Sky Not Falling…Yet

Sureties and False Claims Act Liability Today

By Patrick R. Kingsley and Bridget C. Giroud

Sureties may now be well within the scope of potential False Claims Act liability if they have knowledge about deceptive conduct or erroneous claims by their principals.

The False Claims Act (the FCA) has been around for 150 years. It has evolved considerably over that century and a half. The modern FCA is very different from the original FCA that was enacted in 1863, at the end of the Civil War.

Not only does the FCA carry far greater penalties than it once did, but it also protects the government from far more than overt fraudsters selling gun powder mixed with sawdust to Union and Confederate soldiers. The False Claims Act can now be used to impose liability on just about anyone tangentially related to a fraud against the government. When a defendant is faced with a claim under the FCA, the defendant must proceed with caution because of the strong penalties associated with it. The act is made even more powerful by the fact that actions under it can be initiated by citizen whistleblowers.

Bonded principals have historically been liable under the False Claims Act for their misdeeds. However, sureties have very rarely been the subject of FCA suits. Two recent decisions, *Hanover Ins. Co. v. United States*, 134 Fed. Cl. 51 (2017) and *United States ex rel. Scollick v. Narula*, 2017 WL 3268857 (D. D.C. July 31, 2017), may change that. These cases suggest that sureties may now be well within the scope of potential False Claims Act liability.

Origins of the False Claims Act

Before considering a surety's potential liability under the False Claims Act, it is helpful to know the FCA's background, as well as the categories of conduct that could be considered fraudulent under this statute.

The FCA's Enactment in 1863

The False Claims Act was enacted in 1863 for a much more targeted purpose than it now serves. At that time, it was directed specifically "at stopping the massive frauds perpetuated by large contractors during

■ Patrick R. Kingsley is an attorney with Stradley Ronon Stevens & Young LLP in Philadelphia. He has tried more than 40 cases across the country in several different forums, involving diverse legal claims and fact patterns. As a trial lawyer, he has tried both jury and non-jury cases and has represented clients in arbitrations, mediations and hearings before administrative law judges and referees. Mr. Kingsley is co-chair of the firm's Construction Practice Group. He also handles a wide variety of complex commercial disputes. Bridget C. Giroud is an associate with Stradley, where she focuses her practice on complex civil litigation, representing corporate and institutional clients in a wide variety of business litigation matters, including commercial contract disputes and insurance coverage matters. Her client representation includes researching and drafting legal memoranda and motions, assisting with case management, and attending conferences and hearings.

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the Civil War." *Universal Health Servs., Inc. v. United States*, 136 S. Ct. 1989, 1996 (U.S. 2016). Congressional hearings before enactment "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." *Id.* The "worthless goods" sold to the Union Army during the Civil War included weapons and animals that could not perform during battle and food that could not be eaten by the soldiers. *Id. See also* 13 Bus. & Com. Litig. Fed. Cts. §138:1 (4th ed. 2017).

The act's introducer described the need for the act this way:

> The country, as we know, has been full of complaints respecting the frauds and corruptions practiced in obtaining pay from the Government during the present war; and it is said, and earnestly urged upon our attention, that further legislation is pressingly necessary to prevent this great evil; and I suppose there can be no doubt that these complaints are, in the main, well founded. From the attention I have been able to give the subject, I am satisfied that more stringent provisions are required for the purpose of punishing and preventing these frauds; and with a view to apply a more speedy and vigorous remedy in cases of this kind the present bill has been prepared.

United States v. McNinch, 356 U.S. 595, 600 n. 9 (1958) (quoting Cong. Globe, 37th Cong., 3d Sess. 952).

Qui Tam Actions

Since enactment, the False Claims Act has empowered whistleblowers, or "qui tam" plaintiffs, to bring actions on the government's behalf. This means that civil actions for the violation of the FCA may be brought by private individuals (so-called whistleblowers) in the name of the government. *See* 31 U.S.C.A. §3730(b). Significantly, this makes every disgruntled employee of a bonded principal a potential whistleblower. These whistleblowers are incentivized by the fact that they may receive between 15 and 30 percent of the government's proceeds, depending on the qui tam plaintiff's role in the action, as well as their costs and fees. *See* 31 U.S.C.A. §3730(d). Approximately 70 percent of FCA actions brought from 1987 to 2016 were qui tam actions. *See* 13 Bus. & Com. Litig. Fed. Cts. §138:1 (4th ed. 2017).

