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BUILDING SOLUTIONS

Size Matters For Federal Government Contractors: SBA Adjusts Its Size Standards Again Due To Unprecedented Inflation

by Hanna Lee Blake, Partner

On November 17, 2022, the U.S. Small Business Administration (SBA) released a final and interim final rule making adjustments to its receipts-based and assets-based industry size standards, disadvantaged thresholds and 8(a) sole source eligibility thresholds to account for the unprecedented inflationary economic conditions experienced in recent times. The SBA's statutory mission is to aid and assist small businesses through a variety of financial, procurement, business development, and advocacy programs. It is also tasked with defining which businesses are deemed "small" in order to access these programs and associated benefits. The SBA recognizes the negative impact that inflation has had on small business concerns, including limiting access to certain SBA and other federal benefits. In particular, inflation has caused monetary-based size standards to decrease in real terms, thereby forcing businesses to lose small business status and eligibility for federal assistance. The SBA's recent rulemaking seeks to remedy this, and to benefit the U.S. economy as a whole by expanding those entities eligible for federal assistance and set-aside contracts. The SBA's rulemaking becomes effective on December 19, 2022.

The SBA's Statutory Mandate

The Small Business Act of 1953 (P.L. 83-163, as amended) authorized the SBA and justified the agency's existence on the grounds that small businesses are essential to the maintenance of the free enterprise system. The congressional intent was to assist small businesses as a means to deter monopoly and oligarchy formation within all industries and the market failures caused by the elimination or reduction of competition in the marketplace. Congress delegated to the SBA the responsibility to establish size standards to ensure that only small businesses were provided SBA assistance. Since that time, the SBA has analyzed various economic factors, such as each industry's overall competitiveness and the competitiveness of firms within each industry, to set its size standards.

The SBA currently uses two types of size standards to determine SBA program eligibility: (1) industry-specific size standards; and (2) alternative size standards based on the applicant's maximum tangible net worth and average net income after federal taxes. The SBA also uses industry-specific size standards to determine eligibility for federal small business contracting purposes. For the majority of industries and subindustry activities identified in the North American Industry Classification System (NAICS), the size standards are based on either the firm's number of employees or average annual receipts. Overall, about 97% of all employer firms qualify as small, and these firms represent about 30% of industry receipts.

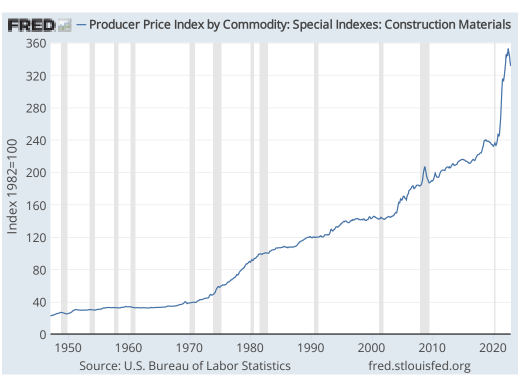
In 2010, Congress enacted the Small Business Jobs Act (Jobs Act). Section 1344 of the Jobs Act requires the SBA to conduct a detailed review of all size standards and to make appropriate adjustments to reflect market conditions. Specifically, the Jobs Act requires the SBA to review at least 1/3 of all size standards during every 18-month period after the date of the law's enactment and to review all size standards not less than once every five years, thereafter. The rolling reviews conducted by the SBA under the Jobs Act focus primarily on industry structure (i.e., average firm size, startup costs and entry barriers, industry concentration, and distribution of firms by business size) and federal contracting trends (i.e., small business share of federal contract dollars relative to small business share of total industry receipts) for industries with significant contracting activities. The SBA completed its first five-year rolling review under the Jobs Act in 2016. It is estimated that as a result of the first five-year review, more than 72,000 small businesses gained SBA eligibility. The SBA does not typically account for inflation as a factor in these five-year reviews, but monitors inflation separately to determine whether to make additional adjustments to the size standards. The SBA estimated that the changes it made in July 2019 for inflation, enabled approximately 89,890 firms above the SBA's size standards at the time to gain small business status and become eligible for SBA programs, resulting in between $700 million and $750 million in additional small business federal contract dollars.

Economic Conditions Warranting SBA Action

Per its own regulatory requirements, the SBA assesses the impact of inflation on its monetary-based size standards at least once every five years. Until November 17th, the SBA had adjusted its monetary-based size standards for inflation on eight occasions, i.e., 1975, 1984, 1994, 2002, 2005, 2008, 2014 and 2019.

Having just made adjustments for inflation in 2019, the SBA could have waited until 2024 to make another adjustment. It, however, determined that the undeniable and unprecedented inflationary factors impacting contractors justified intervention. Contractors have been and continue to be plagued by the COVID-19 pandemic that first surfaced in 2020, supply-chain issues, drastic material escalation, labor shortages and related economic effects. Inflation is currently at a 41-year high. Throughout 2022, the Federal Reserve has enacted multiple interest rate increases, including the highest interest rate hike in the last 28 years in June.

Per the U.S. Census Bureau report in 2019, approximately 90% of all construction establishments had less than 20 employees, although firms with more than 500 employees employed over 80% of the workforce. Thus, the construction industry is comprised of many small businesses that are particularly susceptible to market fluctuations and related economic challenges.



The Producer Price Index for construction materials made a significant leap during the pandemic and reached an all-time high in 2022.

Construction costs for key commodities have been volatile over the past two years. Sharp cost escalation, such as that seen in steel, lumber, fuel, and construction materials have caused significant economic hardship particularly for small and disadvantaged firms. Recognizing that size matters, particularly in the current economic climate, the SBA identified the following primary benefits of its November 17th rule:

- Some businesses that are above the current size standards may gain small business status under the higher, inflation-adjusted size standards, thereby enabling them to participate in federal small business assistance programs;

- Growing small businesses that are close to exceeding the current size standards will be able to retain their small business status under the higher size standards, thereby enabling them to continue their participation in the programs; and

- Federal agencies will have a larger pool of small businesses from which to draw for their small business procurement programs.

SBA's Adjustments To Its Size Standards

The SBA used the chain-type price index for the U.S. Gross Domestic Product (GDP) as the measure of inflation to adjust its size standards. The GDP price index for the base period (i.e., fourth quarter of 2018 – the end period for the 2019 inflation adjustment) was 111.191 and, according to the Bureau of Economic Analysis (BEA) GDP advance estimate released on July 28, 2022 (the latest available when the rule was prepared), the GDP price index for the end period (i.e., second quarter of 2022) was 126.367. As such, the SBA determined that inflation increased 13.65 percent since the fourth quarter of 2018.

- **Receipts-Based Industry Size Standards**

The SBA adjusted all receipts-based size standards by multiplying the size standard by 1.1365 and rounding the results to the nearest $500,000 (except for agricultural industries that were rounded to the nearest $250,000). For construction firms that fall into the various building construction and heavy and civil engineering construction sub-categories, the new threshold will be set at average annual receipts of $45 million, up from the $39.5 million in 2019. For companies in the specialty trade contractors category, the new benchmark is $19 million, an increase from $16.5 million. For architectural and engineering services, the SBA's new thresholds are $12.5 million and $25.5 million, up from $11 million and $22.5 million, respectively.

