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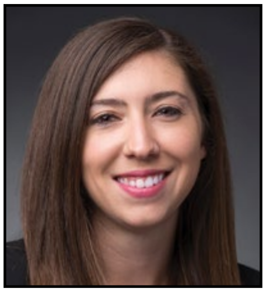
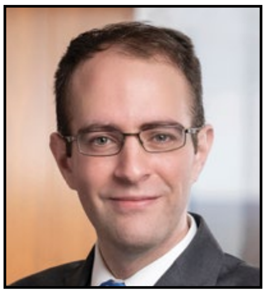
Contractors Are Confronting The Realities Of A Federal COVID-19 Vaccine Mandate



Sarah K. Bloom

by Sarah K. Bloom, Associate and Gregory M. Wagner, Associate



Gregory M. Wagner

Since September 9, when President Biden issued his Executive Order imposing a sweeping vaccine mandate for federal contractors, companies have grappled with two primary concerns: how to address the new requirements, and how the mandate will affect their business. President Biden's Executive Order 14042, titled "Ensuring Adequate COVID Safety Protocols for Federal Contractors" requires executive agencies to include in their contracts a clause requiring compliance with all guidance published by the Safer Federal Workforce Task Force ("the Task Force").

Covered Contractors Must Adhere To All Task Force Guidance

The Task Force first issued its COVID-19 Workplace Safety Guidance ("the Guidance") on September 24, 2021. The Guidance requires contractors and subcontractors with a covered contract to implement certain workplace safety protocols to protect against COVID-19.

Specifically, the Guidance requires all "covered contractor employees" to be fully vaccinated for COVID-19 by December 8, 2021, with certain exceptions for religious and medical accommodations. Because "fully vaccinated" status is not conferred until two weeks after a second dose, first doses were needed by October 25. Hence, contractors must put plans in place now for their employees. The Task Force has issued templates for use by employees requesting an accommodation in the form of a medical or religious exemption.

Under the new Guidance, the vaccine mandate applies to any full-time or part-time employee of a covered contractor working on "or in connection with" a covered contract, or working at a covered contractor workplace. Personnel working "in connection with" a covered contract may include human resources, accounting, and legal personnel who support federal contracts, but who do not work directly on a federal project. The vaccine mandate also applies to employees who share facilities with covered contractor employees, even if those employees are not themselves working on a covered contract. The requirement even covers employees working remotely.

In addition to the vaccine mandate, the Guidance requires contractors to ensure that all covered employees and visitors comply with published Centers for Disease Control and Prevention ("CDC") guidance for masking and physical distancing. Contractors also must designate a person to coordinate implementation of and compliance with the Guidance.

Contractors Must Adhere To FAR 52.223-99, Which Imposes Changing Requirements

In accordance with EO 14042, the FAR Council developed FAR 52.223-99, "Ensuring Adequate COVID-19 Safety Protocols for Federal Contractors." This new clause is required for contracts awarded on or after November 14 from solicitations issued before October 15; new solicitations issued on or after October 15 and contracts awarded under those solicitations; extensions or renewals of existing contracts and orders awarded on or after October 15, 2021; and options on existing contracts and orders exercised on or after October 15, 2021.

Despite the apparent limited application of the FAR clause to new contracts, the FAR Council strongly encourages agencies to apply the Guidance to all contracts – even those awarded before November 14, contracts for the manufacturing of products, and contracts under the simplified acquisition threshold. The FAR

Council also encourages agencies to exercise their FAR 1.4 authority to issue class deviations and adopt FAR 52.223-99 immediately, rather than awaiting a formal amendment to the FAR.

Perhaps the most notable aspect of FAR 52.223-99 is its mandate that contractors adhere to all guidance issued by the Task Force "including guidance conveyed through Frequently Asked Questions, **as amended**." FAR 52.223-99 (c) (emphasis added). By its nature, this clause requires contractors to constantly monitor the FAQs for changes, and to adhere to potentially new interpretations. In light of the ever-changing federal guidance related to COVID-19 safety protocols, this requirement imposes yet another potential ambiguity upon contractors.

Several agencies, including DoD, GSA, DOJ, DHS, and NASA, have already adopted FAR 52.233-99. For example, on October 1, 2021, the DoD required Contracting Officers to incorporate DFARS 252.223-7999, "Ensuring Adequate COVID-19 Safety Protocols for Federal Contractors (Deviation 2021-O0009)" into contracts as required by Executive Order 14042. The DoD also authorized its contracting officers to include the clause in solicitations issued before October 15. Notably, the DoD requires a bilateral modification when modifying existing contracts to include the deviation clause.

As of the time of this article, the federal vaccine mandate is facing legal challenges from at least 20 states. *See Florida v. Nelson et al.*, No. 8:21-cv-02524 (M.D. Fla. filed Oct 28, 2021); *Brnovich v. Biden et al.*, No. 2:21-cv-01568 (D. Ariz. filed Sept. 14, 2021); *Georgia v. Biden*, No. 1:21-cv-00163 (S.D. Ga. filed Oct. 29, 2021); *Missouri v. Biden*, No. 4:21-cv-01300 (E.D. Mo. filed Oct. 29, 2021); *Texas v. Biden*, No. 3:21-cv-00309 (S.D. Tex. filed Oct. 29, 2021). Until those matters are decided, however, the mandate remains in place. And as set forth above, vaccine mandates as set forth in the Guidance may soon apply to almost all federal contractors.

Recommended Path Forward For Affected Contractors

- **Review Workspaces For Application And Compliance**

Contractors should carefully review the Guidance and determine how the vaccine mandate applies within their organizations. As noted above, the requirement applies not only to employees working on a covered contract, but also to employees working "in connection with" a federal contract, to include human resources, accounting, and legal. It also applies to employees who share work facilities with those working on a covered contract, even if the employees themselves are not working on or in connection with a covered contract.

Contractors who have federal and commercial business lines should carefully review their office spaces to determine whether, and to what extent, its commercial business lines may be affected by the Guidance. Contractors that have not already implemented an organization-wide vaccination program may require dedicated work locations for private sector business lines to avoid running afoul of the new federal requirements.

- **Closely Track Costs Of Compliance**

The DoD authorizes contracting officers to include the FAR clause into existing contracts, but requires a bilateral modification to do so. The GSA issued similar guidance addressing existing contracts. GSA's September 30 memorandum states that "[c]ontracting officers shall send a cover letter and modification request to add the clause at FAR 52.223-99 for existing contracts . . . . The modification must be bilateral."

Based upon requirements for bilateral modifications, an opportunity exists for contractors to pursue recovery of unanticipated costs of compliance with the Guidance. Contractors who receive a modification to implement the Guidance should review the costs associated with compliance. All direct and indirect costs associated with complying with the Guidance requirements should be closely tracked. These may include costs to vaccinate employees, downtime associated with getting the vaccine and addressing associated side effects, designating an individual to ensure compliance, processing requests for medical or religious exemptions, any necessary physical changes to the workplace, costs to test employees for COVID-19, costs associated with implementing visitor protocols, subcontractor costs, loss of productivity, etc. As mentioned above, many agencies have already applied the mandate beyond what is required in EO 14042.