Amendments to the False Claims Act

When it was first enacted, the FCA imposed significant civil and criminal penalties on fraudsters, including double damages, forfeiture, and up to five years of imprisonment. *Universal Health*, 136 S. Ct. at 1996. Today, the civil stakes have risen even higher, with defendants found liable under the False Claims Act facing treble damages, the government's costs, and civil penalties of more than $22,000.00 per violation. *Id.* 28 C.F.R. §85.5 (adjusting civil penalties for inflation). The treble damages imposed by the False Claims Act may be reduced to double when the wrongdoer self-reports within 30 days of discovery, without actual knowledge of any investigation, and cooperates with any investigation. 31 U.S.C.A. §3729(a)(2). As recently as 2015, the maximum penalty was less than half of what it is today. *See* 28 C.F.R. §85.3.

Beyond the penalties, the False Claims Act's scope has also been steadily expanded to provide more rights to the government and the whistleblowers entitled to bring claims on the government's behalf. The FCA has undergone four rounds of significant amendments since its enactment after the Civil War, in 1943, 1986, 2009, and 2010. *See* 13 Bus. & Com. Litig. Fed. Cts. §138:2 (4th ed. 2017).

In 1943, the FCA was amended to deprive whistleblowers of the ability to bring a qui tam action based on information that the government already knew. *Id.* However, the FCA was amended again in 1986, to loosen restrictions on claims based on information that was publicly disclosed prior to the whistleblower action. *Id.*

In addition to other changes that made qui tam actions easier to bring and more lucrative for whistleblowers, the 1986 amendments also lowered the level of intent required, lengthened the statute of limitations, and increased the civil remedies from double to treble damages, with higher fines for each violation. *Id.* Today, the statute of limitations for claims for liability for violations of the FCA is the latter of six years from the violation or three years from "when facts material to the right of action are known or reasonably should have been known by the official[,]" but no more than 10 years from the date of the violation. *See* 31 U.S.C.A. §3731(b). As a result of the 1986 amendments, claims were easier to bring and carried greater penalties.

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More recently, in 2009, the FCA was amended to make clear that a false claim need not be directly presented to a government official or employee but can instead be presented to a government contractor, grantee, or other recipient of government funds. *Id.* The 2009 amendments also, among other things, added a materiality requirement for false statement and reverse false claim actions, and it added definitions of "material" and "obligation" to the FCA. *See id.* The new definition of "material" resolved a circuit split on whether a "natural tendency" to influence a payment by the government or a more strict "outcome materiality" test should be applied. *See* 13 Bus. & Com. Litig. Fed. Cts. §138:19 (4th ed. 2017). The more lenient "natural tendency" standard was adopted through the 2009 amendments. *See id.*

In 2010, the FCA was amended yet again, primarily to expand whistleblowers' rights. *Id.*

These amendments had their intended effect. Before the False Claims Act was amended in 1986, the statute was rarely used. 13 Bus. & Com. Litig. Fed. Cts. §138:1

(4th ed. 2017). However, from 1987 to 2016, there were 16,187 cases brought under the FCA (11,304 of which were qui tam actions), leading to the recovery of fifty-three billion dollars. *Id*. The amendments have allowed False Claims Act liability to expand far beyond defense contractors, for example, into the health-care and financial services industries. *Id*.

According to the Court, the materiality requirement requires more than "minor or insubstantial" non-compliance with a government requirement.