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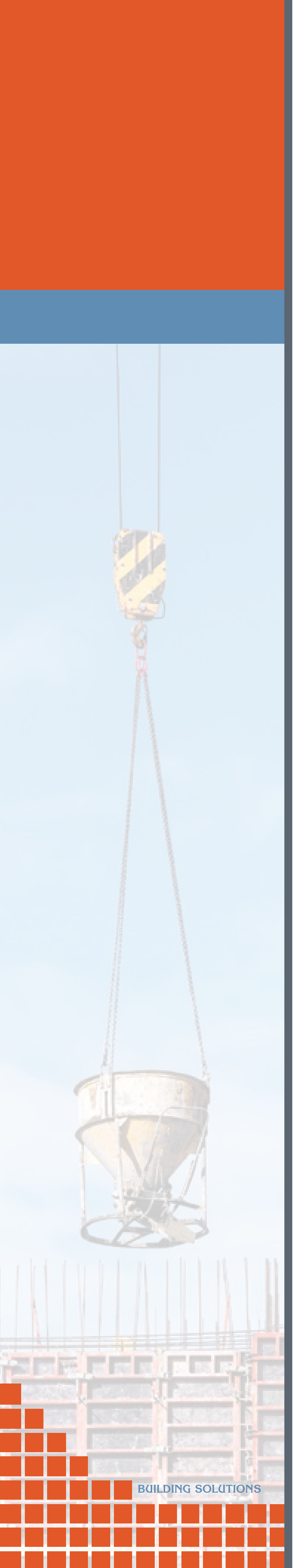


SBA's Adjustments To Economic Disadvantage Thresholds

The SBA also reviewed its thresholds used to determine whether an individual is "economically disadvantaged" for purposes of the 8(a) Business Development (BD) Program and the Economically-Disadvantaged Women-Owned Small Business (EDWOSB) Program. Using the GDP price index, the SBA determined that inflation has increased by 11.86 percent since the existing monetary thresholds had been implemented in the second quarter of 2020. By multiplying each limit by 1.1186, and then rounding the figures, the SBA has increased the net worth limit for economically-disadvantaged individuals to $850,000, the aggregate gross income limit to $400,000, and the total asset limit to $6.5 million.

SBA's Adjustments To Monetary Limits For 8(a) Sole Source Contracts

Since 1998, 8(a) BD participants were precluded from receiving sole source 8(a) contract awards if they had received a combined total of competitive and sole source 8(a) contracts in excess of $100,000,000 during participation in the 8(a) BD Program. The SBA had never adjusted this threshold for inflation. The SBA found that inflation has increased by 68.33 percent since 1998. Accordingly, the SBA has now increased this threshold to $168,500,000 (rounded).

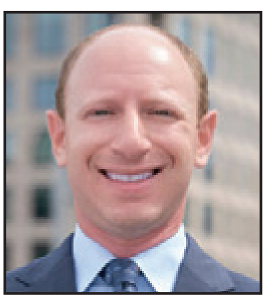
Conclusion

Thanks to the SBA's November 17, 2022 adjustments to the size standards and monetary thresholds, a number of contractors will be able to retain their "small" status, and more contractors may benefit from federal assistance, programs, and contracts earmarked for "small" concerns. In the SBA's view, small businesses should not lose their "small" status due solely to price level increases rather than from increases in business activity. It is anticipated that federal agencies may choose to set aside more contracts for competition among small businesses given the greater number of businesses that may be deemed "small" as a result of the SBA's recent rule. In light of this, small businesses should consider whether it is prudent to register or update their existing profiles in the System for Award Management (SAM) to participate in federal contracting. In addition, contractors bidding for federal contracts should review solicitations closely to determine which size standards will apply, particularly if offers are due after the SBA's rule becomes effective on December 19, 2022. As noted by the SBA, per 48 CFR 19.102(c), "it is the contracting officer's decision whether to amend a solicitation to incorporate the new size standards if SBA amends the size standard and it becomes effective *before* the due date for receipt of initial offers."

CONSTRUCTION UPDATE

Revisiting Termination For Convenience Clauses In Uncertain And Ever-Changing Economic Times

by Adam M. Tuckman, Partner and Brittney M. Wiesner, Associate



Adam M. Tuckman

Brittney M. Wiesner

In these times of persistent inflationary forces and efforts to tame the consequences through rising interest rates, economic uncertainty abounds in the United States and around the world. As an approximately $1 trillion contributor to the economy in the United States (4.2% of GDP in 2021) alone according to the Associated General Contractors of America, the health and the growth of the construction industry is certainly susceptible to these rapidly changing macroeconomic conditions.

Presently, an unanswered question is how project developers will react to unpredictable fluctuations in project costs and interest rates. Although it seems unlikely to be a prevalent response, it is possible that substantial increases in borrowing, labor, or material costs would cause owners to pull the plug on projects that are in the advanced stages of construction. For projects in the nascent stages of development or construction, however, the calculous for owners becomes more tenuous. Both public and private owners may find it more prudent to indefinitely suspend or cancel pending or ongoing projects due to any, or a combination of, forecasted increases in project costs, shrinking funding, higher borrowing costs, or macro-economic uncertainty. Facing this quandary, how would an owner already under contract with a constructor and design team suspend or cancel its project? One potential approach is to invoke a termination for convenience clause found in the parties' contract.

Boiled down to its basic premise, a termination for convenience clause ("T4C clause") permits the owner to discontinue the project at any time. The T4C clause has its roots in federal government contracting dating back to the civil war era and has since found a foothold as a risk allocation device in public procurement generally, as well as in private construction contracting. *See Torncello v. United States*, 681 F.2d 756, 764 (Ct. Cl. 1982). Given the potential for owners to terminate for their convenience to address ever-changing market conditions, it is an important time to revisit the basics of the owner's authority to issue a termination for convenience under a typical T4C clause.

In most contract matters, the motive behind the exercise of a contract provision is not subject to scrutiny. A termination for convenience is an exception, however. Under federal procurement law, which may be guidance for interpreting analogous public and private T4C clauses in any particular jurisdiction, the owner may exercise its termination for convenience rights so long as the decision was not a product of bad faith or abuse of discretion. *See, e.g., Linan-Faye Constr. Co., Inc. v. Housing Auth. of City of Camden*, 49 F.3d 915, 917 (3d Cir. 1995); *Krygoski Constr. Co., Inc. v. United States*, 94 F.3d 1537, 1541 (Fed. Cir. 1996). Proving bad faith or abuse of discretion is a "very weighty" proposition. The contractor must show that the owner acted maliciously or intended to injure the contractor when it decided to terminate for convenience. *Kalvar Corp. v. United States*, 543 F.2d 1298, 1302 (1976). Stated the other way, "[a]ny legitimate good-faith reason prompted by conditions external or internal to the terminated contract may justify termination for convenience." Philip L. Bruner & Patrick J. O'connor, Jr., Bruner & O'Connor On Construction Law § 18:47 (July 2022 Update). Case law provides relevant examples of economic changes, funding challenges, and other external factors, being upheld as the basis for a termination for convenience.

