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Federal Court Weighs Sureties' False Claims Act Liability for Principals' Alleged Fraud

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The surety industry is keeping an anxious eye on the pivotal and controversial case of *Scollick v Narula*,[1] which is pending in the U.S. District Court for the District of Columbia. In *Scollick*, the "whistleblower" plaintiff-relator ("Scollick") seeks to extend False Claims Act ("FCA") liability to two surety companies alleging that, by virtue of their underwriting processes, the sureties knew or should have known facts that show their bond principals falsely claimed service-disabled veteran-owned small business ("SDVOSB") status, or otherwise were not qualified to procure certain contracts from the federal government. The suit is premised on the sureties' "indirect presentment" of false claims by failing to detect and report the bond principals' non-compliance with SDVOSB status during the underwriting process. In addition, the sureties could be liable for "reverse false claims" under the FCA based upon the Miller Act[2] Standard Form 25 performance guarantee, which extends to a bonded contractor's violation of any "understanding, covenants, terms, conditions and agreements of the contract," such as its SDVOSB status.

Intended to root out fraud, the False Claims Act[3] makes a person or entity liable for knowingly presenting or causing to be presented a false or fraudulent claim for payment or approval. However, Scollick's proposed application of the FCA to sureties is alarming, as it pushes the envelope of surety liability far beyond traditional surety risk expectations, including exposure to treble damages, well beyond the penal sum limits.

Such surety FCA liability is particularly concerning in the context of alleged fraud within programs for which the government itself certifies a participant's qualifications and enforces the standards. SDVOSB set-aside contracting is extremely complex and governed by a voluminous, multi-faceted statutory and regulatory scheme. Since certain government contracts are "set aside" for SDVOSB businesses, an unfortunate byproduct of these programs is the prevalence of fraud. As such, the government agency tasked with awarding SDVOSB status, the Veterans Administration, is responsible for vetting a business's SDVOSB-specific parameters and determining its qualifications.

Scollick's consequences could turn the long-standing government construction bonding paradigm on its head. The logical end of Scollick's argument is that sureties, rather than (or at least in addition to) government agencies, must police fraud in the SDVOSB program, a duty far exceeding historical surety bond obligations.

Scollick's claim rests on the legally dubious proposition that, by virtue of the underwriting process alone, the sureties should have known that the principals were committing a fraud on the government. Scollick attempts to tie the sureties to the fraud with the contention that the sureties failed to "take [the] simple last step" of applying the facts reflected in underwriting documents "to the ownership and control regulations" applicable to SDVOSB set-aside contracts. In failing to act, Scollick alleges, the sureties "at the very least acted with reckless disregard or deliberate ignorance under the FCA."[4]

Scollick's position is problematic for several reasons. A victory for Scollick could trigger the unprecedented transformation of surety companies from for-profit business enterprises into

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Surety Discharged: Termination of Principal a Condition Precedent under A312

NELL M. HURLEY

The Massachusetts federal district court recently held that a contractor-obligee's termination of its subcontractor was a condition precedent to the surety's obligation to perform under an AIA[1] A312-2010 subcontract performance bond, and granted the surety's summary judgment motion, declared its bond liability discharged, and dismissed all counterclaims of the contractor.[2]

The matter arose out of a new apartment building project in Boston commenced in 2017. Arch Insurance Co. ("Arch") provided the A312 performance bond ("Bond") for a modular construction subcontract between its principal, R.C.M. Modular, Inc. ("RCM"), and the general contractor, The Graphic Builders LLC ("TGB"). The subcontract, which was incorporated by reference into the bond, required RCM to:

> fabricate, deliver and assemble modular components of the apartment building, warrant that all work by RCM will be free from defects and indemnify TGB for any cost of damage arising from that work.

Soon after RCM began installing the modular units in May 2018, TGB discovered that the units were defective, with many windows leaking and exteriors misaligned. Rather than calling on the Bond at that time, TGB

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Can a Surety Recover from its Principal's Accountant For Misleading Reports?

MATTHEW D. HOLMES

A surety typically relies, at least in part, on reports and financial statements provided by its principal to make bond underwriting decisions. What happens if the principal's accounting firm misrepresents the financial health of the principal's company and the surety later incurs losses? A federal district court in Pennsylvania ruled that a surety's claim against an accounting firm in just those circumstances could proceed, finding that the surety showed sufficient details of the misrepresentation.[1] The decision highlights important considerations for any similarly situated surety, including the need to review applicable state law.

In the case, the surety alleged that the accounting firm ("JPMC") prepared a 2017 independent auditor's report, financial statement and related schedules for its principal ("Cohen"), concluding that Cohen was expected to remain profitable in the upcoming year. JPMC affirmed that the audit conformed to generally accepted auditing standards ("GAAS"). The financial statement:

> "...opined that the information [therein] presented fairly, in all material respects, the financial position of Cohen in conformity with generally accepted accounting principles ("GAAP") ..."

The surety further alleged that it justifiably relied on JPMC's representations in evaluating and approving Cohen's requests for surety bonds and surety credit, including performance and payment bonds for a 2018 project in Princeton, New Jersey.