Theories of False Claims Act Liability Today

Today, the FCA specifically provides several broad categories of actions imposing liability. These categories include, among others, (1) the presentment of false claims, (2) causing the presentment of false claims, (3) making false statements material to false claims, (4) causing false statements material to false claims to be made, (5) making or causing "reverse" false statements to avoid payment obligations owed to the government, and (6) conspiracies. *See* 31 U.S.C.A. §3729(a)(1)(A)—(C), (G). Lesser-invoked provisions of the FCA also impose liability for withholding of government property, improper certification of receipt of property for government use, and improper receipt of public property from an officer or employee. *See* 31 U.S.C.A. §3729(a)(1)(D)–(F). Additionally, the United States Supreme Court recently recognized the "implied false certification" theory of liability for failure to disclose some non-compliance. *See Universal Health Servs., Inc. v. United States*, 136 S. Ct. 1989 (U.S. 2016).

False Claim Presentment Liability

False claim liability may be imposed when a person "knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval[.]" 31 U.S.C.A. §3729(a)(1)(A). The False Claims Act broadly defines a claim as the following:

(A) any request or demand, whether under a contract or otherwise, for money or property and whether or not the United States has title to the money or property, that—
- **(i)** is presented to an officer, employee, or agent of the United States; or
- **(ii)** is made to a contractor, grantee, or other recipient, if the money or property is to be spent or used on the Government's behalf or to advance a Government program or interest, and if the United States Government—
  - **(I)** provides or has provided any portion of the money or property requested or demanded; or
  - **(II)** will reimburse such contractor, grantee, or other recipient for any portion of the money or property which is requested or demanded; and

(B) does not include requests or demands for money or property that the Government has paid to an individual as compensation for Federal employment or as an income subsidy with no restrictions on that individual's use of the money or property[.]

31 U.S.C.A. §3729 (b)(2). For example, a contractor that knowingly submits an inflated invoice to the government would have potential false claim presentment liability. *See* 13 Bus. & Com. Litig. Fed. Cts. §138:12 (4th ed. 2017).

Generally, the False Claims Act's knowledge requirement may be met through actual knowledge, deliberate ignorance, or reckless disregard. 31 U.S.C.A. §3729(b)(1)(A). Indeed, the statute specifically provides that it does *not* require "proof of specific intent to defraud[.]" 31 U.S.C.A. §3729(b)(1)(B). As such, "'what constitutes the offense is not [the specific] intent to deceive but [the] knowing presentation of a claim that is either fraudulent or simply false,' as opposed to an 'innocent mistake' or 'mere negligence.'" 13 Bus. & Com. Litig. Fed. Cts. §138:21 (4th ed. 2017)(citations omitted).

False Statement Liability

False statement liability may be imposed when a person "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim[.]" 31 U.S.C.A. §3729(a)(1)(B). False statement liability might arise if a defendant does not actually assert a false claim but makes a false statement that is material to a false claim. For example, false reports to the government under an education grant agreement can create liability under 31 U.S.C.A. §3729(a)(1)(B). *See, e.g., United States v. Bd. of Educ. of City of Union City*, 697 F. Supp. 167, 176 (D.N.J. 1988).

"Material" is defined as "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property[.]" 31 U.S.C.A. §3729 (b)(4). The United States Supreme Court recently clarified that definition in *Universal Health Servs., Inc. v. United States*, 136 S. Ct. 1989 (U.S. 2016), calling it a "demanding" standard. *Id*. at 2003. The Court disagreed with the First Circuit's interpretation of the materiality requirement—that "any statutory, regulatory, or contractual violation is material so long as the defendant knows that the Government would be entitled to refuse payment were it aware of the violation." *Id*. at 2004. According to the Court, the materiality requirement requires more than "minor or insubstantial" non-compliance with a government requirement. *Id*. The Supreme Court explained that "proof of materiality can include, but is not necessarily limited to, evidence that the defendant knows that the Government consistently refuses to pay claims in the mine run of cases based on noncompliance with the particular statutory, regulatory, or contractual requirement." *Id*. at 2004.

"Reverse" False Claims

An actionable reverse false claim occurs when a person does one of the following:

> knowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the Government, or knowingly conceals or knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the Government[.]

31 U.S.C.A. §3729(a)(1)(G). In other words, "reverse" FCA liability stems from a fraud

perpetuated to avoid a debt to the government, rather than to obtain payment from the government. For example, a failure to return an overpayment by the government can result in "reverse" FCA liability.

