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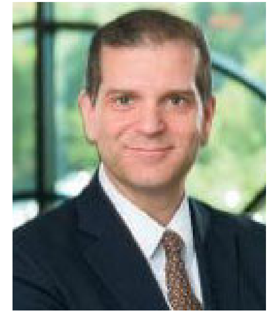
Bonding Set-Aside Contractors:

What Bond Producers and Sureties Should Know About Potential False Claims Act Liability



BY ARMEN SHAHINIAN AND BRIAN KANTAR

FEDERAL CONTRACTING CAN be an attractive source of business for contractors. There is seemingly an endless supply of work, the owner/obligee is solvent and typically pays its bills on time, and, if bid properly, the projects can be profitable. However, the process of qualifying for and procuring federal contract work can be difficult and, thus, out of reach for many contractors. For example, pursuant to the Miller Act (40 U.S.C. § 3131 *et seq.*), as implemented by the Federal Acquisition Regulations (FAR), contractors that enter into any contract of more than $150,000 for the construction, alteration, or repair of any public building or public work for the federal government are required to furnish the government with, among other things, a performance bond securing the contractor's obligation to the government to complete the project and a payment bond securing the contractor's obligation

to pay laborers, subcontractors, and suppliers that provide labor and materials in connection with the project. Because small businesses and other historically disadvantaged business entities are often thinly capitalized and may have limited performance track records, they frequently struggle to qualify for surety credit. Because the ability to furnish surety bonds is a *sine qua non* to obtaining federal contracts, many of these businesses would rarely, if ever, succeed in procuring federal contracts without assistance.

Set-Aside Contracts

Due in part to the belief that small businesses are responsible for much of the job creation and technical innovation in the United States, the federal government has encouraged participation by small and historically disadvantaged businesses in federal contract work. The federal government often sets aside, in each contract, a proportion of work that is to be performed by such businesses. The targeted participation level for such set-aside contractors varies by the type of work being performed, the region where the work is to be performed, and the size and complexity of the project. For instance, the government may set a more ambitious goal for participation by set-aside contractors in regions where access to such contractors is readily available. A non-exhaustive list of the types of entities for which the federal government sets aside work on federal contracts is set forth below:

- Small Disadvantaged Businesses (SDB)
- Disadvantaged Business Enterprise (DBE)
- Women-Owned Small Businesses (WOSB)
- Women Business Enterprise (WBE)
- Minority Business Enterprise (MBE)
- Historically Underutilized Business Zone (HUBZone)
- Service-Disabled Veteran-Owned Small Business (SDVOSB)
- Veteran-Owned Small Businesses (VOSB)

The goal of set-aside programs is to provide set-aside contractors the chance to "learn the ropes" of federal contracting, earn a profit, and, hopefully, grow into the type of business that can one day qualify for a prime contract without participating in such programs. However, none of these programs provides any mechanism to relax the requirements of the Miller Act. Even where set-aside contractors serve as subcontractors, a prime contractor will often require that the set-aside contractor furnish performance and payment bonds in favor of the prime contractor. While in the ordinary course it might be difficult for many set-aside contractors to qualify for and obtain surety credit, the federal government has established a number of programs that allow sureties to extend surety credit to set-aside contractors that would not otherwise qualify for bonds under traditional underwriting standards.

Opportunities for Bonding Set-Aside Contractors

One such program is the Small Business Administration's (SBA) Surety Bond Guarantee Program, which reimburses a surety a percentage of loss with respect to bonds issued on behalf of qualifying set-aside contractors. The rate of reimbursement is 90% if the contract is $100,000 or less, or it is awarded to a socially or economically disadvantaged, HUBZone, SDVOSB, or VOSB firm; otherwise, the guarantee is 80% for contracts up to $6.5 million or up to $10 million if a federal contracting officer certifies the SBA's guarantee is necessary for the small business to obtain a bond.

Several departments or agencies have also created "mentor-protégé" programs, which encourage established federal contractors (mentors) to partner with small or historically disadvantaged businesses (protégés) in an effort to help protégés improve their ability to compete for government contracts. Mentors can provide a wide variety of assistance in an effort to accomplish this goal. This may include financial assistance, such as taking a minority equity stake in the protégé to help raise funds. Mentors and protégés can also form joint ventures to pursue contracts.