It soon became apparent that the 2017 report and financial statement significantly oversold Cohen's financial status and ability to operate as a going concern. Cohen defaulted on the Princeton project and the surety was called upon to complete the work, allegedly incurring significant losses and expenses, including attorney's fees. JPMC's 2018 independent auditor's report disclosed significant operating losses for Cohen, and liabilities markedly exceeding assets.

In 2020, the surety brought suit against JPMC for negligent misrepresentation alleging that the information contained in Cohen's 2017 financial statement provided by JPMC was not GAAP-compliant, and that JPMC's audit itself was not GAAS-complaint, at least in part because of its reliance on unverified figures from Cohen. The surety presented a JPMC draft financial statement reflecting a nearly $10 million "revenue adjustment" due to work in progress and percentage completion errors, as compared to the 2017 financial statement.

JPMC moved to dismiss the surety's complaint, arguing that the surety failed to allege a specific misrepresentation of material fact. The court was unpersuaded, finding that the surety identified several specific misrepresentations, including that JPMC's 2017 financial statement overstated the value of Cohen's contracts by $10 million.

JPMC next argued that the surety failed to show an intent by JPMC to induce the surety to act. Under Pennsylvania law, the court explained, a negligent misrepresentation claim does not require actual knowledge, but instead requires only a traditional duty of care for foreseeable harm. Even so, the court said, the surety here sufficiently alleged both foreseeability and actual knowledge by JPMC that its reports would be shared with, and relied upon by, the surety.[2]

Finally, the court found the surety had properly alleged damages, despite unresolved disputes as to its obligations on the Princeton project.[3] It is sufficient at the early stages of litigation that the surety claims that it "is incurring significant expenses, including attorney's fees, in attempting to mitigate and recover for its losses in connection with the [bonds]," reasoned the court.

Negligent misrepresentation actions against a principal's accountant can be tricky but, as this case shows, are not impossible. Be aware that jurisdictions vary as to the proof required to be successful, but if the accountant reports provided are way out of line with the principal's actual condition, it may be worth exploring such a claim if losses are experienced. E&D

1 *Platte River Ins. v. Joseph P. Melvin Co.*, 2020 U.S. Dist. LEXIS 214284 (E.D. Pa., November 17, 2020).

2 Some states, like New York, have circumscribed liability for negligent misrepresentation claims against accountants by non-clients, requiring a "near privity" relationship, proof that reports were created for a particular purpose, and conduct by the accountant linking it to the third party. *See, e.g. Credit Alliance Corp. v. Andersen & Co.*, 65 N.Y.2d 536 (1985).

3 The issue of the surety's obligations on the Princeton project was the subject of litigation pending before another court.

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quasi-governmental watchdogs tasked with legal analysis and application of the SDVOSB regulations during, and even after, the underwriting process. The "continuing affirmative duty" of a principal to maintain SDVOSB status, if imputed to the surety, would convert the surety into a 24/7 auditor of the principal, which would be a seismic (i.e. prohibitively expensive) and unwelcome metamorphosis. If sureties are forced to assume the duty of verifying the government's review of the principal's compliance with set aside requirements, there will be a chilling effect on the underwriting process, which will undermine the very purpose of set aside requirements: to benefit small, disadvantaged, and emerging contractors.

Indeed, federal statutes and regulations make it clear that the VA, not the third-party surety, is the responsible entity tasked with vetting the SDVOSB compliance of bidding contractors. No such third-party obligation for underwriting can be found in the terms of any surety bond, nor is such a duty imposed by the plain text of the Miller Act. Historically, duties to third-parties do not spring from the surety underwriting process. Scollick's attempt to foist such a duty onto the sureties is a thinly-veiled play at the sureties' deep pockets.

Competing summary judgment motions are currently pending before the District Court in *Scollick*. We continue to monitor the developments and are hopeful for a fair and sensible outcome. Stay tuned. E&D

1 *United States ex. rel Scollick v. Narula et.al*, No. 14-cv-01339-RCL (D.C Dist.).

2 40 U.S.C. § 3131, *et seq.*

3 31 U.S.C. § 3729, *et seq.*

4 *Scollick*, No. 14-cv-01339-RCL, Scollick Brief, ECF 331-1 at pp.28-29.

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unilaterally arranged for other parties to remediate RCM's work at a cost of over $2.8 million, but it did not terminate RCM's subcontract. Beginning in October 2018, TGB notified Arch that it was considering declaring RCM in default on the subcontract and sought contractual warranty and indemnification payments from Arch for the remediation work. TGB later declared RCM in default per Section 3.1 of the Bond,[3] and notified Arch, but emphasized that it was not terminating RCM. Arch acknowledged the notice but refused to make the demanded payments to TGB, denying liability because TGB had failed to terminate RCM, as required by Section 3.2 of the Bond.[4]

Arch filed suit seeking a declaration that TGB breached the bond by failing to terminate RCM, which is a condition precedent to Arch's obligation to perform, and discharging Arch from liability thereunder. TGB counterclaimed that, independent from any condition precedent, Arch is obligated under Section 1 of the Bond to cure RCM's defective work, indemnify TGB, and issue TGB warranty payments.[5] It also asserted state law claims against Arch for unfair and deceptive conduct.

