AMERICAN BAR ASSOCIATION
Tort Trial and Insurance Practice Section

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COMMITTEE NEWS

Fidelity & Surety Law

Being Mindful Of The False Claims Act

Michael Stover
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All sureties knew that because of the False Claims Act ("FCA" or the "Act")[1], a surety needed to be very careful about certifying an affirmative claim against the government. However, a few years ago, the surety world was jolted when an FCA case was filed against two sureties and a broker. The case essentially alleged that the sureties were liable under the FCA because they continued to bond a principal, allegedly with knowledge or under conditions in which they should have had knowledge, that the principal was not a properly certified disabled veteran-owned business. In an unrelated case, in September 2019, a settlement was announced between the United States Attorney's Office for the Western District of North Carolina and a surety whereby the surety agreed to pay $1 million dollars to resolve an FCA claim that the surety should have known the principal it was bonding was not a proper U.S. Small Business Administration Section 8(a) contractor. In that matter, the U.S. Attorney stated:

> By enabling fraudsters, these companies play a key part in unlawfully usurping government contract opportunities from socially and

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1 31 U.S.C.A. § 3729 (West 2019) *et seq.*

In This Issue

Chair Message

Darrell Leonard
Zurich American Insurance Company

Chair, ABA TIPS Fidelity and Surety Law Committee

Dear FSLC Members,

Each and every day as Chair, I am reminded how lucky I am to be part of such a great organization! The generosity, in terms of both time and resources, of our members makes for such a joyful process, and I thank each and every one of you for your contributions.

Co-chairs Richard Baudouin and Megan Manogue did a fabulous job of putting together the Fall Fidelity program in Boston. The program provided both the newer fidelity practitioner as well as the seasoned veteran with valuable tips and insights into handling the fidelity bond claim. If you were unable to attend the Fall Fidelity program in Boston, you will not want to miss picking up a copy of the third edition of *Handling Fidelity Bond Claims*. Megan Manogue, Bob Flowers and Mike Keeley put together a book that every person who handles fidelity bond claims will want on their shelf, so be sure to pick up a copy through the ABA website.

I hope that everyone is excited to return to New York City for the FSLC 2020 Midwinter Conference, which will be held at the Grand Hyatt next to Grand Central Station January 29-31, 2020. Our program co-chairs have put together programs that you will find both innovative and informative.The Construction program, entitled "Vital Signs of a Healthy Contractor" and co-chaired by Mary Jean Pethick and Ryan B. DeLaune, will explore what successful contractors do to thrive both in the present and in the future. The Surety program, co-chaired by Tina Kocke, Shashauna Szczechowicz, and Brian Kantar, "CPR for a Dying Contractor," will discuss various methods that a surety might employ to assist its principal when the contractor faces severe challenges that may impact its ability to continue on as a viable entity. Last but not least, Jim Knox and Omar Harb have put together the Fidelity Program, "A Whole New World: The Impact of Technology and Cyber Crime on Fidelity Policies," which will explore how the fidelity world has adapted to new technologies and threats. If you have not done so already, please register and make your hotel reservations as soon as possible!

Looking ahead, please make plans to join me at what I consider to be one of the most beautiful places in the world, Lake Tahoe, for the Spring Surety Meeting, May 6-8, 2020, which will be held at the Grand Hyatt in Incline Village, Nevada. Chad Schexnayder and Michael Collins will present the new *Surety and Bankruptcy* book which they co-edited, a scholarly book aimed at assisting counsel when representing a surety in a bankruptcy proceeding and at judges and their clerks to assist them in understanding the special aspects of suretyship as it pertains to cases in their

courtroom. The book and program will also provide valuable insights for the claims handler in bankruptcy situations. Please mark your calendars and make plans to attend this extremely important program!

Finally, I want to thank the editors and authors who have made this newsletter possible. They have done a tremendous job, and I know you will find the articles included herein to be of great interest to you.

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THE FIDELITY AND SURETY LAW 2020 MIDWINTER CONFERENCE

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Payment Bond Claim Or A Disguised Performance Bond Claim

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A special thank you to Jennifer Chavez-Rivera for her research assistance on this project.

A recent trial experience raised an extraneous issue: could a litigant seek recovery from a surety by alleging a payment bond claim when the claim is really a performance bond claim?