Over the last several years, these programs have allowed sureties to provide bonding to set-aside

contractors, confident that their risk is mitigated by, among other things, an SBA guarantee or additional indemnity provided by a mentor company. And when the financial wherewithal of the set-aside contractor matures to the point where it can qualify for bonding on a plenary basis, producers may very well find themselves procuring bonding for a new account.

The *Narula* Decision

Unfortunately, a recent decision issued by a U.S. district judge sitting in the District of Columbia, *United States ex rel. Scollick v. Narula*, 2017 WL 3268857 (D.D.C. July 31, 2017), has caused sureties to more closely scrutinize the risks attendant to bonding set-aside contractors. In *Narula*, the court held that reverse false claims liability (described below) and the potential for treble damages (that is, up to three times the penal sum of the bond) can extend to a surety where its producer becomes aware of facts suggesting that the bonded principal was fraudulently participating in a government set-aside program and the surety nonetheless proceeds to issue Miller Act bonds for that principal. A review of the facts and background giving rise to the *Narula* decision follows.

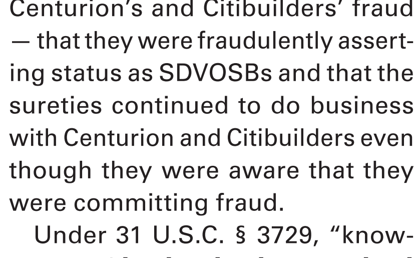
Plaintiff-relator[1] Andrew Scollick alleged that a number of individuals engaged in a scheme to fraudulently claim or obtain SDVOSB status, HUBZone status, or section 8(a) status so as to allow certain companies to bid on and obtain set-aside contracts, when in fact the bidders did not qualify for the status claimed. The defendants are alleged to have falsely certified their status, made false claims regarding past performance, hidden certain aspects of the management and control of the companies at issue, and hidden or falsified certain information regarding the employees of the companies at issue. Some of the defendants established a number of "front companies," including Centurion Solutions Group, for the purposes of allowing them to bid on and obtain SDVOSB set-aside contracts. To qualify for SDVOSB status, one of the defendants, Amar Gogia (who is a service-disabled veteran), was falsely identified as a 100% service-disabled owner of Centurion, even though he did not actually exercise control or ownership over the entity. Centurion secured millions of dollars of government contracts. One of the defendants, Neil Parekh, established another entity, Citibuilders Solutions Group, to branch out his fraudulent SDVOSB contracting activity. Parekh falsely certified Citibuilders as being a service-disabled veteran-owned entity, using defendant Melvin G. Goodweather's service-disabled veteran status, even though Parekh was the *de facto* owner and controller of Citibuilders. He is also alleged to have misrepresented Citibuilders' past performance and project personnel. Citibuilders similarly obtained millions of dollars in government contracts. There were a number of other entities and

individuals involved in the alleged scheme. Plaintiff claimed that, to varying degrees, the individuals and the companies established by them were alter egos of each other.

Claims were also asserted against the sureties issuing bonds on behalf of the companies alleged to have been qualified through fraud, as well as against the bond producers. Plaintiff contended that the bond producer, allegedly serving as the sureties' agent and attorney-in-fact, had a long-standing relationship with Parekh and knew that the companies shared a single office and that individuals, other than genuine service-disabled veterans, were in functional control of one or more of the front companies. Plaintiff further alleged that the sureties, through their alleged agent, understood that the front companies shared common ownership, requiring corporate resolutions acknowledging this fact, and deliberately disregarded this fact when issuing bonds in connection with the false certifications contained in the bidding proposals submitted to the government. On these facts alone, the court initially dismissed plaintiff's reverse false claims allegations against the sureties and the bond producers.

