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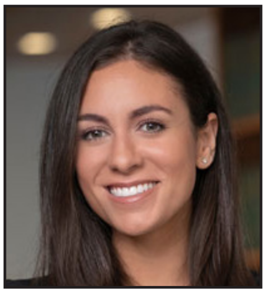
Fraud And Small Business Administration Programs

Timothy E. Heffernan

by Timothy E. Heffernan, Senior Partner and Nicole C. Gregory, Associate



Nicole C. Gregory

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

The Federal Paycheck Protection Program

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

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

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

SBA Set-Aside Contracting And Its Potential Effect On Surety Liability

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

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

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

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

Second, the application of the FCA to Miller Act sureties based on allegedly fraudulent contractor representations regarding SBA program status creates significant challenges for bonding companies and bond producers. The rules and regulations governing small business program status eligibility are complex, voluminous, and often subject to revision. To force sureties and bond producers to familiarize and train their workforce on the details of the Federal Acquisition Regulation and SBA rules is likely to either deter sureties from bonding set-aside contracts and/or result in a dramatic increase of cost for Miller Act bonds.

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

According to the SFAA, the consequence of the court adopting the relator's legal theory and allowing the plaintiff to proceed against the surety defendants in this case, thereby expanding sureties' risk exposure, is the imposition of a duty during underwriting to verify the government's review and ensure the prospective principal's compliance with set aside requirements. Imposition of this duty will cause sureties to question, and undoubtedly halt, the extension of surety credit to small, disadvantaged, and emerging contractors,

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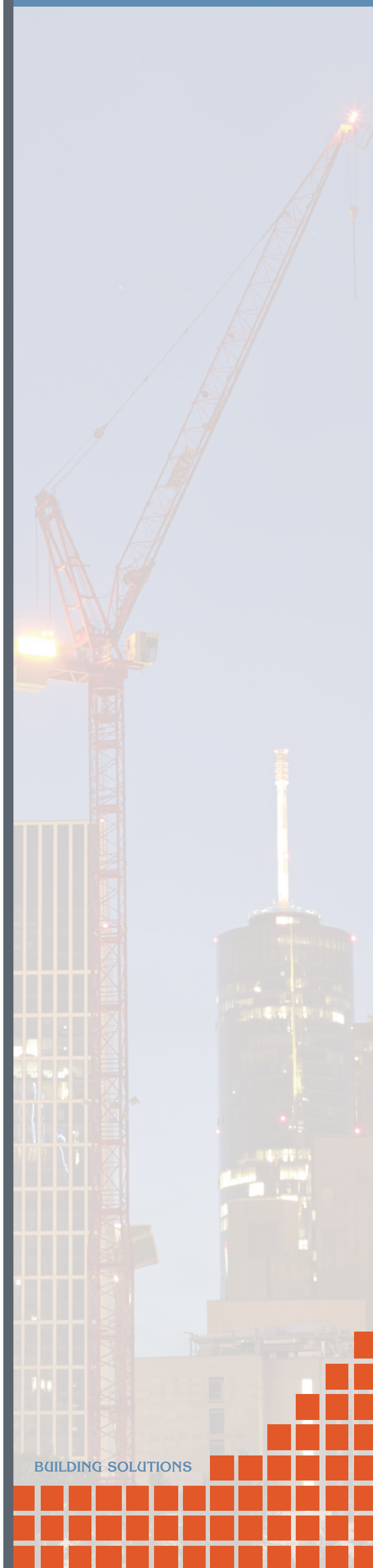
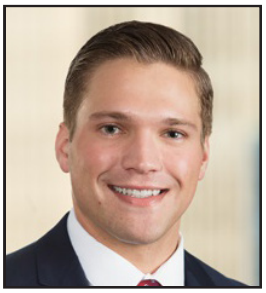


not to mention create a slippery slope to the expansion of this duty to require sureties to monitor the principals' compliance with set aside requirements for contracting during performance of the contract. Absent the availability of surety bonding for this market sector, the SFAA argues that there will be a cascading and catastrophic effect across the federal government procurement system, rendering it nearly impossible for many socio-economically disadvantaged contractors to bid on, receive, or perform any government contracts, despite a preference by the federal government for procurement with those contractors.

The *Scollick* case is currently awaiting the District Court's ruling on multiple cross motions for summary judgment. Pending the outcome of this lawsuit, the surety industry is left to contemplate whether its underwriting and bond-producing process will soon be subject to unending scrutiny by fraud investigators and whistleblowers alike. Until such time as the courts clarify a surety's potential liability under the FCA, those participating in such activities are well advised to discuss any questions or concerns with your in-house legal counsel.



De-escalating The Impact Of Price Escalation

by Brian C. Padove, Associate

What happens when construction material prices abruptly rise by 15%, 35%, 50% or more within a year? Moreover, what happens to a construction project when such volatility occurs? While there is no definite answer, more likely than not, the construction project will be impacted by delays in procuring such materials and cost overruns. The question then becomes what steps can parties take to mitigate the impact of material price fluctuations?

This question has become frequent the last 15 months as owners, contractors, and suppliers work through extraordinary construction material price increases. Notably, from April 2020 to April 2021, the U.S. Bureau of Labor Statistics' producer price index (an index measuring average price changes over time) reveals a substantial increase to a number of different construction materials. For example, from April 2020 to April 2021, there have been increases to the producer price index for lumber (by 90%), iron and steel (by 58%), and plastic construction products by (14%). *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, PPI Detailed Report (Apr. 2021). Undoubtedly, the unprecedented COVID-19 pandemic in conjunction with extraordinary supply chain disruptions caused, at least in part, these price increases. That said, while there is no statistic quantifying the impact such increases have had on the construction industry, the increases surely have had an influence, whether it has been through lost profits, delays, or damage to contractors' otherwise strong reputation for timely performance.

With that in mind, this article will provide practical guidance for parties to consider in mitigating the impact of price escalation prior to and after executing their contract and will conclude with a list of best practices for all parties to consider.

Considerations Prior To Contract Execution

The first way to mitigate price escalation is identifying materials most susceptible to price volatility during the bidding process. Namely, once the parties identify these materials, they can have an open discussion with the upstream parties regarding potential price volatility that may occur. The bid may also include either (1) an allowance for the materials providing additional funds, if necessary, should the material price increase, or (2) a shortened timeframe in which the bid is open, which would, on account of the reduced time, mitigate the likelihood of price shifts.

