



# Connecticut Construction Industries Association, Inc.

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## Senate Bill 1428, An Act Concerning Fraud Against the State

Committee on Government Administration and Elections  
March 16, 2007

### CCIA position: Oppose

Connecticut Construction Industries Association, Inc. (CCIA) represents the commercial construction industry in Connecticut and is committed to working together to advance and promote a better quality of life for all citizens in the state. CCIA is comprised of approximately 400 members, including contractors, subcontractors, suppliers and affiliated organizations representing all aspects of the construction industry.

CCIA is **opposed** to Senate Bill 1428, which would establish a state false claims act.

A false claims act imposes civil liability on any person or entity that submits a false or fraudulent claim for payment to the government. The federal False Claims Act, revised in 1986, allows the government to bring civil actions to recover damages and civil penalties when false claims are made. It also provides for *qui tam* suits, that is, suits brought by private informants in the name of the government charging fraud on the part of persons who improperly receive or use public funds.

CCIA believes that a state false claims act **should not be enacted** in Connecticut for a number of reasons, including the following:

**Potential misuse.** A false claims act is a powerful tool that could be used to intimidate lawful contractors who have done business with the state and are genuinely owed money by the state. Determining liability and calculating damages is never certain in construction disputes and often involves wide-ranging opinions from accountants to engineers. Even though reasonable minds may disagree without making a "false" statement, SB 1428 could easily be used to turn a contract dispute into a false claim. Following are examples of false claims act abuse that also show how this act could be used in unintended ways for improper purposes.

**Significant penalties and burdens.** A false claims act typically imposes monetary penalties, treble damages and exposure to suspension and debarment from public contracting. Although SB 1428 does not include criminal penalties, if enacted the law could later be amended to provide such penalties. Most importantly, a contractor could be suspended from state contracting upon filing of a civil action (even though it is completely frivolous and intended to harass the contractor) and the contractor could be debarred from public contracting following a civil judgment. Likewise, frivolous civil actions could cost contractors their prequalification status to



perform state work.

**Reduce business with the state and revenue.** Contractors faced with a false claims act in the state that is capable of being misused and with its significant penalties will be less likely to engage in business with the state. This will raise the cost of compliance and doing business with the state. There will be a cost to the state to administer the act as additional staff will be needed to sort through and dismiss the many frivolous actions brought by bounty-seeking whistleblowers and the segment of the plaintiff's bar that services those whistleblowers.

**The incentive for abuse would increase.** In the federal Deficit Reduction Act of 2005, Congress passed and the President signed into law a provision that establishes a financial incentive to states that enact a false claims act comparable to the federal False Claims Act. Effective January 1, 2007, the federal government will give the state 10% of funds recovered as part of Medicaid enforcement actions brought under such state's law that should have otherwise gone to the federal government. Such a financial incentive would increase the temptation to abuse the act.

CCIA commends the legislature for a sincere attempt to address the contracting challenges confronting the state. Members support these efforts and would like to work with the legislature to improve the business climate in the state. We believe, however, the dangers inherent in the incentive for abuse of the false claims act must be weighed against any perceived benefit to the state, and SB 1428 should not be enacted.

Following are examples of False Claims Act abuse and an analysis of some of the provisions in this bill that are of grave concern to the construction industry.

Examples of abusive lawsuits include:

