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Does the civil False Claim Act liability of a bonded contractor extend to its surety?

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In a recent case from the U.S. District Court for the District of Columbia, *United States ex rel. Scollick v. Narula*,[1] two surety companies and the broker that issued bonds on federal construction projects succeeded in summarily dismissing civil False Claims Act allegations involving federal small business set-aside contracts. The case is alarming because it suggests that payment and performance bond sureties could potentially be liable for the civil False Claims Act violations of the principals on the bonds they issue.

On July 19, 2022, in the decision filed under seal, the District Court ruled in favor of Hudson Insurance Co., Hanover Insurance Co., and Centennial Surety Associates (collectively, the Sureties) denying whistleblower Andrew Scollick's claims, which attempted to extend the scope of civil False Claims Act liability to sureties that provide bid, performance, and payment bonds on federal construction projects.

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The whistleblower contended that the Sureties reasonably knew through underwriting activity that large contractors were using service-disabled veteran-owned small business (SDVOSB) and in some cases, Historically Underutilized Business Zones (HUBZone) contractors as fronts to obtain work set aside for those socio-economic categories.

The civil False Claims Act (FCA) imposes liability on anyone who commits fraud against the federal government and provides considerable civil and criminal penalties for violations of the FCA.

For instance, submitting false invoices or inflated material costs to the government for payment or certifying knowingly false information will fall within the conduct punishable under the FCA. In the past, bond sureties however were hardly ever parties to the FCA lawsuits.

In *Scollick*, the whistleblower filed suit on behalf of the government against several large contractors who allegedly fraudulently obtained federal contracts worth of millions of dollars set aside for HUBZone and SDVOSB concerns.

Scollick alleged that the Sureties either knew or should have known that the SDVOSB contractor was really only a shell company not eligible for SDVOSB status.

In addition, Scollick sued the Sureties that issued bid, performance, and payment bonds based on the theory that the Sureties allegedly knew that the small business, SDVOSB contractor was actually controlled by a large contractor and issued the bonds based on the strength of the large contractor's bonding capacity. Without that bonding, the SDVOSB contractor allegedly would not have been able to compete and obtain federal government contracts set aside for SDVOSB or HUBZone concerns.

The whistleblower claimed that Sureties knew that the large contractors were neither small business concerns as defined by the Small Business Administration (SBA) regulations, nor Service-Disabled Veteran-Owned Small Businesses as defined by the Department of Veterans Affairs (VA) and that the large contractor was actually going to perform the work and issued the bonds despite allegedly having that knowledge in furtherance of the fraud.

The District Court initially dismissed claims against the Sureties because the whistleblower failed to plead facts sufficient to support his claims. Scollick then filed an amended complaint, in which he alleged that the Sureties either knew or should have known through a due diligence and surety underwriting process that the SDVOSB contractor was really only a shell company not eligible for SDVOSB status.

The amended complaint asserted that the Sureties had an existing business relationship with the large contractors; that the Sureties knew the SDVOSB contractor shared an office space with one of

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the large contractors; and that they shared finances and common ownership.

Furthermore, the Sureties reviewed proposals that large contractors submitted as a SDVOSB concern to the federal government.

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Finally, the Sureties required the large contractors to sign indemnification agreements on behalf of the SDVOSB contractor as the SDVOSB contractor allegedly did not have the financial capacity on its own to perform on the construction contracts that it was awarded.

Accordingly, the whistleblower concluded that despite knowing that large contractors did not meet eligibility requirements for SDVOSB status, Sureties issued bonds and that way enabled large contractors to bid on and obtain federal government construction contracts that were set aside for small businesses. Based on these factual allegations, the District Court allowed the case to proceed against the Sureties.

At the conclusion of discovery, upon filing motions for summary judgment, the District Court granted the Sureties' motions dismissing the FCA claims pending against them. The decision was filed under seal due to certain documents being filed under seal. Consequently, it's hard to tell what the Court's reasoning was in deciding not to extend the FCA liability to the Sureties.

Nevertheless, *Scollick*'s lesson for sureties is that they should be more cautious when conducting a due diligence. A surety cannot simply bury its head in the sand. If the surety learns through an underwriting process about some misleading statements or dishonest actions taken by the principal on the bond, then the surety should not issue a bond; otherwise, the surety could expose itself to the FCA liability.

Notes

[1] Case No. 1:14-cv-01339.

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