SPECIAL ISSUE THE SHIFTING WORLD OF PUBLIC CONTRACTING

Peckar & Abramson newsletter

ATTORNEYS SERVING THE CONSTRUCTION INDUSTRY • Volume XVI, Issue 1, Summer 2006

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False Claims Liability for Construction Contractors

An Overview

It used to be that the greatest risks to profitability faced by construction contractors performing public work related to their skill in executing functions unique to their industry. Success—and profits—on a particular project depended on a sound estimate, the selection of competent subcontractors and the employment of conscientious supervisors who knew how to build a building. Now success, profitability and even survival are threatened by circumstances beyond the normal control of the contractor.

ILLUSTRATIONS: LIAM ROBERTS

Increasingly, one of the greatest risks faced by a public construction contractor is an allegation that the contractor has engaged in fraud or the submission of false claims. These allegations can emanate from low-level government employees involved with the project, *qui tam* relators, inspectors general working for the contracting agency and attorneys within the U.S. Department of Justice.

The mere allegation, often trumpeted in news releases or leaks by government officials, can be enough to scare off clients and require disclosures in responsibility questionnaires that may impair a public contractor's ability to obtain profitable work. Significantly, it does not take much to be accused of fraud. Rules pertaining to government contracting are complex and often were intended to apply to defense contractors building billion dollar weapons' systems as their exclusive business, not construction contractors who occasionally perform government work. Procedures and policies that may be acceptable in the rough-and-tumble world of purely commercial enterprise may not pass muster under these complex rules. Worse yet, government employees, who may never have known the need to turn a profit to survive, may view policies designed to decrease costs, maximize profits and increase the contractor's ability to compete for business as unwarranted attempts to steal from the public trough.

A prime example of this latter phenomenon is represented by a July 2005 decision in the U.S. Court of Federal Claims, the venue where contractors seeking payment from the government on federal construction projects are required to bring claims, subject to the government's right to counterclaim and seek offsets. The case, *Morse Diesel, Inc. d/b/a Amec Construction Management, Inc. v. United States of America*, involved an arrangement between the contractor and its insurance broker whereby the broker rebated part of the commission it received for selling performance and payment bonds to the contractor. The bond-

ing company paid the broker its normal commission, and the broker paid a rebate to the contractor's parent company. Those involved in the construction industry as well as numerous other businesses will recognize this arrangement as resembling many of the discount and rebate arrangements common in the commercial world, including such things as bulk and prompt payment discounts that many suppliers commonly offer. These types of arrangements allow contractors to lower their overall costs and compete more effectively for work. Presumably this arrangement served to lower the contractor's costs and allowed it to offer a lower price to the government on the competitively bid lump-sum projects that were the subject of the government's complaint.

However, to U.S. Department of Justice lawyers, this beneficial discount arrangement looked like something sinister and inappropriate: a kickback in violation of the Anti-Kickback Act. By definition, a kickback is a payment made by a subcontractor or supplier to a contractor or its employees to exert or reward "improper" influence on a procurement decision. The classic example is the payoff to a purchasing agent to influence the decision to hire the less than optimal subcontractor. The legislative history of, and early cases under, the Anti-Kickback Act suggest that Congress was aiming to outlaw just such "commercial bribery," but had no intention of discouraging normal discount and rebate arrangements.

All but ignoring the distinction between legal discount arrangements and commercial bribery, the court ruled that the discount arrangement between the contractor and its broker *was* an illegal kickback. The court struggled to find a way that the arrangement constituted improper influence. Clearly, the arrangement influenced the contractor to maintain its relationship with its broker. However, is it "improper" to be influenced to hire someone by what is in essence a lower price? Many would observe that that is the nature of capitalism and, indeed, the very foundation of the competitive bidding system that the government utilized.

It is becoming routine for contractors seeking to enforce their rights under government contracts to be met with counterclaims based on the False Claims Act.

A BAD DECISION

The court never directly discussed the distinction between proper and improper influences. Instead, it made the rather obvious conclusion that the contractor was, in fact, influenced, and observed that:

> The ultimate customer for the bond services was the Government, which had no knowledge of the kickback scheme and received no financial benefit from [the broker's] financial largess. In fact, but for [Morse Diesel's] contracts with the Government, [the brokers and Morse Diesel's parent] would have earned no brokerage fees on that work, and any financial accommodations made to obtain that work should have been accomplished by submitting the lowest possible price for [Morse Diesel's] services. Instead, a higher price for bond services was included in the fixed contract price that [Morse Diesel] was awarded.

The ruling is almost bizarre. It suggests that whether or not the discount was "improper," and therefore a kickback, depended upon how the contactor accounted for the discount. If the discount was recorded as a reduction of its bond costs, it would be okay. If not so recorded, it would be a crime. Such reasoning leads to the anomaly that the guilt or innocence of a briber would depend upon the accounting practices of the one supposedly bribed. Indeed, the reasoning could be applied to turn any discount, not properly accounted

for, into a kick-back and to render an actual bribe (such as the surreptitious payment to the purchasing agent) innocent by giving a discount to the ultimate purchaser. The reasoning is all the more bizarre since it was applied in the context of a lump-sum competitive bid contract under which the price paid by the government was governed, not by the contractor's costs, but by the price determined by the competition. How much it paid for its bonds was irrelevant to the price.