- **Labor Shortages May Result From The Vaccine Mandate**

Current CDC data indicates that over 66% of Americans have received at least one dose of a COVID-19 vaccination. Vaccination rates in particular industries or localities, however, may be substantially lower. A recent study

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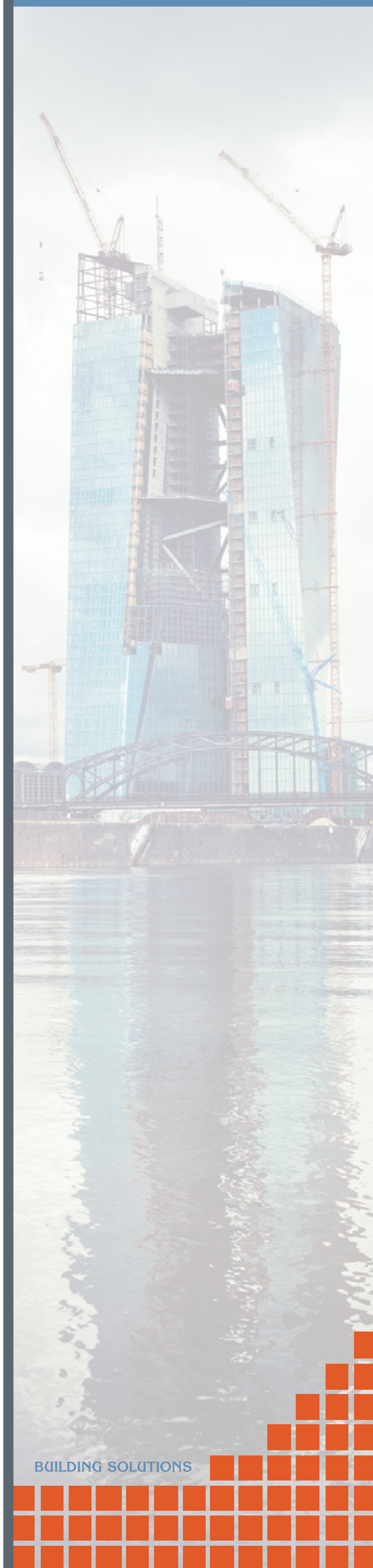


conducted by the Center for Construction Research and Training found that, as of September 2021, only 53.8% of construction workers surveyed were vaccinated, compared to 80.9% in all other occupations. Further, 41.8% of construction workers surveyed reported vaccine hesitancy, compared to only 16.8% in all other occupations. Thus, in some industries, the new requirements may compound labor shortages that have already plagued contractors throughout the year.

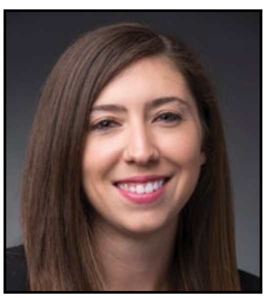
Contractors should keep careful records regarding their efforts to staff federal projects. While a labor shortage generally does not entitle a contractor to relief from the government, certain rare exceptions have been recognized where the government caused the labor shortage in question. *See J. A. Jones Const. Co. v. United States*, 390 F.2d 886, 893 (Ct. Cl. 1968) (Air Force had a duty to disclose plans for a high-priority construction program involving payment of premium wages in same labor area as contractor's project, creating labor shortage; granting summary judgment as to liability and referring for further proceedings as to quantum). At a minimum, labor shortages arising from the vaccine mandate may require contractors to estimate increased prices or premium prices in their proposals for future federal contracts.

If you have questions about the Guidance or its impact on your business, do not hesitate to contact Watt Tieder for assistance.

Scott P. Fitzsimmons

New OSHA Standard Would Impose Vaccine Mandate Or Weekly Testing Requirement For Large And Mid-Size Businesses; Enforcement Stayed Pending Legal Challenges

by Scott P. Fitzsimmons, Senior Partner and Sarah K. Bloom, Associate



Sarah K. Bloom

On November 4, 2021, the Occupational Safety and Health Administration ("OSHA") issued its long-awaited emergency temporary standard regarding COVID-19 Vaccination and Testing ("the ETS").

Within hours of the ETS's publication in the Federal Register, states and affected companies began to launch legal challenges. Just two days after the ETS was issued, the U.S. Court of Appeals for the Fifth Circuit granted a nationwide stay, citing "cause to believe there are grave statutory and constitutional issues" with the ETS. As discussed in further detail below, legal challenges are also pending in other jurisdictions.

New OSHA Standard Requires Covered Employers To Identify Vaccination Status, Impose COVID-19 Safety Requirements, And Report Data

The ETS generally applies to employers under OSHA's jurisdiction that have a total of at least 100 employees. The ETS does not apply to workplaces covered under the Safer Federal Workforce Task Force COVID-19 Workplace Safety: Guidance for Federal Contractors and Subcontractors or in settings where employees provide healthcare services or healthcare support services, which are covered by separate COVID-19 rules. The ETS also does not apply to employees who work remotely.

Covered employers face significant new requirements. The ETS requires employers to determine the vaccination status of each employee, obtain acceptable proof of vaccination, maintain records of each employee's vaccination status, and maintain a roster of each employee's vaccination status.

Further, covered employers are required to develop, implement, and enforce a mandatory COVID-19 vaccination policy. An exception exists, however, for employers that instead establish, implement, and enforce a policy requiring employees who are not fully vaccinated to undergo weekly COVID-19 testing and wear a face covering at the workplace. The ETS requires employers to support vaccination by providing employees reasonable time, including up to four hours of paid time, to receive each dose, and reasonable time and paid sick leave to recover from any side effects experienced following each dose. Employers are not required to pay for testing. Notably, booster shots are not included in the ETS definition of "fully vaccinated." Thus, employers need not mandate that employees receive boosters.

The ETS also requires employers to: (1) require employees to promptly provide notice when they receive a positive COVID-19 test or are diagnosed with COVID-19; (2) immediately remove any such employee from the workplace, regardless of vaccination status; and (3) keep removed employees out of the workplace until they meet criteria for returning to work.

Employers must report work-related COVID-19 fatalities to OSHA within 8 hours of learning about them, and work-related COVID-19 in-patient hospitalizations within 24 hours of the employer learning about the hospitalization. "Work-relatedness" is determined by reference to 29 C.F.R. § 1904.5.