A practitioner's misclassification of each claim in relation to the proper type of bond claim may create a situation of a volunteer payment by the surety, or force an otherwise proper claimant to lose its claim. Research demonstrates that it is important for practitioners to be aware of the possibility of misclassification, and properly categorize each claim and the obligations under each bond to avoid negative consequences for the client.

The following cases serve to illustrate the point, and demonstrate that such claim casualties actually exist. The cases may also serve to help the knowledgeable practitioner cut-off such issues and save the client time and money on dealing with claims.

North Carolina Federal Court

In *Flatiron-Lane v. Case Atlantic Co.*, the court examined the precise issue of whether payment and performance bond claims were appropriately made under the respective bonds.[1] In *Flatiron-Lane*, the general contractor was awarded a design-build contract to construct two highway bridges in North Carolina.[2] The general contractor engaged a subcontractor to construct foundation pilings, otherwise called drilled piers.[3] After substantial delay, requests for information, and design alterations, the general contractor filed suit against the subcontractor and its surety under the payment bond and the performance bond.[4] During the course of the subcontractor's work on the project, the general contractor incurred unanticipated extra work to assist the subcontractor with its scope of work.[5] Some of the work included moving the subcontractor's equipment from one location to another on the jobsite.[6] The payment bond claim was also in some part related to the significant delays allegedly caused by the subcontractor on the project.[7]

Read more on page 23

1 Flatiron-Lane v. Case Atl. Co., 121 F. Supp. 3d 515, 549 n.23 (M.D.N.C. 2015).
2 *Id.* at 520–21.
3 *Id.* at 524.
4 *See id.* at 549.
5 *See id.* at 526–36.
6 *Id.* at 529.
7 *See id.* at 549 n.23

Consistent Coverage Positions Are A Good Thing—Right?

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An interesting case pending in the Eastern District of California styled *rePlanet Holdings, Inc. v. Federal Insurance Co.*[1] recently challenged conventional wisdom by permitting an insured to maintain fraud claims against an insurer based on a coverage position claimed to render its crime policy illusory.

The *rePlanet* Decision

rePlanet Holdings, Inc. ("rePlanet") is a recycling company that allows customers to exchange recyclables for vouchers that can be redeemed for cash or used in place of money at participating stores.[2] rePlanet then uses funds generated from the disposition of the customer's recyclables to reimburse the store for the amounts paid to customers under the vouchers.[3]

In July 2017, rePlanet discovered that unknown third parties had used computer software to forge rePlanet vouchers and that a rogue employee had stolen rePlanet printers and paper to create his own vouchers.[4] None of these fictitious vouchers were backed by any recyclables remitted by a customer.[5] The vouchers were entered into commerce and eventually redeemed, and rePlanet reimbursed the participating stores that had cashed them.[6] rePlanet allegedly lost millions of dollars because of these schemes.[7]

rePlanet submitted a claim under its Crime Policy's "Employee Theft," "Forgery," and "Computer Fraud" coverages.[8] "The 'Employee Theft Coverage' purports to cover the ***'direct loss'*** of 'Securities' resulting from 'Theft'[9] or 'forgery[10] committed by an "Employee" acting alone or in collusion with others.'"[11] "The 'Forgery Coverage' protects against ***'direct loss'*** sustained by an 'Insured' resulting from 'Forgery' or

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1 rePlanet Holdings, Inc., v. Fed. Ins. Co., No. 119CV00133LJOEPG, 2019 WL 3337907 (E.D. Cal. July 25, 2019).
2 *Id.* at *1.
3 *See id.*
4 *Id.*
5 *Id.*
6 *Id.*
7 *Id.*
8 *Id.* at *2.
9 *See id.* for the policy's definition of "Theft."
10 *See id.* for the policy's definition of "Forgery."
11 *Id.* (emphasis added).

Case Note

Editor's Note: We encourage our readers to submit case summaries, like the one below, discussing significant developments, practical lessons, and new support in the case law for long-standing principles of surety and fidelity law.