Once the bidding is completed, another mitigation strategy is to utilize material price escalation provisions within the contract itself. These provisions are common throughout the industry, frequently incorporated in contracts on both private and public projects. For example, Federal Acquisition Regulation ("FAR") §16.203-3 permits price escalation provisions in certain agreements when the government's Contracting Officer determines that the use of an escalation clause is necessary. Similarly, ConsensusDocs includes a price escalation provision amendment designed to establish "baseline prices" for materials identified by the parties as potentially "time and price-impacted" and provide a method for adjusting the contract price due to the fluctuation in those baseline prices. *See* ConsensusDocs 200.1, Amendment No. 1, "Potentially Time and Price-Impacted Materials." In relevant part, the ConsensusDocs provision calls for price increases or decreases to specified materials, a "baseline price" for each material designation, and notice requirements for subsequent contract adjustments. The provision also allows for the possibility of a time extension if there is delayed delivery due to material unavailability outside the contractor's control. These price escalation provisions are just a few of the many examples of specific contract clauses parties can utilize to mitigate the impact of price escalation on future projects.

Overall, price escalation provisions have similar characteristics to consider and recognize. First, the provisions generally require specific identification of the materials to which the clause will apply, or in other words, the parties must identify the materials which are anticipated to have price fluctuations during the course of construction. After identification, parties will agree to the "baseline price" for the materials, which will generally be premised on anticipated or current market conditions and are oftentimes linked to published material cost indexes such as the previously cited U.S. Bureau of Labor Statistics' monthly publication providing national price information on all sorts of products, including construction materials (e.g., lumber). Tying the baseline price to a published cost index will provide the parties with an objectively verifiable method of determining the extent of any material price fluctuation. From there, the provisions can sometimes include a minimum fluctuation triggering threshold which will allow for an adjustment only if there is a change over a minimum amount (e.g., there must be an increase over 3% of the market price for there to be a contract adjustment). There also may be limits as to the maximum adjustment amount, such as in FAR § 52.216-2, which sets a standard 10% increase limit. Finally, price escalation provisions will generally require adherence to specified notice procedures in order to qualify for an adjustment.

While a price escalation clause may initially seem entirely in favor of contractors, the truth of the matter is that there are benefits to all parties. For contractors or suppliers, the benefits are rather obvious – there is "protection" when facing market conditions similar to those parties are dealing with today (where the costs of certain materials has rapidly increased 50% or more over a year). On the other hand, including a price escalation clause can also benefit owners and other upstream parties as its inclusion may result in limiting delayed performance claims related to material price escalation, avoiding potential costly defaults and terminations, and ensuring that parties are paying relatively close to market prices for the materials used on the project. Accordingly, utilizing price escalation clauses can prove to be the key factor in mitigating the impacts of future material price volatility.

After Executing The Contract – Can I Still Mitigate Price Volatility?

Unfortunately, sometimes it is impossible to foresee which materials will be impacted by unanticipated events and the extent to which a price may fluctuate before completing a project. Thus, what happens when an extraordinary price escalation occurs that the parties did not account for when contracting?

The first step is to go to the contract to determine whether a price escalation clause is included or if there are any other provisions that may assist in determining responsibility for unanticipated changes and the steps parties must follow to address such changes. As referenced above, the majority of price escalation provisions include steps that parties must follow to adjust a contract when fluctuation occurs (e.g., notice requirements). Other contract provisions should also be reviewed for guidance and potential alternative relief. For instance, impacted parties should check whether the contract includes a force majeure provision addressing delays caused by events outside the contractor's control. While these provisions will typically allow for additional time to perform the contract work if certain criteria are met, they often will not allow additional compensation. Both the AIA A201-2017 General Conditions and ConsensusDocs 200 Series establish procedures for obtaining changes based on impacts to work that are outside of the contractor's control. *See* AIA 201-2017 General Conditions §8.3.1; ConsensusDocs 200 §6.3. Similarly, change order provisions should be carefully reviewed to determine the extent the contract price may be adjusted on account of either a change in the scope of work or price relating to material price fluctuation. The change order provisions will likely specify the necessary documentation needed to obtain a price adjustment as well as the requirements contractors must follow prior to making such a request. Finally, it is also

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prudent for parties to be aware of any contract acceleration clauses. By way of example, where price escalation coincides with a delay in the delivery of materials to the project, the owner may have a right to require acceleration and the contractor may have additional rights and remedies when such acceleration is required.

Best Practices

While the above considerations may assist parties when faced with an unforeseen material price escalation, one thing is certain: open communication is key to mitigating the impact of price escalation. If the owner does not have knowledge of the contractor's difficulties in obtaining materials at contract cost, for instance, early opportunities to negotiate a resolution to overcome such challenges and efficiently progress the project may be lost. If the contractor promptly advises the owner of a substantial and unexpected price increase, however, the owner and contractor may be able to come up with alternative materials or revised plans for the project. Not only does this reduce the likelihood of potential delay claims and default, but it also allows the parties to work together towards their common goal – timely project completion. With that in mind, below is a list of best practices parties can utilize in order to de-escalate the impact of price escalation:

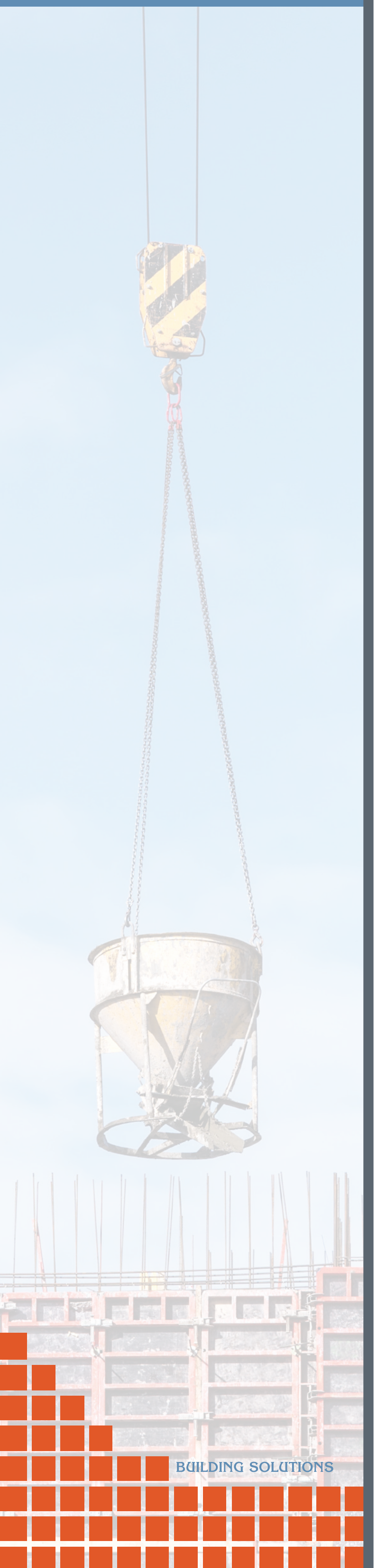
- **Review and Research** - Before negotiating your contract, do your research on the price volatility of materials required for the project by using experienced contractors or suppliers and examining U.S. Dept. of Labor national price index statistics.
- **Price Escalation Clauses** - Negotiate a price escalation clause that works for you. There is no uniform clause that fits every contract but consider using a clause allowing for a triggering price that can adjust both upward and downward.
- **Document** - Make sure to continue your review of material prices throughout the course of the project and keep detailed documentation of price changes along with potential supply chain disruptions that may impact work on the project.
- **Early Purchasing** - If possible, allow parties to pre-purchase, and be paid for, materials which can be ordered early and which may be particularly susceptible to volatility.
- **Communicate** - Be sure there is open communication between the parties. Open and comprehensive communication can lead to mitigation efforts by all parties which, taken as a whole, may result in a minimized impact on the project.