AN EMBOLDENED JUSTICE DEPARTMENT

Because the overall lawsuit between the contractor and the government may go on for many more years, an appellate court reversal of what appears to be an unsound trial court decision may be a long time in coming. And if the case is settled, the reported decision may never be reviewed. In the meantime, Department of Justice lawyers have a decision to point to in asserting that one or another normal discount arrangement is an improper kickback. The consequences of such allegations can be colossal. For Morse Diesel, the arrangement affected some $290 million in government contracts, and the Justice Department is seeking to have it forfeit its right to receive up to $75 million in claims. Indeed, the DOJ has begun to argue in many claims for payment initiated by construction contractors against the government that the government can avoid its contractual payment obligations if it can prove fraudulent activity by a contractor. In fact, it is becoming routine for contractors seeking to enforce their rights under government contracts to be met with counterclaims based upon the False Claims Act and related statutes. While the counterclaims are often of dubious validity and seek to misconstrue minor, innocent failures by a contractor to comply with the letter of a contract into deliberate fraud, they have significant potential to force a contractor to relinquish its contract rights for less than full value.

This phenomenon is spreading to the states. Partly as a result of encouragement from Congress, many states and some municipalities have adopted statutes known as "Little False Claims Acts" that subject a public contractor to severe potential liability. At last count, at least 16 states as well as the cities of New York and Chicago had enacted such provisions. California entities have been especially aggressive in using such provisions as a threat to discourage claims and leverage to obtain favorable settlements.

THE BEST DEFENSE IS A GOOD OFFENSE

What is a contractor to do? It could resolve never to perform any work involving any governmental entity. Given the sheer volume of government contracts and the fact that many otherwise private contracts can involve government financing, such a resolution may be difficult and costly to keep. Instead, a prudent contractor who does any government work needs to examine its practices and its personnel, develop appropriate procedures as well as ethics and compliance programs, and educate itself and its employees as to the special requirements of government contracting. Such steps will help avoid improper actions and serve to demonstrate the contractor's dedication to proper and ethical contracting, should a mistake be made, negating any assertion that the contractor was intentionally trying to take advantage of the government.

The articles that follow will explore in more detail the False Claims Act and how, unwittingly, contractors can be subject to its drastic penalties, the implementation of compliance programs, the most effective tool for not only avoiding liability but for making one's business sound and profitable, and the controversial phenomenon of the *qui tam* or "whistle-blower," lawsuits. ■

CONTRACTOR CANNOT PASS THROUGH COSTS NOT ACTUALLY INCURRED

Riley Construction v. U.S. (2005)

The U. S. Court of Federal Claims has held that a contractor may be liable under the FCA for including in its claim additional design costs where the contractor's design consultant had not submitted to the contractor a claim for those costs. The project at issue was design/build, and the agreement between the contractor and design consultant established a fixed fee for the consultant that was roughly 6 percent of the prime contract price. At the conclusion of the project, the contractor submitted a claim based on an increase in the scope of work, and included in its claim an amount for additional design costs. The amount included was 6 percent of the total claim. During discovery, the government learned that the design consultant had not submitted a claim to the contractor for these costs, and brought a counterclaim under the FCA against the contractor.

The contractor argued that it did not knowingly submit a false claim because its agreement with the design consultant entitled the consultant to 6 percent of the prime contract price and that it intended to pay any recovery to the design consultant. The court made two important rulings:

- First, that "Filing a request for equitable adjustment implies that the contractor has incurred all costs submitted unless the claim clearly states otherwise."
- Second, that the contractor had an obligation to make a limited inquiry into the accuracy of the additional design costs included in its claim. Specifically, the contractor had the obligation to inquire whether the consultant incurred additional costs and intended to demand those additional costs from the contractor.

In the absence of this inquiry, the court allowed the case to move forward to trial in order to determine if the contractor acted in reckless disregard of the facts.

article

The Civil False Claims Act—A Hidden Risk Assumed by Contractors

I. INTRODUCTION: Contracting for construction services with

the federal government has always entailed a certain level of risk. For example, contractors assume the risk of a fluctuating labor market, non-performing subcontractors and the monetary impact of excusable but non-compensable delays such as unusually severe weather. Although the extent of these risks can never be accurately forecast, successful contractors have devised numerous means to effectively manage these risks. However, one risk that is often overlooked by contractors is the False Claims Act (FCA).

Unfortunately, violations of the FCA can lead to severe consequences for the offending contractor. Contractors overlook this risk because they fail to appreciate the very broad reach of the FCA and the situations that routinely arise over the course of a construction project where violations can occur. The effective management of the risk presented by the FCA requires contractor management and its key personnel to understand both how the FCA works and the types of conduct that may subject the contractor to FCA liability. This brief primer on the FCA focuses on the construction industry and includes a discussion of FCA basics, the elements of an FCA violation, and a description of the acts and/or omissions of construction contractors that have been found to violate the FCA.

II. FCA BASICS

The FCA identifies seven acts that violate it. The four circumstances most relevant to the construction industry include: knowingly submitting a false or fraudulent claim for payment to the federal government; making a false statement in order to have a claim paid; conspiring to defraud in order to have a claim paid; and making a false record or statement to conceal an obligation to pay money to the federal government. The most common violation of the FCA is the knowing submission of a false or fraudulent claim, the four essential elements of which are: (1) submission of a claim for payment to an agent of the federal government; (2) the claim was false or fraudulent; (3) the contractor knew that the claim was false or fraudulent; and (4) the falsity was material to the government's decision to pay the claim. These elements will be discussed in more detail in the following section. Probably the most underappreciated violation is the making of a false record or statement to conceal an obligation to pay money to the federal government. Examples in the construction industry would include covering up a deficient item of work that would entitle the government to a credit, or falsifying records to mask unexcusable delays that would entitle the government to liquidated damages.