1. In *Valley Engineers, Inc. v. City of Vernon*, Los Angeles County Superior Court Case No. BC 227815, the government entity filed a counterclaim based on the FCA against a contractor's claim for payment alleging that the contractor "under-billed" for an item of work and submitted a "false" claim. Even though the under-billing allegation runs contrary to the purpose of the FCA (deposition testimony of the government's expert witness is attached – see page 5), the potent threat of FCA allegations raised the stakes in litigation to a point that the contractor, after laying-off workers and selling equipment to raise the money necessary to defend against the counterclaim under the FCA, had no choice but to settle its claim with the city for a fraction of what the city actually owed the contractor. Without surprise, the abusive FCA allegations in the counterclaim were dropped after the contractor agreed to relinquish part of its claim.
2. In *US ex rel. Bettis v. Odebrecht Contractors*, 393 F.3d 1321 (D.C.Cir. 2005) a whistleblower filed a FCA action against a contractor (that received a "Contractor of the Year" award for exceptional performance on the project), alleging that the contractor purposely "deflated" its bid to induce the government to award the contract. The whistleblower and the plaintiff's attorney serving him were seeking their share of millions of dollars of alleged "false claims". Here, the contractor had the resources to defend against the FCA action in the US District and Appellate Courts where the courts held that none of the evidence offered by the plaintiff proved the contractor's bid was fraudulent and dismissed the case. After years of expensive investigations and litigation, public humiliation, and risk of suspension or debarment, the contractor was left without a remedy to recover any of the costs to defend against the abusive lawsuit.
3. In *U.S. ex rel. Durchholz v. FKW Inc.*, 189 F.3d 542 (7<sup>th</sup> Cir 1999) a government official was one of the victims of an abusive lawsuit. In this action, a whistleblower alleged a government contracting officer was part of a conspiracy because he had instructed the contractor to prepare its invoices in a way that was allegedly "false". Here, the whistleblower was a disappointed bidder who utilized the FCA to further its challenges to the award of the contract to a competitor. However, the courts recognized that frequently in the real world: for purposes of convenience, efficiency, common sense, and just getting the work done, the government customer and contractor agree to depart from the strict terms of a contract or procedure without committing false claims. Like above, after years of expensive investigations and litigation, the case was dismissed.
4. In *U.S. ex rel. Stierli v. Shasta Services, Inc.*, 2006 WL 1897109 (July 11, 2006), a case decided under both the federal and California state False Claims Acts, the federal district court for the Eastern District of California dismissed a disappointed bidder's qui tam complaint alleging that the awardee of a federally-funded state construction contract had violated both acts by submitting incomplete information in its proposal regarding its efforts to enlist disadvantaged subcontractors. Remarkably and atypically, the successful motions to dismiss were filed by both the federal and state governments who were the alleged victims of the fraud.

In the case, the court was persuaded not only by the fact that the state government customer had full knowledge of the alleged noncompliance prior to awarding the contract, but

also by the California Attorney General's contentions that the state government has a "legitimate interest in ensuring that the [FCA] is not "misused by unsuccessful, disgruntled public contract bidders as a device to intimidate competitors' [and that otherwise] 'every award process could potentially be converted into a[n FCA] action with the winning bidder facing the specter of civil penalties and treble damages even with the state—the real party in interest—contends no false claim was committed.'"

FCA abuse is growing and expanding. The incentive for abuse is encouraging some whistleblowers and federal agencies to push the curious proposition that estimates of future costs can be fraudulent, thus triggering liability under a FCA. *See: The Strange Notion of Estimates as Fraud: Will Weather Predictions Be Next Under the False Claims Act?*, 40 Proc. Law. 1 (Summer 2005); "False" or "Inaccurate" Estimates, West Publications: Briefing Papers, Second Series No. 05-13 (December 2005). Here, FCA plaintiffs are in quest of virtually unlimited opportunities to abuse the FCA by using 20/20 hindsight to second-guess good faith judgments made by contractors and accepted by government contracting agencies during negotiations.

Significant points that identify the many aspects of this FCA, that are of grave concern to the construction industry include:

- The act does not require a showing of specific intent to defraud. *The standard for this “scienter” requirement for civil liability is much easier to meet than for common law fraud or the criminal FCA. Here, a corporation may be held liable under the civil FCA for acts of its employees and subcontractors as long as they acted within the scope of authority, even if no management personnel knew about the false claims.* (Sec. 1 (1))
- The term “false” is not defined. *In many cases falsity is not clear. For example, questions of scientific or engineering judgment are neither strictly true nor strictly false. Questions of interpretation of specifications, drawings or other technical requirements may be matters of opinion on which reasonable minds may disagree without making a “false” statement. Here, any contractor that shares his or her true thinking to the government can be liable for a false claim.*
- The definition of “claim” is so broad, that almost any action by a contractor could be a claim. *Some interpret a claim to be a single document; others interpret it to be separate phrases or items within a single document. A claim need not be in writing at all. Likewise, there is no distinction where negotiations over a difference of opinion end and a claim begins.* (Sec. 1 (2) and Sec. 15 (b))
- The definition of “knowing” and “knowingly” is expanded by two broad provisions to have no boundaries. *Acting in deliberate ignorance or reckless disregard of the truth or falsity leaves the provision open to interpretation.* (Sec 1. (1) and Sec. 15(b))
- The act does not require a showing of materiality. *Materiality means that the claim’s falsity must have had a natural tendency to influence the Government’s decision to pay. Without it, the Act allows misconstruing trivial violations of the letter of the contract documents as false claims.*
- The “preponderance of the evidence” standard of proof is lower than the “clear and convincing evidence” standard of proof that applies to actions in fraud. *The low standard of proof combines with the broad elements of a claim to make actions relatively easy to allege and prove, especially considering the gray-area of construction judgment. The low standard of proof encourages abuse, because it compounds the problems with the broad definitions.* (Sec. 13)
- The high penalties and damages often far exceed any harm to the government. *Penalties of \$5,000 to \$10,000 per claim, three-times the state’s damages, litigation costs and attorney fees, plus potential suspension and debarment under other statutes combine with the easy legal standards to create a tremendous threat.* (Sec. 2 (b), suspension, debarment, and contract termination are in other statutes and proposed bills)

- The attorney fees and costs provisions are unbalanced. *A successful plaintiff automatically collects expenses, reasonable attorney fees, and cost; on the other hand, a successful defendant only has a remedy against the plaintiff for abuse of the act in rare and unusual circumstances.* (Sec. 5 (e)(f), compared to Sec. 6 (c))

For further information, contact Matt Hallisey or Don Shubert at 860-529-6855.

## FALSE CLAIMS ACT

### Valley Engineers, Inc. v. City of Vernon

Should a contractor be penalized for mistakenly cheating himself by requesting a progress payment from a public entity which is less than the amount actually owed? One such public entity says yes. In *Valley Engineers, Inc. v. City of Vernon*, Los Angeles County Superior Court Case No. BC 227 815, recently resolved at mediation, Valley Engineers, Inc. was faced with defending a claim that it had violated the California False Claims Act by mistakenly underbilling the City for work performed on the project.

### California False Claims Act

Recently, much has been written regarding the application of the California False Claims Act ("CFCA") (*Government Code*, Section 12650-12656) by public entities involved in public works construction projects, and involving recent cases in which the CFCA has been applied and interpreted. (*False Claims Act, An Overview*, Steven D. McGee, Esq., Kimble, MacMichael & Upton; *Recent Developments in False Claims Act Litigation*, Timothy M. Truax, Chair, AGCC Legal Advisory Committee; *False Claims Act Litigation*, David B. Casselman, John R. Herrig & David Polinsky.)

In summary, the CFCA was modeled after the Federal False Claims Act ("FFCA") originally enacted into law in 1863 by President Abraham Lincoln to stop fraud being perpetrated by contractors against the government during the Civil War. As such, the CFCA is interpreted

broadly to provide for civil penalties and treble damages for any person who "knowingly presents or causes to be presented [to the state or any political subdivision] . . . a false claim for payment or approval." (Section 12651(a)(1); *City of Pomona v. Superior Court* (2001) 89 Cal. App.4th 793, 801.) A governmental plaintiff may recover three times the damages it incurred and costs. (Section 12651(a).) A governmental plaintiff may also recover a penalty of \$10,000.00 for each false claim. (Section 12651(a).)

A "claim" includes any request or demand for money, property or services made to the state or any political subdivision thereof. (Section 12650(b)(1).) In addressing the issue of falsity of a claim, the CFCA does not require that a claimant have a specific intent to defraud the government. The government must only show that the claimant had the requisite knowledge as to the falsity of the claim. For purposes of the CFCA, a claimant is determined to have the requisite "knowledge" of the falsity of a claim if he (1) has actual knowledge of the information; (2) acts in deliberate ignorance of the truth or falsity of the information; or (3) acts in reckless disregard of the truth or falsity of the information. (Section 12650(b)(2).)