SURETY UPDATE

Another Surety Win: Squaring Off Bond Conditions Precedent Against The "Warm And Fuzzies"

by Jonathan C. Burwood, Partner

Most construction attorneys, whether they represent owners, contractors, or sureties, are by now familiar with the dozens of decisions issued by courts across the country over the past 20 years that identify, interpret, and enforce the "conditions precedent" detailed in the AIA A312 performance bond. By and large, those decisions hold that certain provisions of that bond (for example, Section 3) contain express conditions precedent that must be satisfied by a bond obligee before any performance obligation on the part of a surety will arise. *See, e.g., Seaboard Sur. Co. v. Greenfield*, 266 F. Supp. 2d 189, 196 (D. Mass. 2003), aff'd 370 F.3d 215 (1st Cir. 2004); *St. Paul Fire & Marine Ins. Co. v. Green River*, 93 F. Supp. 2d 1170, 1177 (D. Wy. 2000), aff'd 6 Fed. Appx. 828 (10th Cir. 2001); *Solai & Cameron, Inc. v. Plainfield Comm. Consolidated School Dist. No. 202*, 374 Ill. App. 3d 825, 837 (2007); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166, 179 (D. Mass. 2003). Recently, obligees have



argued that those express conditions precedent are superseded by general language in the bond acknowledging the joint and several obligations of the principal and its surety under the bond, and incorporating the bonded contract. Such "Section 1" arguments reflect an effort by bond obligees to avoid the almost inevitable impact of the weight of authority that uniformly defines and enforces the "Section 3" conditions precedent. Watt Tieder and Arch Insurance Company ("Arch") recently dealt a setback to obligees trying to advance such a "Section 1" argument in Massachusetts.

On February 12, 2021, the United States District Court for the District of Massachusetts issued a declaratory judgment in favor of Arch, reaffirming that Section 3 of the A312 performance bond establishes conditions precedent that must be satisfied prior to any performance obligation arising on the part of the surety, including any obligation established by Section 1 of the bond. The obligee's failure to terminate Arch's bond principal as required by Section 3.2 constituted a material breach of the bond and discharged the surety from any and all liability.

Defaulted But "Not Yet Terminated" Falls Short

Arch issued an A312 (2010 ed.) performance bond on behalf of R.C.M. Modular Inc. ("RCM") in connection with the construction of an apartment building in Boston ("Project"). RCM had subcontracted with the Project owner, The Graphic Builders, LLC ("TGB"), for certain modular construction work. A dispute arose between RCM and TGB during the Project relative to RCM's work. TGB claimed it had incurred costs in the approximate amount of three million dollars to unilaterally repair and complete RCM's work. TGB issued a series of letters to RCM and Arch declaring RCM in default. In one such letter TGB recognized the condition established by Section 3.1 of the bond by declaring RCM in default. Though in that same letter, the obligee also stated that it was "not yet terminating" the bonded subcontract. In doing so, TGB acknowledged that it had not satisfied the condition established by Section 3.2 of the bond. Arch wisely confirmed receipt of TGB's letter and affirmed that RCM had not been terminated. TGB thereafter sent additional letters to the surety alleging RCM's default, and ultimately demanded the surety's performance in the form of payment to the obligee exceeding three million dollars. At no point did TGB terminate RCM as conditioned in Section 3.2 of the bond. On that basis, the surety denied the obligee's performance bond claim and immediately filed a complaint seeking a declaration that TGB discharged Arch's performance obligations by failing to satisfy the conditions precedent set forth in the bond.

The obligee counterclaimed, seeking reimbursement of the amounts TGB alleged it paid to repair and complete RCM's work. TGB also asserted a claim against Arch alleging unfair and deceptive acts as proscribed by M.G.L c. 93A, §§ 2 and 11. In connection with the c. 93A claim TGB sought an award of treble damages and attorneys' fees.

The Obligee's Attempt To Dig Itself Out Of The Hole

Arch sought and was granted an expedited period of discovery limited to the facts necessary to pursue summary judgment on its claim for declaratory relief. Through the course of that discovery, TGB admitted that it never terminated RCM. In fact, in what proved to be a valuable show of candor, the obligee admitted that its failure to terminate the principal was intentional. TGB's corporate representative testified that TGB did not have the "warm and fuzzies" about terminating RCM given concerns about delay, and that terminating RCM would be the "equivalent of shooting ourselves in the face." Instead, TGB opted to prematurely enforce its own remedy by unilaterally arranging for performance of the alleged repair and completion work without first satisfying the conditions precedent established by Section 3 of the bond. In doing so, the obligee deprived the surety of its rights under the bond.

Six months after filing its complaint the surety moved for summary judgment on the grounds that the obligee exonerated and discharged the surety - rendering the bond null and void - by choosing not to satisfy the condition precedent of terminating the principal as required by Section 3.2. Because TGB admitted it did not satisfy Section 3.2, it was forced to argue in opposing Arch's motion that the court should ignore Section 3 entirely. In doing so, TGB asked the court to disregard the clear and unambiguous language of the bond, along with the significant body of caselaw establishing that the obligee's satisfaction of Section 3.2 is a condition precedent to any performance obligation on the part of the surety. *See, e.g., Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003).