A single FCA violation—even where the government suffered no actual damages—could be the death knell of the company.

Contractors that violate the FCA can be severely punished. First, any actual damages suffered by the government will be trebled. Significantly, however, actual damages are not necessary to establish an FCA violation. Accordingly, a contractor can be found liable for violating the FCA even if the false claim was never paid by the government — the violation is in the submission, not the payment, of the false claim. Second, each violation carries a penalty of up to $11,000. Third, and perhaps most importantly, an FCA violation is grounds for suspension or debarment from doing business with the federal government. Finally, violation of the FCA also may serve as a basis for state governments to exclude the contractor from state contracting opportunities. Thus, for contractors that regularly undertake public construction projects, a single FCA violation—even where the government suffered no actual damages—could be the death knell of the company.

FCA claims are brought in one of two ways. First, the federal government, through the Justice Department, can file a civil action against a contractor in a federal court. The government may also pursue an FCA claim against the contractor in the court of federal claims by way of a counterclaim in an action originally initiated by the contractor. In these cases, which are quite a rude awakening for the contractor, the government learns of the alleged violation while conducting discovery relating to the contractor's Contract Disputes Act claim. It is important to note that the FCA counterclaim is not required to relate to the contractor's claim; rather, the FCA counterclaim need only relate to the underlying project.

Second, the FCA includes "whistleblower" provisions that permit private parties with knowledge of an alleged FCA violation to file a complaint against a contractor on behalf of the

federal government. The whistle-blower is formally referred to as a *qui tam* relator, and the FCA provides powerful incentives for relators to come forward with information about potential FCA violations. Specifically, the FCA provides a bounty in the form of an entitlement to a significant percentage of any recovery from the contractor, including the treble damages. Not surprisingly, many qui tam claims originate with a disgruntled current or former employee. Qui tam complaints are filed under seal and must be served on the Justice Department before they are served on the contractor, thereby giving the Justice Department the opportunity to join in and take over the prosecution of the claim. At this point, the Justice Department will investigate the relator's allegations in order to determine whether or not to join the litigation. The Justice Department frequently will notify the contractor that it is under investigation, and the contractor may have an opportunity to respond to the allegations. The contractor's goal at this stage is to quietly settle any meritorious claims or, at the very least, to convince the Justice Department not to join the qui tam litigation.

III. ESSENTIAL ELEMENTS OF AN FCA VIOLATION

A. The Submission of a Claim

This element has two distinct components: a claim and a submission, or "presentment," of the claim. The FCA defines "claim" very broadly: "[A]ny request or demand, whether under a contract or otherwise, for money or property which is made to a contractor, grantee, or other recipient if the United States Government provides any portion of the money or property which is requested or demanded, or if the Government will reimburse the contractor, grantee, or other recipient for any portion of the money or property which is requested or demanded." This definition has been interpreted to capture any call upon the government fisc.

A false claim that never leaves the contractor's office is not actionable. To be liable under the FCA, the contractor must physically submit the claim. However, liability attaches not only where the claim is submitted directly to the federal government, but also where the claim is submitted to an intermediary that will be using federal government funds to pay or reimburse the claim and the claim is forwarded by the intermediary to the government. Consequently, subcontractors can be liable for violating the FCA if they submit false claims to the general contractor, which then forwards the claims to the government. Similarly, a contractor can violate the FCA for submitting a false claim to a state government agency on a construction project where the federal government provided some of the funding for the project, and the state agency forwards the claim to the federal government. Significantly, the contractor need not know that the federal government was to be the source of the funding. In a recent case, a federal district court found that a contractor could be liable for submitting false claims to the Coalition Provisional Authority in Iraq where the CPA—ostensibly a coalition of "willing" allied governments — used U.S. funds to pay the claim.

In sum, a contractor may face FCA liability for any false or fraudulent request or demand for payment on any construction project that utilizes federal funding, even if the contractor did not directly submit its claim to the federal government.

B. What Is a "False" Claim?

The FCA does not provide a definition of "false." Although, in many cases, the falsity of a claim will be unquestionable, in other cases, this element is intensely disputed. It is widely recognized that a claim must be a "lie" in order to be considered false. In the contract setting, the question of falsity frequently turns on the interpretation of the contract's requirements, to include the terms, conditions, specifications and any statutes or regulations that may apply to the contract. The courts have consistently held that the FCA was not intended to create liability for simple errors in judgment, the misreading of specifications or the misinterpretation of contract requirements.

Every contractor working on a government project has had occasion to disagree with the contracting officer regarding the requirements of the contract. More often than not, this disagreement is based on competing interpretations of the contract's terms,

There are, however, those atypical cases where the falsity of a contractor's claim hinges on the contractor's interpretation of the contract requirements.

conditions or specifications, and more often than not, either the parties amicably resolve the dispute or a judge is called upon to determine which party's interpretation is correct. In the typical case, no one would argue that the contractor's interpretation constituted a lie. There are, however, those atypical cases where the falsity of a contractor's claim hinges on the contractor's interpretation of the contract requirements. More specifically, falsity will be judged based upon the reasonableness of the contractor's interpretation. Although a bright-line rule has not been established, the consensus view of the courts is that a contractor's interpretation that is objectively unreasonable can be considered a lie and, consequently, can serve as the basis of an FCA claim. Contractors are not held to an absolute correctness standard; however, a contractor's interpretation of the requirements of its contract must at least be plausible. For this reason, frivolous claims should never be submitted, even as a negotiation strategy!

