Federal Fraud Investigations Update: Some Construction and Surety Industry Hotspots

THIS PAPER WAS WRITTEN IN CONJUNCTION WITH A BREAKOUT SESSION AT AGC'S 2021 SURETY BONDING AND CONSTRUCTION RISK MANAGEMENT CONFERENCE.

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Session Title: DOJ Fraud Investigation Warning: Construction and Surety Industry Hotspots

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I. Introduction

Increasingly, companies engaged in federal contracting find themselves in the precarious position of dealing with investigators appearing at the company's office or an employee's home without warning and demanding information related to a particular contract. Typically, investigators not only insist on taking computers and files but also seek to question management or employees about the government contract, often without any explanation of the purpose of the visit. In the last few years, the government has added sureties, brokers, and bond producers to the ever-growing list of targets of fraud investigations. How would your company respond to a government fraud investigation that may be in high gear?

Despite the pandemic, the Department of Justice (DOJ) announced that the government recovered over $2.2 billion last year in civil fraud settlements and judgments. The DOJ boasts that the recoveries are the culmination of aggressive investigations and prosecutions of government contractors, among others. Such an attitude undoubtedly suggests that the government's campaign against fraud, waste and abuse is intensifying rather than abating. In fiscal 2020, the government and *qui tam* relators initiated the largest number of False Claims Act (FCA) lawsuits in a single year. The message to the construction industry is clear -- be prepared and stay vigilant.

Typically, procurement fraud cases involve either mischarging of labor costs, defective pricing, or improper progress payments. Thus, it is not surprising that investigations of labor charging and progress payment applications remain a top priority for auditors and investigators. A host of government contractors have paid dearly for past transgressions -- in many cases, well over $1 million in civil, criminal, or administrative penalties and recoveries. Few if any federal programs related to construction receive more attention by investigators than the Small Business Administration (SBA) rules programs related to set-asides and preferences afforded to qualifying disadvantaged contractors. More recently, the SBA's Paycheck Protection Program and related self-certifications also are under the spotlight. Participants in these SBA programs can expect to be closely scrutinized not only by federal investigators but also erstwhile whistleblower attorneys.

Of particular importance to the surety industry are the policy and other concerns raised by pending cases involving fraud claims. A *qui tam* relator's lawsuit, *Scollick v. Narula*, seeks to adopt a novel and precedent setting theory of imposing a duty on sureties during underwriting of Miller Act bonds to examine, report, and police their principals' socio-economic eligibility compliance under SBA rules. The potential "cataclysmic effects" will result across the surety industry if the court issues a ruling that imposes such a duty on sureties for its principals' violations related to size and status eligibility standards. In addition, sureties and contractors alike have been following the eight-year odyssey at the United States Court of Federal Claims arising from the fallout of a catastrophic cofferdam failure in South

Florida. After several years of litigation involving the contractor's claims and the government's default termination, the DOJ upped the ante in 2017 by filing a fraud counterclaim against the contractor and its sureties. While the litigation involving the sureties was recently transferred, the contractor's claims and certain fraud counterclaims are heading to trial.

There are steps that companies can take to avoid that fateful knock on the door by a fraud investigator. Although all contractor employees should be aware of compliance issues and potential for fraud, personnel such as upper management, financial officers, contract administrators, legal department, and salesmen engage in particularly scrutinized activities. Such personnel are susceptible to creating a defective pricing, mischarging or fraud situation by their actions or inaction. One cost effective method of educating your employees in dealing with government auditors is a company compliance program seminar. Besides familiarizing employees with the fraud indicators, such a seminar is useful in keeping abreast with the latest changes and amendments to statutes and regulations related to compliance matters.

II. The Government Recovered $2.2 Billion from FCA Cases in Fiscal 2020

The DOJ announced that it obtained more than $2.2 billion in settlements and judgments from civil cases involving fraud and false claims against the government in fiscal year 2020. For comparison purposes, the civil fraud recoveries in fiscal 1985 were $37 million. At first blush, the $2.2 billion recovered in 2020 sounds like a downward trend from the $3 billion taken in fiscal 2019. The hardship of prosecuting cases in the face of a nationwide pandemic, however, cautions against reading too much into the 2020 results. Indeed, the DOJ advised that its results do not include settlements totaling billions of additional dollars that were not yet final or did not become final before the end of the fiscal year. Moreover, 2020 saw the largest number of new FCA matters initiated in a single year. The DOJ initiated new FCA matters at its highest rate since 1994, with 250 new cases brought in 2020. Astonishingly, *qui tam* relators filed 672 new matters in 2020, which on average is about 13 new cases per week.