Undeterred, the obligee urged the court to abandon the settled rules for interpreting contracts and consider only Section 1 of the

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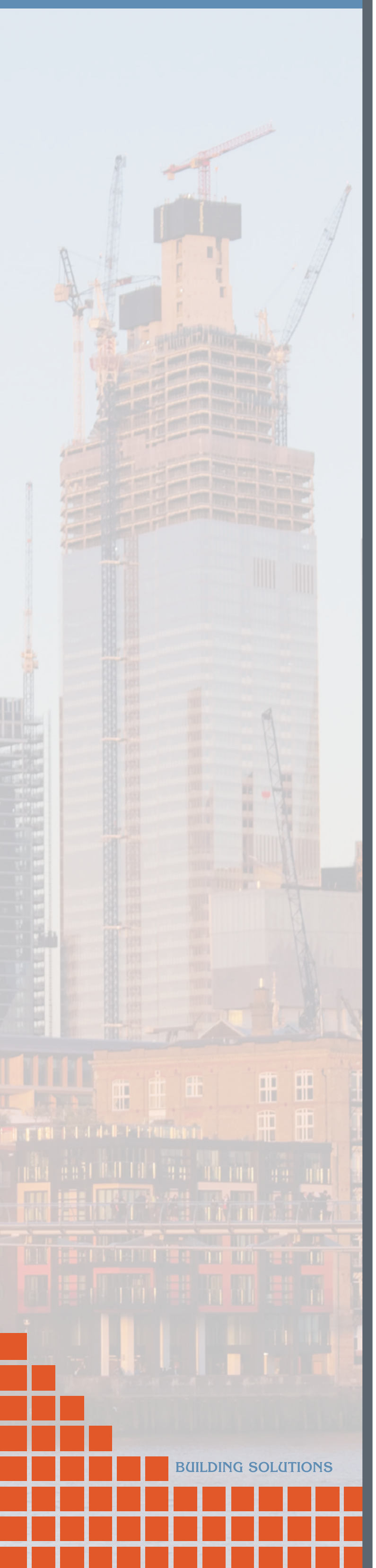


bond, which provides that the principal and surety jointly and severally bind themselves to the obligee for performance of the bonded contract. TGB argued that the subcontract permitted TGB to correct non-conforming work and seek reimbursement from RCM – and in that regard TGB had that same right against Arch independent from the Section 3 conditions precedent. TGB argued for a distinction between Section 3 type claims that require the surety to actually perform the principal's work, and Section 1 type claims that seek only the surety's reimbursement of costs incurred by an obligee that has already performed the principal's work. Contrary to TGB's arguments, there is no performance distinction in the bond between "work" and "payment," and adopting TGB's position would simply void the bond's conditions precedent. By TGB's interpretation, an obligee could bypass the Section 3 conditions precedent at its convenience by unilaterally performing the principal's work and then demanding reimbursement from the surety pursuant to Section 1.

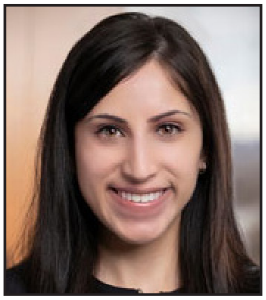
The Obligee Cannot Cherry Pick From The Surety's Performance Obligations

On February 12, 2021, the court issued summary judgment in favor of the surety on all claims. In doing so, the court reinforced that the bond "clearly and unambiguously imposes conditions precedent which must occur before [the surety] is required to perform any of its obligations thereunder." As to TGB's argument that the indemnity language in Section 1 of the bond supersedes the obligations of Section 3, the court found that Section 3 "clearly and unambiguously imposes several conditions which precede all of [the surety's] obligations to perform under the Performance Bond." The court noted that "[n]o provision in the bond or the incorporated subcontract distinguishes between claims as to which the conditions precedent are or are not applicable." As a result, TGB could not enforce any surety performance obligations, including those detailed in Section 1 of the bond. On that basis, the court held that the obligee "materially breached the Performance Bond" and discharged the surety "from any and all liability relating thereto." At the same time, the court resolved TGB's counterclaims in favor of Arch, including its bad faith claim arising under M.G.L. c. 93A. In doing so, the court found that the counterclaims relied on the surety's obligations under the bond, which TGB itself discharged.

Notably, in rejecting TGB's argument that Section 1 creates surety performance obligations immune from the Section 3 conditions precedent, the court elected not to follow two anomalous decisions relied upon by the obligee: *Mid-State Surety Corporation v. Thrasher Engineering, Inc.*, 575 F. Supp. 2d 731 (S.D. W. Va. 2008) and *Forest Manor, LLC v. Travelers C&S Co., et al.*, 2018 WL 11357580 (Conn. Super. Ct. Jan. 30, 2018). Both *Mid-State* and *Forest Manor* rely on *International Fidelity Insurance Company v. County of Rockland*, 98 F. Supp. 2d 400 (S.D.N.Y. 2000), a decision that has been subject to considerable criticism and distinction over the past 20 years. Instead, the court relied on a different decision from the Second Circuit, *Stonington Water Street Associates, LLC v. National Fire Insurance Company of Hartford*, 792 F. Supp. 2d 253 (D. Conn. 2011), aff'd 472 Fed. Appx. 71 (2nd Cir. 2012) (a project owner's failure to terminate the contractor and its unilateral decision to hire successor contractors constituted a material breach of the performance bond).

Obligees Ignore Conditions Precedent At Great Risk

By ruling in Arch's favor, the court simultaneously affirmed that Section 3 of the A312 performance bond establishes conditions precedent to a surety's performance obligations, and rejected the viability of an obligee end-around premised on Section 1. This District of Massachusetts decision follows closely on the heels of a similar decision in the surety's favor issued by the Rhode Island Superior Court on June 30, 2020, in *Providence Builders, LLC v. Costa Brothers Masonry, Inc. and Travelers Casualty and Surety Company of America*, PC-2019-7689 (R.I. Super June 30, 2020). And both the *Arch* and *Travelers* rulings are consistent with the *National Fire Insurance Company of Hartford* decision issued by the District of Connecticut and affirmed by the Second Circuit in 2012. All three decisions reflect the largely uniform judicial view in southern New England and other jurisdictions that obligees will not be entitled to have their cake and eat it too when it comes to claims on the A312 performance bond. At times, obligees will be tempted to self-perform a defaulted principal's work for reasons of expediency or otherwise. And often those obligees will have secured themselves that right in the bonded contract. In taking that fork in the road though, obligees will *very likely* forfeit the right to later seek reimbursement from an A312 performance bond surety. A failure to satisfy – timely and in full – the conditions precedent set forth in the A312 performance bond will exonerate and discharge the surety, rendering the bond null and void.



