Imputation of False Claims Act Liability to Prime Contractors

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The specter of the civil False Claims Act (FCA) is, by now, well known to companies doing business with the federal government. The FCA creates liability for any entity that "knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval," or that "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim."[1] In Fiscal Year 2018, the U.S. Department of Justice recovered over $2.8 billion in FCA matters, including over $107 million from the defense industry.[2]

Less understood are the myriad ways in which a company can find itself on the wrong side of an FCA action. Government contractors frequently focus their attention inwardly, thinking they can improve their own internal ethics and compliance systems to ward off potential FCA suits. But FCA threats are not so limited in nature. A company can find itself in hot water based not just on its own conduct, but also on the conduct of its employees, agents, or subcontractors.

This article discusses how subcontractor misconduct can give rise to FCA liability for prime contractors who have not committed any wrongdoing directly. The Supreme Court of the United States has explicitly held that, although a subcontractor does not have privity of contract with the government, it still may be subject to FCA liability by causing a prime contractor to submit a false claim to the government on the subcontractor's behalf.[3] But what of the prime contractor's liability when one of its subcontractors has committed an FCA violation? Under what circumstances can a prime be held liable for its subcontractor's misconduct?

The answers to these questions are not always clear. Frequently, prime contractor liability for subcontractor misconduct depends on whether the prime contractor exercised reasonable care in its efforts to manage the subcontractors' contract performance. This necessarily is a fact-intensive inquiry that does not lend itself to bright-line rules. As discussed below, however, several best practices can help prime contractors mitigate the risk of FCA liability for subcontractor violations.

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Subcontractor FCA Liability

The FCA imposes liability on any entity—whether a prime contractor or a subcontractor—whose unlawful conduct induces the government to pay a false claim. Thus, although prime contractors typically submit claims for payment to the government on behalf of subcontractors, subcontractors can still face FCA liability where they cause the prime contractor to present a false claim for payment to the government.[4]

Importantly, FCA liability may attach regardless of whether the subcontractor submitted false claims to the prime contractor or the subcontractor knew the prime contractor would submit false claims to the government based on the subcontractor's representations or conduct.[5] This is because the FCA extends beyond the person making a false claim to anyone "who engages in a fraudulent course of conduct that induces payment by the government."[6] As the U.S. District Court for the District of Wyoming found in *United States ex rel. Grynberg v. Ernst & Young LLP*:

> "Cause" means to bring about or compel, produce, effect, etc. To be sure, the word "cause" in § 3729(a) has been used to reach persons or firms that do not deal directly with the government, but receive a financial benefit indirectly from the government by motivating an intermediary to file a false report. A common example is the subcontractor who, by submitting false information to the general contractor, causes the general contractor to submit what amounts to a false claim to the government. It has long been established that the subcontractor's conduct is reached by the FCA because the subcontractor is the moving force behind the false report. The fact that a false claim passes through the hands of a third party on its way from the claimant to the United States does not release the claimant from culpability under the Act.[7]

Thus, what matters is not simply what the prime contractor did, or did not do, but also what any downstream subcontractors have done that may have influenced the government's decision to pay.

Below, we have highlighted cases that define the contours of this overarching principle of subcontractor FCA liability.

United States v. Bornstein

The Supreme Court's decision in *United States v. Bornstein* is the seminal case on subcontractor FCA liability.[8]

In *Bornstein*, a prime contractor was under contract with the government to provide radio kits.[9] The contract specifications required the prime contractor to install a certain type of electron tubes in the kits.[10] The prime contractor entered into a subcontract with the subcontractor to provide the electron tubes for integration.[11] The subcontractor's electron tubes, however, did not meet the contract specifications, a fact hidden from the prime contractor because the subcontractor falsely branded its tubes to meet the contractual requirements.[12] Subsequently, the prime contractor delivered the integrated radio kits and, unknowingly, submitted false claims for payment to the government.[13]

The U.S. District Court for the District of New Jersey entered judgment for the United States, holding that the subcontractor's fraudulent acts caused the prime contractor to submit false claims to the government.[14] The U.S. Court of Appeals for the Third Circuit affirmed, in part, and vacated in part the district court's decision.[15]