C. When Is a False Claim Knowingly Submitted?

The FCA defines "knowing" and "knowingly" as follows:

> For purposes of this section, the terms "knowing" and "knowingly" mean that a person, with respect to information —
> (1) has actual knowledge of the information;
> (2) acts in deliberate ignorance of the truth or falsity of the information; or
> (3) acts in reckless disregard of the truth or falsity of the information, and no proof of specific intent to defraud is required.

Significantly, the "knowing" stan-

dard is met even without proof of a specific intent to defraud the government. On the other hand, the courts have routinely held that gross negligence regarding the truth or falsity of the information is not sufficient to meet the "knowing" standard. Because the FCA penalizes the reckless disregard and the deliberate ignorance of the truth or falsity of information, the FCA places a limited duty to inquire on those submitting claims to the government. Specifically, a contractor is required to make an inquiry regarding the truth or falsity of a claim that is reasonable under the circumstances. Obviously, this is a flexible standard that will be governed by the unique facts of each situation.

The knowledge element often works hand-in-hand with the falsity element in FCA claims relating to the correct interpretation of a contract's requirements. As indicated above, the falsity element is an objective standard, i.e., whether the contractor's interpretation was plausible. The issue is slightly different from the perspective of the knowledge element. Courts will examine whether the contractor's reliance on its contract interpretation was in good faith, because a contractor cannot possess the requisite mental state to satisfy the FCA where its interpretation was developed and relied upon in good faith. Clearly, in contrast to the objective standard utilized to judge the falsity element, consideration of the knowledge element is a far more subjective exercise.

Contractors have a potent defense available to them relating to the knowledge element. Commonly referred to as the "government knowledge defense," contractors have escaped FCA liability where they have proven that responsible government officials had complete knowledge of the facts that allegedly render a claim false. Courts have held that this government knowledge negates the FCA's *scienter* requirement. A component of the proof of the government knowledge defense will frequently be that the government contemporaneously approved of the conduct now alleged to violate the FCA. The mechanics of this defense can be illustrated through a simple example: Where an FCA violation is alleged based on the contractor's noncompliance with the requirements of its contract, the knowledge element may not be met where the contractor proves that the government shared the contractor's interpretation during the course of the project. Not surprisingly, the government knowledge defense is most often employed in qui tam litigation, where the relator disagrees with the contractor's conduct and either is not aware of or simply disregards the government's knowledge of the contractor's conduct. In these cases, the qui tam relator may feel that the government is a conspirator in the alleged fraud.

D. How Does Materiality Factor into the Puzzle?

The materiality element is not found in the FCA itself. Instead, courts have imposed this element on the government and qui tam relators. In a nutshell, the false information submitted by the contractor must have had the natural tendency to influence the government's decision making with respect to the payment of a claim. Accordingly, the government must prove that it relied on the false information or would have relied on the false information in making its decision to pay the claim. False information that is not relied upon by the government or that would not have been relied upon by the government in making its decision to pay a claim is deemed not to be material and therefore cannot serve as the basis of an FCA claim.

FEDERAL FUNDING OF NONFEDERAL PROJECTS CAN INVOKE FCA LIABILITY

United States v. Sequel Contractors, Inc. (2005)

The False Claims Act (FCA) imposes liability on anyone who "knowingly presents, or causes to be presented, to an officer or employee of the United States Government . . . a false or fraudulent claim for payment or approval." But can there be a FCA violation on a state or local contract that is partially federally funded? The recent California federal court case of *United States v. Sequel Contractors, Inc.* makes it clear the answer is: "Yes, sometimes."

In *Sequel Contractors*, the qui tam relator alleged that a contractor fraudulently overbilled Orange County, California, on an airport construction project partially funded by the Federal Aviation Administration (FAA). The County paid the contactor's invoices and then requested and received reimbursement from the FAA for 80 percent of the project's costs.

The contractor moved to dismiss the FCA claims, arguing that the contractor did not present the false claim to the government. The court denied the motion, ruling that the language of the FCA encompassed situations where a contractor caused the presentation of a false claim for payment to the federal government.

A different outcome under slightly different facts was reached in the earlier case of *Totten v. Bombardier Corp.*, a federal court case out of Washington, D.C. In *Totten*, the contractor submitted allegedly false claims to Amtrak. Amtrak, which is not a federal agency, paid the claims with federal grant money that Amtrak already had on hand. The D.C. Circuit Court found no possible FCA violation because, although federal government funds were used to pay the contractor, no one ever "presented" the claim to the federal government for payment.

The subtle distinction between these two cases highlights the potentially tricky application of the FCA to nonfederal contracts.

IV. FCA VIOLATIONS IN THE REAL WORLD OF CONSTRUCTION CONTRACTING

FCA violations can occur during every stage of a construction project, from bid preparation and submission to project closeout. By no means a comprehensive listing of all potential FCA violations that could occur on a construction project, the following examples are based on actual violations — and vividly illustrate the long arm of the FCA.

Bid and Proposal Preparation

False information or misrepresentations included within the contractor's bid or proposal can serve as the basis of an FCA claim. Once awarded the contract, each pay application submitted by the contractor may be deemed a false claim. Significantly, the pay applications may otherwise have been perfectly truthful

and accurately reflect the sums due for work performed. Nevertheless, the pay application is false because the underlying contract was procured through misrepresentation and/or fraud.