Termination For Convenience To Obtain A Lower Project Cost

The Massachusetts Supreme Judicial Court held in *A.L. Prime Energy Consultant, Inc. v. Massachusetts Bay Transportation Authority* that a public owner could terminate a contract for convenience when it finds another contractor to perform the same work for a lower price. 95 N.E.3d 547 (Mass. 2018). In the context of a private construction project, a Florida appellate court similarly upheld a termination for convenience exercised for the same reason. In *Vila & Son Landscaping v. Posen Constr., Inc.*, the contractor terminated its subcontract for convenience because it found another entity that was willing to perform the subcontractor's work for a lower price. 99 So. 3d 563, 564 (Fla. Dist. Ct. App. 2012). The terminated subcontractor argued that the contractor's attempt to secure the subcontract work from a cheaper option amounted to bad faith. While declining to apply the bad faith standard from federal procurement, the court nevertheless found that the contractor's termination was proper because the termination for convenience clause allowed it, and invoking the clause was therefore not contrary to the parties' expectations at the time of contracting.

Termination For Convenience Due To A Loss Of Project Funding

The owner's loss of expected project funding also may be found to be a legitimate reason for the owner to terminate for its convenience. An example of this outcome is *Handi-Van, Inc. v. Broward County*, a case heard by a Florida appellate court. 116 So. 3d 530, 533 (Fla. Ct. App. 2013). In *Handi-Van*, the County procured a para-transit system for compliance with the Americans with Disabilities Act. Subsequently, Florida voters approved an amendment to the Florida constitution that resulted in a $50 million loss in property taxes for the County. Since the property taxes were the County's main source of funding for the project, the County terminated its contracts for convenience with its para-transit providers once the funding disappeared. In a legal challenge to the County's termination, the appellate court upheld the termination for convenience because the contract contained an addendum stating that the County can terminate the contract if a cheaper para-transit system is procurable. Thus, the court held that the contractor knew its "contract would be terminated at a later point based on the County's good faith economic reason for so acting."

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Termination For Convenience Due To External Forces Impacting The Owner's Project

A termination for convenience also may be justified when the owner desires to change contractors based upon legitimate external factors that are not directly tied to project funding, such as good faith political motives. In *Northrop Grumman Corp. v. United States*, NASA terminated for convenience a contract to construct a space station. NASA originally contracted with four prime contractors, including Northrop Grumman ("Grumman") for construction of the space station, but this contract structure led to significant cost overruns. 46 Fed. Cl. 622 (Ct. Fed. Cl. 2000). The cost overruns led to members of Congress and the President expressing political concerns surrounding the space station. As a result, NASA streamlined the contract structure to include only one prime contractor, with the remaining three contractors being "novated" and reassigned as subcontractors to the selected prime contractor. Grumman was dissatisfied with the new contract structure, and NASA ultimately terminated Grumman's work on the space station for convenience. Grumman argued that the termination for convenience was done in bad faith. The court disagreed, finding that NASA had a good faith reason to terminate Grumman because otherwise, the space station "was in serious jeopardy politically."

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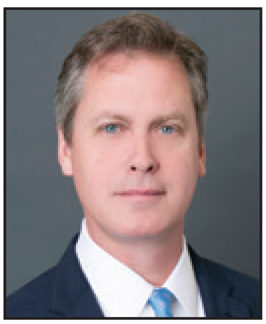
The cases summarized above provide an important lesson for contractors with a backlog of contracts incorporating termination for convenience clauses. The present uncertain and ever-changing economic conditions may upend that backlog, along with the anticipated profits to be generated from the ongoing projects. Now is a good time for contractors to revisit the specific terms and conditions of any termination for convenience clauses in their agreements and carefully monitor any known financial or other forces that may cause project owners or upper-tier contractors to consider invoking the clause to address potential economic risks to the viability of their projects.



Contract And IP Implications Of Design Professionals Monetizing Non-Fungible Tokens Comprising Digital Construction Designs

by Colin C. Holley, Partner

There is an emerging market that appears poised to increasingly provide opportunities to monetize architectural and other construction designs through the sale of non-fungible tokens (NFTs). Last year, artist Krista Kim reportedly made the first sale of a digital home design via an NFT marketplace, for over $500,000. With some NFTs selling for millions of dollars, monetizing digital designs is undoubtedly an enticing prospect for architects, engineers, and other design professionals. It is thus critical to understand the application of intellectual property rights to NFTs and to address those rights in contracts involving design professionals.

What Is An NFT?

To understand the market for NFTs it is necessary to first understand blockchain technology. A blockchain is a decentralized system of recording information via a digital ledger of transactions duplicated and distributed across many computers. The manner in which each block of the ledger chain is created—using a cryptographic mathematical algorithm tied into the previous block, a timestamp, and transaction data—prevents it from being changed retroactively without a change to all subsequent blocks and consensus of the decentralized network.

An NFT is a 'token' secured to a blockchain. It can represent ownership of any item that is non-fungible, i.e., any item that has unique qualities that add value and make the item non-interchangeable. NFTs can take unlimited forms, including, for example, tokens representing unique artwork, music, fashion items, in-game items, essays, collectibles, memorabilia, furniture, and real estate.

The highly secure nature of NFTs allows for an efficient market for purchase and sale with little concern regarding authentication of ownership, counterfeiting, or fraud. There is a growing demand for NFTs from investors, collectors and traders, and people interested in the new technology and in owning one-of-a-kind items. NFTs are also increasingly used as a part of both profit and non-profit enterprises to help raise funding and launch new campaigns, especially when younger audiences are being targeted.

NFTs Representing Building And Construction-Related Designs

The nature of NFTs is well suited to monetization of building and construction-related designs. In addition to Krista Kim's sale of a digital home design for over $500,000, another example is property developer Stately Homes' listing of yet-to-be-built luxury real estate to be sold with an NFT of the blueprint and virtual version of the home. In the area of architecture design, the company Aureal is creating and marketing NFT designs that can be used to build in either the virtual metaverse or in the physical world.

Construction design professionals around the world are undoubtedly brainstorming an endless variety of lucrative ways to monetize all manner of artwork, architectural and engineering renderings, graphic designs, videos, and other creative items relating to development and construction. As these uses of NFTs become increasingly common, it is important to consider associated intellectual property and contract issues.

Intellectual Property Rights And Protection Applicable To NFTs

Depending on its content, laws governing copyrights, design patents, and trademarks may apply to an NFT.

In the United States, copyrights protect ownership of original works of art. Protection in a work exists automatically from the moment of creation, whether or not the work is registered with the United States Copyright Office. The owner of a copyright generally controls all rights to use the work in any way.

Patents are rights protecting uniquely original and usable inventions and designs for a prescribed period of years. U.S. patent rights arise from successful registration through the United States Patent and Trademark Office. Registration gives the owner the ability to prevent others from using or selling the invention or design without permission.

Trademark rights exist only in connection with commercial use of a word, phrase, symbol, or design, such as product brand names and logos, to identify goods or services as originating from a single source. Under U.S. law, "common law" trademark rights can exist without the need for registration when there has been sufficient use of a mark in commerce. Registration with the United States Patent and Trademark Office creates additional protections that do not exist under common law, such as "constructive" notice to others of the registrant's ownership of the mark.