Traditionally, courts held that the obligation to the government must have existed at the time of the fraud. *See, e.g., United States v. Q Int'l Courier, Inc.*, 131 F.3d 770, 773 (8th Cir. 1997) ("A defendant must have had a present duty to pay money."); *U.S. ex rel. Marcy v. Rowan Companies, Inc.*, 520 F.3d 384, 392 (5th Cir. 2008) ("The relevant time for assessing the defendant's obligation to pay is when they made or used the false statements."). As a result, courts held that contingent obligations—those that might or might not result in the creation of an obligation to pay the government and will arise only after the exercise of discretion by government actors—are *not* sufficient to establish reverse false claim liability. *See, e.g., Am. Textile Mfrs. Inst., Inc. v. The Ltd., Inc.,* 190 F.3d 729, 738 (6th Cir. 1999) (noting that "contingent obligations (such as the imposition of a civil penalty for an antitrust violation) attach only after the exercise of administrative or prosecutorial discretion, and often after a selection from a range of penalties" and are not actionable); *Zelenka v. NFI Indus., Inc.*, 436 F. Supp. 2d 701, 706 (D. N.J. 2006) (finding that an obligation to pay inspection fees was contingent upon government agency's decision to inspect shipments and that it therefore did not create reverse false claim liability). The 2009 amendments to the False Claims Act, however, defined the term "obligation" as "an *established* duty, *whether or not fixed*, arising from an express or implied contractual, grantor-grantee, or licensor-licensee relationship, from a fee-based or similar relationship, from statute or regulation, or from the retention of any overpayment." 31 U.S.C. §3729(b)(3) (emphasis added). While there was some initial uncertainty about this definition, courts still seem to agree that it does not include obligations that are merely contingent. *See, e.g., United States ex rel. Petras v. Simparel, Inc.,* 857 F.3d 497, 506 (3d Cir. 2017) ("We conclude then that for a reverse FCA claim, the definition of an 'obligation' refers to one existing at the time of the improper conduct to pay the Government funds, the amount of which may not be fixed at the time of the improper conduct."); *United States ex rel. Simoneaux v. E.I. duPont de Nemours & Co.*, 843 F.3d 1033, 1036 (5th Cir. 2016) ("Although [the amendment]'s new definition resolved uncertainty regarding whether the *amount* of an obligation needs to be fixed, it did not upset the widely accepted holding that contingent penalties are not obligations."); *United States ex rel. Barrick v. Parker-Migliorini Int'l*, LLC, 878 F.3d 1224, 1231 (10th Cir. 2017) (noting that even following the amendment, "there is no liability for obligations to pay that are merely potential or contingent.").

Liability for Non-Presenting Entities: "Indirect" Presentment

The False Claims Act further imposes liability on those who knowingly *cause* the presentation of false claims and false statements, not just those who directly present them to the government. *See* 31 U.S.C.A. §3729(a)(1).

As explained by the First Circuit:

> When the defendant in an FCA action is a non-submitting entity, the question is whether that entity knowingly caused the submission of either a false or fraudulent claim or false records or statements to get such a claim paid. The statute makes no distinction between how non-submitting and submitting entities may render the underlying claim or statements false or fraudulent.

U.S. ex rel. Hutcheson v. Blackstone Med., Inc., 647 F.3d 377, 389 (1st Cir. 2011) (holding that a medical device manufacturer that allegedly provided physicians with kickbacks could be held liable under the FCA because they purportedly knowingly caused the presentment of fraudulent Medicare reimbursement claims by physicians and hospitals through their kickbacks).

The U.S. District Court for the District of Columbia summarized when indirect presentment may generally be sufficient for liability in *United States ex rel. Tran v. Computer Scis. Corp.*, 53 F. Supp. 3d 104 (D.D.C. 2014). Surveying the case law, the court noted that a defendant could be liable for being a "substantial factor in causing" a false claim or statement to be presented where the defendant (1) "takes advantage of an unwitting intermediary," (2) "was the driving force behind an allegedly fraudulent scheme[,]" (3) "agreed to take certain action in furtherance of the fraud[,]" or (4) "continued to do business with an entity upon becoming aware that that entity was submitting false claims[.]" *Id*. at 126–27 (citations omitted). The key to causation is to "look at the degree to which that party was involved in the scheme that results in the actual submission." *Id*. at 127. But a "mere conduit" without knowledge of the fraudulent scheme would not be liable. *Id*.