Numerous Legal Challenges Raised, ETS Effective Date In Question

Challenges to the legality of OSHA's ETS were filed in the 5th, 6th, 7th, 8th, and 11th U.S. Circuit Courts of Appeals. *See, e.g., BST Holdings, LLC, et al. v. OSHA*, No. 21-60845 (5th Cir. filed Nov. 5, 2021); *Kentucky v. OSHA*, No. 21-4031 (6th Cir. filed Nov. 5, 2021); *Indiana v. OSHA*, 21-3066 (7th Cir. filed November 5, 2021); *Missouri, et al. v. Biden*, No. 21-3494 (8th Cir. filed Nov. 5, 2021); *State of Florida v. OSHA*, No. 21-13866 (11th Cir. filed Nov. 5, 2021). Private companies and states alike have argued that the ETS exceeds the authority of the federal government and/or OSHA's authority under its enabling statute. *See id.* Additional appeals appear likely.

On November 6, 2021, the Fifth Circuit granted a nationwide stay, citing "cause to believe there are grave statutory and constitutional issues" with the ETS. On November 12, 2021, after briefing on both sides, the three-judge panel issued an order affirming the stay that had previously been granted preventing the ETS's vaccine mandate from taking effect. Order Affirming Stay, *BTS Holdings, LLC et al. v. OSHA*, 21-60845 (Nov. 12, 2021). In its Order, the court described the ETS as "staggeringly broad," noting that it appeared to be both over-inclusive to the extent that it fails to account for natural immunity and varying COVID-19 exposure risk in differing work environments, *and* under-inclusive in that it offers no protection to employees working for companies with 99 or fewer employees. *See id.* at 6, 13, 15. While the Order did not decide the case on the merits, it signaled that the court has serious doubts that the ETS is appropriately tailored to meet its stated purpose, or that it falls within OSHA's statutory authority to regulate workplace safety.

Pending resolution of the case on the merits, the court ordered that OSHA "take no steps to implement or enforce" the ETS "until further court order." OSHA announced it has suspended activities related to the implementation and enforcement of the ETS pending future developments in the litigation.

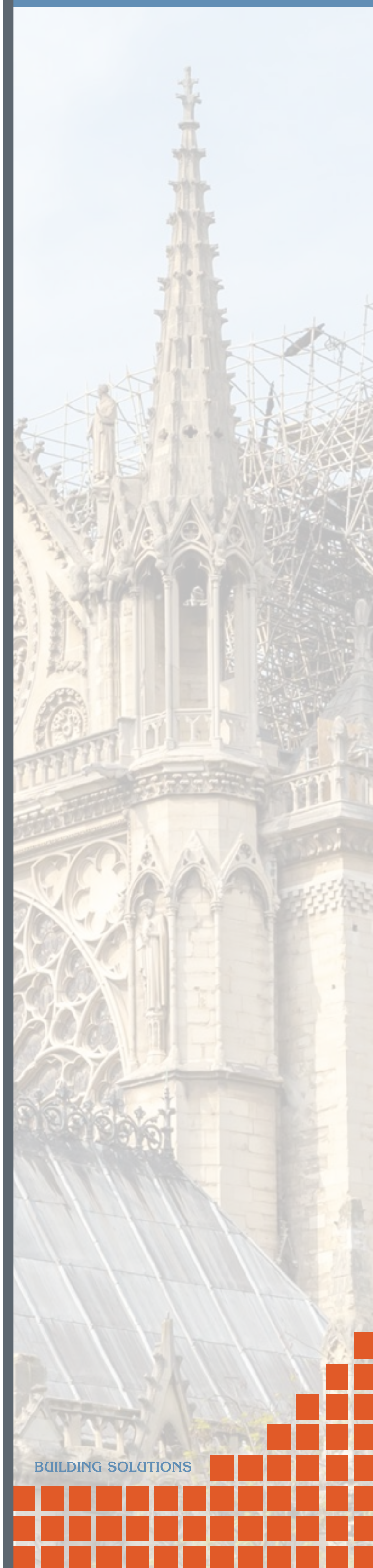
As of the date of publication, pending challenges to OSHA's ETS have been consolidated and will be decided by a three-judge panel from the U.S. Court of Appeals for the Sixth Circuit.

Pending Resolution Of Legal Challenges, Employers Should Prepare To Achieve Compliance

Because the developments are continuing to evolve as of the date of publication of this article, the outcome of OSHA's ETS is uncertain. Companies that would have been impacted by the ETS should follow developments in the litigation closely.

Pending resolution of the legal challenges, employers should thoroughly review the requirements of the ETS and prepare to achieve compliance. This includes determining who within the organization will be subject to the vaccination or test-and-mask requirements, how and when data on employee vaccination and/or testing status will be collected and maintained, and who will be responsible for maintaining required records and reporting qualifying events to OSHA. Employers that have not already implemented an organization-wide vaccination program should consider what an appropriate program might look like, and how such a program would be administered.

If you have questions about the ETS or its impact on your business, do not hesitate to contact Watt Tieder for assistance.



Three Recent Cases Strike Down Liquidated Damages Clauses In Settlement Agreements…A Trend Or An Aberration?

by Adam M. Tuckman, Partner

Beginning more than one century ago, owners and contractors generally have adopted the convention of including liquidated damages in their contracts to fix potential liability for delay (and other losses) at the inception of the project. The proliferation of liquidated damages clauses in modern contracts can be attributed to economic and legal factors. From the owner's standpoint, it may be exceedingly difficult to prove the actual cost impact of a delayed completion of the project. A properly calculated liquidated damages rate would save the owner the significant expense of quantifying its delay damages. On the contractor's side, a reasonable amount of liquidated damages may be preferable to uncapped or unknown liability, allowing the contractor to more accurately price its bid and efficiently allocate risk.

Coinciding with, or perhaps a leading cause of, the industry's embrace of liquidated damages provisions, was the shift in courts throughout the country from disfavoring such clauses to accepting them (within limits) as an appropriate exercise of contract rights. While some variation exists among the states, courts have generally recognized that liquidated damages clauses are a viable alternative to proof of actual loss so long as (i) actual losses were difficult to quantify, and (ii) the stipulated sum bears a reasonable relationship to the anticipated loss at the time of contracting. *See, e.g.*, Restatement (Second) of Contracts § 356. Conversely, a clause that penalizes the breaching party rather than serving as an estimate of probable loss is likely to be found unenforceable.

Liquidated damages provisions have not only been used as a remedy for delayed project completion. For instance, when contracting parties resolve pending or anticipated disputes by requiring performance or payment from one party over time, the other party may insist upon including a liquidated damages provision in their settlement agreement to incentivize the obligor to fulfill such obligations. Consider the following hypothetical. Party A is determined to file a lawsuit against Party B for $100,000. To avoid the lawsuit, Party B agrees to settle the dispute by paying $60,000 in monthly installments of $5,000 over 12 months. To ensure that Party B pays the installment payments, Party A insists upon a settlement term providing that, in the event full payment of the $60,000 is not made, then Party B will be liable for the full amount of the original claim – $100,0000 – net of any payments already made, plus an additional lump sum of $20,000 covering interest, attorneys' fees and other losses.