On appeal, the Supreme Court held that the subcontractor was liable for three statutory forfeitures to match the three shipments of falsely branded materials to the prime.[16] In so holding, the Supreme Court emphasized that the number of deceitful acts perpetrated by the subcontractor controlled the damages calculation, not the number of claims for payment the prime contractor submitted to the government on behalf of the subcontractor.[17] In other words, the FCA "does not penalize [the prime] for what the [subcontractor] did. It penalizes [the subcontractor] for what [the subcontractor] did."[18]

United States v. Toyobo Company Limited

The Supreme Court's decision in *Bornstein* opened the floodgates for subcontractors to be held liable under the FCA despite not enjoying privity of contract with the government. One of the many decisions that followed is *United States v. Toyobo Company Limited*.[19]

Toyobo America, Inc. (Toyobo) manufactured a synthetic fiber called "Zylon" for bulletproof vests.[20] Toyobo distributed Zylon to three weaving companies that sold its woven products to vest manufacturers.[21] The vest manufacturers then sold vests to the federal government under a General Services Administration (GSA) multiple award schedule.[22] The government purchased over $30 million in vests from these various manufacturers over a six-year period.[23]

According to the government, before and during the sale of Zylon to the weaving companies, Toyobo conducted a series of tests and discovered that the Zylon degraded significantly over time when exposed to moisture and sunlight.[24] Toyobo executives allegedly agreed to keep these results quiet.[25] A couple of years later, however, one of the vest manufacturers allegedly reported to Toyobo that one of its Zylon vests failed ballistic testing.[26] Although Toyobo disclosed this information to other vest manufacturers, it also apparently assured them the test results were not indicative of "strength degradation."[27]

Over time, Toyobo conducted its own testing and, according to the government, selectively revealed negative tests results.[28] Further, Toboyo allegedly provided refunds

to certain vest manufacturers for faulty Zylon as long as they would use replacement Zylon that Toyobo had produced.[29] Ultimately, the National Institute of Justice conducted independent ballistics testing, which the "bulk of Zylon vests failed."[30] Thereafter, the government filed suit, alleging Toyobo violated the FCA by, among other things, using "the prospect of refunds, rebates, and reimbursements . . . to [fraudulently induce prime contractors] to continue producing Zylon products—and selling them to the government."[31]

In considering the government's allegation, the U.S. District Court for the District of Columbia noted that a "subcontractor may be liable under § 3729(a)(1) even when it did not itself present any false claims to the government if it engaged in a fraudulent scheme that induced the government to pay claims submitted by the contractor."[32] Accordingly, finding that the government sufficiently pled "Toyobo's misrepresentations about Zylon's accelerated deterioration induced the vest manufacturers to sell Zylon vests to the government," the court held that the government stated a valid basis for FCA liability.[33]

Key Takeaways on Subcontractor FCA Liability

The above cases demonstrate that courts examine FCA liability for subcontractors and prime contractors independently. Thus, the mere fact that a subcontractor has violated the FCA, without more, does not mean the prime contractor has also violated the FCA. To the contrary, as in *Toyobo*, prime contractors sometimes are just as much victims as the government. The next section examines when a court may properly impute a subcontractor's misconduct to its supervising prime contractor.

Prime Contractor Responsibility for Subcontractor Performance

Although the Supreme Court in *Bornstein* held that FCA liability attaches based on the specific conduct that gives rise to the false claim for payment—and not on whether the responsible actor is a prime or subcontractor—prime contractors nevertheless face the risk of FCA liability where their subcontractors are engaging in misconduct. This is because prime contractors are responsible for supervising their subcontractors' compliance with applicable contractual and legal requirements.[34] Where a prime contractor acts with "reckless disregard" or "deliberate ignorance" with respect to the truth of a subcontractor's representations or performance, the government may be able to impute the subcontractor's misconduct to the prime.

We examine the below examples of how courts have applied this "reasonable supervision" requirement with respect to prime contractors.