In the past year, the DOJ pursued a variety of fraud matters involving the government's purchase of goods and services. For example, major federal contractors agreed to pay over $57 million to resolve allegations that they submitted false claims to the Department of Energy by charging inflated labor hours and by billing for work not actually performed to construct and maintain the Hanford Waste Treatment Plant. In some cases, the government pursued allegations that government contractors intentionally failed to comply with contract requirements. For example, a leading supplier of high-yield steel for naval submarines paid over $10 million to resolve allegations that it produced and sold substandard steel components for installation on U.S. Navy submarines. The government alleged that the contractor produced castings that failed lab tests and did not meet the

Navy's standards, and that its Director of Metallurgy falsified test results to hide the failures.

Several corporate settlements required defendant individuals, particularly senior executives and owners, to pay a portion of the settlement amount. For instance, as part of a $4.25 million settlement, five individual shareholders of an asphalt contractor agreed to pay a total of nearly $2 million to resolve the government's allegations that the company violated the False Claims Act by misrepresenting to the government the asphalt mix that it was using to pave federally funded roads.

DOJ enforcement efforts have also encompassed foreign military sales (FMS) as these sales have increased in recent years. In November 2019, a company agreed to pay $2.8 million and give up $16 million in potential administrative claims to settle allegations that it violated the FCA by fraudulently obtaining a foreign military sales contract reserved for American companies. The settlement resolved allegations that the company presented false claims to the government certifying that it was performing work as the prime contractor when, in fact, the work was performed by its parent company, which was a foreign company.

III. Fraud Involving Small Business Administration Programs

A. The Federal Paycheck Protection Program

In March 2020, Congress passed a $2.2 trillion economic relief bill known as the Coronavirus Aid, Relief, and Economic Security (CARES) Act designed to provide emergency financial assistance to the millions of Americans who are suffering the economic effects caused by the COVID-19 pandemic. Administered by the SBA, the CARES Act created a Paycheck Protection Program (PPP) to enable businesses to apply for low-interest private loans to fund payroll costs, as well as rent and utilities. The loans may be forgiven in total or in part if businesses prove that they maintained both employee counts and payroll. Anticipating the need to protect the integrity of these taxpayer funds, the DOJ is aggressively pursuing efforts to identify, investigate, and prosecute COVID-19 pandemic fraud. On March 26, 2021, the DOJ announced that it has publicly charged 474 defendants with criminal offenses based on fraud schemes connected to the pandemic.

DOJ is also using numerous civil tools to address fraud in connection with CARES Act programs. For example, a California internet e-retailer was the first business to settle with the DOJ following allegations of fraud involving PPP loans. DOJ asserted civil claims under the FCA against the company and chief executive officer arising from false statements to federally insured banks to influence those banks to approve, and the SBA to guarantee, a $350,000 PPP loan. While the settlement was the first and most high-profile of its kind, many more FCA claims are expected over the next several months as the DOJ intensifies investigations of abuse of the program.

As the case reflects, both businesses and the individuals that prepare and submit loan documentation can be held liable for false claims. Businesses who have received PPP loans and/or are considering seeking forgiveness of these loans should fully understand their obligations under the program and take appropriate steps to ensure that all documentation fully substantiates compliance with PPP rules. Although the SBA requires only loans above $2 million to be audited, this case demonstrates that the DOJ will pursue allegations of fraud regardless of the dollar amount loaned.

B. SBA's 8(a), HUBZone, Service-Disabled Veteran-Owned, and Women-Owned Small Business Programs

Regulations dealing with government contracting programs for small businesses are outlined in the Title 13 Part 125 of the Code of Federal Regulations (CFR). The government works to make sure small businesses get at least 23 percent of all federal contracting dollars. Additionally, the government aims to award a certain percentage (e.g., 5%) of all federal prime contracting dollars to small businesses that meet certain socio-economic conditions. Under set-aside award conditions, small business prime contractors are required to perform minimum levels of work on a government contract. These limitations ensure that otherwise ineligible businesses do not improperly use small or disadvantaged businesses merely as vehicles to access set-aside contracts. The limitations apply to contract set-asides for small businesses when the contract amount exceeds $150,000, and all other set-aside contracts under the SBA's 8(a), HUBZone, service-disabled veteran-owned, or women-owned small business programs.