Assuming the creator of an NFT owns the intellectual property rights associated with its content, those rights may be transferred, in whole or in part, to a buyer of the NFT. A design might, for example, be licensed to the NFT buyer to use only for personal, non-commercial purposes, or for specific limited commercial uses.

The creator of an NFT cannot, however, transfer to a buyer any intellectual property right the NFT creator never had in the represented content. For example, an architect who has already assigned the rights in a particular design to a developer cannot convey any rights in the design by minting and selling a token representing the design.

Contract Implications

Because NFTs are a new type of asset, having been in use for less than a decade, building industry owners, developers, contractors, and design professionals, and their legal counsel, should review their contracts to ensure there is certainty regarding intellectual property rights associated with any NFTs representing related designs. For example:

- Where contracts address ownership and assignments of design work product, the terms "work" and "intellectual property" should be defined to expressly include any and all NFTs, digital tokens, and any other assets based on blockchain technology, incorporating any aspect of the design or engineering work associated with the project.

- Provisions in a consultant or independent contractor agreement should require any design or engineering consultant to disclose to the company any and all NFTs, digital tokens, and any other assets based on blockchain technology, in existence, or created during the project, incorporating any aspect of the design or engineering work associated with the project.

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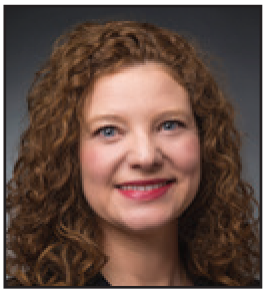
- Where a contract allows a consultant or independent contractor to identify as "excluded property" specific works, ideas, processes, or designs that the consultant or independent contractor previously created and wishes to exclude from the operation of the contract, the contract should require such identification to include any NFTs, digital tokens, and any other assets based on blockchain technology.
- Contracts between owners, developers, contractors, and design professionals, should expressly address whether any party to the contract is allowed to create NFTs, digital tokens, and any other assets based on blockchain technology, incorporating any aspect of the design or engineering work associated with the project, and, if allowed, how any rights associated with monetizing such assets are to be allocated among the parties.

SURETY AND CREDITOR'S RIGHTS



Jennifer L. Kneeland

Recent Bankruptcy Case Development: When A Bankruptcy Discharge Is Not Absolute

by Jennifer L. Kneeland, Senior Partner and Marguerite Lee DeVoll, Partner

Marguerite Lee DeVoll

Introduction

One of the hallmarks of a chapter 7 bankruptcy is that pre-petition debts are generally discharged. A recent decision from the United States District Court for the Eastern *District of Wisconsin (the "District Court"), Reinhart Foodservice LLC v. Schlundt*, — B.R. —, 2022 WL 15523157 (E.D. Wis. Oct. 27, 2022), however, highlights a growing split among bankruptcy courts regarding whether a chapter 7 bankruptcy case discharges a post-petition liability arising under an individual debtor's pre-petition promise to pay that could impact sureties' rights against indemnitors who file for bankruptcy.

Summary Of *Reinhart Foodservice* Facts

In *Reinhart Foodservice*, the debtor, David S. Schlundt (the "Debtor"), operated a restaurant pre-petition – The Refuge. The Refuge received goods and services from Reinhart Foodservice LLC ("Reinhart") pursuant to a supply agreement entered into on September 11, 2003 (the "Agreement"). Within the same document, the Debtor also signed an "Individual Personal Guaranty" (the "Guaranty"). Under the Guaranty, the Debtor agreed that he would "personally guarantee prompt payment of any obligation" of The Refuge to Reinhart "whether now existing or hereinafter incurred." The Debtor further promised "to pay on demand any sum which is due … whenever [The Refuge] fails to pay same." The Debtor also agreed that the Guaranty was "absolute, continuing, and irrevocable."

Approximately 10 years later, the Debtor and his wife filed a joint chapter 7 bankruptcy case. At the time the Debtor filed his case, The Refuge owed Reinhart $10,000. The record in the case did not clarify whether the $10,000 was overdue as of the Debtor's petition date or whether The Refuge had failed to pay sufficiently to trigger the Debtor's obligations under the Guaranty. Regardless, on April 11, 2014, the chapter 7 trustee issued a report of no distribution and on April 21, 2014, the bankruptcy case was closed with the Debtor and his wife receiving their discharge. No action was taken before, during, or after the Debtor's bankruptcy case to terminate the Guaranty.

Meanwhile, The Refuge continued to operate and continued to purchase supplies from Reinhart. Four years later, in 2018, however, The Refuge closed. At this time, The Refuge owed Reinhart $36,839.62 for goods and services purchased in 2018. Because the restaurant failed to pay this sum, Reinhart made demand on the Debtor, who in turn, cited his 2014 bankruptcy discharge and refused to pay.

In response, Reinhart returned to bankruptcy court, reopened the case, and filed an adversary proceeding seeking a declaratory judgment that the approximately $37,000 in debt arising from 2018 sales was not subject to the Debtor's 2014 bankruptcy discharge. Reinhart's primary argument was that the liability did not arise until 2018.

The Bankruptcy Court's Decision

On summary judgment, the bankruptcy court ruled in favor of the Debtor. In reaching its decision, the bankruptcy court applied the general rule that debts arising from pre-petition contracts are discharged regardless of when the right to payment arises. Reinhart appealed to the District Court, which reversed.

The District Court Holds That A Debtor's Guaranty Is Not Discharged In Bankruptcy

On appeal, the District Court reversed the bankruptcy court and decided that the approximately $37,000 in debt owed to Reinhart arose from post-bankruptcy sales and had not been discharged in the Debtor's 2014 bankruptcy. The District Court first examined what the term "debt" means in the context of Title 11 of the United States Code (the "Bankruptcy Code"). Under section 727(b) of the Bankruptcy Code, the Debtor's chapter 7 bankruptcy operated to discharge "all debts that arose before the" petition date. Section 101(12) of the Bankruptcy Code defines the term "debt" to mean "liability on a claim." A "claim," in turn, is defined under section 101(5)(A) as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." Consequently, these Code-sections operate to discharge all debts that arose before the Debtor's petition date.

Turning to the specific facts of the case, the District Court looked at the nature of Reinhart's claim against the Debtor: the guaranty of all present and future debts of the restaurant. When the Agreement and the Guaranty were signed, no debt existed because no goods or services had been purchased. As such, Reinhart had no right to payment. When the Debtor filed his bankruptcy, any debt, if one existed, would have been for any goods or services purchased pre-petition for which The Refuge had failed to pay. There, however, could be no debt, claim, or right to payment for goods and services not yet purchased. Consequently, when the restaurant purchased goods and services in 2018, this created a new debt and right to payment.

The District Court further explained that there is a difference between a contractual "promise" and a "debt" explaining that "the mere existence of a promise or a contract does not necessarily create a legal liability." The District Court compared the Debtor's pre-petition Guaranty and the post-petition sale purchases with a debtor using a pre-petition line of credit to make post-petition purchases: the debtor does not draw on that line of credit until post-petition, and therefore, the obligation to pay does not arise until post-petition. Thus, those post-petition purchases are not discharged.

The District Court also explained that nothing in the Bankruptcy Code automatically terminates all of a debtor's existing contractual obligations, and, indeed, a discharge only precludes the enforcement of debts, not promises, that arose pre-petition.