United States ex rel. Folliard v. Government Acquisitions, Inc.

Folliard concerned whether a prime contractor's reliance on a subcontractor's certification was reasonable and precluded FCA liability for the prime contractor.[35]

In *Folliard*, the prime contractor, Govplace, sold products to the federal government that were subject to the Trade Agreements Act, which bars the federal government from purchasing products that do not originate from certain "designated countries."[36] To determine whether the products it sold to the government complied with the Trade Agreements Act, Govplace relied on certifications from its distributor, Ingram Micro, which expressly certified that the products complied with the statute.[37]

A relator brought a *qui tam* action alleging Govplace had violated the FCA by falsely submitting claims for payment even though it was providing products to the federal government that originated in nondesignated countries, in violation of the Trade Agreements Act.[38] In particular, the relator alleged that Govplace acted in reckless disregard of the falsity of its sales to the federal government because Govplace unreasonably relied on Ingram Micro's certification.[39] The relator claimed Govplace's reliance on Ingram Micro's certification was unreasonable for two reasons. First, the relator alleged Govplace had received an email from Ingram Micro's vendor indicating that some of the products Ingram Micro had sold to Govplace "were produced in China, a nondesignated country."[40] Second, the relator alleged one of Ingram Micro's competitors sent the prime an "unsolicited price list which, according to [the relator], contradicts the [country of origin] information Govplace received from Ingram Micro."[41]

The U.S. District Court for the District of Columbia granted summary judgment in Govplace's favor, holding Govplace did not violate the FCA.[42] On appeal, the Court of Appeals for the D.C. Circuit affirmed.[43] The court of appeals observed that Ingram Micro's vendor emailed Govplace regarding the country of origin of the products only after Govplace sold the products to the government.[44] Thus, the relator could not use the email as evidence that Govplace knowingly submitted false claims for payment to the government.[45] Moreover, the court noted that the vendor's email highlighted multiple versions of the product at issue, including products made specifically for public sector consumption that were manufactured in designated countries.[46] The email, therefore, did not necessarily undermine Govplace's reliance on Ingram Micro's express certification of compliance with the Trade Agreements Act.[47] Similarly, the court rejected the relator's reliance on the price list provided by a competitor because Govplace had reason to ignore the information contained therein based on Ingram Micro's participation in the GSA's pass-through program. [48]

Thus, the court declined to impute Ingram Micro's wrongdoing to Govplace because Govplace reasonably relied on Ingram Micro's certification of compliance with the Trade Agreements Act.[49]

United States v. Kellogg Brown & Root Services, Inc.

In contrast to the D.C. Circuit in *Folliard*, in *United States v. Kellogg Brown & Root Services, Inc.*, the U.S.

District Court for the Central District of Illinois held that the prime contractor may not have acted reasonably in relying on its subcontractor's representations.[50]

In 2001, the U.S. Army awarded Kellogg Brown & Root Services, Inc. (KBR) a contract to provide living quarters at Camp Anaconda in Iraq.[51] KBR subsequently awarded a subcontract to an in-country contractor, First Kuwaiti, to deliver and install thousands of trailers designed as living quarters.[52]

In 2004, First Kuwaiti submitted various requests for equitable adjustments (REAs) for repair costs and delays.[53] After some negotiations, KBR and First Kuwaiti settled on proposed amounts, and KBR submitted the requests to the government for reimbursement.[54] Thereafter, the government brought an FCA claim against KBR alleging KBR failed to verify First Kuwaiti's costs before passing those costs along to the government, and made affirmative false statements regarding the accuracy and veracity of the REAs submitted.[55] KBR, in turn, moved to dismiss, arguing that neither its contract nor the Federal Acquisition Regulation required it to verify First Kuwaiti's actual costs prior to seeking reimbursement from the government.[56]