1. A Surety's Potential False Claims Act Liability for a Principal's Fraudulent Certification of SBA Compliance

The Miller Act, 40 U.S.C.A. § 3131, requires contractors on certain federal construction projects to post performance and payment bonds. Sureties, who are not involved in the SBA's certification or compliance process, have long maintained a right to rely upon the government's certification and subsequent award of a set aside construction contract based on the government's determination of an awardee's qualification under the set aside standards. In a pending whistleblower lawsuit, however, the *qui tam* relator (i.e., plaintiff) contends that sureties are subject to FCA liability if they reasonably knew that the bonded contractors did not qualify for the set aside contract award. This constructive knowledge alleged by the relator was supposedly gained during the underwriting process. See *United States ex rel Scollick v. Narula*, 2017 WL 3268857 (D.D.C. July 31, 2017).

The original complaint alleged that the defendant contractors fraudulently asserted HUBZone or Section 8(a) status to bid on and obtain set-aside contracts. The relator also alleged that defendant sureties and/or broker acting as its agent enabled the contractors' allegedly fraudulent bid submissions by issuing Miller Act bonds with knowledge that the contractors were not eligible for the set-aside contracts. The surety defendants moved to dismiss the claims against them, arguing the complaint failed to allege sufficient facts that, even if true, would state a plausible claim for relief. The U.S. District Court for the District of Columbia agreed, finding that the complaint failed to allege sufficient facts to support any of the FCA claims against the sureties.

The relator subsequently amended his complaint asserting the same four causes of action against the surety defendants but provided some additional factual allegations in support of each count. More specifically, the amended complaint alleged that through the underwriting process and an on-site inspection of the contractors' offices the surety defendants knew, or should have known, that some of the subject contractors were shell companies dependent on the resources of other companies; some of the contractors did not have the needed construction experience or financial capabilities to perform the work; and one of the subject contractors claiming service-disabled veteran-owned small business (SDVOSB) status was not operating from the claimed location. The District Court issued a second decision finding that the amended complaint contained sufficient factual allegations to withstand a motion to dismiss, and it allowed the relator's claims against the surety defendants to proceed. While the court's decision did not find that sureties would ultimately be held liable under the FCA, the decision is nonetheless significant for several reasons.

First, the court's reasoning might be utilized to impose liability on sureties and their brokers for a wide variety of FCA violations committed by its principal. The court in *Scollick* found that the relator had sufficiently alleged facts supporting a theory of "reverse false claim" against the surety defendants in violation of the FCA. In reaching this conclusion, the court noted that the Miller Act standard form states that the surety's performance guarantee extends to all the covenants, terms, and conditions of the contract. Accordingly, even though the facts pled in *Scollick* are focused on allegedly false assertions of SBA program status, the decision arguably may be extended in other cases to encompass a Miller Act surety's potential liability for a reverse false claim for a bonded contractor's violation of any covenant, term, or condition of the contract. Under such a theory, any false claim that a contractor submits on a bonded contract may give rise to a reverse false claim assertion against the Miller Act surety, if a relator merely contends that the surety knew or should have known such facts.

Second, the application of the FCA to Miller Act sureties based on allegedly fraudulent contractor representations regarding SBA program status creates significant challenges for bonding companies and bond producers. The rules and regulations governing small business program status eligibility are complex, voluminous, and often subject to revision. To force sureties and bond producers to familiarize and train their workforce on the details of the Federal Acquisition

Regulation and SBA rules is likely to either deter certain sureties from bonding set-aside contracts and/or result in a dramatic increase of cost for Miller Act bonds.

A recent motion for leave to file an *amicus curiae* brief filed by the Surety & Fidelity Association of America (SFAA) asserts that “cataclysmic effects” will result across the surety industry if the District Court issues a ruling imposing a duty on sureties during underwriting of Miller Act bonds to examine, report, and police their principals’ socio-economic eligibility compliance under SBA rules. According to the SFAA, sureties are in the business of issuing bonds guaranteeing completion of construction projects and payment for incorporated labor and materials. The surety defendants argue on summary judgment that they underwrite bonds purely for their own financial benefit and risk evaluation – not for the benefit of third parties.