Considering the many certifications and representations that are required, a contractor must exercise extreme caution in preparing its bid or proposal to ensure the accuracy and truthfulness of the information submitted to the government.

Statutory and Regulatory Compliance

Contractors routinely are required to certify their compliance with various statutory and regulatory schemes. For example, contractors are required to certify that they are paying the prevailing wages under the Davis-Bacon Act. Likewise, contractors are required to certify that they have not violated the Anti-Kickback Act, that the materials that they are supplying are in accordance with the Buy American Act, and that they are in compliance with the contract's DBE requirements. A contractor that submits a materially false certification may subject itself to FCA liability. In this context, the actionable claim arises from the contractor's monthly pay application. The application is deemed false because the contractor would not be entitled to payment after truthful certification regarding previous certifications concerning violations of the Anti-Kickback Act.

Certifications Embedded in Monthly Pay Applications

The contractor's monthly pay application contains a host of representations and certifications. For example, FAR Clause 52.232-5(c), "Payments under Fixed-Price Construction Contracts," requires three extremely important certifications:

> (1) The amounts requested are only for performance in accordance with the specifications, terms and conditions of the contract;
>
> (2) All payments due to subcontractors and suppliers from previous payments received under the contract have been made, and timely payments will be made from the proceeds of the payment covered by this certification, in accordance with subcontract agreements and the requirements of Chapter 39 of Title 31, United States Code [the Prompt Payment Act]; and
>
> (3) This request for progress payment does not include any amounts that the prime contractor intends to withhold or retain from a subcontractor or supplier in accordance with the terms and conditions of the subcontract.

The certification in the first quoted paragraph addresses the work performed for which payment is requested. The certification may be considered false under the following circumstances:

- The quantity of work performed is overstated; or
- The quality of the work does not comply with the requirements of the contract. This could include deficient work, material or equipment that is not as described in the specifications, or inspections or tests that were required but that were not performed or were not adequately performed. Misrepresentations with respect to the quality of the work performed are often referred to as "product substitution."

A contractor that is unaware of the long arm of the FCA is blinding itself to substantial risks inherent in doing business with the government.

The certifications in the second two quoted paragraphs address how the contractor has handled the payments previously received from the government on behalf of subcontractors, and how the contractor intends to handle payments currently requested. As its name suggests, the Prompt Payment Act (PPA) requires contractors to promptly pay its subcontractors from monies received from the government on those subcontractors' behalf. Failure to pay subcontractors in accordance with the PPA — or worse, failure to pay at all — can lead to allegations of FCA noncompliance because the government will only pay the contractor if it certifies on a monthly basis that it has paid its subcontractors and is complying with the PPA. These certifications also address present intentions to withhold monies from subcontractors.

More specifically, if at the time that the contractor executes the certification, it has the intention to retain or withhold the requested monies from its subcontractor, this, too, could be deemed a false certification.

Contract Disputes Act Claims and Requests for Equitable Adjustment

Pursuant to the Contract Disputes Act (CDA), in order to obtain a contracting officer's final decision on claims in excess of $100,000, the contractor is required to submit a certification that states in part: "I certify that the claim is made in good faith; that the supporting data are accurate and complete to the best of my knowledge and belief; that the amount requested accurately reflects the contract adjustment for which the Contractor believes the Government is liable…." Several agencies, to including the Department of Defense and the General Services Administration, require similar certifications for Requests for Equitable Adjustment in excess of $100,000 as well.

These certifications may be considered false if any aspect of the claim or REA is inaccurate or untrue. It is extremely important that the price adjustment requested be supported by solid and credible data — inflated claims are a frequent target of FCA allegations. In 2005, a construction contractor paid nearly $25 million in damages and penalties for submitting inflated claims. Also, as discussed above, claims and REAs based on implausible contract interpretations may also render a CDA/REA certification false.

V. CONCLUSION

The FCA is a powerful tool in the government's anti-fraud arsenal. Further, it appears that the FCA is being utilized more regularly in the construction industry to regulate contractor conduct. A contractor that is unaware of the long arm of the FCA is blinding itself to substantial risks inherent in doing business with the government. To successfully manage these risks, a contractor must educate its management and key personnel regarding the mechanics of the FCA, and then implement a compliance program that is aimed at preventing violations before they occur. ■

Contracting with Federal Funds? You Need a Compliance Program

I. INTRODUCTION: Newspapers chronicle daily the travails

of corporations that have been criminally prosecuted or subjected to stiff civil penalties for "fraud, waste and abuse." Government oversight, investigations and prosecutions have been steadily increasing in the last 20 years following the "Ill Wind" prosecutions of the 1980s. In 1987, the federal government collected only about $87 million from contractors who submitted false or fraudulent claims. Now the total collections from contractors are well over $1 billion annually.

The Enron debacle fueled the government's enforcement trend by teaching corporate America that:

- Corporate officers will be held personally responsible for profiting at the expense of investors;
- Directors will be held personally accountable for failure to detect or deter misconduct; and
- Compliance programs are essential to corporate health.

As President Bush warned dishonest corporate leaders shortly after the anouncement of the WorldCom bankruptcy: "You will be exposed, and you will be punished. No boardroom in America is above or beyond the law." Whereas the government's focus used to be primarily defense contractors and the $500 toilet seat procurements, that focus is now increasingly on other business sectors, including construction contractors and supply and service contractors that sell to the government through "schedule" contracts with the General Services Administration.

