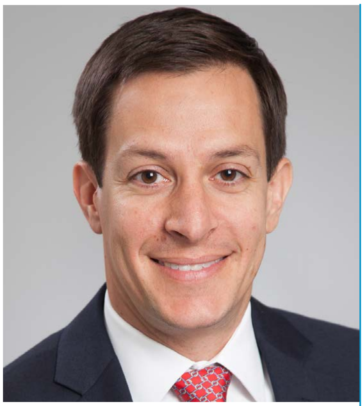
# Sureties and Bond Producers May Be Liable For a Contractor's False Claims Act Violations



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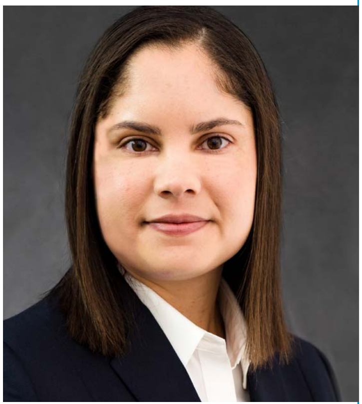

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Two recent decisions from the United States District Court for the District of Columbia and the United States Court of Federal Claims highlight that sureties and bond producers are not immune to the potentially severe consequences of the False Claims Act ("FCA") and related federal fraud statutes. In each case, the Court determined that sureties and bond producers can face potential liability under these fraud statutes for direct and indirect submission of false claims to the federal government.

For several years we have warned of the potential exposure for sureties and surety bond producers for direct and indirect violations of the FCA and related fraud statutes which carry criminal and civil penalties including treble damages of those sustained by the government, fines between $5,000 and $10,000 per violation, forfeiture of claims and debarment. Two recent decisions demonstrate that our warnings were well-founded. In *United States ex rel. Scollick v. Narula*, 2017 WL 3268857 (D.D.C. July 31, 2017), Plaintiff-relator Andrew Scollick filed suit on behalf of the United States against multiple defendants, including government contractors, their sureties, bonding agency and individual bond producer alleging a scheme to defraud the government by submitting bids for government construction contracts while fraudulently claiming service-disabled veteran-owned small business ("SDVOSB") status. The District Court initially dismissed the FCA claims against the bonding defendants, but ultimately allowed them to proceed after Scollick amended the complaint to allege that the bonding defendants knowingly provided bonding for dozens of government construction contracts worth millions with the knowledge that the bonded contractor did not in fact qualify as a SDVOSB. In particular, Scollick asserted that the bonding defendants' underwriting and due diligence would have reasonably revealed facts about the contractor that they knew or should have known violated the government's SDVOSB contracting requirements, and therefore the bonding defendants perpetuated the alleged fraud by continuing to do business with the contractor.

Similarly, in *Hanover Insurance Company v. United States*, 2017 WL 4082075 (U.S. Ct. Fed. Cl., Sept. 15, 2017), the Court of Federal Claims determined that while a performance bond surety is not liable for its bond principal's penalties for fraud, a surety can forfeit its subrogation rights to a claim found to be fraudulent and can be held liable for its own fraudulent actions as well as cost incurred by the government in reviewing the fraudulent claims.

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After the government terminated for default its contract with Lodge Construction, Inc. ("Lodge"), Lodge appealed the contracting officer's denial of its claims. In the action, Hanover Insurance Company ("Hanover"), Lodge's surety, declared entitlement to any funds recovered by Lodge pursuant to the parties' indemnity agreement and Hanover's equitable subrogation rights.

During the course of the litigation, the government moved to add counterclaims and affirmative defenses against Lodge and Hanover under the FCA, the anti-fraud provision of the Contract Disputes Act ("CDA"), and the Special Plea in Fraud Statute (the "Forfeiture Act"). The government alleged that Lodge submitted a fraudulent claim by including a $1.16 million pass-through claim from a subcontractor, which Hanover previously settled for $370,000. In granting the government's motion, the Court determined that this allegation was sufficient to support the FCA, CDA and Forfeiture Act claims and defenses against Lodge and Hanover.

The Court went on to determine that if Lodge committed fraud, it forfeits its claims against the Government under the Forfeiture Act and, as a result, Hanover would have no subrogation claim. The Court also held that if Lodge committed fraud, Hanover can be liable for the damages caused by Lodge (i.e., the government's costs to review the fraudulent portions of the claim) but not the statutory fraud penalties unless the bond so provides. Finally, the Court determined that the government alleged plausible direct fraud claims against Hanover because Hanover allowed a false claim to be presented by failing to alert the government of the settlement with Lodge's subcontractor. The Court determined that if proven, the government's allegations against Hanover amount to fraud and give rise to a direct claim against the surety under the FCA, CDA, and Forfeiture Act.

Although the final outcome of these cases is still unknown, they highlight the need for sureties and surety bond producers to understand the FCA and related fraud statutes and develop robust due diligence protocols in order to prevent violations.