Recent Case Development: Supreme Court Holds That Mere Retention Of Debtor's Property Does Not Violate Automatic Stay

by Zahra Syed Abrams, Associate

Introduction

A recent decision from the United States Supreme Court, *City of Chicago, Illinois v. Fulton*, 141 S. Ct. 585 (Jan. 14, 2021), addressed a split among the United States Courts of Appeals over whether an entity that retains possession of property of a debtor violates the automatic stay under section 362(a)(3) of the Bankruptcy Code. In particular, creditors often want to keep possession of a debtor's property to continue perfection of a pre-petition lien that may be jeopardized by relinquishing the collateral. In *Fulton*, the Supreme Court held that mere or passive retention of a debtor's property, without something more, does not violate the automatic stay. The Supreme Court's decision provides some comfort to creditors that are holding debtor property, including collateral, when the debtor files for bankruptcy protection by reducing the risk that the creditor will be found to violate the stay and face potential sanctions. The Supreme Court's decision, however, left open the question of whether other provisions of the Bankruptcy Code may still require a creditor to return debtor's property upon commencement of a bankruptcy case in order to avoid violating the automatic stay.

The Split

The purpose of the automatic stay is to preserve the status quo when a debtor files for bankruptcy protection. Section 362(a)(3) of the Bankruptcy Code specifically stays "any act to obtain possession of property of the estate or of property from the estate or ***to exercise control over property of the estate***." The split among the Courts of Appeals arose from differing interpretations as to what it meant to "exercise control over property of the estate" under section 362(a)(3) when a creditor refuses to turnover a debtor's property immediately upon commencement of a bankruptcy case. The Tenth Circuit adopted the minority position that an automatic stay violation under section 362(a)(3) only occurs when there are affirmative acts by the creditor to gain possession of, or to exercise control over, property of the debtor's estate. Thus, a debtor could not use section 362(a)(3) and simply file a motion for stay relief to compel the creditor to return the property. Instead, the debtor must rely on a different section of the Bankruptcy Code to compel the return of the property. In contrast, Second, Seventh, Eighth, Ninth, and Eleventh Circuits took the majority position that simple retention of the debtor's property, *i.e.*, keeping a car or refusing to approve the sale of a liquor license until fines are paid, was sufficient to constitute an act to "exercise control" over debtor's property. Thus, a debtor could simply file a motion to enforce the automatic stay if the property is not returned and seek damages.

Summary of *Fulton* Facts

The issue in *Fulton* arose out of a series of cases in which the City of Chicago (the "City") impounded the debtors' vehicles for failure to pay fines for various parking and driving related infractions. After the vehicles were impounded, the debtors each filed Chapter 13 bankruptcy petitions and sought to have the City return their vehicles. When the City refused, the bankruptcy court found the refusal to be a violation of the automatic stay. The Court of Appeals for the Seventh Circuit affirmed the bankruptcy court's decision and held that the City's retention of the vehicles constituted an "exercise of control" that violated section 362(a)(3). The Seventh Circuit's decision was consistent with the majority view and its prior holding in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009).

The *Fulton* Decision

In its unanimous decision written by Justice Alito, the Supreme Court held that "merely retaining possession of estate property does not

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violate the automatic stay." The Supreme Court examined what it meant "to act … to exercise control" over something. The Supreme Court found that by using the words "to act" and "to exercise control" in the language of section 362(a)(3) necessarily implies something more than mere retention. In other words, only affirmative acts, not passive acts, are prohibited.

The Supreme Court found further support for its analysis by examining the interplay between section 362(a)(3) and the Bankruptcy Code's turnover provision, section 542. Section 542 generally requires persons who have possession, custody, or control of estate property to turn the property over to the trustee or debtor. The Supreme Court reasoned that if section 362(a)(3) prohibited the passive retention of property, it would create two problems within the Bankruptcy Code. First, it would render section 542 superfluous, reducing it to nothing more than a footnote. Such an interpretation runs afoul of established principles of statutory interpretation that err against interpreting a provision in such a manner that results in surplusage. Second, adopting the debtor's argument would result in a conflict between section 362(a)(3) and section 542. Specifically, there are exceptions to when property must be turned over under section 542 that are not recognized in section 362(a)(3). As a result, under the debtor's interpretation, section 362(a)(3) would "require a creditor to immediately do what § 542 excuses."

The Supreme Court's decision in *Fulton* is consistent with its prior decision in *Citizen Bank of Md. v. Strumpf*, 516 U.S. 16 (1995). In *Strumpf*, the Supreme Court held that a creditor bank's administrative hold on a debtor's bank account to preserve the bank's right of setoff did not violate section 362(a)(3). The Supreme Court similarly found – as in *Fulton* – that a contrary ruling would conflict with section 542's provisions and exceptions.

The Limits Of The *Fulton* Holding

Justice Sotomayor wrote a concurring opinion to highlight unresolved issues from the Supreme Court's holding. Specifically, she emphasized that the Supreme Court did not decide whether other provisions of section 362(a), such as sections 362(a)(4) and 362(a)(6), may nonetheless require a creditor to return a debtor's property when a bankruptcy case is filed or risk facing stay violations. Under section 362(a)(4), the automatic stay prohibits any "act to create, perfect, ***or enforce*** any lien against property of the estate." Section 362(a)(6), in turn, prohibits "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case[.]" These sections raise additional questions as to whether holding onto debtor's property constitutes enforcement of a pre-petition lien or an act to collect a debt.

The Seventh Circuit then took Justice Sotomayor's words to heart when it considered *Fulton* on remand. The Seventh Circuit ultimately determined that the proceedings must be remanded to the bankruptcy court to determine if the stay was violated under section 362(a)(4) or section 362(a)(6).

Key Takeaways From *Fulton*

Creditors may find some comfort in knowing that section 362(a)(3) does not automatically require them to turn over collateral comprising the debtor's property to the bankruptcy estate once a debtor files for bankruptcy or risk a stay violation. Creditors, however, should still act with caution and take steps to actively protect themselves and preserve their rights during a bankruptcy case. In particular, as demonstrated by Justice Sotomayor's concurring opinion and the Seventh Circuit's decision on remand, a debtor (or a trustee) could compel return of property and assert a stay violation claim under alternate sections of the Bankruptcy Code. Thus, while helpful under certain circumstances, the Supreme Court's decision under *Fulton* should not be considered as a blessing by the Supreme Court for a creditor to ignore the impact of a debtor's bankruptcy filing, particularly if the creditor is holding property that potentially may belong to the debtor's estate.

