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FEATURE COMMENT: Surety Industry FCA Risks In The Aftermath Of *Scollick* And The Contours Of Scienter As Set Forth In *SuperValu*.

For several years, surety industry participants watched the False Claims Act case, *U.S. ex rel. Scollick v. Narula,* 215 F. Supp. 3d 26 (D.D.C. 2016), progress through motions to dismiss, amended pleadings, and discovery because the case carried tremendous risk for surety professionals issuing Miller Act bonds to construction companies working on Government buildings. The case proceeded through multiple rounds of motions to dismiss and amendments to the complaint before reaching the summary judgment phase. When the U.S. district court dismissed the claims against sureties at the summary judgment stage in 2022, the industry breathed a sigh of relief. See generally, *Scollick ex rel. U.S. v. Narula*, , 2022 WL 3020936 (D.D.C. July 29, 2022). However, limitations in the decision and the subsequent Supreme Court decision in *U.S. ex rel. Schutte v. SuperValu Inc.* suggest that surety industry participants continue to face FCA risk. This article discusses the *Scollick* case, its import for surety industry participants, and how the *Scollick* decision, paired with the *Schutte* decision, may provide a narrow path for relators to continue to bring FCA cases. Finally, the article provides potential risk-mitigation strategies for surety industry participants to consider as they seek to reduce potential risks and argument strategies should a surety industry participant end up as a FCA defendant.

The District Court's Decision in *Scollick* Found No Evidence of Surety Knowledge—The relevant allegations in *Scollick* included that sureties, a bonding agency, and a bond producer (collectively, and adopting the term used by the court in its decision, "insurance defendants") knew or should have known that the companies performing various types of Government contracts were shell entities, organized in manner rendering them eligible to obtain certain categories of Government contracts awarded on a no-bid or limited-competition basis only to particular types of businesses, and that the insurance defendants knew about the fraud. See generally, Second Am. Compl., ECF 298 (Sept. 8, 2020), no. 14-cv-01339-RCL.

The core of the case against the insurance defendants was that they had more knowledge about the true nature of the shell companies than the Government did, and by not speaking up, they permitted, facilitated, or otherwise caused false claims for payment to be presented to the Government. These claims were false, allegedly, because otherwise ineligible companies submitted them to the Government. Or, stated differently, the contracts were set aside for service-disabled veteran-owned small businesses (SBVOSB) but the shell companies were not, in fact, those types of companies. Therefore, their invoices for work performed, supposedly as set-aside contractors, were all false claims within the reach of the FCA. 31 USCA § 3729(a).

At first, the surety industry was incredulous. Nothing in the surety-related statutes and regulations require participants to disclose any information to the obligee about the principal's eligibility for set-aside contracts. See 40 USCA § 3131. As such, the industry wondered how the bonding process, which is for the sole benefit of the surety to

decide whether to bond a specific construction job, could create FCA liability?

But industry concerns deepened when, in July 2017, the *Scollick* judge decided that the complaint adequately pled that the insurance defendants had knowledge of the fraud sufficient to permit the case to continue. *U.S. ex rel. Scollick v. Narula*, 2017 WL 3268857, at *1 (D.D.C. July 31, 2017). The amended complaint alleged that the insurance defendants' underwriting processes gave the insurance defendants access to facts that they "knew or should have known violated the government's contracting requirements, but ... not only concealed those facts from the government, [they also] issued surety bonds." Id. at *14. Discovery began.

Three years of worry culminated in dismissal on summary judgment of all claims against the insurance defendants. *Scollick ex rel. U.S. v. Narula*, 2022 WL 3020936 (D.D.C. July 29, 2022). The decision ended the immediate risk for the *Scollick* defendants, but it did not foreclose the possibility of future FCA claims against surety industry participants.

The opinion highlighted:

> [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 [set aside contractors]." 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 *23 (internal citations omitted).

The *Scollick* court observed that, "[i]n the context of the FCA, knowledge requires either actual knowledge, acting in deliberate ignorance, or acting in reckless disregard. Actual knowledge is subjective knowledge, while deliberate ignorance is the kind of willful blindness from which subjective intent can be inferred, and reckless disregard is an extension of gross negligence or gross negligence-plus." Id. at *12 (internal citations, quotations, and alterations omitted). The court stated that "summary judgment is appropriate when plaintiff provides *no* evidence to support a finding of knowledge of an FCA claim, since knowledge is an essential element of the claim." Id. (emphasis in original).