According to the SFAA, the consequence of the court adopting the relator’s legal theory and ruling against the surety defendants in this case, thereby expanding sureties’ risk exposure, is the imposition of a duty during underwriting to verify the government’s review and ensure the prospective principal’s compliance with set aside requirements. Imposition of this duty will cause sureties to question, and undoubtedly halt, the extension of surety credit to small, disadvantaged, and emerging contractors, not to mention create a slippery slope to the expansion of this duty to require sureties to monitor the principals’ compliance with set aside requirements for contracting during performance of the contract. Absent the availability of surety bonding for this market sector, the SFAA argues that there will be a cascading and catastrophic effect across the federal government procurement system, rendering it nearly impossible for many socio-economically disadvantaged contractors to bid on, receive, or perform any government contracts, despite a preference by the federal government for procurement with those contractors. The *Scollick* case is currently awaiting the District Court’s ruling on multiple cross motions for summary judgment.

2. Recent Changes to SBA’s Mentor-Protégé Programs

Effective late last year, the SBA’s 8(a) Mentor-Protégé Program and the All Small Mentor-Protégé Program (ASMPP) merged into one Mentor-Protégé Program (MPP). See SBA’s Final Rule at 85 Fed. Reg. 66147. The primary purpose of both programs was to encourage small businesses (protégés) to gain capacity and win government contracts through partnerships with more experienced businesses (mentors). A significant benefit of an approved mentor-protégé relationship is that the mentor and protégé can joint venture as a small business for any government prime contract or subcontract, provided that the protégé qualifies as small for the procurement.

While the SBA initially created the 8(a) Mentor- Protégé Program only for qualified 8(a) small businesses in 1998, it expanded the mentor-protégé relationship to all small businesses with the creation of the ASMPP in 2016. Such businesses include women-owned small businesses (WOSB), service-disabled veteran-owned small businesses (SDVOSB), and Historically Under-Utilized Business Zone (HUBZone) small businesses. Like the 8(a) Program, the ASMPP also provides an exception to affiliation for assistance that a protégé firm receives from a mentor and allows the protégé and mentor to joint venture as a small business provided the protégé qualifies as small for the size standard corresponding to the NAICS code assigned to the procurement. The affiliation exceptions under the mentor-protégé programs are significant because SBA's regulations require a small business to count its own annual receipts or employees, plus the annual receipts or employees of each affiliate, when determining its size status. The ASMPP has been enormously popular because it gives all small protégé businesses more capability to compete for larger and more sophisticated work while simultaneously giving large mentor businesses the opportunity to conduct up to 60% of work on a federal set-aside contract when that mentor may not have otherwise qualified to do any of that work. See 13 C.F.R. § 125.8 and § 125.9.

The consolidation of programs also led SBA to change its required pre-approval of joint venture agreements for competitive 8(a) contract awards. Previously, an 8(a) protégé and its mentor were required to get SBA's pre-approval of their joint venture agreement before an award of any 8(a) contract to the joint venture. See 13 C.F.R. § 124.513(e) (before November 16, 2020). Since November 16, 2020, a joint venture agreement must still satisfy the regulations but the mentor and protégé are no longer required to submit the agreement to SBA for approval prior to competitive 8(a) awards. 13 C.F.R. § 124.513(e). Without stating a reason, the Final Rule still requires SBA pre-approval of a joint venture agreement before award of a sole source 8(a) contract. 85 Fed. Reg. 66147.

The SBA's Final Rule has been well received by the government contracting community as a welcome change that provides further clarity for small businesses and removes unnecessary agency red tape. Interestingly, the surety industry has been hesitant to embrace certain of the changes, such as the relaxation of SBA pre-approval of the joint venture agreement. One reason for the wait-and-see attitude of sureties is the potential expansion of a surety's risk under the FCA.

The amendments to the SBA's mentor-protégé programs and related regulations are significant and should be closely reviewed by all government contractors. In addition to the changes noted above, the Final Rule includes several other significant amendments. See 85 Fed. Reg. 66147.