Contractors Pay Heed: The Federal Circuit Clarifies Two Important Issues For Bid Protestors

by Andrew Balland, Associate

The United States Court of Appeals for the Federal Circuit (Federal Circuit) recently decided two cases that are relevant to many disappointed offerors considering a bid protest. One decision rendered in March 2021 confirmed the authority of the United States Court of Federal Claims (COFC) to hear a protest based on an agency's breach of an implied-in-fact contract. A second decision issued in February 2021 reversed a COFC decision from last year regarding the timeliness requirements to obtain a CICA stay and their interplay with Department of Defense (DoD) enhanced debriefing regulations.

Federal Circuit Confirms The Court Of Federal Claims' Jurisdiction Over Procurement-Related Implied Contract Claims

When a contractor's bid protest is denied by the Government Accountability Office (GAO), the unsuccessful protestor may challenge the GAO's decision as arbitrary and capricious in an action before the COFC. While 28 U.S.C. § 1491(b)(1) authorizes the COFC to hear such procurement-related challenges, § 1491(a) also permits the court to adjudicate claims against the United States based on any express or implied contracts.

The authority defining the contexts in which – as well as the code sections under which – a protestor may raise an implied contract claim is an evolving body of law. On October 19, 1996, Congress passed the Administrative Dispute Resolution Act (ADRA) and enacted § 1491(b)(1) to unify bid protest law under one court: the COFC. *See* H.R. Rep. No. 104–841, at 10. Since the ADRA's passage, however, it has been unclear whether the COFC is still authorized to hear implied contract claims in the procurement context.

The procurement-related implied-in-fact contract claim emanates from a 1956 Court of Claims opinion which held that disappointed offerors were entitled to sue the United States to recover bid preparation costs under an implied contract theory that the government would "give fair and impartial consideration to [the disappointed offeror's] bid." *See Heyer Prods. Co. v. United States*, 140 F. Supp. 409, 413 (Ct. Cl. 1956). Although the court in *Heyer Products* did not cite its jurisdictional authority to hear such claims, § 1491 authorized implied contract claims against the United States under the same operative language found in the current language of § 1491(a).

COFC judges have been uncertain about whether the procurement-related implied contract claim survived the enactment of § 1491(b)(1), which makes no reference to implied contracts and is now the sole provision authorizing the COFC to hear procurement challenges. In 2010, the Federal Circuit held that contractors retained the right to pursue an implied-in-fact contract claim against the government **outside the procurement process** under § 1491(a). *See Res. Conservation Grp., LLC v. United States*, 597 F.3d 1238, 1245 (Fed. Cir. 2010). Because the *Resource Conservation Group* decision only involved the lease of government property, the Federal Circuit did not articulate whether the COFC had jurisdiction over implied contract claims related to the procurement process under § 1491(b)(1).

The absence of authority in this area led to inconsistent rulings by the COFC. Specifically, some judges have held that jurisdiction over procurement-related implied contract claims no longer exists. *See Linc Gov't Servs., LLC v. United States*, 96 Fed. Cl. 672, 693 (2010); *Metro. Van & Storage Co. v. United States*, 92 Fed. Cl. 232, 249 n.7 (2010). At least one judge, however, has held that such jurisdiction exists under § 1491(a), while others have found that such jurisdiction exists instead under § 1491(b)(1). *See L-3 Commc'ns Integrated Sys., L.P. v. United States*, 94 Fed. Cl. 394, 398

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(2010); *see also J.C.N. Constr., Inc. v. United States*, 107 Fed. Cl. 503 (2012); *Castle-Rose, Inc. v. United States*, 99 Fed. Cl. 517, 531 (2011).

In March 2021, the Federal Circuit finally resolved the split in *Safeguard Base Operations, LLC v. United States*, 989 F.3d 1326, 1342-43 (Fed. Cir. 2021). The court in *Safeguard* found the COFC could hear a protestor's breach of an implied-in-fact contract claim under § 1491(b)(1), and this section alone, where the protestor alleged the Department of Homeland Security failed to honestly and fairly consider its proposal in the procurement process. *Safeguard* provided much needed clarity for protestors and confirmed the viability of the procurement-related breach of an implied contract claim.

Within a week of the opinion, the COFC acknowledged its jurisdiction over these § 1491(b)(1) claims. In *Colonna's Shipyard v. United States*, the COFC permitted a claim to proceed where the protestor alleged the Navy breached its implied contract of fair dealing by acting in bad faith when reviewing the contractor's proposal. 152 Fed. Cl. 631, 640, 646-47 (2021). Although the court in *Colonna's Shipyard* ultimately found the protestor's argument unavailing, the success of future § 1491(b)(1) implied contract claims will be worth monitoring. For now, contractors at least have an additional tool in their belts to deploy at the COFC, and they can rest assured this claim's viability no longer depends on the judge assigned to the case.

Federal Circuit Clarifies The Interplay Between DoD Enhanced Debriefing Regulations And CICA Stay Timeliness Requirements

The Federal Circuit has also clarified a complex interplay between DoD enhanced debriefing regulations and the filing requirements to obtain an automatic stay under the Competition in Contracting Act (CICA).

Protestors often choose to file at the GAO to trigger the CICA stay, which automatically suspends any contract award or performance upon the filing of a GAO protest. 31 U.S.C. § 3553(c)(1). The stay is only available when a contractor files its protest within five (5) days of receiving a written debriefing from the agency or within ten (10) days of the contract's award, whichever is later. 31 U.S.C. § 3553(d)(4)(A).