Plaintiff subsequently amended its complaint and further alleged that, among other things, during the underwriting process, the sureties conducted an on-site inspection of one of the front company's offices, after which the sureties "necessarily understood" that Centurion was a shell company dependent on the resources, capabilities, and capital of the other front companies, as well as the experience and knowledge and financial backing of non-service-disabled veterans. Plaintiff alleged that underwriting and due diligence would reasonably have revealed that Centurion did not possess the necessary construction history or financial ability to carry out the scope of the contracting activity ultimately undertaken in its name. The Amended Complaint further alleged that the underwriting and due diligence reasonably led to the conclusions that Parekh, Vijay Narula, and Shobha N. Madan (all defendants in the action) exerted dominance and control over Centurion; that Gogia lacked the skill, knowledge, resources, and past performance to engage in the scope of contracting activity undertaken by the Centurion conspirators; and that Centurion was not a service-disabled small business. The court held that these additional facts were sufficient to allege that the sureties had knowledge of Centurion's and Citibuilders' fraud — that they were fraudulently asserting status as SDVOSBs and that the sureties continued to do business with Centurion and Citibuilders even though they were aware that they were committing fraud.

BECAUSE THE BOND PRODUCER/ALLEGED AGENT WAS AWARE THAT THE DEFENDANTS WERE BIDDING ON SET-ASIDE CONTRACTS, EVEN THOUGH THEY WERE NOT QUALIFIED TO SUBMIT SUCH BIDS, THE COURT IMPLIED THAT THE SURETIES SHOULD NOT HAVE ISSUED THE BONDS.



Under 31 U.S.C. § 3729, "knowingly mak[ing], us[ing], or caus[ing] to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the Government, or knowingly conceal[ing] or knowingly and improperly avoid[ing] or decreas[ing] an obligation to pay or transmit money or property to the Government" violates the False Claims Act. Reverse false claims occur when "the defendant's alleged deception results in no payment to the government when a payment is obligated. In contrast to typical false claims actions, a typical reverse false claim action involves a defendant knowingly making a false statement in order to avoid having to pay the government when payment is otherwise due." *Narula*, at *15. Plaintiff argued that, in issuing Miller Act bonds, the sureties:

> agreed to compensate the government for losses sustained should the specifications found in the contract, including the specification that the construction activity be paid a service-disabled, veteran-owned small business entity, fail to occur. The [sureties] exercised due diligence to obtain facts from the other defendants that the [sureties] knew or should have known violated the government's service-disabled, veteran-owned contracting requirements. For example, each time the [sureties] knew that the government made a payment that violated the service-disabled, veteran-owned specification they knowingly avoided an obligation to compensate the government for that loss. The [sureties] also knowingly concealed information and committed other acts that facilitated the fraudulent scheme and caused the other defendants to violate the [False Claims Act].