Indeed, the United States Supreme Court recently noted that the focus of the False Claims Act is "those who present or directly induce the submission of false or fraudulent claims."

When the non-submitting entity's involvement in the fraud is high, there is more likely to be a finding of liability. For example, in *United States v. Toyobo Co.*, 811 F. Supp. 2d 37 (D. D.C. 2011), a district court held that a manufacturer of faulty synthetic thread used in bulletproof vests sold to federal agencies could be held liable under the FCA, even though the thread manufacturer did not directly seek payment from the government or make a false statement directly to the government. Instead, the court held that the complaint adequately alleged that the thread manufacturer's misrepresentations about the thread's performance induced the vest manufacturers to sell the vests to the governments, making each of the vest manufacturers' claims for payment false. *Id*. at 47. The court noted that "[a] subcontractor may be liable under §3729(a)(1) even when it did not itself present any false claims to the government if it engaged in a fraudulent scheme that induced the government to pay claims submitted by the contractor." *Id*. at 45. As for causation, the court found sufficient the government's allegation that the thread manufacturer

marketed the synthetic thread to the vest manufacturer and induced them to continue using the synthetic thread in their products, which were being sold to the government, after issues about the thread's quality arose. *Id.* at 48.

On the other hand, courts have consistently made clear that a mere failure to act is not sufficient for imposition of False Claims Act liability. *See U.S. ex rel. Sikkenga v. Regence Bluecross Blueshield of Utah*, 472 F.3d 702, 714 (10th Cir. 2006) (holding that liability under a causation theory "requir[es] more than mere passive acquiescence" and requiring "affirmative action on the part of a defendant before imposing liability under the FCA" because "too broad an interpretation of the causes to be presented language in the FCA would impose liability on parties merely for failing to prevent the fraudulent acts of others"); *United States ex rel. Landis v. Tailwind Sports Corp.*, 51 F. Supp. 3d 9, 50 (D. D.C. 2014) (holding that officer of company that owned cycling team that allegedly submitted false claims due to team members' doping did not cause submission of false claims where he had no role in submission and was only alleged to have failed to stop it); *United States ex rep. Piacentile v. Wolk*, Civ. No. 93-5773, 1995 WL 20833, at *3–4 (E.D. Pa. Jan. 17, 1995) (granting a defendant's motion to dismiss where he did not affirmatively misrepresent any fact to the government, but merely failed to inform the government of false statements made by submitter and to take action to ensure that the practice was discontinued); *United States v. Murphy*, 937 F.2d 1032, 1038–39 (6th Cir. 1991) ("Constructive knowledge that something illegal may have been in the offing is not enough to prove the government's case.… It does not eliminate the need under subsection (a)(1) for some action by the defendant whereby the claim is presented or caused to be presented."). Indeed, the United States Supreme Court recently noted that the focus of the False Claims Act is "those who *present or directly induce* the submission of false or fraudulent claims." *Universal Health Servs., Inc. v. United States*, 136 S. Ct. 1989, 1996 (U.S. 2016) (emphasis added). However, it has been noted this in dicta:

> Where the 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 itself becomes "a course of conduct that allowed fraudulent claims to be presented to the federal government."

United States v. President & Fellows of Harvard Coll., 323 F. Supp. 2d 151, 187 (D. Mass. 2004) 151, 187 (citation omitted).

The surety's liability seems to have been predicated on the surety's assertion that it had a lien on its principal's recovery. That is a valid and well-established proposition of law. So how can asserting it create liability?