As such, the District Court held that the Debtor's 2014 discharge did not discharge the Debtor's Guaranty to Reinhart or the Debtor's obligation to pay for the 2018 debts.

Recognizing A Split Among The Courts

In their respective decisions, both the bankruptcy court and the District Court noted that there is a split among courts – even among courts in the same circuit encountering this issue.

On one side, several courts hold the view that a debtor's bankruptcy does not effectuate a discharge of the debtor's pre-petition guaranty for debts for post-petition extensions of credit or enforcement of claims. Those courts include the Fourth Circuit Court of Appeals, the United States Bankruptcy Court for the Northern District of Alabama, the United States Bankruptcy Court for the Western District of Virginia, the United States District Court for the District of Maryland, and the United States Bankruptcy Court for the Western District of Michigan.

On the other side, several courts hold the view that a pre-petition guaranty is a contingent claim that may be discharged in a later bankruptcy, regardless of when the obligation to pay arises. Those courts include the Sixth Circuit Bankruptcy Appellate Panel, the United States Bankruptcy Court for the Eastern District of Michigan, and the United States Bankruptcy Court for the Middle District of Florida.

The District Court in Wisconsin ultimately adopted the view that a chapter 7 discharge does not necessarily discharge a debtor's pre-

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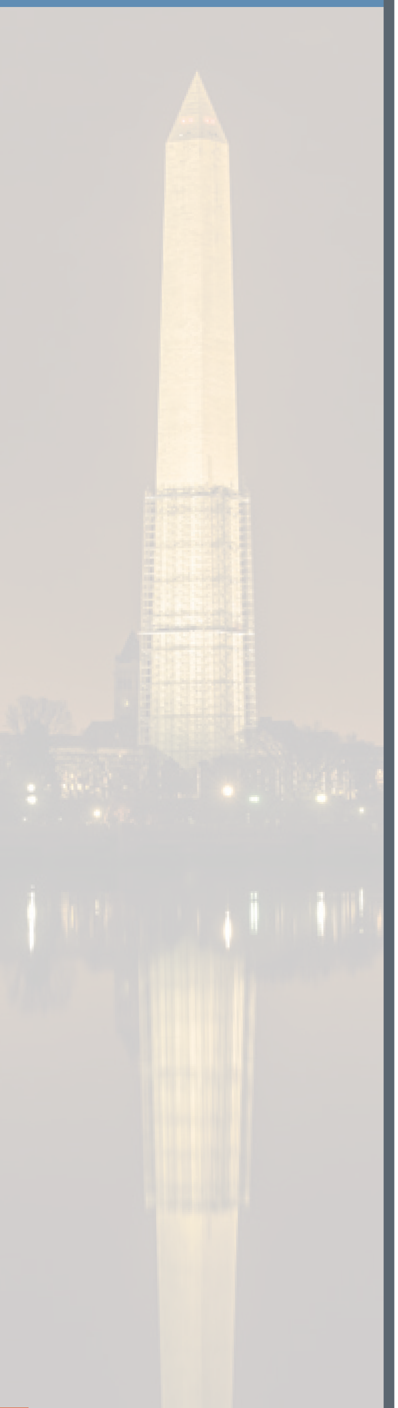
petition guaranty for liability arising under the guaranty for post-petition credit extensions or enforcement claims.

Take-Away From The *Reinhart Foodservice* Decision

For surety and creditors' rights practices, the *Reinhart Foodservice* decision and similar cases are worth a second look. These cases stand for the proposition that, absent more in a bankruptcy case, pre-petition guaranties, including indemnity agreements, are not terminated at the conclusion of a chapter 7 case. Therefore, a creditor should not assume that an obligor's bankruptcy automatically precludes future efforts by the creditor to recover a debt that arose after a debtor's bankruptcy case concluded, nor should a creditor automatically assume that an obligation was necessarily discharged.

We recommend making a careful analysis of the nature of the indemnity, guaranty, or other promise to pay, including when the obligation was created and when a debt arose. Next, the chapter 7 case docket should be closely examined to determine if any steps were taken in the case to impact the underlying obligation to pay the creditor.

After considering these factors, if a promise to pay was not adversely impacted in a bankruptcy and the debt to the creditor arose after the conclusion of a bankruptcy case, all hope may not be lost and recovery could, in fact, be a permissible option for the creditor to pursue. If a bankruptcy case is filed in a jurisdiction where the courts have adopted the same approach as the District Court in *Reinhart Foodservice*, then the creditor may be able to pursue enforcement of the debt notwithstanding the debtor's prior bankruptcy filing. Even if the jurisdiction may have taken the opposite approach from *Reinhart Foodservice*, subsequent case law or even factual differences may open the door to post-discharge enforcement of the obligation. As such, we recommend reaching out to experienced bankruptcy counsel to assist you in evaluating your options.



FALSE CLAIMS ACT

Knowing Is Not Omniscient: A Shifting Interpretational Trend And Possible Decisive Outcome For The Scienter Requirement For Legally False Claims Under The False Claims Act

Jordan A. Hutcheson

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"Any fool can know. The point is to understand." Although this famed quote from Albert Einstein may lend itself to many contexts, the False Claims Act, 31 U.S.C. §§ 3729 ("FCA"), is not one of them. The FCA proscribes knowingly defrauding the government. The FCA defines what it means to act "knowingly," but its definition has recently resulted in more questions than answers, specifically in cases involving the submission and payment of legally false claims. The federal courts of appeals that have been presented with these cases have followed Supreme Court precedent in *Safeco Insurance Co. of America v. Burr*, 551 U.S. 47 (2007) – a case interpreting the scienter of "willfully," as the term is used in the Fair Credit Reporting Act ("FCRA") – and applied the test articulated by the Court to interpret the meaning of the FCA's scienter requirement. The Fourth Circuit recently disrupted this trend in late 2022, however, when it changed course and vacated its previous ruling in which it adopted the *Safeco* test in the FCA context. When it comes to the FCA, understanding what it means to "know" is not something that is easily determined.

As of this writing, the issue has been presented to the Supreme Court through appeals from decisions of the U.S. Courts of Appeals for the Seventh and Eleventh Circuits. Whether or not the Court decides to hear the appeals, with the significant penalties and damages that government contractors are exposed to under the FCA, it is important to understand and recognize the contested and developing landscape of the FCA's scienter element.

The False Claims Act

Enacted during the Civil War, the FCA prohibits presenting knowingly false or fraudulent claims to the Government for payment. The FCA empowers both the U.S. Attorney General and private parties to bring a civil action on the Government's behalf against a party alleged to have violated the FCA. While the statute originated to address fraud perpetrated by defense contractors, modern FCA claims often arise in the context of submission of claims under federally funded healthcare programs. Following a series of amendments, the FCA currently provides that a claimant that is proven to have materially defrauded the Government under the FCA faces not only civil penalties of up to $25,076 (adjusted for inflation) per individual claim submission, but also treble damages.

For a claimant to be found liable under the FCA, the Government must sufficiently demonstrate the following four elements: falsity, causation, knowledge, and materiality. The element of falsity has evolved into two distinct categories. A claim is factually false when the claimant misrepresented the goods or services it provided to the Government, and it is legally false when the claimant misrepresented that he or she has complied with statutory, regulatory, or contractual requirements necessary for payment.