### The Project

In 1999, Valley Engineers, Inc., founded in 1948 in Fresno, California, entered into a publicly bid contract with the City of Vernon to construct 13,000 feet of 10-inch diameter underground steel gas pipeline, a bridge crossing and two gas regulator stations. The plans for the project called for electric resistance welded (ERW) pipe for the underground mainline work, and for seamless pipe for the bridge crossing and the regulator stations. The contract price was approximately \$2.7 million.

As Valley's contract work was concluding, the City issued a unilateral change order for an additional 8,200 feet of ERW gas pipeline for work not completed by a previous contractor, all at Valley's bid unit prices. As work progressed on the job, Valley encountered a total of 39 incidents of changes and changed conditions giving rise to requests for additional compensation and time extensions, most of which involved areas of the project added by the City's unilateral change order.

As the project was nearing completion, the City discovered through inspection that 40 lineal feet of eight-inch and 20 lineal feet of two-inch ERW pipe was installed in the regulator stations instead of the specified seamless pipe, and immediately issued a "Stop Work" order. The City also advised Valley, under the threat of arrest, not to enter the regulator station work sites. Valley could not positively trace the origin of the ERW pipe, but nonetheless agreed to replace the non-conforming pipe with seamless pipe, which it did at its expense.

After filing the Notice of Completion, the City continued to withhold progress payments and retention in the amount of approximately \$381,000.00, separate and apart from amounts claimed for extra work on the job. Valley was left no choice but to file a *Government Code* claim and embark upon costly litigation.

### The Litigation

Valley retained the law firm of Monteleone & McCrory, LLP, to represent its interests. Valley's claim for breach of written contract was met immediately with a counter-claim from the City, which included a cause of action alleging a violation of the CFCA. Valley's hope was to

engage in early mediation to keep its litigation costs to a minimum. The parties participated in the Los Angeles County Superior Court's Pilot Mediation Program. The mediation was unsuccessful. During the case, the City also successfully sought two continuances of the trial date, which Valley opposed, the latter of which was obtained approximately two months before the scheduled trial date to afford the City time to file an amended cross-complaint to add factual allegations to its alleged False Claims Act violations. Meanwhile, the City had propounded numerous sets of lengthy written discovery. The documents exchanged filled several bankers boxes. Through no fault of Valley, the litigation became protracted and very costly. For Valley to continue the litigation, it was required to down size its work force by terminating the employment of many employees, some of which had been with the company for more than 20 years.

After approximately two years of discovery, the City's false claim accusations appeared to rest on the following:

1. Valley allegedly received three progress payments for the two regulator stations where ERW instead of seamless pipe was installed, amounting to six false claims penalties of \$10,000.00 each;
2. Valley allegedly made eight wrongful demands for labor costs detailed in the claim, for which the city sought penalties of \$10,000.00 each, and treble damages for the labor cost differential;
3. Valley allegedly made wrongful quantity demands in six progress estimates for two off-haul items, amounting to 12 penalties of \$10,000.00 each, plus treble damages for the quantity differential;

4. Valley allegedly improperly prepared four items in the claim at a penalty of \$10,000.00 each; and
5. Valley allegedly requested two wrongful under billings in progress estimates at a penalty of \$10,000.00 each.

On this last issue, the deposition testimony of the City's designated trial expert was as follows:

“Q Next bullet point says, “Two of the improper billings were net underbillings.” What does that mean?

A It means there was improperly reported time, but in those two instances, it was incorrect – it was an incorrect underbilling.

Q So the contractor claimed less money than he was entitled to?

A That's correct.

Q As to those two improper billings where he claimed less than what he was entitled to, you still determined that the City is owed \$10,000.00 for each of those billings under the False Claims Act; is that correct?

A That's correct.

Q How did you arrive at that conclusion?

A It's an incorrect billing.

Q So even if the billing is false in the sense that the contractor mistakenly cheated himself, he still has to pay the City \$10,000 a pop. Is that your analysis?