The issue before the court was whether a prime contractor that fails to verify adequately a subcontractor's request for reimbursement may be held liable under the FCA, when the failure to verify is attributable to the contractor's "reasonable" interpretation of its contractual and regulatory obligations.[57] The court responded in the affirmative. Noting that "[o]ne can make an objectively reasonable claim he or she subjectively knows to be false," the court held that KBR could be held liable under the FCA if the government proved that it "knew of but recklessly disregarded information that undermined the accuracy of material facts" for the underlying requests for reimbursement.[58] At least at the motion to dismiss stage, the court found that the government alleged facts sufficient to show that KBR "failed both to verify First Kuwaiti's costs and to determine the amount of the REA claims in accordance with sound business practices, by recklessly failing to require First Kuwaiti to prove its expenses in the face of evidence that First Kuwaiti was untrustworthy and the prices it claimed were likely inflated."[59]

Key Takeaways on Imputation of FCA Liability

The case law on imputation of FCA liability from subcontractors to prime contractors demonstrates that prime contractors must exercise reasonable care when relying on representations from subcontractors. Prime contractors should not blindly accede to subcontractor assertions, especially where there is contradictory evidence reasonably available that may undermine the subcontractor's claims.

Best Practices

As evident from the above, prime contractors face a veritable minefield when it comes to FCA liability. Not only must they exercise due care and diligence over their own performance of government contracts, but they also must be vigilant in monitoring their subcontractors' performance. Fortunately, in navigating the latter, there are several proactive measures that primes can take to mitigate the risk of FCA liability.

Understand the Prime Contract

The prime contract is the source of the prime contractor's duties and obligations and is the first resource a contractor should consult when analyzing whether it has breached a duty of care with respect to managing its subcontractors. For example, does the contract require the prime to verify or test any of the work performed by a subcontractor? Is the prime required to certify the completion of any compliance checks or tests before transmitting a deliverable to the government? Understanding the prime contract is a critical first step in assessing potential FCA liability.

Understand the Subcontract

If understanding the prime contract is the first step, understanding the subcontract follows shortly thereafter. A well-drafted subcontract will clearly delineate the roles and responsibilities of each party and lay the groundwork for how the parties can determine whether the subcontractor has performed its duties responsibly and in accordance with applicable requirements. For example, is the subcontractor required to submit certificates of conformance along with its deliverables? If the subcontractor relied on lower-tier subcontractors, is the subcontractor required to obtain additional certificates of conformance for these second-level subcontractors? Is the subcontractor required to submit test data to the prime contractor, or at least make that data available for inspection? Answers to these and similar questions can help a prime contractor understand how it can best supervise subcontractor performance.

Have a Robust Quality Assurance Plan in Place

As demonstrated by the cases discussed above, prime contractors are expected to exercise reasonable supervision over their subcontractors. An effective mechanism for conducting this supervision is to have an established quality assurance plan that leverages routine quality checks and audits, random spot checks, and a system for documenting and curing noncompliant practices. More and more government solicitations are incorporating requirements for quality assurance plans, but, even when one is not required, it would behoove prime contractors to have one in place.

Require Subcontractor Certifications for Deliverables

The U.S. Court of Appeals for the D.C. Circuit's decision in *Folliard* provided prime contractors with an effective safeguard against subcontractor misconduct: supplier certifications of conformance with contract requirements.

Although prime contractors cannot blindly rely on such certifications where there is other evidence suggesting the subcontractor may not be complying with applicable requirements, the certificates can provide an effective defense against FCA liability where the prime contractor has no reason to suspect wrongdoing.

Reserve Audit/Investigation Rights in Subcontracts

Prime contractors should include a clause in subcontracts granting the prime contractor audit or investigation rights in the event the subcontractor finds credible evidence of an FCA violation. Alternatively, prime contractors could flow down FAR 52.203-13, Contractor Code of Business Ethics and Conduct, or otherwise create an independent duty for subcontractors to report to the prime contractor whenever there is credible evidence (or some lesser standard to cast a wider net for potential misconduct) of an FCA violation (including a detailed root cause analysis). Including such clauses in subcontracts would allow prime contractors to have at least some ability to assess independently potential subcontractor wrongdoing and determine whether a mandatory disclosure to an agency Office of Inspector General is necessary. PL