Arch moved for summary judgment based on the conditions precedent contained in Section 3 of the Bond, and TGB's failure to terminate RCM as required under Section 3.2. TGB countered with a novel argument that the Bond distinguishes between (1) claims that require the surety to complete work on the project, for which termination of the subcontract is a condition precedent, and (2) claims that simply require the surety to reimburse TGB for damages caused by RCM's breach of the subcontract, for which there is no condition precedent. TGB asserted that the distinction is based upon the fact that the subcontract authorizes TGB to correct deficiencies and seek indemnification from RCM without termination, the subcontract's express incorporation into the Bond, and Bond Section 1's "joint and several liability" of RCM and Arch for the subcontract work.

Without directly addressing this argument, the court found that the Bond unambiguously imposed conditions precedent to *any* Bond obligation of Arch. The court held that Section 3.2 of the Bond required that RCM be terminated. Since it was undisputed that this never happened, said the court, TGB failed to comply with that condition precedent. The court ruled that Arch was thus discharged from all obligations under the Bond, and dismissed TGB's counterclaims based on subcontract warranty and indemnity, as well as TGB's "last ditch" claim that RCM could not be terminated because it had substantially completed the work.[6]

The court here cited to uncontroversial case law that holds the provisions of Section 3 of the Bond are conditions precedent to surety performance obligations. But the decision stops short of an express ruling on the contractor's argument that a surety could possibly be obligated, independent of Section 3, for indemnity or warranty under Section 1, where its principal's work proves defective. Of course, where remedial work is performed without the surety's knowledge, it certainly belies a fundamental tenet of surety law and practice: the right of the surety to investigate. But since TGB filed its appeal immediately following this decision, we could see the argument again, in its effort to fashion "subguard" coverage from a performance bond. E&D

1 American Institute of Architects

2 *Arch Ins. Co. v. Graphic Builders LLC*, 2021 U.S. Dist. LEXIS 27017* (D. Mass. Feb 12, 2021), *appeal filed*, No. 21-1126 (1st Cir. Feb 16, 2021).

3 AIA A312-2010 Section 3.1 sets forth required notice provisions, which were not at issue in the case.

4 AIA A312-2010 Section 3.2 provides that the obligations of Arch under the Bond "shall arise after [TGB] declares a Contractor Default, terminates the [subcontract] and notifies [Arch]."

5 AIA A312-2010 Section 1 provides that [RCM] and [Arch] agree to "jointly and severally bind themselves to [TGB] for the performance of the [subcontract]" which is incorporated by reference into the Bond.

6 While many states follow the so-called "substantial performance" rule regarding termination, the court relied upon the subcontract, which permitted termination until the work was fully completed, and TGB's failure to show that termination was impossible or impracticable.

E&D's attorneys enjoying a firm golf event last fall at Cobblestone Creek Country Club in Victor, New York. Those pictured here are, L to R, Matt Holmes, Brian Streicher, John Dreste and Kevin Peartree.

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Ernstrom & Dreste, LLP also publishes the ContrACT Construction Risk Management Reporter. If you would like to receive that publication as well, please contact Clara Onderdonk at conderdonk@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).

FIRM NEWS

Todd Braggins authored an article titled "*Profiles in Character: Two Tales of Financing,*" highlighting the bond producer's role in financing the principal, to be published in the National Association of Surety Bond Producers summer edition of *Surety Bond Quarterly*. Todd was also a featured guest on this topic on NASBP's "*Let's Get Surety*" podcast recorded May 4, 2021 and available for listening at the NASBP website.

Brian Streicher's article on page 1 of this issue of E & D's Fidelity & Surety Reporter, "*Federal Court Weighs Sureties' False Claims Act Liability for Principals' Alleged Fraud*," appears in extended form in the May 2021 publication of the Surety Claims Institute's Newsletter.

Matt Holmes presented on the topic of "*Bid Errors*" at the ABA TIPS *Fidelity and Surety Law 2021 Virtual Midwinter Conference: Construction Lawyer as Disaster Artist* held on Feb. 3-4, 2021.

Todd Braggins plans to attend and be a featured speaker at the Pearlman Association Annual Conference at the Willows Lodge in Woodinville, Washington, September 8-10, 2021.

John Dreste co-presented a program entitled *A Practical Guide to Construction Litigation from Experienced Practitioners* put on by the Monroe County Bar Association in Rochester, New York on March 3, 2021.

Martha Connolly, Tim Boldt, and Kevin Peartree are on the faculty for the Associated General Contractors NYS training program *Future Construction Leaders of New York State: Educating the Next Generation of Construction's Select Few*. They will lead the June 29, 2021 session at the Strathallen Rochester Hotel & Spa entitled "*Controlling Risk in Construction Project Delivery Systems*."