III. Fraud Discovered During the Contract Disputes Act Claims Process

One of the novel aspects of federal procurement law is that a contractor has the unilateral right to choose the forum for most contract disputes. The Contract Disputes Act (CDA) sets forth a comprehensive system for resolving disputes between a contractor and a procuring agency relating to the performance of most construction contracts. The starting point for resolving disputes under this system is the submission of a formal claim seeking a contracting officer's final decision. The claims of both the contractor and the agency must be the subject of a contracting officer's final decision. See 41 U.S.C. § 7103(a). A contractor dissatisfied with an adverse contracting officer's final decision may appeal the decision to the appropriate agency board of contract appeals (BCA) within 90 days of receipt of the decision. 41 U.S.C. § 7105. Alternatively, the contractor may file suit on its claim in the United States Court of Federal Claims (COFC) within 12 months from the date of receipt. 41 U.S.C. § 7104(b).

Under the CDA, the contractor has the sole right to elect whether and where to appeal a final decision. The contractor's choice of forum can have significant consequences. Once a contractor makes an election to appeal a final decision in one forum, the election is binding, and the contractor loses its right to pursue the appeal in another forum. Thus, before making a forum election, contractors should carefully consider the differences between the COFC and the BCAs.

One of the most significant risks in choosing the COFC for a contract dispute is that it could expose the contractor to government counterclaims based on alleged fraud, including, for example, the special plea in fraud statute (also referred to as the "Forfeiture Statute"), the False Claims Act, the Anti-Kickback Act, or the anti-fraud provisions of the CDA.

A. Fraud Counterclaims at the U.S. Court of Federal Claims

Of particular interest to construction contractors and sureties is the eight-year odyssey at the COFC arising from the fallout of a catastrophic cofferdam failure in South Florida. In *Lodge Construction, Inc. v. The United States*, Case No. 13-499, 13-800 (Fed. Cl.), the Plaintiff, Lodge Construction, Inc., in 2013 originally brought several claims seeking contract damages, retroactive modification of the construction contract, and conversion of its termination for default into a termination for convenience. This case also included claims asserted by Lodge's sureties, which were consolidated with Lodge's claims. After several years of litigation involving the contractor's claims and the government's default termination, the DOJ upped the ante in 2017 by filing three statutory fraud counterclaims against the contractor and its sureties. The litigation involving the sureties was subsequently transferred to the District of Massachusetts. For its part, Lodge narrowed its challenge by withdrawing several claims. Lodge's only remaining claims seek a 129-day contract extension and a conversion of the termination of default into a termination for convenience. *Lodge Construction, Inc. v. United States,* No. 13-499, 2021 WL 1418847 (Fed. Cl. Apr. 14, 2021).

The litigious journey began in 2012 when, after water catastrophically breached the cofferdam's sheet pile wall, Lodge submitted two certified claims regarding the sheet pile design and the damages for the actual breach of the cofferdam. Citing Lodge's failure to produce a new cofferdam design or otherwise make progress toward completing the project, Lodge was terminated for default. Subsequently, Lodge's surety tendered a new contractor and paid the Corps $23 million, which was the difference between the amount paid to the new contractor to complete the work and the unpaid balance of the contract with Lodge. Both Lodge and its surety challenged the default termination before the COFC.

In 2017, the government sought and was granted leave to assert several fraud counterclaims against Lodge and its surety. See *Hanover Ins. Co. v. United States*, 134 Fed. Cl. 51 (2017). The government asserted three specific fraud counterclaims against Lodge under three separate statutes: (1) a False Claims Act claim under 31 U.S.C. § 3729 et seq.; (2) a claim under the CDA's anti-fraud provision, 41 U.S.C. § 604; and (3) a Special Plea in Fraud claim under 28 U.S.C. 2514. For jurisdictional reasons, the COFC subsequently transferred the government's FCA claims against the surety to the District of Massachusetts. Now, approaching eight years of litigation, the remaining parties recently presented cross motions for summary judgment.

