, 568 F. App'x 783, 798–99 (11th Cir. 2014). *See also* United States *ex rel.* Medrano v. Diabetic Care RX, LLC, No. 15-CV-62617, 2019 WL 1054125, at *4 (S.D. Fla. Mar. 6, 2019); United States *ex rel* Phalp v. Lincare Holdings, Inc., 116 F. Supp. 3d 1326, 1345 (S.D. Fla. 2015), *aff'd as modified sub nom.* United States *ex rel.* Phalp v. Lincare Holdings, Inc., 857 F.3d 1148 (11th Cir. 2017); United States v. Amin Radiology, No. 5:10-CV-583-OC-PRL, 2015 WL 403221, at *6 (M.D. Fla. Jan. 28, 2015), *aff'd sub nom.* U.S. *ex rel.* Fla. v. Amin Radiology, 649 F. App'x 725 (11th Cir. 2016).

27 *United States ex rel. Lorona*, 2019 WL 3778389, at *16.

28 *Id.* at 16–17.

make a specific representation about the goods or services provided; and second, the defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths.[29] Defendants can be liable for violating requirements even if they were not expressly designated as conditions of payment.[30] The Supreme Court has held that what matters is not the label the government attaches to a requirement, but whether the defendant knowingly violated a requirement that the defendant knows is "material" to the government's payment decision.[31]

The FCA defines "material" to mean "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property."[32] Thus, "materiality 'look[s] to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation.'"[33] The Supreme Court has stated that the materiality requirement is a demanding standard.[34] Materiality cannot be found where the noncompliance is minor or insubstantial.[35]

In construing the FCA broadly, courts have held the "causes to be made" or "presented" prong of the FCA extends liability beyond a prime contractor, and reaches to any person knowingly assisting in causing the government to pay claims grounded in fraud. The "causes to be presented" prong will attach liability to a defendant whose conduct was "at least a substantial factor in causing, if not the but-for cause of, submission of false claims."[36] Thus, a prime contractor who submits false subcontractor claims for reimbursement to the federal government will be liable under the FCA if the prime contractor had actual knowledge of the falsity or acted with reckless disregard or deliberate ignorance of the falsity.[37]

In instances where courts have considered the liability of a non-submitting entity, so long as the person agreed to take critical actions in furtherance of the fraud, courts may find the entity liable. For example, a court held "[w]here a defendant has an ongoing business relationship with a repeated false claimant, and the defendant knows of the false claims, yet does not cease doing business with the claimant or disclose the false claims to the United States, the defendant's ostrich-like behavior

29 *Universal Health Services, Inc.*, 136 S. Ct. at 2001.

30 *Id.* at 2001–02.

31 *Id.* at 2001–04.

32 31 U.S.C.A. § 3729(b)(4).

33 *Universal Health Services, Inc.*, 136 S. Ct. at 2002 (quoting 26 Williston on Contracts § 69:12 (4th ed. 2003)).

34 *Id.* at 2003.

35 *Id.*

36 United States *ex rel.* Landis v. Tailwind Sports Corp., 324 F. Supp. 3d 67, 72 (D.D.C. 2018) (quoting United States v. Toyobo Co., 811 F. Supp. 2d 37, 48 (D.D.C. 2011)).

37 *See* 31 U.S.C.A. § 3729(b)(1)(A).

itself becomes 'a course of conduct that allowed fraudulent claims to be presented to the government.'"[38]

False Claims Act – Scenarios to Consider

With this FCA background in mind, let's look at some scenarios. In certain circumstances a surety will deem it appropriate to takeover a project, retain a completion contractor, and finish the work on the project. As is typical on many government projects, there may be a socio-economic participation goal with the requirement that a certain portion of the work be completed by a minority business, woman-owned business, small business, etc. (hereinafter, "MBE"). What if during its investigation the surety discovers that a portion of the socio-economic participation looks "suspect?" Even if the surety brings in new MBE subcontractors and/or suppliers going forward, can the surety continue to submit applications for payment stating that "X" percent of the participation goal has been satisfied, when a part of that participation gives credit to the suspect MBE? Consider a case where a surety refuses to accept a credit for the suspect MBE participation, discloses the issue to the governmental owner, and seeks a waiver of that portion of the MBE goal. A surety might also refuse to pay the suspect MBE's subsequent payment bond claim all in an attempt to insulate itself from any potential FCA exposure. However, once the surety becomes aware of a potential issue, it may not be enough to simply change course going forward; the surety must consider how to excise the potential issue altogether and consider if any actions going forward are still "benefiting" from the prior issue – like stating in future applications for payment that "X" percent of the MBE goal has been satisfied if that "X" percent includes participation of a suspect MBE.