Some courts have required that a non-submitting entity have some role in the payment process. *See Harvard*, 323 F. Supp. 2d at 186 (noting that "some degree of participation in the claims process" as opposed to "mere knowledge of the submission of claims and the falsity of those claims" is required). *See also, e.g., United States ex rel. Kinney v. Hennepin County Med. Ctr.*, Civ. No. 97-1680, 2001 WL 964011, 9 (D. Minn. Aug 22, 2001) (determining that a non-submitting defendant was not liable for a fraudulent submission because the defendant had "no control over the content of the claims" and no "apparent right to review the forms being submitted."). Notably, liability may be imposed on a defendant with a role in the claim process even when that role is delegated. *See United States v. Mackby*, 261 F.3d 821, 827 (9th Cir. 2001) (holding the non-submitting defendant, owner of the clinic, liable for instructing a billing company and clinic's office manager to use fraudulent information on claim forms); *United States v. Krizek*, 111 F.3d 934, 943 (holding the defendant liable where he delegated authority to submit claims to his wife and did not review the submissions).

Implied False Certification

On June 16, 2016, the United States Supreme Court recognized the "implied false certification" theory of liability for failure to disclose some non-compliance. *See Universal Health Servs., Inc. v. United States*, 136 S. Ct. 1989 (U.S. 2016). According to the Court, a defendant may be held liable under the False Claims Act for this type of violation when two conditions are met: (1) "the claim does not merely request payment, but also makes specific representations about the goods or services provided;" and (2) "the defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths." *Id.* at 2001.

In *Universal Health*, the surviving parents of a mental health facility patient brought a qui tam action against the facility's operator, alleging that the facility submitted Medicaid claims for particular services performed without disclosing violations of legal requirements for those services. *Id.* at 1998. The Supreme Court held that such failure could support an implied false certification claim if the violations of legal requirements were material to the government's payment decision. *Id.* at 2002. The Court recognized the limits of the "implied false certification" theory by rejecting a creative example presented by the Government:

> If the Government contracts for health services and adds a requirement that contractors buy American-made staplers, anyone who submits a claim for those services but fails to disclose its use of foreign staplers violates the False Claims Act. To the Government, liability would attach if the defendant's use of foreign staplers would entitle the Government not to pay the claim in whole or part—irrespective of whether the Government routinely pays claims despite knowing that foreign staplers were used.

Id. at 2004.

FCA Conspiracies

A conspiracy to commit any type of False Claims Act violation can create liability. 31 U.S.C.A. §3729(a)(1)(C). Courts have applied general conspiracy principles to claims under this provision, because the False Claims Act does not define the term. *See* 13 Bus. & Com. Litig. Fed. Cts. §138:12 (4th ed.). Therefore, similar to any conspiracy action, an action based on a conspiracy to commit a FCA violation requires "(1) the existence of an unlawful agreement between the defendants to commit [a FCA] violation, (2) at least one overt act performed in furtherance of the conspiracy, and (3) proof that the defendants intended to defraud the government." *Id.* (citation omitted).

Potential Surety Liability Under The False Claims Act

Two recent decisions have very plainly put bonding companies on notice that they can be liable under the False Claims Act for seemingly innocuous conduct. In *Hanover Ins. Co. v. United States*, 134 Fed. Cl. 51 (2017), the United States Court of Federal Claims decided that a surety can be held liable simply because the surety merely relied upon its *principal's* claims when it asserted a lien. In *United States ex rel. Scollick v. Narula*, 2017 WL 3268857 (D.D.C. July 31, 2017), the United States District Court for the District of Columbia went even further, holding that a surety can be liable under the FCA for its principal's participation in a fraudulent scheme on a bonded federal project, when the surety did nothing more than issue a bond. Both of these cases are surprising because the surety's conduct did not seem to be a material part of any fraudulent scheme. However, these decisions were decided at just the pleadings stage, meaning that they underwent only the lowest level of scrutiny.

In *Hanover*, it was alleged that the principal asserted several false claims against the government. Included among them was a settled pass-through claim in the amount of $1.1 million, asserted for the full amount of the claim, even though the underlying claim had been previously settled by the surety for just $370,000.00. *Id.* The surety's only alleged conduct was to assert "an equitable lien on all funds due or to become due" to the principal. *Id.* at 57. Although the case does not specifically address it, it appears that the surety did not assert any particular underlying claim as part of its lien, did not specify any amount for any particular underlying claim, and did not even an assert an amount for the aggregate of its recovery. The government alleged that this assertion by the surety opened the surety up to FCA liability, because the surety knew the amount for which the claim *asserted by the principal* had in fact settled.