On April 14, 2021, the COFC found that issues of material fact preclude summary judgment on both the liability and fraud issues. *Lodge Construction, Inc. v. United States*, No. 13-499, 2021 WL 1418847 (Fed. Cl. Apr. 14, 2021). However, in its cross motion, Lodge successfully argued that the government's claim based on the CDA's anti-fraud provision is time-barred. Lodge successfully argued that the CDA's six-year limitations period began running when the claims were submitted to the Contracting Officer in 2012 and elapsed six years later because no court intervened in that time period to "determine" liability as required by 41 U.S.C. § 7103(c)(2). In opposition, the government argued that the COFC should apply the "discovery rule," impose equitable tolling, and that the COFC should read the statute such that a "determination" need only be made by the DOJ to satisfy the requirements of § 7103(c)(2). In a major win for government contractors, the COFC disagreed with the government on all fronts dismissed the government's second counterclaim for lack of subject matter jurisdiction. *Id.*

The COFC indicated that each of the two remaining claims requires the government to show a level of knowledge and intent on the part of Lodge and its agents. The FCA counterclaim requires actual knowledge, deliberate ignorance, or reckless disregard for the truth of a false or fraudulent claim. 31 U.S.C. § 3729. To prevail on this counterclaim, the government must "prove all essential elements of the cause of action, including damages, by a preponderance of the evidence." 31 U.S.C. § 3731. The Special Plea in Fraud counterclaim has even more demanding standards. To prevail under 28 U.S.C § 2514, the government must establish, by clear and convincing evidence, that the contractor submitted claims with knowledge of their falsity and with an intent to defraud the government. *Id.*

B. Fraud Issues Discovered at the Board of Contract Appeals

The CDA provides the agency contracting officer with authority to decide claims submitted by contractors. 41 U.S.C. § 7103(a)(3). However, the CDA "does not authorize an agency head to settle, compromise, pay, or otherwise adjust any claim involving fraud." 41 U.S.C. § 7103(c)(1). As a result, the United States Court of Appeals for the Federal Circuit has held that CDA jurisdiction at the BCA requires "both a valid claim and a contracting officer's final decision on that claim." *M. Maropakis Carpentry, Inc. v. United States*, 609 F.3d 1323, 1327 (Fed. Cir. 2010).

Thus, it is generally understood that an appeal of a contracting officer's final decision denying a claim based on allegations of contractor fraud cannot be brought before the BCA (a contractor in that situation would need to seek relief from the COFC). What happens, however, if the government's allegations of fraud arise after submission of an appeal to a BCA? Interestingly, this situation was just confronted by Armed Services Board of Contract Appeals (ASBCA).

In *Mountain Movers/Ainsworth-Benning, LLC*, ASBCA No. 62164, August 7, 2020, the Board's jurisdiction vested after the contractor timely filed an appeal of the contracting officer's final decision in which the Government had found partial merit to the certified claim. After the appeal, however, the contracting officer issued a new decision that rescinded his final decision purportedly due to fraudulent statements made by the contractor years earlier. The government then moved to dismiss the contractor's ASBCA appeal for lack of subject matter jurisdiction. The government's motion was premised on the novel theory that the government should be entitled to unilaterally remove litigation from the boards of contract appeals, whenever it suspects fraud. The government argued that Congress did not intend for the government to have to defend claims involving fraud in agency boards, where the government cannot avail itself of the various defenses and fraud-based counterclaims that would be available were the same contract claim to have been filed in federal court. The government also argued that keeping jurisdiction over this claim at the ASBCA would provide a "safe forum" for contractors perpetrating fraud to sue the government while avoiding any liability for its related fraudulent behavior.

In a significant win for contractors, the ASBCA soundly rejected the government's arguments and refused to create a governmental right of removal that would force contractors to litigate their appeals before the COFC. In finding that the recission had no effect on jurisdiction, the Board reasoned that once it is vested with jurisdiction over a matter, the contracting officer cannot divest it of jurisdiction by unilateral action.

Notably, the Board found incorrect as a matter of law the argument that because the contracting officer's reasoning for denying the claim was rescinded, neither the agency, nor the Board, had authority to raise or settle other issues where a reasonable suspicion of fraud existed. Citing Federal Circuit and its own precedent, the Board reasoned that it possessed jurisdiction to review a final decision involving fraud if fraud is not the sole basis for denial. Given that the contracting officer's original final decision found partial merit in the claim, and, in fact, did not include fraud at all, the Board concluded it had jurisdiction to entertain the appeal. A finding contrary would allow the government, whenever it expected to lose on appeal, to divest the boards of jurisdiction by withdrawing any final decision on an alleged suspicion of fraud.