Another scenario to consider involves the surety receiving a payment bond claim where the bonded principal was utilizing alleged "independent subcontractors" to provide labor. Upon review, a surety might find that the alleged independent subcontractor may be misclassified, that the alleged subcontractor is paying the laborers in cash, improperly classifying the laborers as independent contractors, and cannot provide proof of immigration compliance or proof of payment of any taxes or insurance for the labor. While work was actually performed on the project by the laborers in question, can the surety pay the payment bond claim when it appears that numerous wage, employment, immigration, and tax laws have been violated? Might the surety be subject to an FCA claim if it pays the claim and seeks

38 United States v. President & Fellows of Harvard Coll., 323 F. Supp. 2d 151, 187 (D. Mass. 2004) (quoting United States *ex rel.* Long v. SCS Bus. & Tech. Inst., 999 F. Supp. 78, 91 (D.D.C. 1998), *rev'd sub nom.* United States *ex rel.* Long v. SCS Bus. & Tech. Inst., Inc., 173 F.3d 870 (D.C. Cir. 1999), *supplemented*, 173 F.3d 890 (D.C. Cir. 1999)).

the contract funds from the owner? The surety could take the position that it is denying the claims because they arise from an illegal contract and that contract has been performed in an illegal manner. As a result of such illegalities, the surety is not obligated to pay. Most jurisdictions follow the equitable principles that courts do not recognize rights arising from illegal agreements, will consider such agreements void, will leave the parties as the court finds them, and will not lend the court's aid to a person who founds their cause of action upon an illegal or immoral act.[39]

In June 2019, a federal district court ruled in favor of a surety's denial of a claim based on illegality involving the FCA. In *Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC*, the surety became aware that its principal and the bond obligee violated the service-disabled veteran law[40] by subcontracting more than 85% of the work.[41] The obligee was a service-disabled veteran-owned business ("SDVOB"), and it subcontracted all of the work to the subcontract principal for an amount that equaled 87.6% of the SDVOB's contract price.[42] The obligee also hired one of the owners of the subcontract principal to act as the project manager for an additional $62,000.[43] The obligee eventually terminated the subcontract and made demand upon the surety to perform under the performance bond.[44] The surety denied the claim and filed a declaratory judgment action.[45]

On summary judgment, the court found that the subcontract between the principal and obligee violated federal law.[46] The court reasoned as follows: "[a]ny act which is forbidden, either by the common or the statutory law, whether it is *malum in se*, or merely *malum prohibitum*, indictable or only subject to a penalty or forfeiture, or however otherwise prohibited by a statute or the common law, cannot be the foundation of a valid contract; nor can anything auxiliary to or promotive of such act."[47] The court held that "[b]ecause the Subcontract is illegal, [the surety] is not obligated to fulfill its obligations under the Bond which ensured performance of the

39 *See In re* Dublin Sec., Inc., 133 F.3d 377, 380 (6th Cir. 1997) (quoting *In re* Dow, 132 B.R. 853, 860 (Bankr. S.D. Ohio 1991)); *In re* Fair Fin. Co., 834 F.3d 651, 676 (6th Cir. 2016). *See also* Gibbs v. Consol. Gas Co. of Baltimore, 130 U.S. 396, 410–11 (1889).

40 13 C.F.R. § 125.6(a)(3) requires that the SDVOB not pay more than 85% of the amount paid by the government to it to firms that are not SDVOBs.

41 Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC, No. 3:18CV00054 JM, 2019 WL 2353046, at *1 (E.D. Ark. June 3, 2019).

42 *Id.*

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.* at 2.

47 *Id.* at 3 (quoting Eager v. Jonesboro, Lake City & E. Exp. Co., 103 Ark. 288, 147 S.W. 60, 64 (1912)).

Subcontract."[48] The court further noted that if the surety were to perform under its bond, it may have had liability under the FCA.[49] This is a great example of using the potential for FCA exposure as a shield against claims. Being mindful of the FCA may include finding ways to make it work for the surety.

Another scenario for a surety to consider is the typical books and records review conducted by a consultant for the surety. In the course of the review, the consultant can be exposed to a great deal of information that might reveal a violation of applicable laws in the prosecution of the work by the principal or might be of a sufficient nature to require further investigation. Is the surety liable for the knowledge of the consultant? Of course, the surety's position would be that a consultant is an independent contractor, performing a limited function and is not a general agent of the surety. But an argument could be made to the contrary. Does the surety need to "debrief" its consultant to determine if anything discovered in the books and record review could give rise to an FCA claim against the surety? Should the surety put provisions in its agreements with its consultants placing a duty on them to disclose such potentially significant information and perhaps indemnify the surety for failing to do so? Are consultants even qualified to make such determinations? The parameters of the duties and obligations of sureties and alleged agents of sureties has not been defined sufficiently in the FCA context to provide answers to these questions.

For now, it is enough to raise the questions and awareness so that sureties and their counsel can start looking at the issues and begin to plan responses and to alter activities. The takeaway here is that sureties need to start looking critically at what they routinely do with the eyes of a "whistleblowing relator."

48 *Id.*

49 *Id.*