Iowa Great Lakes Sanitary District v. Travelers Casualty And Surety Company Of America[1]

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Iowa Great Lakes Sanitary District ("IGLSD") entered a contract with a construction company, McHan Construction, Inc., in 2007 for a wastewater treatment facility.[2] The project included the installation of a UV System to kill bacteria in the wastewater.[3]

To guarantee performance under the contract, McHan obtained a Performance and Maintenance Bond (the "Bond") from Travelers.[4] The company then purchased the UV System from Evoqua.[5] The purchase agreement for the UV System was accompanied by a two-year limited warranty, guaranteeing the system was free of "defects in workmanship and materials."[6] This two-year warranty was to begin once the system successfully passed a sixty-day performance test.[7] When McHan defaulted, Travelers agreed to take over and complete the project under the terms of the contract and the Bond.[8] Although there were additional delays in the completion of the project by Travelers, IGLSD's project engineer advised on November 8, 2011, that the installation of the system was "Substantially Completed" after successfully passing the performance test.[9] The warranty period was deemed to begin November 1, 2011.[10]

Despite its finding of "Substantial Completion," IGLSD claimed the system was defective and "often nonoperational."[11] IGLSD based a warranty claim on several

1 913 F.3d 760 (8th Cir. 2019).
2 *Id.* at 761-62.
3 *Id.*
4 *Id.* at 762.
5 *Id.*
6 *Id.*
7 *Id.*
8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*

incidents, such as an electrical fire damaging one of the modules in June 2012 and system malfunctioning in May 2013.[12] In July 2013, IGLSD's engineer informed Travelers of numerous issues with the system needing repair.[13] The engineer further expressed concerns that Evoqua had not supported the system.[14] The engineer noted the two-year warranty's expiration date and asked Travelers to "develop a plan to repair/replace the equipment by the end of the Warranty date."[15]

In response, Evoqua assessed the equipment in September 2013 and, in April 2014, proposed the UV systems "undergo a substantial rehab" with costs being split by both Evoqua and IGLSD.[16] In May 2014, IGLSD responded that it did not wish to "go any further to repair the failed equipment" and asked that the system be removed and the initial cost of the system refunded.[17]

Procedural History And Court Rulings:

IGLSD brought a breach of warranty claim against Evoqua and a claim against Travelers under the Bond.[18] After sanctioning IGLSD from proffering expert testimony because of its failure to comply with the district court's deadlines, the district court granted summary judgment against IGLSD with respect to both claims.[19] The district court reasoned that without expert testimony, IGLSD could not prove the indispensable element of its breach of warranty claim that the system was defective as the issue involved "sophisticated technology" that was "far beyond the common knowledge and experience of the average layperson."[20] Thus, a lay person's testimony as to the defects in the system would not be sufficient.[21] The district court also ruled that because IGLSD failed to respond to "Statements of Undisputed Material Facts" submitted to it by Evoqua and Travelers in violation of a local court rule, such statements were deemed to be admitted by IGLSD.[22]

IGLSD did not challenge these procedural rulings on appeal.[23] Rather, IGLSD claimed in its appeal that the court should have allowed it to prove defects in the

12 *Id.*
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.* at 761.
19 *Id.* at 761-62.
20 *Id.* at 763.
21 *See id.* at 764 ("Only expert testimony could possibly justify IGLSD's warranty claim for a remedy excluded by the warranty.").
22 *Id.* at 762.
23 *Id.*

system and show that Evoqua breached the two-year express warranty for the UV System by *lay* testimony that "the UV equipment failed to function frequently and in so many ways that it clearly was defective."[24] IGLSD further argued that their claim against Travelers should not depend on its claim against Evoqua.[25] Finally, IGLSD claimed its demand for a refund was, nonetheless, justified under the contract.[26]

Court's Analysis:

To determine whether IGLSD could use lay witnesses, the court noted a breach of warranty claim "requires proof of a product defect,"[27] and that summary judgment is mandated "against a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial."[28] The court held that "[i]n cases involving 'complicated technical and scientific issues...expert testimony is required to submit the issue of a product defect under Iowa law.'"[29] Expert testimony is required when there "is a fact issue upon which the jury needs assistance to reach an intelligent or correct decision."[30]

In affirming the district court's dismissal of IGLSD's claim against Evoqua, the appellate court held that, when viewed in a light most favorable to IGLSD, the record did in fact show the system "often malfunctioned."[31] However, without expert testimony, IGLSD could not establish that such malfunctions were "caused by equipment defects that breached the express warranty."[32] The court reasoned that "buyer's remorse" was not proof the equipment had serious defects in workmanship and materials and did not justify IGLSD refusing to allow Evoqua to repair such equipment.[33] Again, the district court held that such refusal by IGLSD and its decision to instead bring a warranty claim could only be justified by expert testimony.[34]

The appellate court also affirmed the district court's decision to dismiss IGLSD's claim against Travelers under the Bond.[35] The court held that had IGLSD been

24 *Id.* at 763.