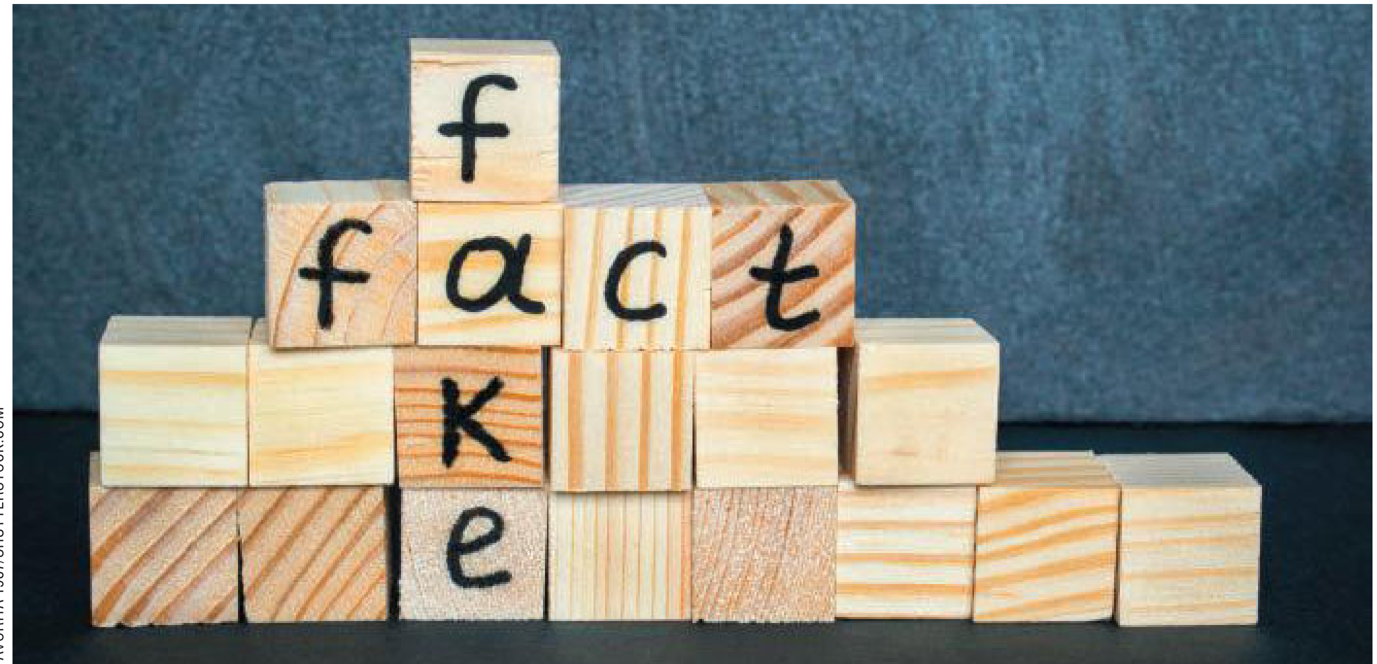
Narula, at *16.

The court agreed that plaintiff's amended complaint asserted a viable theory of liability, noting that the Miller Act bonds "were separate instruments entered between the United States government [and the sureties] and although submitted with the contract, did separately obligate the [sureties] to compensate the government for losses sustained if the specifications found in the contract, including the specification that the construction activity be paid a service-disabled, veteran-owned small business entity," were not followed. *Narula,* at *16.

What Does *Narula* Mean?

It is critical to note, as a threshold matter, that this decision does not actually hold that the sureties or producers are or ever will be held liable under the False Claims Act. Instead, the court held that, for purposes of deciding a motion to dismiss for failure to state a claim (which was filed at the initial pleading stage of the case), under certain circumstances, if a factual basis is ultimately proven, the sureties and the brokers *may* be held liable for enabling their principals' false statements and fraudulent receipt of payments from the government. The circumstances in *Narula* are narrow. The surety bond producer is alleged to have become intimately familiar with the business dealings of the defendants involved in the alleged scheme.[2] And because the bond producer/alleged agent was aware that the defendants were bidding on set-aside contracts, even though they were not qualified to submit such bids, the court implied that the sureties should not have issued the bonds. By doing so, the sureties allegedly assisted the defendants in perpetrating the fraud and could be liable for breach of the contract provisions requiring SDVOSB status and damages amounting to three times the contract payments made, plus attorney's fees. It should be noted that, although the plaintiffs' allegations against the surety bond producers relating to reverse false claims were dismissed by the court because the producers/alleged agents did not actually issue the bonds and, thus, did not owe any obligation to the government under the bonds, the court allowed plaintiffs' remaining claims against the producers (that is, presentment of false claims under the False Claims Act, making of false statements, and conspiracy) to proceed.

While no liability has yet been determined, the decision is still of extraordinary concern. This ruling opens the door for additional relators to assert claims under the False Claims Act against sureties and producers (which are usually the only parties with the financial ability to satisfy such claims), where potential liability includes treble damages (often measured by the full penal sum of the bonds) and additional penalties of up to $22,363 for each



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individual false claim (for example, each payment requisition arguably represents a separate false claim). In the federal contracting arena, where the penal sums of bonds are frequently in the millions of dollars, this can represent an unpalatable exposure. Underwriting departments nationwide are already assessing the wisdom of and additional risk involved in continuing to bond set-aside contractors.