IV. Recommended Action Items to Avoid Fraud Investigations

A. Identify and Conduct Appropriate Training

Although all employees should be aware of compliance issues and potential for fraud, there are certain groups within construction companies that are more directly involved with closely scrutinized activities. These groups include upper management, financial officers, contract administrators, legal department, and salesmen. Personnel in these departments are susceptible to creating a defective pricing, mischarging or fraud situation by their actions or inaction. All employees in these target groups should be intimately familiar with the legal and practical requirements for dealing with a government customer.

The Defense Contract Audit Agency has published guides and manuals for its auditors conducting comprehensive labor, material, or pricing audits to recognize potential fraud. These guidelines discuss the most common "indicators" of fraud and advise government auditors how to recognize and pursue the indicators. The guidelines go so far as to emphasize that auditors should "think fraud" when conducting pre- or post- award reviews. Consequently, your internal control program should be structured to minimize the number and occurrence of such indicators in your time distribution system and estimating and contract pricing systems.

B. Early Detection is Critical

Since even the appearance of labor charging discrepancies or a defective pricing problem can result in a costly full-scale investigation, you want to be able to spot any signs of a problem early and correct mistakes before one comes to the attention of the government. One way to identify a potential problem is to study the "indicators" of fraud on which the government auditors will focus. Such a review can be effective in not only identifying mischarging or defective pricing problem areas but may assist in evaluating your own procedures. Thus, you might even consider incorporating many of these indicators into your own internal review process to assist in labor and material charging.

C. Develop and Maintain an Adequate Compliance Program

One cost effective method of educating your employees in dealing with government auditors and establishing or enhancing an appropriate response strategy to a government investigation is a company Compliance Program Seminar. Besides familiarizing employees with the fraud indicators, such a seminar is useful in keeping abreast with the latest changes and amendments to statutes and regulations related to compliance matters. Moreover, depending on your company's needs, a compliance seminar can easily be expanded to include contractual concerns as well. For instance, how to respond to a cure notice or show cause letter in such a manner as to prevent waivers or accommodations of rights or remedies that might better be asserted; how to examine delays or losses on contracts to determine actual causes and whether recoveries may be obtained or settled for more favorable delivery or other terms and conditions; how to prepare monthly project schedule updates to protect your right to recover for owner-caused delays; how to establish counters to claims made by others; and how to recognize pre-award issues which may or do result in the loss of a contract. In today's climate, every company engaged in a contract or subcontract with the government is well advised to initiate and maintain a comprehensive compliance program. The same holds true for contractors, subcontractors and suppliers contracting with state and local government agencies. Assuring that appropriate steps are taken to avoid a fraud investigation and being adequately prepared for an investigation in the event one does befall your company is an essential part of doing business today and in the future.

(The following Section V by William A. Boeck)

V. Insurance and the False Claims Act

Defending against a False Claims Act (FCA) claim can be expensive, both in terms of legal expenses to defend an investigation and/or litigation and the cost to settle the matter. Companies caught in this situation naturally look to their insurers to step in and help resolve such claims. However, the nature of FCA claims often creates problems for triggering insurance coverage.

Because most fraud claims seek economic damages insurance policies that cover bodily injury and property damage will not apply. Insurance coverage for an FCA claim likely will depend upon policies that cover economic losses. Professional liability, directors and officers liability, and employment practices liability policies are typically the ones most likely to respond to an FCA claim.

A. Issues Common to All False Claims Act Claims

An insurance issue central to all False Claims Act claims is whether the claim seeks an insurable loss. Courts across the country hold that the return of money obtained through fraud is restitution or disgorgement that is not legally insurable. Insurance policies covering economic losses specifically exclude such amounts. The rationale for that is that permitting coverage would incentivize companies and their managers to defraud the federal government because insurers would pay the loss if the company gets caught. Arguments can sometimes be made that losses considered to be restitution of ill-gotten gains are insurable. Those arguments are heavily dependent on the facts of the case and the applicable state law. Insurers typically will be unpersuaded by those arguments though. It is therefore extremely rare for FCA settlements and judgments to be paid by insurers.