25 *Id.* at 764.

26 *Id.*

27 *Id.* at 763 (citing Cummings v. Deere & Co., 589 F. Supp. 2d 1108, 1118 n.22 (S.D. Iowa 2008) (quoting Wright v. Brooke Group Ltd., 652 N.W.2d 159, 182 (Iowa 2002)).

28 *Id.* (quoting Celotex Corp. v. Catrett, 477 U.S. 317, 322, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986)).

29 *Id.* (quoting *Cummings*, 589 F. Supp. 2d at 1118).

30 *Id.* (citing Reed v. Chrysler Corp., 494 N.W.2d 224, 226 (Iowa 1992), *overruled by* Jahn v. Hyundai Motor Co., 773 N.W.2d 550 (Iowa 2009)).

31 *Id.* at 763.

32 *Id.*

33 *Id.*

34 *Id.* at 763–64.

35 *Id.* at 764-65.

successful in its claim against Evoqua, Travelers would have been required to correct, repair, or replace the defective work.[36] Yet, because IGLSD's claim against Evoqua failed, so did its claim against Travelers.[37] Finally, the appellate court rejected IGLSD's contractually-based argument.[38] The contract allowed IGLSD to reject the work during the construction phase.[39] After "Substantial Completion," however, the contract required Evoqua to repair or replace, at no cost to IGLSD, any defects.[40] IGLSD, however, initially accepted the system, but then rejected Evoqua's offer to repair or replace the system and, instead, tried to reject the system for known defects three years after the date of "Substantial Completion."[41] However, as the court already held, IGLSD needed expert testimony to establish a construction, installation, or equipment defect, but its inability to procure expert testimony to do so warranted the dismissal of IGLSD's claims of defective work.[42] The court also noted that in Iowa, the general rule as to known defects is that "acceptance of the work in the absence of fraud or mistake is a complete bar to recovery on the construction bond."[43]

Lessons Learned:

This case demonstrates the devastating impact which can occur in a construction dispute when an expert is excluded. Luckily, in this case, the surety benefitted from the exclusion of the obligee's expert. This case also serves as a reminder that in cases involving "complicated technical and scientific issues...expert testimony" may be required to submit the issue of a product defect or other technical matter.[44] It is never too early to evaluate whether an expert will be needed in a particular case and how to ensure that expert's testimony is admitted before the court.

36 *Id.* at 764.
37 *Id.* at 764-65.
38 *Id.*
39 *Id.* at 764.
40 *Id.* at 764-65.
41 *Id.* at 762, 764-65.
42 *Id.* at 764-65.
43 *Id.* at 765 (quoting Elliott Consol. Sch. Dist. v. Busboom, 227 F. Supp. 858, 862 (S.D. Iowa 1964)).
44 *Id.* at 763 (quoting *Cummings*, 589 F. Supp. 2d at 1118).

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Being Mindful... continued from page 1

> economically disadvantaged individuals who the 8(a) Program is intended to assist...My office will pursue vigorously bonding companies and other entities that, by turning a blind-eye or willfully ignoring blatant indicia of program fraud or abuse, enable the submission of these false claims and cause harm to the government program.[2]

As a result, sureties are starting to awaken to the fact that the FCA can have much wider application than previously understood. While we believe that such cases are a misapplication of the FCA as to sureties, until the surety industry can lobby Congress to change the laws or sureties can obtain favorable results in court, the FCA will continue to darken the industry's door. Accordingly, regardless of what your views are on the applicability of the FCA to the ordinary activities of sureties (underwriting, issuing bonds, satisfying claims), it is nevertheless prudent for a surety to review its normal processes and protocols, including claims handling activities, to see if there may be exposure to FCA claims. Awareness now of potential issues can help the surety avoid FCA exposure altogether later. In this article we will look at the FCA generally and discuss some scenarios where potential FCA claims may be lurking.