This increased scrutiny is evidenced by the questions that have been raised about the billing practices of Halliburton and reports of profiteering in Iraq. The Defense Contract Audit Agency (DCAA), the federal agency that audits the contracts of most agencies, questioned $813 million in costs on a Halliburton contract to provide logistical support to troops in Iraq, and $219 million on a sole source contract to restore Iraq's oil fields, plus $442 million in "unsupported" costs. Among the costs questioned were $560,000 in heavy equipment costs that the DCAA considered unnecessary.

Even routine audits have become a vehicle to the government to uncover potential fraud. A recent initiative by the Department of Justice's fraud task force calls for investigators of the Inspector General's offices to be "embedded" in the contract administration offices of federal agencies. This program has already been implemented by the Navy, and other agencies are expected to follow. Agencies have clearly begun to audit more aggressively. The General Services Administration, for example, has initiated a program to conduct more post-award audits aimed at uncovering defective pricing in response to Congressional criticism.

Further, it is important to remember that even a contract with state and local agencies may be subject to federal audit and enforcement actions if the contract is federally funded. For example, the Inspector General of the U.S. Department of Transportation (USDOT) has pursued and settled a number of False Claims Act actions against highway contractors and engineers under federally funded contracts with state agencies. A contractor on a DOT contract paid the government $1.3 million for "misrepresenting in monthly progress reports its progress in implementing the [disadvantaged business enterprises] bond program." (DOT OIG press release, February 6, 2001).

Federal as well as state and local government contracting can be a dangerous minefield for the uninformed. Seemingly innocent mistakes in progress payment requests or written certifications can subject a contractor to criminal penalties of five years or more, plus penalties of $5,000 to $11,000 for each false claim, plus treble damages, plus the forfeiture of even unrelated claims under a contract where fraud has been committed, plus suspension or debarment from contracting. In other words, the stakes are high.

Fortunately, the potential for compliance problems can be minimized by implementing a comprehensive compliance program that has been established before a problem develops. When the Department of Justice investigates a government contractor, its first question is usually, "Do you have a compliance program," followed by the question, "Do you consistently follow it?" Savvy contractors should be in a position to answer both questions affirmatively.

II. FEDERAL LAWS THAT PUNISH FRAUD, WASTE AND ABUSE

Numerous statutes impose civil and criminal penalties upon federal government contractors for fraud, waste, and abuse. Among them are:

- False Claims Act (an average of about 400 *qui tam* false claims cases are filed every year)
- False Statements Act (criminal penalties of up to five years imprisonment)
- Forfeiture Statute (forfeiture of claims where fraud has been committed under a federal contract)
- Anti-Kickback Act
- Truth in Negotiations Act
- Bribery and Gratuities statutes
- Mail and Wire Fraud statutes
- The Public Integrity Act and recent legislative initiatives to strengthen criminal penalties for violations of conflict-of-interest laws
- A government contractor also may

be suspended or debarred from receiving government contracts or subcontracts for fraudulent conduct.

The government's investigative and prosecutorial tools include the right to audit the contractor's books and records (for up to three years after completion of a contract). The Inspector General of each federal agency also has the authority to issue a subpoena for documents. When an agency investigation leads to the suspicion that fraud has been committed, the fraud section of the Department of Justice, as well as the local U.S. Attorney's office, often become involved. When that happens, the Federal Bureau of Investigation, in concert with the agency Inspector General, usually gather's the facts for the investigation.

Examples of potential violations by contractors include progress payment requests that contain labor mischarges, product substitutions, false certifications, defective pricing of contracts or modifications and false schedule updates. The USDOT has provided "guidance" to federal and state transportation officials for detecting fraud. USDOT advises that "consistent cost overruns" because of "bidding by contractor in order to receive the contract" may indicate mischarging. USDOT also warns officials to be on the lookout for collusive bidding (for example, an unsuccessful bidder subcontracting with the successful bidder), conflicts of interest and product substitution (for example, the substitution of foreign-made materials).

Another red flag is "Questionable Documentation from Contractors," which includes "Any documents or certifications with altered, backdated, modified, or missing information concerning the contractor's bond and prequalifications, minority- or women-owned business status, financial history, previous debarment or suspension, ownership of equipment and facilities, performance on other jobs, etc., for the purpose of obtaining the contract." (FHWA Briefing, "Fraud Prevention — Suspension/Debarment," (February 26, 2002).

The Inspector General of the Department of Defense (DoD) has similarly issued to its auditors and investigators a guide entitled "Indicators of Fraud in Department of Defense Procurement," which identifies factors suggesting "the presence of, or enhanced potential for, fraud at various stages in the procurement process" from defective pricing in proposals through "progress payment fraud," "fast pay fraud," bribery and kickbacks.

Every company that has a contract with the DoD is required to have a compliance program in place.

III. ELEMENTS OF A SUCCESSFUL COMPLIANCE PROGRAM

Every company that has a contract with the DoD is required to have a compliance program in place. The sophistication of the program depends upon the size of the company and "the extent of their involvement in Government contracting." (DFARS 203.7000(1)).

The elements of the compliance program required by DoD are virtually the same as those recommended by the U.S. Sentencing Commission. Companies must "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law." (U.S.S.C. Guidelines Manual, § 8B2.1). "Due diligence" includes delegation to an individual or individuals the day-to-day operational responsibilities for the ethics program. "To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority."