Disappointed offerors can also take advantage of DoD-specific procedures before protesting the award of a DoD contract. Since the issuance of FAR Class Deviation No. 2018-O0011, DoD protestors have been entitled to unique "enhanced debriefings," including **the right to submit written questions** within two (2) business days after receiving their written debriefings **and to receive written answers to those questions**. The regulations provide that a DoD agency (1) "shall not consider the post-award debriefing to be concluded until the agency delivers its written responses to the unsuccessful offeror," and (2) must "comply with the requirements of FAR § 33.104(c) [which mirrors CICA] regarding the suspension of contract performance." *Id.*

In 2020, the COFC was asked to determine whether the enhanced debriefing regulations affect when the clock begins running for the CICA stay timeliness requirements. *See NIKA Technologies, Inc. v. United States*, 147 Fed. Cl. 690, 692-96 (2020). In *NIKA Technologies*, the Army Corps of Engineers issued a written debriefing to the plaintiff-contractor on March 4, 2020, noting the contractor had two days to submit questions under the DoD enhanced debriefing provisions before the agency would close the matter. The contractor indicated it would prepare questions but ultimately never submitted any before filing its protest at the GAO on March 10, 2020.

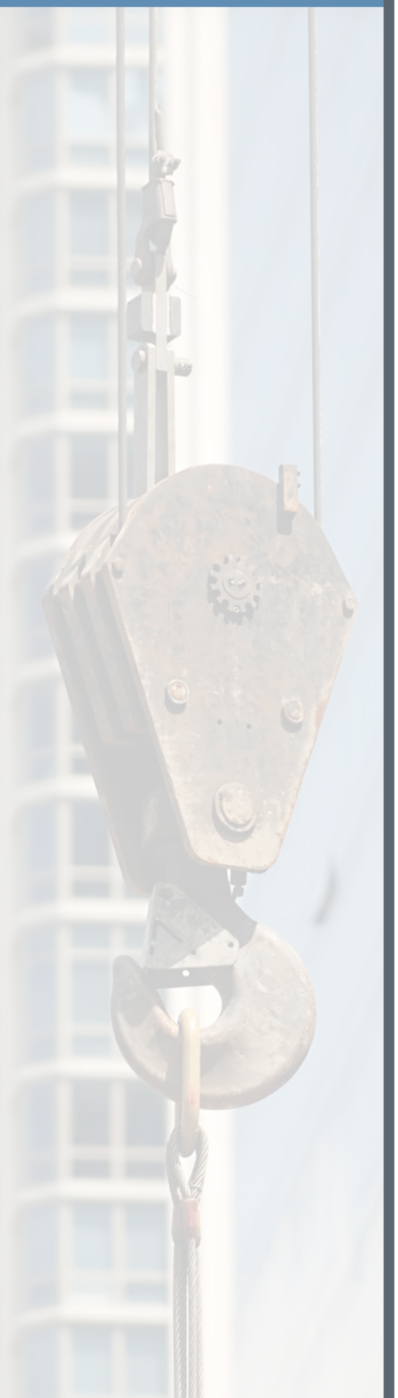
At the GAO, the government opposed the request for a CICA stay, arguing the five-day clock began running as of March 4. The contractor then filed a separate action at the COFC to have the court render judgment on the administrative record and institute the stay. The plaintiff argued that because its ability to submit the enhanced debriefing questions did not end until March 6, its protest was timely under § 3553(d)(4)(A). By contrast, the government argued the written debriefing was issued on March 4 and therefore the contractor's protest was late under the plain language of the statute.

The COFC ultimately sided with the contractor, specifically pointing to case law demonstrating the debriefing date referenced in § 3553(d)(4)(A) had been construed to contemplate a multi-day debriefing process. This decision was a brief victory for protestors who face stringent filing requirements at the GAO, but it was not long lived. In February 2021, the Federal Circuit reversed the COFC in this matter, holding "that the plain meaning of the statute is that the deadline in 31 U.S.C. § 3553(d)(4)(A) is five days after receipt of debriefing." 987 F.3d 1025, 1029 (Fed. Cir. 2021). The Federal Circuit rejected the COFC's determination that the statute contemplates a broader debriefing period as opposed to the specific day on which the protestor receives its debriefing.

DoD contractors can take away two key points from *NIKA Technologies*. First, the Federal Circuit was clear that "the two-day period for questions [under the DoD enhanced debriefing regulations] occurs within the five-day window for filing a protest." 987 F.3d at 1029. Second, the Federal Circuit acknowledged that § 3553(d)(4)(B) specifically states the five-day filing deadline does not begin running until the government issues any responses to additional questions submitted under the enhanced debriefing regulations. *See id*. at 1029, n.1. Thus, while the contractor in *NIKA Technologies* filed its protest late because it **never** submitted any additional questions that would alter the debriefing end date, DoD contractors who timely submit such questions can wait to receive their responses before the clock on the CICA stay starts running.

Conclusion

Contractors should be aware of the *Safeguard* opinion because it confirms the COFC's authority to hear a protest based upon an agency's breach of an implied-in-fact contract in the procurement context. Additionally, to avoid future timeliness issues, contractors should review the *NIKA Technologies* opinion discussing the interplay of CICA stay filing requirements and DoD enhanced debriefing regulations. Contractors are encouraged to read these decisions in their entirety and discuss their relevancy to any pending matters with counsel.



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FIRM NEWS

Recent And Upcoming Events

AGC's 2021 Surety Bonding and Construction Risk Management Conference, June 2-4, 2021; Bonita Springs, FL. **Timothy E. Heffernan** co-presented a session titled "Federal Fraud Investigations Update: Some Construction and Surety Industry Hotspots." **Mariela M. Malfeld** and **Lauren E. Rankins** presented on "Decoding the Mystery of Productivity Claims."

2021 AAA Virtual Construction Conference, June 9-10, 2021. **Shelly L. Ewald** co-presented on "Ethical Issues Arising in Multi-party Mediations and Arbitrations."

Virginia State Bar, June 14, 2021. **Shelly L. Ewald** co-presented on "Nailing Voir Dire, Special Verdicts, and Instructions in Construction Jury Trials."

AACE International Conference, June 15, 2021. **Christopher J. Brasco** and **Matthew D. Baker** co-presented on "Concurrent Events & Other Scheduling Issues in the News."

Northern Virginia Bankruptcy Bar Association, June 17, 2021. **Zahra S. Abrams** will present on "New Caselaw Developments and Hot Topics in Bankruptcy Cases in the Fourth Circuit."

AACE 2021 Retreat, A Symposium on Change and Claims Management in Engineering, Procurement and Construction, June 22, 2021; Boston, Massachusetts. **Christopher J. Brasco**, **Bradford R. Carver** and **Matthew D. Baker** will participate in two Round Table/ Panel Discussions: "Legal Aspects of Contract Changes and Claims in the E, P, and C - What should be in the Contract?" and "What Not to Do When Preparing Claims - Interactive War Stories Session."