At first blush, the above hypothetical seems like a reasonable "carrot and stick" approach by which Party A, in agreeing to compromise forty percent of its claim, is shielded against the risk of Party B's non-compliance with the settlement terms. A trio of recent court cases decided in the last two years – applying New York, California and Florida law – however, demonstrate that a party's ability to impose disincentives for nonpayment through a settlement agreement will be limited in certain jurisdictions. Under the facts of these cases, each court held that a provision in a settlement agreement obligating the payor to remedy a breach by paying a substantial sum of liquidated damages in addition to, or in lieu of, the settlement amount was an unenforceable penalty. Relying upon the general test for the validity of a liquidated damages clause, the courts struck down the respective liquidated damages clauses in the settlement agreements because the liquidated sum was disproportional, and bore no relationship, to the actual damages that likely would flow from a breach of the settlement agreement.

The first of these recent cases to address this issue was a 2019 case in the California Second District Court of Appeal, *Red & White Distribution, LLC v. Osteroid Enterprises, LLC*, 251 Cal. Rptr. 3d 400 (Cal. Ct. App. 2019). In *Red & White*, the parties resolved a claim of default under a loan agreement. Their settlement required *Red & White Distribution* ("R&W") to pay $2.1 million in installments over one year, but if R&W defaulted, then Osteroid Enterprises ("Osteroid") could enter a stipulated judgment that required R&W to pay an additional $700,000 more than the settlement amount, plus interest and attorneys' fees. Recognizing that California law generally limits actual damages for the breach of a payment provision to the balance due plus interest, the court reasoned that the $700,000 additional payment bore "no reasonable relationship to the range of actual damages the parties could have anticipated from a breach of the agreement to settle the dispute for $2.1 million." Consequently, the court found the stipulated judgment to be an unenforceable penalty.

In late-2020, the Court of Appeals of New York reached a similar decision in *Trustees of Columbia Univ. in City of N.Y. v. D'Agostino Supermarkets, Inc.*, where the court refused to enforce a damages provision in a "Surrender Agreement" between a defaulting tenant and the landlord. 162 N.E.3d 727 (N.Y. 2020). The tenant, D'Agostino Supermarkets ("D'Agostino"), could not fulfill its lease with approximately $1,000,000 remaining due to the landlord, Columbia University ("Columbia"). To avoid the time and expense of an eviction process, Columbia agreed to accept $261,000 of the remaining lease balance, paid over time, along with D'Agostino's agreement to vacate the property. Columbia argued that, under the Surrender Agreement, D'Agostino's ensuing failure to pay the settlement amount rendered D'Agostino liable for the full balance of the terminated lease, plus interest, taxes and other costs. Over a vociferous dissent that would have upheld the Surrender Agreement as a proper exercise of freedom of contract, the court concluded that requiring D'Agostino to pay such damages, requiring 7.5 times more than if it fully complied with the payment terms, was a penalty and could not be enforced. Of particular note, the court emphasized that the *Surrender Agreement*, not the original lease, is the relevant agreement to determine whether the liquidated damages provision is proportional to the anticipated loss from a breach.

Finally, earlier this year, the U.S. Court of Appeals for the Eleventh Circuit held in *Circuitronix, LLC v. Kinwong Elec. (Hong Kong) Co.* that, under Florida law, a settlement agreement provision establishing a $2 million liability for each breach of a covenant was found to be a penalty and unenforceable. 993 F.3d 1299 (11th Cir. 2021). The court determined that the $2 million sum far exceeded the actual damages that might have been anticipated for any individual breach, which was expected to be less than $10,000.

While conventional wisdom is that liquidated damages provisions are routinely enforced, these recent cases demonstrate that the freedom of sophisticated parties to craft their settlement agreements will not always win the day, particularly when courts view the agreement as imposing excessive damages as compared to the probable loss that may be experienced by the non-breaching party. Indeed, the court in *Red & White Distribution* stated that it was publishing the decision to remind "practitioners whose clients settle a dispute involving payments over time how to incentivize prompt payment properly, and what may happen if done incorrectly." The court signaled, but did not decide, that an incentive structure may pass muster when the parties stipulate that the full amount of the claim is owed, apply a discount to the claim for timely payments, and then require full payment of the claim if the agreement is breached. While this approach may seem to be a distinction without a difference in practical effect, the key takeaway from the cases discussed above is that the appearance of a settlement procured through inequitable means may be avoided by carefully drafting the payment provisions in the agreement. As construction claims and disputes frequently conclude with a commercial settlement, the industry should be mindful of the thin line that exists between a properly drafted incentive for prompt payment and an unenforceable penalty that could void the resolution of a claim or dispute.

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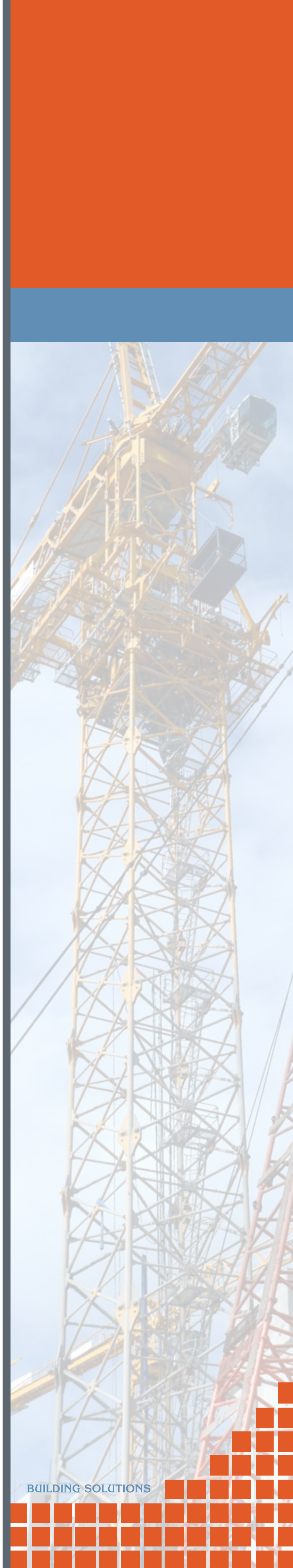

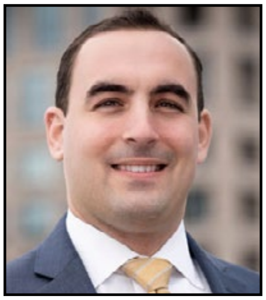

Pitfalls And Precautions For Contractors Teaming With Small Business Concerns

by Noah Meissner, Associate

Federal, state, and local construction spending exceeded $300 billion in the years 2018, 2019, and 2020. Both the federal government, as well as state and local governments have established programs to ensure that a significant portion of these public funds are directed to small, minority-owned, and/or otherwise disadvantaged businesses (hereafter referred to generally as Small Business Concerns or SBCs). Larger businesses may team, partner, and otherwise join with SBCs to gain access to work that would otherwise be unavailable to them in return for providing necessary expertise, resources, and surety credit that SBCs may lack.