False Claims Act - History

The federal civil FCA was first enacted in 1863 to impose liability for presenting false claims to the government in order to prevent fraud by government contractors during the Civil War.[3] Congress intended that the False Claims Act, and its *qui tam* action, would help the government uncover fraud and abuse by unleashing a "posse of ad hoc deputies to uncover and prosecute frauds against the government."[4] Leading up to the enactment of the FCA, "a series of sensational congressional investigations" prompted hearings where witnesses "painted a sordid picture of how the United States had been billed for nonexistent or worthless goods, charged exorbitant prices for goods delivered, and generally robbed in purchasing the necessities of war."[5] Accordingly, Congress responded by imposing civil and criminal liability for various types of fraud on the government, subjecting violators to double damages, forfeiture, and up to five years' imprisonment.[6] The FCA originally allowed for "relator" or whistleblower actions by private citizens, but the Act was later amended to bar such actions. However, in the late 1980s, Congress amended the FCA to once again permit

2 Andrew Murray, United States Attorney, United States Attorney's Office for the Western District of North Carolina (Sept. 4, 2019).

3 *See* Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 784 (4th Cir. 1999).

4 *Id.* (quoting U.S. *ex rel.* Milam v. Univ. of Texas M.D. Anderson Cancer Ctr., 961 F.2d 46, 49 (4th Cir. 1992)).

5 United States v. McNinch, 356 U.S. 595, 599 (1958).

6 Universal Health Servs., Inc. v. United States, 136 S. Ct. 1989, 1996 (2016).

qui tam actions by private individuals. Later amendments by Congress have steadily increased the scope of FCA coverage.

The False Claims Act – In Practice/Procedure

In December 2018, the United States Department of Justice ("DOJ") announced that it obtained more than $2.8 billion in settlements and judgments from civil cases involving fraud and false claims against the government in the 2018 fiscal year.[7] 2018 was the ninth consecutive year that FCA settlements and judgments have exceeded $2 billion.[8] The DOJ stated that it "has placed a high priority on rooting out and pursuing those who cheat government programs for their own gain."[9]

Typically, whistleblower actions comprise a substantial percentage of the FCA cases that are filed each year.[10] In 2018, for example, whistleblowers filed 645 *qui tam* suits and recovered over $2.1 billion of the $2.8 billion total.[11] The government paid out $301 million to the individuals who exposed the fraud and false claims by filing the whistleblower actions.[12] The threat of FCA exposure is always present and can come from multiple sources, including disgruntled current or former employees, customers, vendors, or even "professional" whistleblowers who target certain industries and review publicly available information to generate claims. Any individual with knowledge of fraudulent activity against the government may file a claim as the plaintiff/relator, and the relator need not have been personally harmed by the defendant in order to bring a *qui tam* suit.[13]

Procedurally, an FCA "relator" must cooperate with the government in filing its action.[14] *Qui tam* plaintiffs are required to file their claims under seal and to leave them under seal for at least sixty days.[15] Upon receiving notice of the complaint and a disclosure statement from the relator, the DOJ is required to investigate the relator's allegations of fraud.[16] Upon completing its investigation, the DOJ may elect to: (1) intervene in the case, [17] (2) decline to intervene, [18] or (3) move to dismiss the case.[19]

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7 *Justice Department Recovers over $2.8 Billion from False Claims Act Cases in Fiscal Year 2018*, Dep't of Justice (Dec. 21, 2018), https://www.justice.gov/opa/pr/justice-department-recovers-over-28-billion-false-claim-act-cases-fiscal-year-2018.

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

13 *See* 31 U.S.C.A. § 3730 (West 2019).

14 *Id.*

15 31 U.S.C.A. § 3730(b)(2).

16 *See* 31 U.S.C.A. § 3730(a).

17 31 U.S.C.A. § 3730(b)(2), (4)(A).

18 31 U.S.C.A. § 3730(b)(4)(B).

19 31 U.S.C.A. § 3730(c)(2)(A).