The FCA's scienter requirement is statutorily defined. A party who submits a false claim to the government is subject to FCA liability only if the party acted knowingly. The FCA defines "knowingly" to "mean that a person, with respect to information: (i) has actual knowledge of the information; (ii) acts in deliberate ignorance of the truth or falsity of the information; or (iii) acts in reckless disregard of the truth or falsity of the information." While the FCA lists the scienter levels encompassed by "knowingly," it does not further define those terms. This has left room for interpretational argument in some FCA cases, specifically with regard to the third category of knowledge and what constitutes acting "in reckless disregard of the truth or falsity of the information." For instance, in FCA cases involving allegations of submitting legally false claims to the Government, many claimants have argued that they did not possess the requisite scienter where the claims were submitted under a reasonable belief that the statutory, regulatory, or contractual requirements were met. Relying on the common law definition of "reckless disregard," claimants and their proponents have taken the position that the two-step inquiry applied in *Safeco* should also apply to these categories of cases arising under the FCA.

The *Safeco* Decision

Safeco involved an interpretation of the FCRA's scienter requirement, under which defendants must have acted "willfully" in failing to comply with the terms of the statute. In interpreting "willfully," the Supreme Court in *Safeco* concluded that the word has various meanings that are dependent upon context. The Court stated that "where willfulness is a statutory condition of civil liability, we have generally taken it to cover not only knowing violations of a standard, but reckless ones as well." The *Safeco* plaintiffs argued that Safeco violated the FCRA by offering new insurance applicants higher rates without providing notice of the less favorable policy offers based on applicants' credit scores. Safeco believed that initial rate offers to new customers did not demand the FCRA's notice requirements because Safeco interpreted the statute's language to apply only to existing policies. Citing to the common law definition of "reckless disregard," the Court found that while Safeco's interpretation of the statute was incorrect, it was objectively reasonable and there was no authoritative guidance that contradicted its interpretation. The Court concluded that for these reasons, Safeco did not "willfully" fail to comply with the statute's notice requirements and thus the FCRA's scienter element was not met.

Extending The *Safeco* Test To The FCA

Ultimately, the *Safeco* test has been articulated as a two-prong inquiry. A defendant who acts under an incorrect interpretation of a relevant statute or regulation does not act with reckless disregard if: (i) the interpretation is objectively reasonable, and (ii) no authoritative guidance exists to caution defendants against it. *Safeco* was first extended to the FCA by the U.S. Court of Appeals for the D.C. Circuit in *United States ex rel. Purcell v. MWI Corp.*, 807 F.3d 281 (D.C. Cir. 2015). *Purcell* dealt with diverging interpretations of what constituted "regular commissions" under a Letter of Credit Certificate. The Government argued that a sales commission is "regular" only if "it is consistent with industry-wide benchmarks," while the corporation understood the phrase to refer to commissions that were "consistent with what

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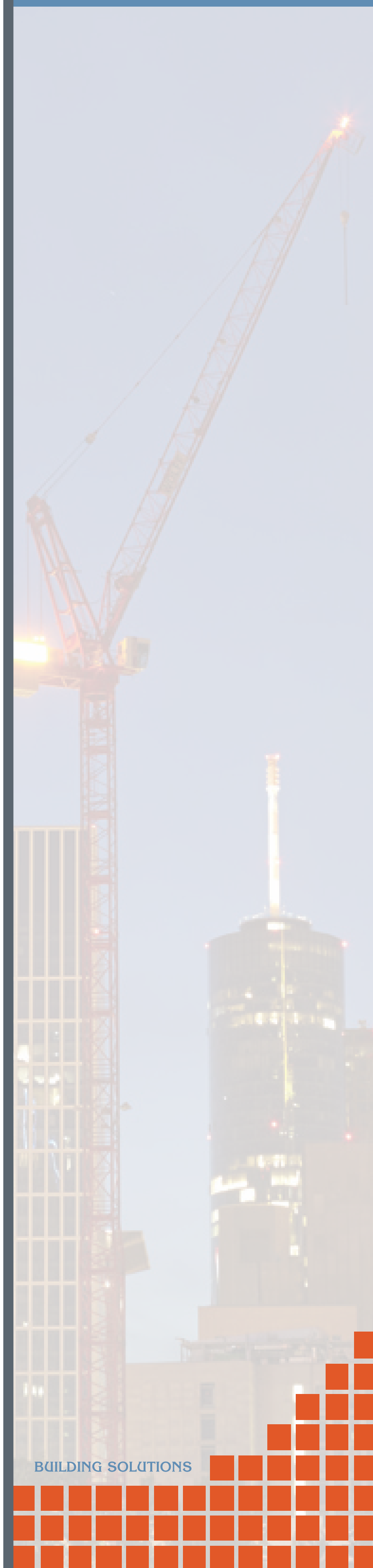

had historically been paid to an individual agent." Overturning the jury's findings, the D.C. Circuit held that the defendant corporation did not act knowingly or with reckless disregard when it submitted claims for payment by inaccurately certifying that it had paid "regular commissions." Applying the *Safeco* test, the court concluded that the statutory phrase was ambiguous, the corporation's interpretation of it was objectively reasonable, and the Government had issued no authoritative guidance that should have "warned [the defendant] away from its interpretation." The court accepted *Safeco*'s common law definition of reckless disregard and seemingly focused more on due-process concerns. The court stated that "[s]trict enforcement of the FCA's knowledge requirement helps to ensure that innocent mistakes made in the absence of binding interpretive guidance are not converted into FCA liability, thereby avoiding the potential due process problems posed by 'penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.'"

After *Purcell*, other circuits followed the D.C. Circuit's lead by applying the *Safeco* test to the FCA, including the Third, Seventh, Eighth, and Ninth Circuits. *See U.S. ex rel. Streck v. Allergan, Inc.*, 746 F. App'x 101 (3d Cir. 2018) (unpublished) (applying *Safeco* analysis to drug manufacturers' interpretation of the Medicaid Drug Rebate Program); *U.S. ex rel. Schutte v. Supervalu Inc.*, 9 F.4th 455 (7th Cir. 2021) (applying *Safeco* in context of Medicare and Medicaid regulations), *petition for cert. filed*, No. 21-1326 (Apr. 1, 2022); *U.S. ex rel. Donegan v. Anesthesia Assocs. of Kan. City, PC*, 833 F.3d 874 (8th Cir. 2016) (same); *U.S. ex rel. McGrath v. Microsemi Corp.*, 690 F. App'x 551 (9th Cir. 2017) (unpublished) (applying the *Safeco* test in the context of the International Traffic in Arms Regulations). The Eleventh Circuit also recently joined its sister courts in applying the *Safeco* test to an FCA case upon the claimant's argument that he did not possess the requisite scienter in submitting a legally false claim because his interpretation of the applicable Medicare regulation was objectively reasonable and the Government failed to lead him to believe differently. The court agreed, citing *Safeco* for support and emphasizing that the FCA's scienter requirement is meant to be "rigorous." *See Olhausen v. Arriva Med., LLC*, No. 21-10366, 2022 WL 1203023 (11th Cir. Apr. 22, 2022) (unpublished), *petition for cert. filed*, No. 22-374 (Oct. 18, 2022). With the exception of the Fourth Circuit, the remaining courts of appeals have not considered *Safeco*'s applicability to the FCA.