These ripe pastures of business opportunities come with a potential minefield of regulatory risk, which requires an informed understanding of the applicable rules to be successfully navigated. This article introduces certain key rules and provides guidance as to how a large contractor can protect itself when it teams with a Small Business Concern.

A Brief Primer On Small Business Concerns And Requirements

This introductory discussion is not intended to be an exhaustive summary of the intricate laws governing small and/or socially and economically disadvantaged business entities. Instead, the purpose is to establish certain core concepts applicable to SBCs, which will inform the discussion of the rules that apply when pursuing work set aside for SBCs.

- <u>The Small Business Administration's (SBA) 8(a) Program</u>

The SBA's 8(a) program establishes set-asides for "socially and economically disadvantaged" small businesses. To qualify, the SBC must be at least 51% unconditionally owned by members of a socially or economically disadvantaged group, as the program defines such groups. 15 U.S.C. § 637 (a)(4). Importantly, the management and daily operations of the business must be controlled by members of a socially or economically disadvantaged group.

- <u>Women-Owned Small Businesses</u>

The SBA also qualifies SBCs as Women-Owned Small Businesses (WOSBs). To qualify as a WOSB, the business must be at least 51% unconditionally and directly owned and controlled by female U.S. citizens. *See* 13 C.F.R. Part 127. An WOSB may further qualify as an economically disadvantaged WOSB (EDWOSB) if the qualifying female owner's net worth is less than $750,000, exclusive of the value of her ownership interest in the EDWOSB itself and equity in a primary residence.

- <u>Service-Disabled Veteran Owned Small Businesses</u>

The SBA also qualifies businesses as Service-Disabled Veteran Owned Small Businesses, or SDVOSBs. In order to qualify as a SDVOSB, the business must be at least 51% unconditionally and directly owned by a service-disabled veteran. The management and daily operations of the business must be controlled by one or more service-disabled veterans. A service-disabled veteran is defined as a veteran with a service-connected disability confirmed by documentation from the Department of Veterans Affairs or the Department of Defense or inclusion in a database maintained by the Department of Veterans Affairs. 13 C.F.R. §§ 125.11-.13.

There are two common requirements that appear in all these definitions: in order to qualify, the business must be (1) owned, and (2) controlled by a member of the qualifying class. It is precisely these requirements and the related issue of affiliation that can become the most problematic when a large contractor considers becoming involved with an SBC.

Federal Government Rules Governing Relationships With Small Business Concerns

Before discussing what a large contractor can do to protect itself when it seeks to pursue federal set-aside work with a SBC, it is vitally important to understand the set of rules that governs the relationship between them and the main areas where a government contractor may run afoul of the rules. The major challenges arise in three separate but interrelated categories: ownership, control, and affiliation.

- Contractors With Minority Ownership Interests In Small Business Concerns

In some cases, a contractor may pursue set-aside work by taking an ownership interest in an SBC. This type of arrangement raises potential issues with the requirements related to ownership as well as control.

-The Qualifying Individual(S) Must Have Direct And Unrestricted Ownership Of The SBC

To qualify as an SBA Section 8(a) small business, WOSB, or SDVOSB, the SBC must be "unconditionally and directly owned" by a qualifying individual as defined by the applicable regulations. 13 C.F.R. §§ 124.105; 127.210; 125.12. Addressed below in turn, a contractor must be aware of what constitutes "unconditional ownership" and what constitutes "direct ownership."

Until relatively recently, the question of what constitutes "unconditional ownership" was left unanswered by the applicable statutes and the courts applied a standard derived from *In re Wexford Grp. Int'l.* SBA No. SDV-105, 2006 WL 4726737 (2006). The *Wexford* definition was subsequently superseded by changes in the SBA's regulation and "unconditional ownership" is now defined consistently under the regulations for 8(a) program participants and SDVOSBs, as follows:

> Unconditional ownership means ownership that is not subject to conditions precedent, conditions subsequent, executory agreements, voting trusts, restrictions on or assignments of voting rights, or other arrangements causing or potentially causing ownership benefits to go to another (other than after death or incapacity). The pledge or encumbrance of stock or other ownership interest as collateral, including seller-financed transactions, does not affect the unconditional nature of ownership if the terms follow normal commercial practices and the owner retains control absent violations of the terms.

13 C.F.R §§ 124.3; 125.11. *See also* 13 C.F.R. § 127.201.

In re: Alog Corp. involved an analysis of a Stock Transfer Agreement that illustrates the issue of unconditional ownership and the potential consequences of limiting the rights of a qualifying individual to transfer an ownership interest in a SBC. SBA No. VET-285, 2020 WL 4559510 (2020). The SBA's Office of Hearings and Appeals (OHA) found that, despite two service-disabled veterans owning over 51% of the SDVOSB in question, the Stock Transfer Agreement in question had limited the rights of one of the qualifying individuals to transfer his shares to anyone outside the company and also required that individual to sell his shares to the company after four years. In concluding that these terms had imposed impermissible restrictions on the qualifying individual's ownership interest and that the company was not an eligible SDVOSB, OHA noted that:

> [T]he definition of unconditional ownership is clear. The service-disabled veteran's ownership of the challenged concern must be unlimited, with no restrictions whatever on their ownership, or their ability to dispose of their shares in any way they choose. The exceptions are agreements dealing with the death or incapacity of a shareholder, and the pledge of stock as collateral if the terms follow normal commercial practices.

The freedom to dispose of an interest in a SBC is a relatively bright-line requirement. Security interests, liens, and other financing instruments must not be structured in a way that unduly restrict the transfer of this ownership interest or fail to follow "normal commercial practices," or else the SBC runs the risk of being found not to be unconditionally owned by the qualifying individual.

Direct ownership generally requires that the qualifying individual personally own his or her shares in the SBC, rather than through another entity like a holding company. It is important to note, however, that SBA OHA has issued conflicting decisions regarding this requirement in the context of joint ventures. A contractor seeking to partner with a SDVOSB, Criterion, ran afoul of the "direct ownership" requirement in *In re CriterEOM, LLC.* SBA No. VET-245, 2014 WL 7640932 (2014). Criterion and the contractor first entered a joint venture agreement to pursue a contract for the U.S. Department of the Air Force, but subsequently formed an LLC superseding the joint venture agreement. Although the sole shareholder of Criterion was a qualifying service-disabled veteran, OHA found that the direct ownership requirement was not met because the LLC was 51% owned by Criterion instead of the qualifying individual.

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Although relatively straightforward, a contractor seeking to partner with a SBC needs to be aware of these limitations if it is considering taking an equity interest in the SBC as part of its security to ensure that the necessary 51% direct ownership interest remains with the qualifying individual.