Compliance programs should consist of the following:

- A written code of business ethics and conduct
- A regular "[i]nternal and/or external" audit program of company policies, procedures and internal compliance controls
- A hotline or similar mechanism for anonymously reporting suspected ethics and compliance violations
- A compliance and ethics education program for employees
- Disciplinary action for ethics and compliance violations
- Full cooperation with all government investigations (and audits)

Counsel can advise a contractor of the

legal risks that a contractor's compliance program must address, based upon the business sector in which the contractor operates and the federal agencies with which it has contracts. Compliance programs are not "one size fits all." A construction contractor with DoD contracts faces somewhat different risks than a GSA schedule contractor. The compliance program must be structured to address the specific risks that a particular contractor faces. This is accomplished by matching the necessary internal controls with the specific risks, given the size of the contractor and the level of federal government work it does.

Compliance programs are not "one size fits all." A construction contractor with DoD contracts faces somewhat different risks than a GSA schedule contractor.

The importance of actually implementing a compliance program is underscored by a Department of Justice policy statement: "A corporate compliance program, even one specifically prohibiting the very conduct in question, does not absolve the corporation from criminal liability under the doctrine of *respondeat superior* . . .. While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives." (USDOJ, "Principles of Federal Prosecution of Business Organizations," January 20, 2003).

IV. BENEFITS FROM COMPLIANCE PROGRAM

The benefits that a contractor derives from a compliance program are obvious. Potential problems are avoided and, if a problem does surface, the contractor's potential liability may be reduced by having a compliance program in place. Another less obvious benefit is that, in the wake of the reforms required by the Sarbanes-Oxley Act of 2002 (popularly referred to as SOX), even privately held companies now recognize the business benefits from having a compliance program.

The impetus for SOX was the well-publicized corporate accounting and governance scandals. The malfeasance of senior executives at the 20 most notorious companies (Enron, WorldCom, Adelphia, Arthur Andersen and so on.) cost shareholders more than $350 billion in equity. As a result, SOX requires, among other things, that the Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) of publicly traded companies must certify each company's financial statements "fairly" present their company's financial condition and results. They must also certify that the company has an operational system of internal controls over financial reporting. In addition, outside auditors must attest to and report on management's evaluation of the strength of the company's internal controls. Whether the company has a corporate ethics program for its senior executives must be publicly disclosed.

Privately held companies are not subject to the disclosure and governance requirements of SOX. Nevertheless, a 2005 survey showed that 80 percent of for-profit private organizations believe that SOX or other corporate governance reform requirements have impacted them. In 2005, 78 percent of private organizations had adopted self-imposed corporate governance requirements, compared with 60 percent in 2004. Audited financial statements are now almost universal, as well as a corporate ethics code. (National Directors Institute, "The Impact of Sarbanes-Oxley on Private and Nonprofit Companies," March 10, 2005).

Why are SOX reforms being adopted by a growing number of private companies? The reasons are purely business related:

- Best practices increase confidence in the valuation of a company by potential buyers.
- Capital investment is attracted at a lower cost.
- As preparation for Initial Public Offerings (IPOs), compliance with SOX is required as soon as a company files a registration statement under the Securities Act of 1933.
- Protection of officers and directors from lawsuits for mismanagement or fraud
- Compliance may be required by insurance (D&O) underwriters.
- Compliance creates credibility with customers and business partners.
- Value-added internal controls increase profitability and preserve wealth in closely held companies.

The fiduciary duties of officers and directors to shareholders are the same for public and private companies. Can they have breached their fiduciary duties if they complied with SOX? Stated differently, will a privately held company's failure to have an independent audit committee, or a code of ethics or some other SOX requirement, lead to claims of mismanagement?

In answering this question, privately held companies should consider the implications of the Second Circuit Court of Appeals' recent decision in *Pereira v. Cogan*, (2005). Although the court reversed a bankruptcy court's ruling that the controlling shareholder and directors of a privately held company were liable to a bankruptcy trustee for self-dealing in receiving excess compensation, the Second Circuit did say: "Given the lack of public accountability present in a closely held private corporation, it is arguable that such officers and directors owe a greater duty to the corporation and its shareholders to keep a sharp eye on the controlling shareholder. At the very least, they must uphold the same standard of care as required of officers and directors of public companies that are not so dominated by a founder/controlling shareholder." The bankrupt company "did not have an audit committee. While Trace [the company] was not alone among privately held companies in Delaware in its choice not have an audit committee, there is no evidence that the Trace Board took over the 'watchdog' role that the audit committee would normally hold as it should have done in the absence of such committee." Thus, SOX standards may be applied to privately held companies.

The bottom line is that, in addition to establishing a compliance program for prophylactic reasons, privately held government contractors should consider adopting SOX reforms because they make good business sense. ■

A Primer on *Qui Tam* Lawsuits
A Hidden Risk Assumed by Contractors

Whether you refer to them as "whistle-blower suits" or choose to characterize them as "shakedowns" (as Supreme Court Justice Antonin Scalia did in 2003), *qui tam* actions under the False Claims Act (FCA) are controversial. They also are becoming increasingly prevalent. Since 1998, an average of 386 new qui tam FCA cases have been filed each year, outnumbering non–qui tam FCA cases by close to four to one.

Qui tam is Latin for "who as well," in the sense that a qui tam plaintiff sues for himself as well as for the government. Under the FCA, private persons are permitted to bring qui tam civil actions against a government contractor in the name of the U.S. government for false claims. Qui tam plaintiffs are known as relators, because they relate (tell) the allegations of false claims to the government. The relator often is an employee of the company being sued and stands to recover up to 30 percent of any recovery on the FCA action against the contractor.