American Road & Transportation Builders Association, June 24, 2021. **Christopher J. Brasco** and **Matthew D. Baker** will present on "Setting up a Successful Mediation, Strategically Selecting Your Mediator, Mediating with the Mediator, Bargaining Essentials and Impasse Breakers."

U.S. Minority Contractor's Association 3rd Annual Technology Day Conference, August 5, 2021; Des Plaines, Illinois. **Lauren E. Rankins** will participate in a panel discussion titled "Meeting your Diversity Goals in an Evolving Technological Industry."

Maryland Bankruptcy Bar Association, September 9, 2021. **Jennifer L. Kneeland** was chosen to serve as a panelist in a discussion lead by the Honorable Laurie S. Silverstein, U.S. Bankruptcy Judge for the District of Delaware and the Honorable Brian F. Kenney, U.S. Bankruptcy Judge for the Eastern District of Virginia. Ms. Kneeland's discussion is titled "Recovering From COVID-19: The Pandemic's Impact on the Bankruptcy Code, Bankruptcy Cases and Bankruptcy Solutions."

Maryland Bankruptcy Bar Association, September 9, 2021. **Marguerite DeVoll** was chosen to serve as a panelist in a discussion lead by the Honorable David E. Rice, U.S. Bankruptcy Judge for the District of Maryland. Ms. DeVoll's discussion is titled "The Small Business Reorganization Act."

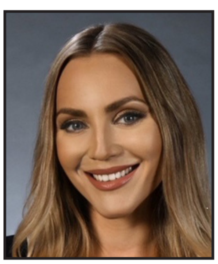
ABA Forum on Construction Law 2021 Annual Conference, October 13-16, 2021; Seattle Washington. **Hanna L. Blake** will participate in a plenary session titled "Going Nuclear: Managing Termination: When & How to Say 'When.'"

Announcement

Marguerite Lee DeVoll after meeting stringent requirements, was randomly selected to participate in the National Conference of Bankruptcy Judges ("NCBJ") annual Next Generation ("NextGen") program in Indianapolis, Indiana from October 5-9, 2021. To qualify for the NextGen program, participants must demonstrate a commitment to the highest standards of civility, ethics, and professionalism, as well as to the continued educational development of bankruptcy professionals and to professional activities that benefit the public, the bankruptcy bar, and the court system.

Watt Tieder Welcomes Three New Attorneys

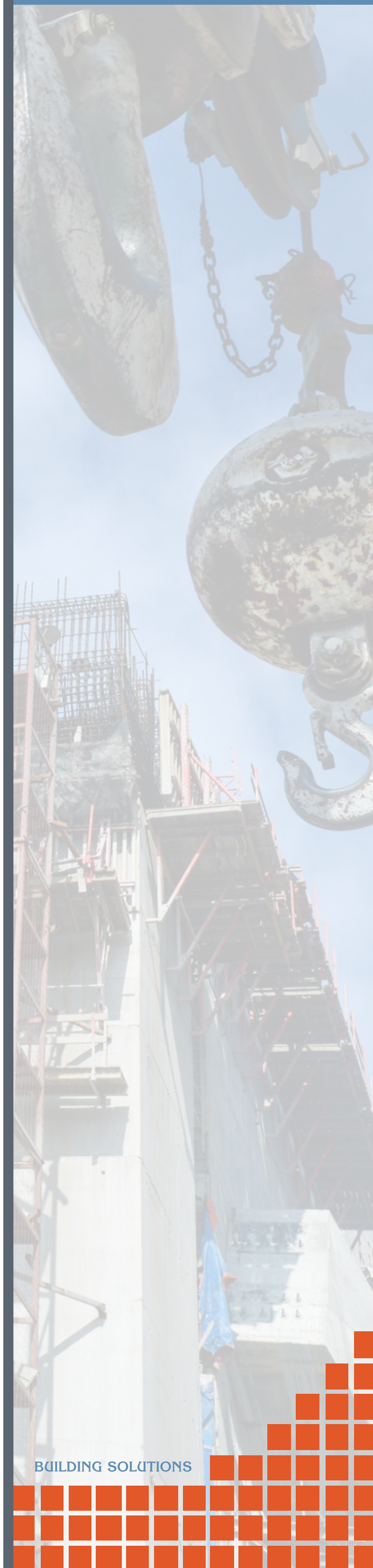
Joanna Kopczyk joins Watt Tieder as an associate in the Chicago office. Joanna's practice focuses on a range of complex litigation and transactional matters, with her core practice centering on commercial, construction, suretyship and insurance disputes. This includes pre-litigation investigation and case analysis, formal litigation including discovery, drafting pleadings, settlement negotiations and case evaluation, mediation, arbitration, motion practice, conducting and defending depositions, and trial. Prior to joining the firm, Joanna practiced in a commercial litigation boutique and in the City of Chicago Law Department, Building and License Enforcement Division. Joanna earned her J.D. from The University of Texas School of Law in 2017.



Elena A. Kuzminova joins the Irvine office as an associate. Elena's practice is primarily focused in the areas of surety and lending, construction and general commercial litigation. She represents large construction companies, surety clients and developers. Elena's expertise includes all phases of litigation and complex dispute resolution in both federal and state courts. Her diverse experience includes construction, surety, real estate, mortgage banking, bankruptcy, insurance, and general business litigation matters. Prior to joining Watt, Tieder, Elena's practice focused on real estate litigation, professional liability, and insurance defense litigation. Elena earned her J.D. in 2014 from The University of California Irvine School of Law.

Joneis M. Phan joins Watt Tieder as Of Counsel in Irvine focusing his practice in the areas of surety and lending, construction litigation and general commercial litigation. Joneis is an experienced litigator who has successfully resolved matters for his clients through negotiation, mediation, alternative dispute resolution, and trial.

Prior to joining the firm, Joneis was with Clyde&Co as part of their complex litigation team providing representation to clients both in the United States and internationally. He has experience in the areas of employment law, data and privacy law, products liability, specialty and catastrophic tort law, professional malpractice and business litigation and handles all aspects of litigation. Joneis earned his J.D. from Whittier Law School in 2006.



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The Watt, Tieder, Hoffar & Fitzgerald newsletter is published quarterly and is designed to provide information on general legal issues that are of interest to our friends and clients. For specific questions and concerns, the advice of legal counsel should be obtained. Any opinions expressed herein are solely those of the individual author.

Special Thanks to Editors, **Timothy E. Heffernan, William Groscup, Christopher M. Harris** and **Marguerite Lee DeVoll**.

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