The court rejected the surety's argument that it was not pursuing the full pass-through claim, but only an "equitable lien over any recoveries that [the principal] may obtain." *Id.* at 69. The court instead decided that the government alleged a plausible claim against the surety simply because the surety allegedly knew or should have known that the pass-through claim was false and failed to take the affirmative step of alerting the court. *Id.* at 70–71. The United States Court of Federal Claims also held that if the principal committed fraud and therefore forfeits its claim, the surety has no subrogation claim. *Id.* at 68. However, the court also held that the surety in such a circumstance is liable for only the damages caused by the principal's fraud, not the penalties associated with it. *Id.* at 70. The court came to this conclusion even though the surety did not specifically address any particular underlying claim or any particular amount for either the specific underlying claim or the aggregate amount of the lien. Thus, the surety's liability seems to have been predicated on the surety's assertion that it had a lien on its principal's recovery. That is a valid and well-established proposition of law. So how can asserting it create liability? We await further analysis from the court in *Hartford*.

In *Scollick*, the court held that a surety could be liable for its principal's fraud when it "should have known" of its principal's fraud and nonetheless issued a bond. No conduct beyond the issuance of the bond was mentioned by the court as required for liability. The alleged conduct of the non-surety defendants in *Scollick* was obviously fraudulent—they purportedly falsely claimed status as a service-disabled, veteran-owned small business (SDVOSB) and touted successful construction projects that did not happen. 2017 WL 3268857, at *2–*3. However, the surety-defendants' conduct was anything but. The sureties just wrote the bond.

In the initial complaint in *Scollick*, the government alleged that the surety defendants knew the bid proposal contents, including about the non-surety defendants' fraudulent claims to have SDVOSB status. *Id.* at *13. The government further

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alleged that were it not for the issuance of the bonds, the fraudulent bid submission would not have been awarded. *Id.* The court rejected the original complaint's assertion that this conduct amounted to a violation of the FCA by the surety defendants, noting that they were not alleged to have "envision[ed]" the fraudulent scheme or "push[ed]" their co-defendants to enact it. *Id*. The court also noted that it was not alleged that the surety defendants agreed to issue the bonds "in furtherance of" the fraudulent scheme or that they "continue[d] to do business with the other defendants upon becoming aware that the other defendants were submitting false claims." *Id*. Consequently, the court dismissed the original complaint.

The government then sought leave to amend its complaint to allege that during the underwriting process, the surety defendants conducted an on-site inspection of the co-defendants' offices. *Id.* As amended, the complaint further alleged that the surety defendants "necessarily" understood that the purported SDVOSB was a shell with no financial capacity or

construction history. *Id*. Therefore, according to the government's new allegations, the surety defendants knew or should have known of the fraudulent scheme after the underwriting process. *Id*.

The court permitted the amendments and held that the new allegations adequately pleaded an "indirect presentment" claim. *Id*. at *15–17. The court held that "the allegations are sufficient to show that the [surety] defendants had knowledge that [their co-defendants] were fraudulently asserting status as SDVOSBs." *Id*. at *15. The court further concluded that the complaint's allegations "are sufficient to allege that the [surety] defendants continued to do business with [their co-defendants] upon becoming aware that [they] were submitting false claims, which… is grounds for alleging an indirect presentment claim." *Id*. Earlier case law seems to require that the non-presenting entity have some causal role in presenting the false claim, which appears entirely absent in *Scollick*, despite the court's conclusion otherwise. In *Toyobo*, for example, the thread manufacturer deceived the garment manufacturer, which deceived the government. In *Scollick*, what did the surety do to present the claim indirectly? Apparently it did nothing other than to issue the bond.

Sureties also need to be careful about filing pleadings and taking other affirmative actions based on the claims and positions of their principals.