The opinion continued that "[n]o evidence suggests that the insurance [defendants] *knew* the bids were fraudulent. There is only evidence that the insurance defendants knew the details of the bid proposals and some details of the ownership of [a principal]. This is insufficient to proceed on a theory of actual knowledge." Id. at *13.

In addition, the court found that there was no deliberate indifference or reckless disregard on the part of the insurance defendants to support a FCA claim. In addition to faulting the plaintiff-relator for failing to proffer facts about producer and surety knowledge of violation of SDVOSB set-aside rules, the court noted the tremendous duty that the relator'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 Veterans Administration 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 *25 (internal citations omitted).

The irony of the *Scollick* decision is that, in the years before the summary judgment dismissal, surety industry participants rushed to train their staff about set-aside contracts and FCA risk. So a central focus of the *Scollick* dismissal—that the relator could not support its argument that the insurance defendants had "basic familiarity" with set-aside contracting and its requirements sufficient to have knowledge of alleged wrongdoing—may be less applicable in future cases.

The Decision in *SuperValu* Illuminated Understanding of Knowledge under the FCA—Then came the U.S. Supreme Court's unanimous June 1, 2023 decision in *U.S. ex rel. Schutte v. SuperValu Inc.,* 143 S. Ct. 1391 (2023); 65 GC ¶ 156. *SuperValu* was a consolidated case; the Supreme Court granted writs of certiorari in *U.S. ex rel. Schutte v. SuperValu Inc., et al.,* no.

21-1326, and *U.S. ex rel. Proctor v. Safeway, Inc.,* no. 22-111 and consolidated the cases. Both cases had resulted in split panel decisions by the Seventh Circuit holding that the defendants' subjective belief did not matter for purposes of scienter under the FCA. While *SuperValu* did not involve sureties as FCA defendants—it was a drug pricing case against retail pharmacies—it did define the contours of "knowledge" under the FCA. And that definition, coupled with the *Scollick* ruling, may prove to be important for the surety industry. The Supreme Court held that a defendant's contemporaneous subjective understanding or beliefs about the lawfulness of its conduct are relevant to whether it "knowingly" violated the federal FCA. Or, put differently, evidence of contemporaneous understanding of alleged violations may influence how an FCA case proceeds.

The key factual allegations were as follows: The defendants offered discount programs for certain drugs. The programs were popular with customers and made up most of the defendants' sales. The plaintiffs argued that although the prices were technically discounted, those discount prices were actually the defendants' "usual and customary" prices *and* that the defendants understood those discount prices to be usual and customary for them. But when seeking reimbursement from the Government under Medicare and Medical programs, the defendants charged their non-discounted (i.e. non-customary) retail prices.

The defendants asserted and the Seventh Circuit agreed that the defendants' subjective beliefs and the guidance they received about what qualified as usual and customary did not matter; the defendants were entitled to summary judgment because their interpretation of the phrase "usual and customary" in the regulation was *objectively reasonable*. In other words, the phrase could have been understood as referring to the defendants' retail prices, not their discounted prices—even if the phrase, as understood by the defendants, referred to their discounted prices. Thus, it did not matter if the defendants thought their discounted prices were their "usual and customary" prices. What mattered, instead, was that someone else, standing in the defendant's shoes and looking only at the words of the regulation, may have reasonably thought the retail prices were what counted.

The Supreme Court disagreed and vacated the Seventh Circuit judgments, finding that the Seventh Circuit's approach was inconsistent with the plain language of the FCA. The Court found that the scienter element of the statute refers to a defendant's knowledge and subjective beliefs—not to what an objectively reasonable person may have known or believed. The Court found that scienter under the FCA tracks "the common law of fraud, which generally focuses on the defendant's lack of an honest belief in the statement's truth." In other words, the facial ambiguity of the regulation did not give the defendants an after-the-fact safe harbor despite their belief that their claims were false.

The Supreme Court's reasoning on what knowledge means in the FCA context was consistent with that of the district court in *Scollick* in that it endorsed subjective intent. The High Court did not reach the factual disputes and remanded the cases to the Seventh Circuit for further proceedings consistent with the legal standard endorsed by the Supreme Court.