The Fourth Circuit Deadlocks On *Safeco*

The Fourth Circuit is one of the latest federal courts of appeals to address *Safeco*'s applicability to the FCA's scienter requirement. But unlike its sister circuits, the Fourth Circuit has demonstrated some hesitance – if not reluctance – to adopt *Safeco*'s test and corresponding analysis. In January 2022, a three-judge panel applied *Safeco* to the FCA in *United States ex rel. Sheldon v. Allergan Sales, LLC*, 24 F.4th 340 (4th Cir. 2022) ("*Sheldon I*"). The court's ruling came down over a dissent, and in September 2022, the Fourth Circuit changed course and vacated *Sheldon I* following rehearing en banc. See *U.S. ex rel. Sheldon v. Allergan Sales, LLC*, 49 F.4th 873 (4th Cir. 2022) (en banc) ("*Sheldon II*"). The court did not reverse *Sheldon I* by way of *Sheldon II*, but instead could not reach a majority decision. By an equally divided vote, *Sheldon II* resulted in affirming the district court's dismissal of the FCA lawsuit for failure of the relator to demonstrate that the defendant possessed the requisite scienter.

In *Sheldon I*, the relator alleged that Forest Laboratories, LLC perpetrated a fraudulent price-reporting scheme by not aggregating the discounts it gave to separate customers when reporting its "best price" to the Government. The relator argued that the Medicaid Drug Rebate Statute required aggregating discounts, and that Forest Laboratories' failure to do so caused the Government to overpay it on the order of $680 million.

Sheldon I affirmed the trial court's dismissal of the lawsuit. The court held that the parallel between the FCA's scienter requirement of "knowingly" and *Safeco*'s interpretation of "willfully" under the FRCA was unmistakable, thereby concluding that "*Safeco*'s reasoning applies to the FCA's scienter requirement." The court buttressed its adoption of *Safeco* by invoking the Supreme Court's admonition that scienter requirements must be given "rigorous" application. And, under *Safeco*, Forest Laboratories had not acted knowingly. First, its interpretation that the Medicaid statute did not require aggregating discounts given to multiple entities along the same supply chain was not only reasonable, but the "best" and "most natural" reading of the statute. Next, the court reasoned that the Government had issued no authoritative guidance that should have alerted Forest Laboratories that its interpretation was erroneous. The court highlighted that the Government had known for years that drug manufacturers were operating under the same understanding of discount-aggregation as the defendant, and yet had taken no action to clarify the requirement. According to the court, the Government had actually injected discretion into the mix by directing manufacturers to make "reasonable assumptions" in their best-price calculations if no specific guidance on the issue existed.

Following the decision in *Sheldon I* but before *Sheldon II*, the Fourth Circuit ruled on a different FCA case in a more circumscribed manner. In *United States ex rel. Gugenheim v. Meridian Senior Living, LLC*, 36 F.4th 173 (4th Cir. 2022), the court applied the *Safeco* test to uphold a ruling that there was insufficient evidence to prove the requisite scienter, but it did so seemingly with caution. Far from adopting *Safeco* outright, *Gugenheim* did not cite *Safeco* at all, nor did it mention any of the other courts that readily adopted *Safeco* (as *Sheldon I* had also done with alacrity) when presented with the opportunity. Further, the court cited *Sheldon I* only once.

The Uncertain Future Of *Safeco* And The FCA

The Fourth Circuit's procedural run around on *Sheldon I* and reluctance in *Gugenheim* to assert a clear position on *Safeco*'s applicability to the FCA leaves contractors and the Government alike without clear direction. A few possible explanations exist for the Fourth Circuit's reticence.

First, the dissent by Judge Wynn in *Sheldon I* articulated colorable arguments against applying *Safeco* to the FCA. The dissent argued that the fact that *Safeco* dealt with the FCRA made it inapposite to the FCA's fraud context. The FCRA is a prescriptive statute aimed at promoting honest credit reporting, efficiency, and consumer privacy. The FCA, in contrast, is a proscriptive statute intended to prevent and punish fraud. Fraud routinely implicates assessing the defendant's subjective state of mind in making certain representations, which is effectively foreclosed under a scienter standard of objective reasonableness. The authorities upon which *Safeco* itself relied dealt with scienter in the context of physical safety, not fraud. The dissent also flagged policy considerations about adopting *Safeco*; the Government is defrauded of up to $360 billion per year in healthcare fraud alone, and the *Safeco* test will only make defrauding the Government easier since it is one "that only the dimmest of fraudsters could fail to take advantage of."

The dissent expressed in *Sheldon I* is not without support from other circuits that examined *Safeco* and the FCA. The Seventh Circuit's decision in *United States ex rel. Schutte v. Supervalu Inc.* also bypassed a dissent by Judge Hamilton, in which he argued that the majority had abandoned the FCA's plain language in misplaced deference to *Safeco*. By doing so, the majority "create[d] a safe harbor for fraudsters who claim taxpayer funds in bad faith, but whose barely-straight-faced lawyers offer an innocent explanation for their conduct." As echoed by the dissent in *Sheldon I*, Judge Hamilton faulted the majority for coopting scienter law from torts into the fraud context where one's subjective "state of mind is critical." The Department of Justice has also expressed disdain for applying *Safeco* to the FCA, as doing so allows a fraudster to "actually understand a requirement correctly, choose to violate it but avoid all liability if its attorney can conjure up a post-hoc alternative interpretation of the requirement that is at least objectively reasonable."

Second, the Fourth Circuit's caution could be due to external factors – namely, the possibility of the Supreme Court considering *Safeco*'s interplay with the FCA in the near future. In April 2022, the disappointed relators in *Schutte* petitioned the Supreme Court to review the Seventh Circuit's holding that the *Safeco* test applied to the FCA. The Court has not ruled on the petition as of the time of writing, but it did signal interest by inviting the Solicitor General of the United States to express the Government's views. *Schutte* squarely presents the Court with the opportunity to settle this question, since the Seventh Circuit affirmed summary judgment for the defendants based on the *Safeco* test for scienter. Though too late to have affected the Fourth Circuit's deadlock in *Sheldon II*, the relators in the Eleventh Circuit case of *Olhausen v. Arriva Medical, LLC* likewise petitioned the Supreme Court in October 2022 to review "[w]hether a False Claims Act defendant alleged to have 'knowingly' violated a provision of federal law can escape liability by articulating, after the fact, an objectively reasonable interpretation of the provision under which its conduct would have been lawful."