-The Qualifying Individual(S) Must Have Formal And Unimpeded Control Of The SBC

The concept of control encompasses both long-term strategic decision-making, as well as managing day-to-day operations. The regulations for 8(a) program participants, SDVOSBs, and WOSBs share certain basic requirements, including that the qualifying individual hold the highest officer position in the SBC and have control over all decisions for the SBC. There are a number of other factors identified in the regulations that can undermine a finding that the qualifying individual has unconditional control of a SBC, such as:

- o A non-disadvantaged individual or entity, having an equity interest in the [SBC], provides critical financial or bonding support or a critical license to the [SBC] which directly or indirectly allows the non-disadvantaged individual significantly to influence business decisions of the [SBC].

- o A non-disadvantaged individual or entity controls the [SBC] or an individual disadvantaged owner through loan arrangements.

- o Business relationships exist with non-disadvantaged individuals or entities which cause such dependence that the [SBC] cannot exercise independent business judgment without great economic risk.

- o In circumstances where the [SBC] is co-located with another firm in the same or similar line of business, and that firm or an owner, director, officer, or manager, or a direct relative of an owner, director, officer, or manager of that firm owns an equity interest in the [SBC].

See 13 C.F.R. §§124.106; 125.13.

These are only a representative sample of the many factors outlined in the regulations for the various programs, which in some cases give rise to rebuttable presumptions that the qualifying individual does not "control" the SBC.

The requirement that a qualifying individual hold the highest officer position in the company was examined in *In re Nelco Diversified, Inc.* SBA No. VET-140, 2008 WL 4694580 (2008). There, the qualifying individual (Felix Nelson) was CEO of Nelco Diversified. However, Nelco's Articles of Incorporation and bylaws did not establish a CEO position and did not give any powers or duties to that position. The bylaws instead provided that the President would be the CEO of the company. The President of Nelco was Daniel Nelson, a non-qualifying individual. Daniel Nelson was also the founder of Nelco and had been the sole owner for many years before he sold a 51% interest in Nelco to Felix Nelson. Despite Felix Nelson's admitted title as CEO, the judge found that Felix Nelson did not hold the highest officer position in the company, and Nelco was therefore not a proper SBC.

While the result reached seems obviously correct, it is the nature of the inquiry that provides the important lesson: the judge went beyond the titles of the individuals and analyzed who really had control and influence over the company. The likelihood of such an inquiry being made demonstrates that a qualifying figurehead will not be sufficient. Instead, the qualifying individual must have true control over the operations of the company, and upon a proper challenge, the SBA will dig into the operation of the company to determine whether control is appropriately vested with the qualifying individual. In short, paying lip service to the requirements is not enough, and the SBA will investigate thoroughly enough to detect noncompliance.

The SBA OHA examined the operating agreement that governed the operations of the SBC in *In re: Heritage of America, LLC.* SBA No. VET-142, 2008 WL 5192403 (2008). That agreement provided, among other things, that certain "Major Decisions" could only be made with the consent of 80% of the ownership of the LLC. Among those "Major Decisions" were any expenditure or obligation above $10,000 and taking out any loan. The qualifying individual owned 51% of the LLC. The judge found that these limitations meant that the qualifying individual did not have the right to control the day-to-day operations of the LLC, and therefore the LLC was not an eligible SBC.

A SBC's operating agreement was also scrutinized by the SBA OHA in *Size Appeal of: Washington Patriot Constr., LLC.* SBA No. SIZ-5447, 2013 WL 1784800 (2013). Although the qualifying individual held 51% ownership and 51% management interests in the SBC, the operating agreement allowed the three minority owners to "thwart [the qualifying individual's] control over [the SBC] in cases of disagreement" as such disagreements would be resolved by a majority vote among the four managers. As well, *In re: Apex Ventures, LLC* focused on the limitations in the SBC's operating agreement that prevented the qualifying individual from managing the SBC's finances without the approval of the minority member, including even writing checks, to find that the qualifying individual lacked the requisite control over the SBC. SBA No. VET-219, 2011 WL 6056789 (2011).

- <u>Contractors Teaming Or Contracting With Small Business Concerns</u>

When a contractor does not have any ownership interest in an SBC, but nonetheless pursues set-aside work by teaming or contracting with an SBC, it must remain cognizant of the possibility that its relationship will be deemed an "affiliation" and potentially subject the SBC to a size challenge (i.e., a disqualification proceeding). The regulations governing the 8(a) program are instructive as to what may be considered an improper affiliation between an SBC and a large contractor, explaining generally that "entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both." 13 C.F.R. § 121.103.

The SBA has made it clear, both through statutory language and judicial decisions, that the SBA will use a "totality of the circumstances" analysis when considering whether two entities are affiliated. The decision in *Size Appeal of: David Boland, Inc.* is an excellent example of how the totality of the circumstances test is applied in practice. SBA No. SZE-4965, 2008 WL 2958383 (2008). The SBA OHA weighed numerous factors before concluding that the SBC was impermissibly dependent on revenue earned in a joint venture with a non-SBC, such that the SBC, joint venture, and non-SBC were all affiliated, and the SBC was disqualified as too large under the SBA's program.

-SBCs And Large Businesses Must Avoid The "Ostensible Subcontractor" Rule

Teaming agreements allow SBCs to compete for and perform set-aside projects with the assistance of a large contractor, to whom a portion of the work is subcontracted. The danger in such an arrangement lies in potentially running afoul of the ostensible subcontractor rule, which can result in a finding of affiliation between the SBC and contractor. There are two prongs to the rule. As the prime contractor, the SBC must perform the "primary and vital" contract requirements, which in the context of a construction project, "is to superintend, manage, and schedule the work, including coordinating the work of the various subcontractors." *Size Appeal of: Milani Constr., LLC*, SBA No. SIZ-5898, 2018 WL 2565178, at *6 (2018). In addition, the SBC cannot be "unusually reliant" on a subcontractor to perform its contract. SBA OHA has identified four key factors that are likely to lead to a finding of unusual reliance:

> (1) the proposed subcontractor is the incumbent contractor and is ineligible to compete for the procurement; (2) the SBC prime contractor plans to hire a large majority of its workforce from the subcontractor; (3) the SBC prime contractor's proposed management previously served with the subcontractor on the incumbent contract; and (4) the SBC prime contractor lacks relevant experience and must rely upon its more experienced subcontractor to win the contract.

Size Appeal of: Nationwide Pharm., LLC, SBA No. SIZ-6027, 2019 WL 4729361, at *16 (2019).

Given that SBCs frequently need to rely on the experience and resources of a teaming partner to effectively compete for a contract award, the ostensible subcontractor rule requires a carefully structured relationship between SBC and its larger contracting partner.

-Mentor-Protégé Programs Offer Significant Protection From Affiliation Scrutiny

SBCs are permitted to enter formal and highly structured relationships with larger mentor firms. Much has been (and can be) written about this process, and a full discussion of the requirements of a mentor-protégé relationship are beyond the scope of this article. However, the upshot of an approved mentor-protégé agreement is that the mentor will be permitted to provide certain assistance to its protégé that would otherwise be prohibited by the affiliation rules. 13 C.F.R. § 121.103(b)(6).