There are similar false claim statutes in various states and other jurisdictions. Many are patterned on the federal FCA and courts in those jurisdictions look to federal law in applying and interpreting the state FCAs. There is also a federal criminal False Claims Act at 18 U.S.C.A. § 287 (West).

The False Claims Act – Legal Overview

Broadly speaking, a violation of the FCA occurs when there has been: (1) a false statement or fraudulent course of conduct; (2) made or carried out with knowledge of the falsity; (3) that was material; and (4) that involved a claim.[20] The FCA statutory language requires a claim to be false, but does not define falsity.[21] Courts have accordingly established definitions of false or fraudulent claims as those claims aimed at extracting money from the government that it otherwise would not have paid or owed. Courts have further defined two general categories of falsity—"factual falsity" and "legal falsity."[22] "Factual falsity involves 'an incorrect description of goods or services provided or a request for reimbursement for goods or services never provided.'"[23] "Legal falsity is where a claim is 'predicated upon a false representation of compliance with a federal statute or regulation or a prescribed contractual term.'"[24] Legal falsities include cases where a contractor has either expressly or impliedly certified compliance with some statutory, regulatory, or contractual requirement.[25] In an "express false certification," the defendant signs or otherwise falsely certifies to compliance with some law, rule, or regulation in connection with the claim submitted.[26] The payee's "certification" need not be a literal certification, but can be any material false statement that was made with scienter and caused the government to pay or forfeit money.[27] An "implied false certification" arises from the notion that when a defendant submits a claim it is impliedly certifying compliance with all conditions of payment.[28] For liability to exist under "implied false certification," two conditions must be satisfied: first, the claim must not merely request payment, but also must

20 31 U.S.C.A. § 3729(a)(1).

21 31 U.S.C.A. § 3729(b).

22 United States *ex rel.* Daugherty v. Tiversa Holding Corp., 342 F. Supp. 3d 418, 424 (S.D.N.Y. 2018).

23 *Id.* (quoting Mikes v. Straus, 274 F.3d 687, 697 (2d Cir. 2001), *abrogated by* Universal Health Servs., Inc. v. United States, 136 S. Ct. 1989 (2016).

24 *Id.* (quoting *Mikes*, 274 F.3d at 696).

25 *See Universal Health Services, Inc.*, 136 S. Ct. 1989.

26 United States *ex rel.* Lorona v. Infilaw Corp., No. 3:15-CV-959-J-34PDB, 2019 WL 3778389, at *16 (M.D. Fla. Aug. 12, 2019) (citing U.S. ex rel. *Keeler v. Eisai, Inc.*, 568 F. App'x 783, 798–99 (11th Cir. 2014). *See also* United States *ex rel.* Medrano v. Diabetic Care RX, LLC, No. 15-CV-62617, 2019 WL 1054125, at *4 (S.D. Fla. Mar. 6, 2019); United States *ex rel* Phalp v. Lincare Holdings, Inc., 116 F. Supp. 3d 1326, 1345 (S.D. Fla. 2015), *aff'd as modified sub nom.* United States *ex rel.* Phalp v. Lincare Holdings, Inc., 857 F.3d 1148 (11th Cir. 2017); United States v. Amin Radiology, No. 5:10-CV-583-OC-PRL, 2015 WL 403221, at *6 (M.D. Fla. Jan. 28, 2015), *aff'd sub nom.* U.S. *ex rel.* Fla. v. Amin Radiology, 649 F. App'x 725 (11th Cir. 2016).

27 *United States ex rel. Lorona*, 2019 WL 3778389, at *16.

28 *Id.* at 16–17.

make a specific representation about the goods or services provided; and second, the defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths.[29] Defendants can be liable for violating requirements even if they were not expressly designated as conditions of payment.[30] The Supreme Court has held that what matters is not the label the government attaches to a requirement, but whether the defendant knowingly violated a requirement that the defendant knows is "material" to the government's payment decision.[31]

The FCA defines "material" to mean "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property."[32] Thus, "materiality 'look[s] to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation.'"[33] The Supreme Court has stated that the materiality requirement is a demanding standard.[34] Materiality cannot be found where the noncompliance is minor or insubstantial.[35]