Despite the Fourth Circuit disrupting the trend of adopting the *Safeco* test, this does not necessarily signal any apparent demise of its application in the FCA context. If the 2016 Supreme Court case *Universal Health Services, Inc. v. United States ex rel. Escobar*, 579 U.S. 176, is any indication of the Court's willingness to extend common law definitions to the FCA, then it is possible that the Court will agree at least to some extent that the scienter requirement in the FCA can be defined as it was in *Safeco*. In *Escobar*, the Court applied the common law meaning of "fraud" to the term "false or fraudulent" as stated in the FCA,

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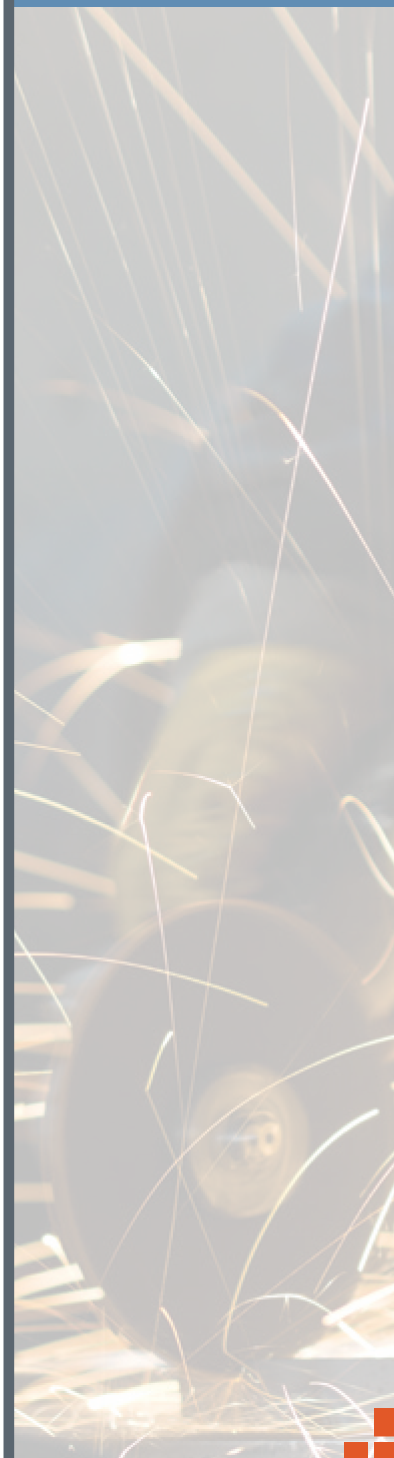


relying on the canon that "Congress intends to incorporate the well-settled meaning of the common-law terms it uses."

Conclusion

Since *Safeco* relied on the same canon in applying the common law definition of "reckless disregard" to "willingly," the Court may well be willing to ignore the differences between the FCA and FCRA and reach the same conclusion as all the other circuit courts of appeals. Unless (or until) the Supreme Court decides the issue, however, parties on both the submitting and receiving end of government claims should be aware of the potential impact of the interpretational differences surrounding the FCA's scienter requirement.

FIRM NEWS

Recent And Upcoming Events

Virginia State Bar 43rd Annual Construction Law and Public Contracts Seminar 2022, November 4, 2022. **Hanna L. Blake** co-presented on "Construction Economic Forecast / Supply Chain Impacts."

National Association of Surety Bond Producers (NASBP), November 30, 2022; Webinar. **C. William Groscup** and **Matthew D. Baker** presented a program titled "Scollick Decision Provides Surety Industry with Important Insights for Avoiding FCA Liability."

ABA Forum on Construction Law Regional Meeting, December 2, 2022; Washington, D.C. **Matthew D. Baker** will co-present on "Contract Negotiation and Philosophy of Risk Shifting."

37th Annual Construction SuperConference, December 6-7, 2022; Las Vegas, Nevada. **Scott P. Fitzsimmons** and **Kathy O. Barnes** will co-present on a panel titled "In-House Counsel Perspective on Effective Mediation Techniques;" **Robert C. Shaia** will present in a session titled "Wrongful or Right: What Makes a Proper Termination;" **Brian C. Padove** will co-present on "Damages and Delays in the context of Supply Chain/ Covid Impact."

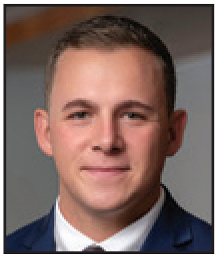
ABA Tort, Trial and Insurance Section's Fidelity and Surety Law Committee's Mid-Winter Conference, January 19, 2022; Washington, D.C. **Vivian Katsantonis** will be Program Co-Chair; **Shelly L. Ewald** will speak on "Technical Issues In Delay And Inefficiency Claims;" **Christopher J. Brasco** will speak on "The Evolving Landscape of Construction Risk Management and the Priority of Effectively Handling Change;" **Hanna L. Blake** will co-present a program titled "The Dream Team: Identifying Experts and the Timing (at claim stage versus litigation stage), and Areas of Expertise Needed to Evaluate Claims."

Watt Tieder Announces New Partner

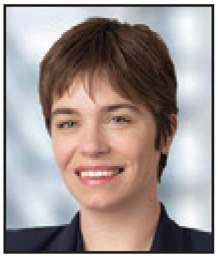
John F. Finnegan III has been elevated to partner in Watt Tieder's McLean, Virginia office. John focuses his practice on construction and commercial litigation, government contracts, and suretyship law. John is an experienced litigator who has obtained successful outcomes for his clients through negotiation, motion practice, and trial. John advises clients on the drafting/negotiation of contracts, risk management, and handling claims. He represents a range of stakeholders in the construction industry, including owners, architects, engineers, general contractors, subcontractors, material suppliers, and sureties, in federal and state court. John has also successfully represented clients at multiple trials before the Armed Services Board of Contract Appeals.

BUILDING SOLUTIONS

Watt Tieder Welcomes New Associates



Jacob F. Kucharski is an associate with Watt Tieder in McLean, Virginia. Jake joined Watt Tieder as a first-year associate after having clerked for the firm as a summer associate. He focuses his practice on construction and government contracts. Jake graduated from The George Washington University Law School with a concentration in government contracts. During law school, he served as a Notes Editor on the Public Contract Law Journal and was on the board of the Military Law Society and a member of the Mock Trial Board. He also worked as a law clerk for the Organized Crime Unit of the Maryland Attorney General's Office.



Kaitlyn M. Linsner joins Watt, Tieder as an associate in the Chicago office. She focuses her practice in the areas of construction and surety law, providing litigation and transactional services to a wide variety of construction industry clients. Prior to joining Watt Tieder, Kaitlyn practiced at a boutique civil litigation firm and insurance defense firm where she gained experience in complex commercial litigation, real estate, banking, employment and professional liability. Kaitlyn graduated *summa cum laude* from Northern Illinois University College of Law in 2020. While in law school, she served as Editor-in-Chief of the NIU Law Review.

Brittney M. Wiesner is an associate at Watt Tieder in McLean, Virginia. She concentrates her practice on construction litigation, government contracts, and suretyship law. She joined Watt Tieder as a first-year associate after having clerked for the firm as a summer associate. Brittney graduated magna cum laude from the Antonin Scalia Law School at George Mason University. In law school, Brittney was a research editor on the George Mason Law Review, a member of the Moot Court Board, and a legal research and writing fellow. She also interned for the Air Force JAG Corps and the United States Department of Justice while in law school. Prior to law school, Brittney attended Texas Tech University, where she majored in political science and minored in legal studies.

Publications

ABA TIPS Fidelity and Surety Law Newsletter, "*No Signature? Potentially No Problem for Sureties Enforcing a Bond's Forum Selection Clause*," **Brian C. Padove**, Fall 2022 (**John E. Sebastian**, Editor).

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

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