Effective late last year, the SBA's 8(a) Mentor-Protégé Program and the All Small Mentor-Protégé Program (ASMPP) merged into one Mentor-Protégé Program (MPP). 85 Fed. Reg. 66147. The primary purpose of both programs was to encourage small businesses

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(protégés) to gain capacity and win government contracts through partnerships with more experienced businesses (mentors).

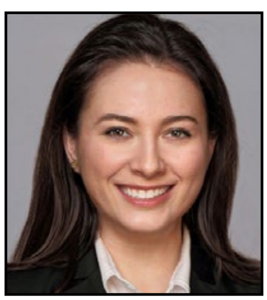
While the SBA initially created the 8(a) Mentor-Protégé Program only for qualified 8(a) SBCs in 1998, it expanded the mentor-protégé relationship to all small businesses with the creation of the ASMPP in 2016. Such businesses include WOSB, SDVOSB, and Historically Under-Utilized Business Zone (HUBZone) small businesses. Like the 8(a) Program, the ASMPP also provides an exception to affiliation for assistance that a protégé firm receives from a mentor and allows the protégé and mentor to joint venture as a small business provided the protégé qualifies as small for the size standard corresponding to the NAICS code assigned to the procurement. The affiliation exceptions under the mentor-protégé programs are significant because SBA's regulations require a small business to count its own annual receipts or employees, plus the annual receipts or employees of each affiliate, when determining its size status. The ASMPP has been enormously popular because it gives all small protégé businesses more capability to compete for larger and more sophisticated work while simultaneously giving large mentor businesses the opportunity to conduct up to 60% of work on a federal set-aside contract when that mentor may not have otherwise qualified to do any of that work. 13 C.F.R. § 125.8 and § 125.9. The amendments to the SBA's mentor-protégé programs and related regulations are significant and should be closely reviewed by all government contractors. 85 Fed. Reg. 66147.

Conclusion

There are substantial restrictions on the influence a contractor can exert over an SBC if the two entities choose to team up to pursue a set-aside project. The exercise of improper levels and/or types of control can lead to successful bid protests, breaches of contract, and even rescission. Brute force approaches to control and security will often put the SBC at risk of disqualification from the SBA program, while overly subtle approaches create too much risk for most contractors to tolerate.

As with much of the construction industry, teaming with a SBC is an exercise in risk control. Understanding the rules and careful selection of a SBC partner is an obvious primary mitigation tool. Intelligently structuring the relationship up-front maximizes the tools available to the contractor to avoid and mitigate any later losses. Careful monitoring and fast action during the project are necessary to ensure that a difficult situation does not spiral out of control.

RECENT DEVELOPMENTS IN FRAUD CASES



Subcontractor Status Reports: A Potential Source Of Liability Under The False Claims Act?

by Joanna Kopczyk, Associate

Introduction

Amendments to the False Claims Act were introduced by a bipartisan group of senators in late July as "The False Claims Amendments Act of 2021" (S.B. 2428). These Amendments could potentially change the False Claims Act - particularly as it pertains to materiality and how federal courts will apply that concept in the context of *qui tam* actions stemming from inaccurate subcontractor status reports.

The New Proposed Legislation

"The False Claims Amendments Act of 2021" (or "the Amendments") was also introduced as the "Anti-Fraud Amendments Act" (Amendment No. 2435), in an earlier version of the Infrastructure Investment and Jobs Act ("Infrastructure Act") that was passed by the United States Senate. Those amendments, however, did not make their way to the Infrastructure Act that passed in the House.

Because one of the sponsoring senators, Senator Chuck Grassley of Iowa, has previously been successful in shepherding amendments to the False Claims Act through Congress, the proposed changes have a fair chance to pass.

The Amendments do not propose changes to the definition of "material" as included in section 3729(b)(4) of the False Claims Act. Instead, they propose a burden-shifting scheme that would apply to the demonstration of materiality. Under the proposed Amendments, the government or relator would still need to establish materiality by a preponderance of evidence, which mirrors the current standard. The defendant could only rebut that showing, however, through clear and convincing evidence. Under the current statutory framework, defendants are not required to rebut a demonstration of materiality. Instead, as set forth in *Universal Health Services, Inc. v. US ex rel. Escobar*, whether a provision allegedly violated by a defendant is labeled a condition of payment is relevant, but not dispositive of, the materiality inquiry into whether the defendant has made an actionable false or fraudulent claim under the Act. 136 S. Ct. 1989, 2001 (2016).

The new language in The False Claims Amendments Act of 2021 could significantly raise the bar for False Claims Act defendants to defeat materiality. Though not clear from the text of the statute, the change may be intended to establish a presumption of materiality in those situations where the government has grounds to deny payment on a claim. When asserted, the defendant would have the burden to show—by clear and convincing evidence—that the alleged violation was not actually material to the government's decision whether to pay the claim(s) at issue. One thing is clear - no matter how the courts interpret this new statutory language, False Claims Act defendants will have more difficultly challenging materiality in the future if the The False Claims Amendments Act of 2021 passes or is incorporated into other legislation.

Subcontractor Status Reports And Materiality

Under current law, whether inaccurate subcontractor status reports meet the materiality standard sufficient to give rise to liability under the False Claims Act is unclear. Standing alone, the status report is not a claim for payment; however, status reports potentially influence claims for payment made by the contractor to the government later in time. As such, an argument could certainly be made that a given status report is material to a subsequent payment decision.

Post-*Escobar* caselaw has embraced an implied certification theory that reflects the materiality standards currently embodied in the False Claims Act. The implied certification theory recognized by *Escobar* does not require an affirmative declaration of compliance that turns out to be false to find a violation of the False Claims Act. Instead "the act of submitting a claim for reimbursement itself implies compliance" with contractual provisions, statutes, and regulations. *Escobar* permits the argument that whatever the defendants' noncompliance is, it may be sufficiently material to the payment decision to qualify the request for payment as a false claim under the False Claims Act.

Escobar was decided in the context of a healthcare provider that hired staff members who violated state regulations for the particular type of care they were providing. The federal government in *Escobar* did not contract for that state-mandated standard of care. The paradigm on which *Escobar* was decided differs significantly from the construction industry. Parallels can be drawn, however, and the question could be asked whether a subcontractor status report amounts to a certification of compliance? Is the report an express condition for payment? The two courts that have addressed that issue to date found that subcontractor status reports do not rise to the level of "material" in most circumstances.