Additional Risk Avoidance Strategies for Surety Industry Participants in Light of These Decisions—Surety industry participants do not need to pivot from a *Scollick* sigh of relief to a gasp of concern just yet. However, they are well advised to consider their FCA risks when writing Miller Act bonds for set aside contracts in light of these two cases. There is little the industry can do to prevent a relator from filing a FCA suit. However, there are strategies that can position surety industry participants to prevail on motions to dismiss. For example:

- *Changes to Underwriting Forms*: Sureties may wish to consider adding language to underwriting forms that indicate the limited purpose of the forms. Namely, that they exist only to permit the surety to evaluate whether or not to bond the job. Additionally, principals should be asked to list whether the contract in question is set aside, and certify that all information provided in the bonding form that is relevant to set-aside eligibility was also available to the Government.
- The classic FCA allegation against the industry is that the surety (1) possessed superior knowledge than the Government had regarding the principal's eligibility for set aside contracts, and (2) knew or should have known that the principal was ineligible, therefore

(3) the surety caused the submission of false claims. Changes to the bond forms can assist the surety in pushing back on superior knowledge claims by making it more difficult for relators to make that argument in the first place.

- *Red Flag Reviews*: Knowledge matters. That is the takeaway from *Scollick* and *SuperValu*. It is unreasonable to expect sureties to be experts in set-aside contract eligibility even after limited initial training. So a reasonable finder of fact cannot expect the industry to issue spot principal eligibility concerns with perfect accuracy. But these cases show that industry participants cannot "bury their heads in the sand" and ignore red flags that might suggest ineligibility for set-aside Government contracts.
- The biggest challenge here is that bonding diligence evaluates the capacity to complete a job, and that analysis typically discusses other companies or capabilities available to assist the principal. That is normal surety analysis. However, that same analysis may be misinterpreted by the Government as knowledge of facts that might cause affiliation, and therefore impact a contractor's status as a small business eligible for set aside contracts. Stated differently, if a small business is, for a lack of a better phrase, "too close to" other businesses or too reliant on them, then the businesses' employees and/or revenue may be added together for purposes of assessing whether the principal is still a small business. See, e.g., 13 CFR 121.103. Analysis of Government contractor affiliation is fact-specific, and technical. Even Government contracting professionals can get it wrong such that a mechanism to challenge a contractor's size exists in the Small Business Administration's regulations. See, e.g., 13 CFR 121.1001–1010.
- So how can sureties mitigate risk in such a complex and uncertain regulatory environment? This is where manuals and training can help. Quality training and policies with easy-to-follow examples for when to seek legal support can help set expectations for reasonable diligence. And efforts to ensure surety industry participants follow these policies are well worth making. After all, the Supreme Court has said that the FCA is not a "vehicle for punishing garden-variety breaches of contract or regulatory violations." *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*, 579 U.S. 176, 194 (2016); 58 GC ¶ 219. Following common-sense policies and procedures and providing adequate training should help to minimize risk, even in situations where sureties mistakenly miss size issues.
- *Representations by Counsel for Principals*: In situations where sureties cannot clear red flags through additional diligence or where questions remain, sureties might consider asking for a signed letter from the principal's counsel certifying that the principal is eligible for set-aside contract programs. Agents and contractors seeking surety bonds should also come to recognize that this additional diligence is not evidence of a lack of respect or trust, but rather of the risk environment in which sureties operate.

Sureties Retain Effective Potential Arguments if a FCA Complaint Survives a Motion to Dismiss—In the unfortunate instance where a FCA case against a surety or producer survives a motion to dismiss, counsel for the insurance industry might consider making the following regulatory history arguments at the summary judgement stage. Where the Small Business Administration has judged a contractor eligible for a particular set-aside program, surety industry participants can argue that, as long as the sureties are acting in good faith, the legislative history of the Small Business Act permits sureties to rely on the SBA's determination. As the regulatory history notes:

> 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 [a key element to False Claims Act 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 Small Business 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 (companies directly involved in contracting, with an understanding of rules and norms) can rely on these indicia of set aside program eligibility, surety industry participants (further removed from contracting with less of an understanding of rules and norms) should be able to do the same.

Requiring more 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, sureties may make their own subjective determinations of a principal's eligibility for set-aside programs—which is precisely what Congress sought 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. No. 95-959, Rep. No. 95-949, at 11 (1978).

Conclusion—Surety industry participants may continue to face FCA risk in the future. But the *Scollick* and *SuperValu* cases also offer insight into how to reduce that risk. This article analyzes FCA risk and presents common sense risk-mitigation strategies for surety industry participants to consider.

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