Professional liability, directors and officers liability, and employment practices liability policies require the insured to provide notice of a claim to the insurer before the end of the policy period in which the claim is made. That is not a significant barrier to coverage for a company that is conscientious about reporting claims to its insurers. It can be a real problem in FCA claims though. FCA claims by individual relators are filed under seal. That prevents the defendant company from being aware of the allegations and possibly of the suit's existence, often for months or even years. This allows the government to decide whether to intervene and take over the FCA lawsuit. When the seal is finally lifted and the company reports the suit to its insurer, the notice is likely to be too late under the terms of the policy. Fortunately, this problem can be solved through changes to a policy's definition of a "claim."

Conduct exclusions are another potential problem for claims under professional liability, directors and officers liability, and employment practices liability policies. Those exclusions apply to claims and loss arising from the insured's criminal, fraudulent, or dishonest acts. Unless such exclusions are limited to circumstances where the conduct is established in a final adjudication of facts, they can be a powerful defense to coverage for insurers presented with an FCA claim.

B. Insurance Issues Under Specific Policies

1. Professional Liability Policies

One of the first policies companies consider when they receive an FCA claim is their professional liability policy. That policy covers errors and omissions in the company's provision of professional services. Insurers challenge whether issuing fraudulent invoices or falsely certifying compliance with federal laws are part of the professional services a company provides. There are many court decisions that discuss whether conduct alleged in an FCA complaint constitutes professional services, and the outcomes vary. Broadly speaking, if a court focuses on just the conduct at issue, e.g., issuing a fraudulent invoice, it is more likely that it will hold that the claim does not involve professional services. If the court can be persuaded to see the conduct alleged in the claim in larger context of the work the insured company is doing, then it probably will find that the conduct alleged is part of the company's professional services.

2. Directors and Officers Liability Policies

Directors and officers (D&O) policies can be a source of coverage for FCA claims. This is particularly true if the defendant company is privately held. Private company D&O policies often cover the company for its own wrongful acts as well as covering the acts of its directors and officers. (This is not true of policies issued to public companies. Those policies only cover the company for its securities exposure.)

A D&O insurer that receives an FCA claim is, ironically considering the discussion above, likely to raise an exclusion for claims arising from the insured company's professional services. While that would seem to suggest that either a D&O or professional liability policy will respond to a claim, in the great majority of cases the policy will only provide a defense because any settlement or judgment would be considered an uninsurable loss. If a company has D&O and professional liability policies issued by different insurers, the insurers may take different views of whether the conduct alleged constitutes professional services. That would, at least temporarily, lead to no insurer defending the claim.

3. Employment Practices Liability Policies

It may seem odd that a policy designed to cover losses resulting from claims by employees for wrongful termination, retaliation, harassment, and other conduct would respond to an FCA claim. Such claims are often brought by whistleblowers who are employees or former employees. Those employees may allege that they were retaliated against for questioning the practices that underlie the FCA claim, or that they have otherwise been treated inappropriately. Those allegations may be made as part of a FCA lawsuit and will therefore trigger the company's employment practices liability (EPL) policy. The EPL insurer will be forced to defend the claim and may also contribute some amount to the settlement of the relator's employment claim.

VI. Conclusion

In 1986, Congress strengthened the FCA by increasing incentives for whistleblowers to file lawsuits alleging false claims on behalf of the government. Whistleblowers filed 672 *qui tam* suits in fiscal year 2020, and this past year the department recovered over $1.6 billion in these and earlier-filed suits. Sureties are now facing false claims regarding both underwriting and claims handling. Although the courts have not yet imposed a duty on sureties in this respect, the industry is closely watching how it may need to respond and adjust to a changing risk landscape.

As for government contractors, there are steps that companies can take to avoid that fateful knock on the door by a fraud investigator. Although all contractor employees should be aware of compliance issues and potential for fraud, there are certain groups within a company that are more directly involved with closely scrutinized activities. Personnel in these departments are susceptible to creating a defective pricing, mischarging or fraud situation by their actions or inaction. One cost effective method of educating your employees in dealing with government auditors and establishing or enhancing an appropriate response strategy to a fraud investigation is a company compliance program seminar. Besides familiarizing employees with the fraud indicators, such a seminar is useful in keeping abreast with the latest changes and amendments to statutes and regulations related to compliance matters.

Finally, while companies cannot rely on their insurers to cover all loss arising from an FCA claim, it is essential for companies facing a claim to notify the relevant insurers as soon as they become aware of the matter. Doing so will ensure that companies receive all the coverage that is available.