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FEATURE COMMENT: Reducing Surety False Claims Act Risk Post-*Scollick*

The surety industry closely watched the False Claims Act case *U.S. ex rel. Scollick v. Narula*, 2022 WL 3020936 (D.D.C. July 29, 2022), for years as the case wound its way through the district court in Washington, D.C. A former employee of a construction company filed this FCA lawsuit against several companies, their principals, a bonding agency, and the sureties that bonded the federal construction projects. The complaint alleged that the principals established shell companies to obtain multiple types of set-aside Government contracts.

What alarmed the surety industry most was that the Court determined in 2018 that the allegations against the bond agency and the sureties were sufficient to survive a motion to dismiss and forced the parties into discovery. Order, *Scollick*, 2018 WL 10758279 (D.D.C. Aug. 21, 2018). Specifically, the complaint alleged that the sureties had obtained information through the underwriting process that should have tipped off the insurance defendants that the contractors were violating Government contracting requirements.

This was alarming because the underwriting process, with its focus on the “three C’s” of character, capital, and capacity, can create documents that determined plaintiffs or Government agents could later argue (unfairly and incorrectly) constitute evidence of knowledge of Government contracting violations. Character is focused on ethics and whether the com-

pany lives up to its commitments, keeps its promises, and deals with others fairly and honestly. This is more of a subjective analysis. Capital and capacity, however, refer to whether the contractor has the resources and the experience to perform the work under contract.

Because of the unique nature of federal contracting rules, military base construction projects are generally awarded in a rush, at fiscal year-end, and to small businesses. Sureties, who want low-risk bonding opportunities, are likely to have notes in their files discussing contractor reliance on other businesses to complete work to analyze capacity and availability of other sources of financing to analyze capital. Under Government contracting rules, however, at some point over-reliance on other companies or other sources of financing violates small business set-aside contracting rules. The *Scollick* case sought to hold surety companies and bonding agents liable for those types of alleged violations.

But the bonding file is completed solely for the surety to understand its risk and whether the surety is likely to need to pay out the penal sum of its bond if a federal construction project is not completed. The language is not always reviewed by lawyers, much less lawyers who understand Government contracts small business set-aside compliance. And surety industry participants are not small business set-aside contracting experts. Indeed, there is no duty assigned by the Miller Act (the statute requiring surety bonds for Government construction projects) that requires sureties to notify the Government about the results of bonding-related diligence. See 40 USCA § 3131.

So the surety industry breathed a collective sigh of relief on July 29, 2022, when Judge Royce C. Lamberth unsealed his memorandum opinion ordering the dismissal of all claims against the

Scollick insurance defendants at the summary judgment stage. *Scollick*, 2022 WL 3020936.

Judge Lamberth noted that the

“most important issue running through all [these claims] is the knowledge possessed by the [i]nsurance [d]efendants.” But plaintiff-relator has produced no evidence permitting a reasonable jury to find that the insurance defendants had knowledge of the construction defendants’ fraud—“that they were fraudulently asserting status as [service-disabled veteran-owned small businesses].” Because such knowledge is an essential element of *all* of the claims brought against the insurance defendants, the Court must grant summary judgment in their favor.

Id. at *12 (internal citations omitted).

In addition to faulting Plaintiff-relator for failing to proffer facts about producer and surety knowledge of the violation of SDVOSB set-aside rules, the Court noted the tremendous duty Mr. Scollick’s theory would impose on the industry. In declining to impose a need to understand specifics of Government contracting rules, the Court notes that doing so is

no “simple step” for the insurance defendants. This would impose a significant duty on third party insurers to familiarize themselves with [Department of Veterans Affairs] regulations before bonding companies. It is a significant leap in terms of liability. Without facts indicating that the insurance defendants *knew* of the specific SDVOSB requirements, this Court will not impose an affirmative duty on insurance and bonding companies to double-check the government’s verification.

Id. at *13 (internal citations omitted).

Particularly helpful in future cases, the *Scollick* Court places the burden of complying with small business set-aside rules squarely upon the principal.

[W]hile there is no doubt that participants in federal programs must familiarize themselves with the requirements, the insurance defendants are not ‘participants’ in the federal VA SDVOSB program—the construction defendants are. It is the *construction defendants* who are obligated to familiarize themselves with the SDVOSB regulations, because they are dealing with and seeking payment from the federal government. ... Plaintiff-relator

has cited no cases—and the Court can find none—that place this obligation on a third-party insurer or bond underwriter.

Id. at *13 (internal citations omitted).

Indeed, the Court faults Plaintiff-relator for trying “to construct a duty out of thin air” that insurance industry participants should have a “basic familiarity” with the concepts behind set-aside contracting. “But plaintiff-relator cannot point to any court recognizing this third-party burden for bonding companies, which ensure [sic] *all* federal contracts—not just SDVOSB-eligible ones.” *Id.* at *14 (internal citations omitted).

While this decision is not a panacea for sureties and producers because it places the emphasis on evidence of the surety industry participants’ knowledge of Government contracting rules, the decision will help the insurance industry push back on the increasingly common claim that superior knowledge of a principal’s business, without more, is sufficient for FCA liability. Additionally, surety defendants in FCA cases can avail themselves of a legislative history argument that should further advance their arguments.

Specifically, the legislative history for the Small Business Act of 1978 offers that:

[t]he 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 [a key element to FCA cases against sureties]. 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.

H.R. Conf. Rep. 95-1714, at 26–27 (1978), as reprinted in 1978 U.S.C.C.A.N. 3879, 3887.

As we see, the Act’s history is expressed in terms of when a prime contractor can rely on a subcontractor’s status and representations. If, according to Congress, prime contractors can rely on these indicia of eligibility, surety industry participants should be able to do the same. Indeed, doing otherwise may frustrate the purpose of the Government’s small business contractor programs. Sureties may decide to exit the federal construction marketplace entirely, leaving the Federal Government to be the guarantor of federal construction projects, or sure-

ties may make their own subjective determinations of a principal's eligibility for set-aside programs. Which is precisely what Congress ought to avoid in small business subcontracting:

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.

H.R. Rep. No. 95-949, at 11 (1978).

While the recent *Scollick* ruling dismissing claims against insurance industry defendants

is helpful and may slow the trend of FCA suits against surety defendants, more can be done to make future cases less likely to succeed. The legislative history arguments covered in this article may help courts narrow the risk of potential FCA liability for surety industry participants. After all, there is no reason why insurance industry players, who by necessity are outside the performance chain of a Government contract, should be held to a higher standard than the prime contractor performing on that contract.



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