A I'm telling you it's an incorrect billing to a public entity.

Q So whether or not he intends to cheat the City or he makes an innocent mistake, in your mind, if it's incorrect, the City is still owed \$10,000 under the False Claims Act?

A I drew a distinction with respect to those two in the next line indicating that under those circumstances, the City didn't suffer any actual damages. Therefore, there would be no treble damages application.

Q But they're still entitled to \$20,000 because the contractor made a mistake and cheated himself?

A You've just made an assumption. All I see is an improper billing. It's incorrect.

Q If it's improper and the contractor made a mistake and underbilled and asked for less money than he was entitled to, the City is still entitled to impose a penalty under the False Claims Act for \$20,000 for that error?

A I'm just telling you - as I said, I drew a distinction between that and the others.

Q But you didn't draw a distinction for the imposition of a \$10,000 penalty, did you, sir?

A No. Where it said that.

Q So in your opinion, in your interpretation of the False Claims

Act, it applies even though the error was made in the City's favor and against the contractor. He still has to pay the City \$10,000 for every error he made whether he intended to cheat the City or not.

Is that correct?

A Yeah. The short answer is yes."

Finally, the City was also considering entitlement to a \$10,000.00 penalty for each of 46 letters written by Valley asking for consideration of time extensions, claiming that Valley falsely claimed time delays. Valley had gathered documentation and was prepared to counter every accusation of the City pertaining to the false claims issues.

After approximately two years of written discovery, motions before the court, depositions and trial preparation, the City agreed to private mediation approximately three weeks before trial following a strong recommendation from the trial judge to do so. While the mediator was successful in increasing the City's offer to approximately 10 times that previously offered in the case, the mediator also utilized the possibility, however remote or unfair, of False Claims Act exposure in encouraging Valley to reduce the amount requested for settlement.

### Lessons Learned

What lessons can contractors learn from this case? What can contractors bidding public jobs do to minimize or eliminate potential exposure on false claims issues? The following are a few suggestions:

1. Prior to bidding a job, investigate the owner. Consider carefully whether you

want to bid jobs with public agencies which have repeatedly used the CFCA as a defense against contractor's legitimate claims.

2. Make every attempt to resolve contract changes at the lowest possible bureaucratic level consistent with the contract documents. You may experience a situation in which the higher up you are required to go in an agency's hierarchy, the less likely a decision will be made.
3. Consider carefully whether you want to accept unilateral change orders, as doing so may run the risk of you not getting paid.
4. If you, as a contractor, find yourself in a differing site conditions or changed conditions dilemma, consider allowing the Owner to direct the resolution on a cost-plus basis. Continue with the other work in an efficient manner, while the Owner ponders over a solution. After all, it is the Owner's project. The Owner or its independent consulting firm designed the project. A contractor only has the obligation to build the project as presented in the contract documents. No more! Anything different should constitute a contractual change and be compensable. Be aware that changes to the contract most often divert the project management's attention away from the original work, to the detriment of the original budget.
5. On larger projects, consider consulting with an attorney specializing in construction law to prepare, review, modify and/or assess the contractor's claim for accuracy prior to submission to the public entity. Innocent mistakes occur during the course of the job. Yet, it is often these mistakes that an agency argues is "deliberate ignorance" or "reckless disregard" as proof of "knowledge" by the

contractor as to the falsity of a claim.

6. If litigation cannot be avoided, retain an experienced attorney specializing in construction law. Exhaust all possibilities of alternative dispute resolution. Consider binding arbitration before one or more arbitrators which specialize in construction law. If the parties cannot agree on arbitration, seek mediation at an early date using an experienced construction law practitioner as a mediator.

### Conclusion

In the present political climate, it is doubtful that significant changes will be made to the CFCA, leaving contractors to work within the broad parameters of the Act. While no one believes that contractors should have the right to submit false claims to any governmental agency, the degree to which some agencies are using the CFCA, even in seeking penalties when the contractor inadvertently cheats himself, must be addressed. If not, established and reputable contractors with a history of providing quality work for the public benefit will refrain from bidding on any public project.

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