Endnotes

1. 31 U.S.C. § 3729(a)(1)(A)–(B).
2. *Fraud Statistics Overview*, U.S. Dep't of Justice, https://www.justice.gov/civil/page/file/1080696/download?utm_medium=email&utm_source=govdelivery (last accessed Nov. 22, 2019).
3. United States v. Bornstein, 423 U.S. 303 (1976).
4. 31 U.S.C. § 3729(a)(1)(A); *see also* United States v. Honeywell Int'l Inc., 798 F. Supp. 2d 12, 19 (D.D.C. 2011) (explaining subcontractor liability under § 3729(a)(1) based on fraud in the inducement despite not having submitted the claim to the government directly); United States v. Carell, 782 F. Supp. 2d 553, 560 (M.D. Tenn. 2011) (noting "a false claim ultimately must be presented to the federal government (whether directly or via an intermediary) in order for liability to attach") (internal quotations omitted).
5. *See Honeywell*, 798 F. Supp. 2d at 19; United States *ex rel.* Smith v. Boeing Co., 505 F. Supp. 2d 974, 984 (D. Kan. 2007) (fastening liability to a subcontractor because the subcontractor caused the prime contractor to present false claims to the government); United States *ex rel.* Pogue v. Diabetes Treatment Centers of Am., Inc., 238 F. Supp. 2d 258, 266 (D.D.C. 2002) ("An argument that the presentation of the claims was the work of another is unavailing as a means to avoid liability under the False Claims Act.").
6. *Pogue*, 238 F. Supp. 2d at 266 (quoting United States v. Incorp. Vill. of Island Park, 888 F. Supp. 419, 439 (S.D.N.Y 1995)).
7. 323 F. Supp. 2d 1152, 1155 (D. Wyo. 2004) (internal quotations and citations omitted).
8. 423 U.S. 303.
9. *Id.* at 303.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. United States v. Bornstein, 361 F. Supp. 869 (D.N.J. 1973).
15. United States v. Bornstein, 504 F.2d 368 (3d Cir. 1974).
16. *Bornstein*, 423 U.S. at 311–13.
17. *Id.*
18. *Id.* at 312.
19. 811 F. Supp. 2d 37 (D.D.C. 2011).
20. *Id.* at 41.
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* at 42.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* at 43.
30. *Id.*
31. *Id.*
32. *Id.* at 45.
33. *Id.* at 46–48.
34. *See* United States *ex rel.* Williams v. Renal Care Grp., Inc., 696 F.3d 518, 530 (6th Cir. 2012) (describing conduct that meets the reckless disregard for the truth standard as burying one's head in the sand and failing to make inquiries as to a claim's validity); United States *ex rel.* Folliard v. Gov't Acquisitions, Inc., 764 F.3d 19, 30 (D.C. Cir. 2014) (holding the prime contractor was entitled to rely on supplier's certification that product complied with Trade Agreements Act requirements); United States v. President & Fellows of Harvard Coll., 323 F. Supp. 2d 151, 187 (D. Mass. 2004) (noting "the defendant's ostrich-like behavior itself becomes a course of conduct that allowed fraudulent claims to be presented to the federal government") (internal quotations omitted).
35. *Folliard*, 764 F.3d at 21.
36. *Id.* at 21.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.* at 30.
41. *Id.*
42. United States *ex rel.* Folliard v. Gov't Acquisitions, Inc., 858 F. Supp. 2d 79, 83 (D.D.C. 2012).
43. *Folliard*, 764 F.3d at 31.
44. *Id.* at 30.
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.* at 30. The GSA's pass-through program allows resellers who do not manufacture the products they sell to obtain a Letter of Supply from the manufacturer that guarantees a source of supply for the entire contract period.
49. *Id.* at 31.
50. No. 4:12-CV-4110-SLD-JAG, 2014 WL 1282275 (C.D. Ill. Mar. 31, 2014).
51. *Id.* at *1.
52. *Id.*
53. *Id.* at *2–3.
54. *Id.*
55. *Id.* at *5.
56. *Id.* at *6.
57. *Id.* at *7–8.
58. *Id.* at *8.
59. *Id.* at *7.