Questions Raised by Narula

Although the *Narula* case itself is still being litigated and no other court appears to have addressed the issues raised by the court's ruling,[3] the decision has created a great deal of uncertainty in our industry. Should brokers become more familiar with an account's operations? Do underwriting departments have an obligation to undertake additional due diligence prior to issuing bonds? The law sometimes imputes knowledge to parties based on what they "should have known." Can the alleged failure to undertake additional due diligence during underwriting expose a surety to liability under the False Claims Act? If the *Narula* decision stands, it would not be surprising if an aggressive relator were to argue that a surety facilitated a contractor's fraud upon the government by issuing a bond (thereby permitting the contractor to qualify for the contract) without having conducted an adequate investigation of its set-aside qualifications. Had it done so, the relator will allege that such investigation would have revealed that the contractor did not, in fact, qualify for the status claimed. This purported knowledge of false claims through payment requests by the principal may be alleged against the deep-pocket surety.

Surety Bond Producers' Potential Reverse False Claims Liability

Even though plaintiffs' allegations with respect to reverse false claims against the producers were dismissed in *Narula*, it is not clear from the reported decision whether the producers entered into managing general agent (MGA) agreements with the sureties. In light of the additional authority delegated to producers under some MGAs, it is possible that the *Narula* court may not have dismissed the reverse false claims allegations against the producers had they entered into such agreements with the sureties. Even in the absence of an MGA and where there is no direct reverse false claims liability under the False Claims Act, when a surety is sued under the False Claims Act on account of its producer's actions, there is the possibility that the surety may assert a third-party claim against the producer, seeking to be indemnified and held harmless for damages sustained arising out of such actions. The relationship

between sureties and producers is typically robust and mutually beneficial. Accordingly, such claims could create an uncomfortable dynamic.

Mitigating Potential Exposure to False Claims Act Liability

Although there is no foolproof way to know for sure whether a contractor is committing a fraud, there are steps that can be taken to mitigate a surety's potential risk. Producers and underwriters should not hesitate to ask contractors who are bidding on set-aside contracts for additional information where questions about the legitimacy of their qualifications arise. If those contractors express resistance or refuse to provide that information, in light of the scope of liability created by *Narula*, additional consideration should be given as to whether surety credit should be extended to the contractor.

In order to establish a violation of the False Claims Act, the government or a relator must prove that the violation was "knowing" or intentional. Although there is no "one size fits all" solution to the issues raised by *Narula*, undertaking no effort at all to avoid issuing bonds to unqualified contractors may be problematic. The government or a relator may argue that deliberate ignorance or reckless disregard of potential red flags may qualify as a "knowing" violation of the False Claims Act. Producers and underwriting departments can and should work together to review and address any potential red flags that suggest a contractor is bidding on a set-aside contract when it does not appear to meet the criteria required to qualify for the set-aside. Maintaining meticulous records of all efforts undertaken to obtain reasonable assurance that the principal qualifies for the set-aside contract that is the subject of a bond request is critical and may make the difference between being subject to liability under the False Claims Act and successfully defeating such claims.●

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References

1 The False Claims Act permits individuals, or "relators," to bring actions on behalf of the federal government when the government chooses not to bring the action itself. In return, the relators are entitled to a portion of the recovery obtained in such actions, which is typically between 15-25%.

2 It is not clear from the court's recitation of the facts whether any representatives from the sureties' underwriting department participated in the on-site inspections of the principal's operations from which knowledge was or should have been obtained, and the decision is unclear regarding whether the court intended to pronounce a rule that the producer/agent's knowledge will always be imputed to a surety.

3 In Hanover Insurance Co. v. United States, 134 Fed. Cl. 51 (Fed. Cl. 2017), issued shortly after *Narula*, the United States Court of Federal Claims held that a surety could be held liable under the False Claims Act for asserting a lien in any proceeds recovered by its principal in connection with claims submitted by the principal to the government, which the government contended violated the False Claims Act. Although that decision is problematic in its own right, it did not involve issues that would have been flagged at the underwriting stage and is thus beyond the scope of this article. Nevertheless, the decision, together with *Narula*, suggests a newfound willingness by the federal courts to hold the surety liable under the False Claims Act.