A reverse false claim had also been adequately alleged, according to the district court. The court explained that the bonds allegedly "obligate the [sureties] to compensate the government for losses sustained if the specification found in the contract, including the specification that the construction activity be paid a SDVOSB entity" were violated. *Id*. at 16. The court agreed with the government that "each time the [sureties] knew that the government made a payment that violated the SDVOSB specification, they knowingly avoided an obligation to compensate the government for that loss." *Id*. at 16. The court rejected a reverse false claim against the brokers, however, because they did not "provide" the surety bonds and therefore had not actually "incurred any obligation to the government." *Id*. The court so held despite the fact that no bond claim was even asserted by the government against the surety, and therefore, it was impossible for the surety to have made a false statement in response to a non-existent clam.

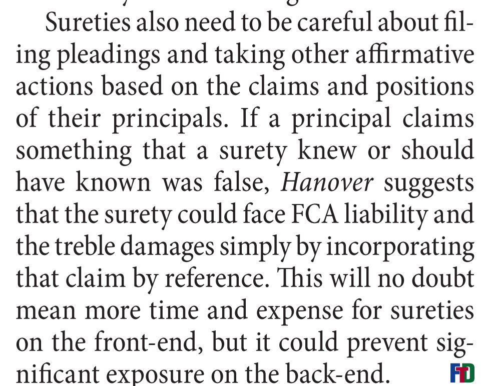
The pleading period in *Scollick* is not yet closed and further developments at the pleadings stage are possible. One of the surety defendants sought to dismiss the amended complaint after this decision, and that motion was also recently denied. *See United States ex rel. Scollick v. Narul*, 1:14-cv-01339-RCL (D.D.C. Aug. 21, 2018), ECF No. 244. In the motion, the surety argued that any obligation it owed under the bond would have been contingent upon a default by the principal and a demand upon the surety, among other things. This is consistent with reverse false claims law generally, which typically does not permit liability for a contingent obligation. The court, however, held that this argument would best be addressed at summary judgment, after discovery. The *Scollick* court seemingly ignores the way that a bond actually works. A bonding company is not automatically (and immediately) required to pay the government any time that its principal allegedly breaches. That skips the entire bond claim process.

Additionally, the *Scollick* court's holding regarding indirect presentment seemingly ignores that failure to intervene to prevent a fraud has long been held insufficient for False Claims Act liability. That is essentially what the surety defendants in *Scollick* are alleged to have done. The surety defendants did not have any role in the payment application process. The opinion seems to conflate the initial bidding process (requiring the bond) with the principal's subsequent claims for payment. Assuming that the surety defendants in *Scollick* acted as a typical surety would, they had no role whatsoever in the principal's submission of pay applications to the government. While the court seems to have gotten some basic facts about how bonds work wrong, the decision is nonetheless in line with the law's recent trend toward more False Claims Act liability—with significant exposure for those charged with some liability.

Lessons for a Surety

Although these cases have troubling holdings, the sky is not yet falling. These decisions were decided at the pleadings stage, and therefore, the underlying complaints have undergone only the lowest level of scrutiny by the courts. The courts have decided only that there was enough in the pleadings to allow the claims to continue, not that the claims will ultimately succeed. The courts did not have the benefit of a fully developed factual record. Such a record may impress upon the courts the way that surety bonds actually work. It is certainly possible that clearer-reasoned decisions on the merits, taking into account a surety's proper role in the construction process will follow. For now, however, sureties must be careful.

After *Scollick*, sureties with any knowledge about deceptive conduct or erroneous claims by their principals involving a bonded federal project should beware that they could be held liable under the False Claims Act for writing a bond in the face of that knowledge. This means that a surety with such knowledge should consider declining to bond the project altogether. Sureties may wish to spend more time investigating their principals' compliance before issuing a bond. Until there is more law on a surety's potential exposure to FCA claims, sureties should assume that their role in issuing the bond could be sufficient conduct to "cause" the presentment of a false claim, where they have knowledge of the fraud.



Sureties also need to be careful about filing pleadings and taking other affirmative actions based on the claims and positions of their principals. If a principal claims something that a surety knew or should have known was false, *Hanover* suggests that the surety could face FCA liability and the treble damages simply by incorporating that claim by reference. This will no doubt mean more time and expense for sureties on the front-end, but it could prevent significant exposure on the back-end. FTD