Qui tam lawsuits under the FCA involve the same legal elements as a cause of action on a false claim brought originally by the federal government. An FCA plaintiff must prove that the defendant knowingly made a false or fraudulent claim for payment to the U.S. government. Procedurally, however, qui tam actions under the FCA differ significantly from FCA suits brought by the government.

First, after a qui tam suit is filed by the relator, the complaint remains under seal at the court for at least 60 days while the Department of Justice (DOJ) decides whether or not to intervene in the case. DOJ often requests, and receives, lengthy extensions of time in order to investigate the allegations. DOJ frequently issues a civil investigative demand (similar to a subpoena) for documents, information or

testimony from the defendant contractor and/or others to aid in its investigation. Alternatively, an agency Inspector General (IG) working in cooperation with DOJ may issue a formal subpoena.

Oftentimes, an IG subpoena or DOJ investigative demand is the first sign a contractor has that it may be the target of a qui tam action. However, federal investigators may also approach contractors or their employees with a request merely for an interview before any formal document demand is made. It is critical for a contractor to obtain legal counsel as soon as it suspects it may be a target. Contractors and their employees need to know what their rights and obligations are. Unconditional voluntary cooperation, especially when unprepared, is fraught with peril.

Historically, DOJ has intervened (or negotiated a settlement before formal intervention) in a little over one-quarter of qui tam cases. Upon intervention, DOJ takes over primary responsibility for the case. Although the qui tam relator continues to be a party, his or her rights are limited. DOJ can settle or even dismiss the case over the objections of the relator if the court determines that the contractor's actions were fair and reasonable. DOJ can also petition the court to limit the relator's participation in discovery proceedings or trial. As a practical matter, however, DOJ and the relator typically need to cooperate because the relator is often the only witness to the alleged fraud.

Defendants normally try to persuade DOJ not to intervene in a qui tam suit. Relators who must prosecute the case on their own typically have a limited ability to litigate FCA cases, especially complex cases, than does DOJ with its greater resources. This may be one reason why monetary recoveries in non-intervention cases have historically been significantly lower than in cases where DOJ has intervened.

If DOJ declines to intervene, the relator has the right to proceed with the

action alone. DOJ can always decide to intervene later for good cause and retains the right to veto for good cause any settlement by the relator, even without intervening. The government also may choose to pursue an alternative path, such as parallel criminal proceedings against the defendant or administrative proceedings for civil penalties or debarment.

The "bounty hunter" aspect of qui tam actions is controversial because it can be a powerful incentive for unscrupulous relators.

Whether or not DOJ intervenes, the mere fact that the relator him- or herself planned or initiated the fraud that is the basis for the qui tam suit is not a defense to the action. It will only serve to reduce or eliminate the relator's share in any recovery on the action. If the relator is convicted of criminal conduct arising from the fraud, the relator will be dismissed as a party and will receive no share of the proceeds. The government, however, can continue with the action against the defendant.

A defendant also cannot subject the relator to retaliatory employment action. The FCA prohibits retaliation against whistle-blower employees by discharging or demoting them, harassing them or otherwise discriminating against them. Although the evidence is mostly anecdotal, there have probably been instances of underperforming employees filing qui tam suits under the FCA in an effort to protect their jobs. Because of the difficulties employers face in proving that a subsequent discharge is based on unsatisfactory job performance rather than retaliation, qui tam plaintiffs may become "bulletproof."

The consequences of the FCA are severe. In addition to civil penalties of $5,000 to $11,000 per violation (which can multiply rapidly, as each false claim or invoice is a separate violation), violators are liable for three times the amount of damages that the government suffers as a result of the violation. A qui tam case does not increase the liability of a defendant under the FCA, but it does affect the distribution of any money paid by a defendant contractor pursuant to a judgment or settlement. If the government intervenes in the case, the relator is entitled to between 15 and 25 percent of the proceeds, depending on the relator's contribution to the case. (However, if the case primarily depended on disclosures from other sources, such as a Congressional investigation, the relator is entitled to no more than 10 percent of the recovery.) If the government does not intervene, and the relator is forced to carry the ball, the relator is awarded between 25 and 30 percent of the proceeds, plus expenses and attorneys' fees, which are charged against the defendant. The "bounty hunter" aspect of qui tam actions is controversial because it can be a powerful incentive for unscrupulous relators.

The great majority of FCA matters (qui tam and non–qui tam) are resolved through settlement. The potential of being held liable for multiple violations and treble damages leads many defendants to the negotiating table. Defendants settle a significant number of qui tam cases with DOJ even before DOJ formally intervenes, as that is normally the best time to settle. As noted, DOJ controls any qui tam settlement, but as a practical matter, DOJ consults with the relator and the federal agency involved before agreeing to a settlement. In a fairly recent development, DOJ has become increasingly willing to engage in mediation of FCA claims, although that is still a rare occurrence.

The potential for qui tam lawsuits, whether they are justified or groundless, has become a fact of life for federal government contractors. Having a proper compliance program in place, including an ombudsman for reporting federal procurement irregularities, can go a long way in heading off qui tam lawsuits. But if all else fails, prompt assistance from experienced government contracts counsel is critical to obtaining the most successful resolution of these potentially crippling suits. ■

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Peckar & Abramson is pleased to announce the opening of its Orange County office.

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Peckar & Abramson Newsletter
Volume XVI, Issue 1, Summer 2006
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