A federal district court in North Carolina recently found that because small business certifications found in inaccurate Individual Subcontracting Reports ("ISR") (Standard Form 294), were not core or basic requirements contemplated for work provided under the contract, the certifications were not "material" as that concept has been applied by *Escobar* and its progeny. *U.S. ex rel. Howard v. Caddell Construction Company, Inc.*, Case No. 7:11-CV-270-FL, 2021 WL 1206584 (E.D.N.C. Mar. 30, 2021). The *Howard* court offered three rationales for its findings. First, it stated that the parties' Subcontracting Plan was not an express condition of payment and the consequence for a contractor that could not verify the accuracy of the ISR was merely the rejection of the report as a deliverable, not a stoppage of work or payments to the contractor. Second, the *Howard* court noted that the government continued to pay on the contract even after the relator filed the *qui tam* litigation and after criminal charges were filed against one of the defendants. The government also decided not to assess liquidated damages against that defendant based upon the defendant's good faith efforts to comply with the subcontracting plan. Finally, the *Howard* court pointed out that

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the defendants did not know that the certification of compliance with the Subcontracting Plan was material to the government's decision to make monthly payments, nor did any government agents tell the defendants otherwise. For those three main reasons, the court held that the subcontractor's inaccurate ISRs did not give rise to a false claim under *Escobar*.

In another decision, the Ninth Circuit in *United States ex rel. Kelly v. SERCO, Inc.*, relied upon *Escobar* to uphold summary judgment dismissing a False Claims Act claim against the contractor brought by a *qui tam* relator. 846 F.3d 325 (9th Cir. 2017). In *Kelly*, the relator employee alleged that a government contractor failed to comply with a national standard related to a cost and progress tracking tool required by the Federal Acquisition Regulation as part of the contractor's project management performance. Instead of filing the required reports, the contractor manually recorded employee hours, compiled these time entries into Excel spreadsheets, and submitted those to the government. The district court granted summary judgment in favor of the defendant contractor. On appeal, the relator argued that the district court wrongly analyzed the relator's claim under the express false certification theory of liability. In its analysis of materiality, the Ninth Circuit quoted *Escobar* stating that "[p]ayment requests by a contractor who has violated minor contractual provisions that are merely ancillary to the parties' bargain are neither false nor fraudulent" demonstrating the limits of the implied certification theory post-*Escobar*.

In light of the pending legislative changes relating to how materiality can be demonstrated and rebutted in implied certification cases, it is important to note the distinction between status reports that certify compliance with a subcontracting plan and the inclusion of certifications of compliance in a document that qualifies as a request for payment. The former is less likely to be deemed violative of the False Claims Act, while the latter will likely face the higher scrutiny contemplated in connection with the proposed changes to the False Claims Act.

The False Claims Act and the required compliance issues that can give rise to liability under the Act are complicated and sometimes difficult to understand. Contractors performing work for the federal government would do well to seek guidance on compliance issues outside of their sphere of expertise.

FIRM NEWS

Honors

U.S. News and World Report - Best Lawyers 2022

WATT, TIEDER, HOFFAR & FITZGERALD, L.L.P. 2022
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The following **Watt Tieder** attorneys were named among the **Best Lawyers** in America for 2022: **Kathleen O. Barnes** (Construction Law, Litigation-Construction); **Christopher J. Brasco** (Construction Law, Litigation-Construction); **Jonathan C. Burwood** (Construction Law); **Bradford R. Carver** (Commercial Litigation, Construction Law, Litigation-Construction); **Shelly L. Ewald** (Construction Law, Litigation-Construction); **Vivian Katsantonis** (Construction Law); **Jennifer L. Kneeland** (Litigation – Bankruptcy); **Mariela Malfeld** (Litigation – Construction); **Robert C. Niesley** (Construction Law, Litigation-Construction); **Edward J. Parrot** (Litigation – Construction); and **Carter B. Reid** (Construction Law, Litigation-Construction).

Recent And Upcoming Events

36th Annual Construction SuperConference, December 7-8, 2021; Orlando, FL. **Robert G. Barbour** will be a key-note panelist on a panel titled "Managing A Construction Law Practice Today and Beyond from the Managing Partners' Perspective;" **Christopher J. Brasco** and **Vivian Katsantonis** will be co-moderators on a panel titled "Concurrent Events and Other Breaking News Affecting the Recovery of Delay Damages;" **Shelly L. Ewald** will appear on a panel titled "The More The Merrier: Trials and Tribulations of Presenting and Defending Construction Claims involving Class Actions, Multi-Plaintiff and Multi-Defendant Jury and Bench Trials;" **Scott P. Fitzsimmons** will moderate a panel titled "Theory Meets Practice in Construction Risk Management;" and **John E. Sebastian**, **Amanda L. Marutzky** and **Lauren E. Rankins** will be speaking on a panel titled "Decoding the Mystery of Productivity Claims."

ABA Tort, Trial and Insurance Section's Fidelity and Surety Law Committee's Mid-Winter Conference, January 19, 2021; Nashville, Tennessee. **Hanna Lee Blake** will present on Takeover Agreements.

Watt Tieder Names New Partner

Watt Tieder is pleased to announce that **Lauren E. Rankins** has been named Partner. Lauren works in Watt Tieder's Chicago, Illinois office, and she focuses her national practice in the areas of construction and surety law, providing a full range of transactional and litigation services for her clients. Lauren represents owners, general contractors, construction managers, subcontractors and material suppliers in a variety of matters involving contract drafting and negotiation, bid protests, breach of contract claims, mechanic's liens, and claims involving changes, differing site conditions, defective design, delay, disruption, acceleration and loss of productivity. Lauren also represents sureties in matters involving payment and performance bond claims on private and public projects, drafting and negotiation of takeover and tender agreements, and collateral and indemnity disputes.

Lauren has extensive experience in resolving disputes through the use of mediation, arbitration and other alternative dispute resolution techniques, as well as representing her clients in federal and state courts.

Lauren serves as the Co-Chair for the Midwest Surety & Construction Claims Conference. She is also a liaison for the American Bar Association Fidelity & Surety Law Committee Newsletter, and is recognized as an Emerging Leader for Construction Financial Management Association.

Watt Tieder Welcomes New Associates

Jordan A. Hutcheson is an associate in Watt Tieder's McLean office. Jordan concentrates her practice on construction and government contracts litigation. She joined the firm after clerking for the Circuit Court judges in the 27th Judicial Circuit in Southwest Virginia.

Jordan graduated *cum laude* from Antonin Scalia Law School at George Mason University in 2019. While in law school, Jordan served as an Articles Editor for the George Mason Law Review. Prior to and during law school, Jordan worked as a paralegal at a small civil litigation firm. She also worked as a law clerk to the general counsel for multiple construction companies in the Mid-Atlantic region where she was responsible for assisting with general employment and business-related matters, as well as several private and government projects involving bid submissions, bond and performance claims, equitable adjustment and change order requests, mechanic's liens, and all stages of general/prime-subcontractor performance and litigation.

Henry O. Taylor is an associate in Watt Tieder's McLean office where he focuses his practice on construction and suretyship law. Henry joined Watt Tieder after clerking for the firm as a summer associate in 2020. Henry graduated from William & Mary Law School in 2021. While in law school, Henry interned with the Office of the Commonwealth Attorney for Petersburg, Virginia, competed in mock trial tournaments as a member of William & Mary's National Trial Team, and served on William & Mary's *Business Law Review*. Prior to law school, Henry worked for Fortune 500 clients in supply chain management.

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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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