In construing the FCA broadly, courts have held the "causes to be made" or "presented" prong of the FCA extends liability beyond a prime contractor, and reaches to any person knowingly assisting in causing the government to pay claims grounded in fraud. The "causes to be presented" prong will attach liability to a defendant whose conduct was "at least a substantial factor in causing, if not the but-for cause of, submission of false claims."[36] Thus, a prime contractor who submits false subcontractor claims for reimbursement to the federal government will be liable under the FCA if the prime contractor had actual knowledge of the falsity or acted with reckless disregard or deliberate ignorance of the falsity.[37]

In instances where courts have considered the liability of a non-submitting entity, so long as the person agreed to take critical actions in furtherance of the fraud, courts may find the entity liable. For example, a court held "[w]here a defendant has an ongoing business relationship with a repeated false claimant, and the defendant knows of the false claims, yet does not cease doing business with the claimant or disclose the false claims to the United States, the defendant's ostrich-like behavior

29 *Universal Health Services, Inc.*, 136 S. Ct. at 2001.

30 *Id.* at 2001–02.

31 *Id.* at 2001–04.

32 31 U.S.C.A. § 3729(b)(4).

33 *Universal Health Services, Inc.*, 136 S. Ct. at 2002 (quoting 26 Williston on Contracts § 69:12 (4th ed. 2003)).

34 *Id.* at 2003.

35 *Id.*

36 United States *ex rel.* Landis v. Tailwind Sports Corp., 324 F. Supp. 3d 67, 72 (D.D.C. 2018) (quoting United States v. Toyobo Co., 811 F. Supp. 2d 37, 48 (D.D.C. 2011)).

37 *See* 31 U.S.C.A. § 3729(b)(1)(A).

itself becomes 'a course of conduct that allowed fraudulent claims to be presented to the government.'"[38]

False Claims Act – Scenarios to Consider

With this FCA background in mind, let's look at some scenarios. In certain circumstances a surety will deem it appropriate to takeover a project, retain a completion contractor, and finish the work on the project. As is typical on many government projects, there may be a socio-economic participation goal with the requirement that a certain portion of the work be completed by a minority business, woman-owned business, small business, etc. (hereinafter, "MBE"). What if during its investigation the surety discovers that a portion of the socio-economic participation looks "suspect?" Even if the surety brings in new MBE subcontractors and/or suppliers going forward, can the surety continue to submit applications for payment stating that "X" percent of the participation goal has been satisfied, when a part of that participation gives credit to the suspect MBE? Consider a case where a surety refuses to accept a credit for the suspect MBE participation, discloses the issue to the governmental owner, and seeks a waiver of that portion of the MBE goal. A surety might also refuse to pay the suspect MBE's subsequent payment bond claim all in an attempt to insulate itself from any potential FCA exposure. However, once the surety becomes aware of a potential issue, it may not be enough to simply change course going forward; the surety must consider how to excise the potential issue altogether and consider if any actions going forward are still "benefiting" from the prior issue – like stating in future applications for payment that "X" percent of the MBE goal has been satisfied if that "X" percent includes participation of a suspect MBE.

Another scenario to consider involves the surety receiving a payment bond claim where the bonded principal was utilizing alleged "independent subcontractors" to provide labor. Upon review, a surety might find that the alleged independent subcontractor may be misclassified, that the alleged subcontractor is paying the laborers in cash, improperly classifying the laborers as independent contractors, and cannot provide proof of immigration compliance or proof of payment of any taxes or insurance for the labor. While work was actually performed on the project by the laborers in question, can the surety pay the payment bond claim when it appears that numerous wage, employment, immigration, and tax laws have been violated? Might the surety be subject to an FCA claim if it pays the claim and seeks

38 United States v. President & Fellows of Harvard Coll., 323 F. Supp. 2d 151, 187 (D. Mass. 2004) (quoting United States *ex rel.* Long v. SCS Bus. & Tech. Inst., 999 F. Supp. 78, 91 (D.D.C. 1998), *rev'd sub nom.* United States *ex rel.* Long v. SCS Bus. & Tech. Inst., Inc., 173 F.3d 870 (D.C. Cir. 1999), *supplemented,* 173 F.3d 890 (D.C. Cir. 1999)).

the contract funds from the owner? The surety could take the position that it is denying the claims because they arise from an illegal contract and that contract has been performed in an illegal manner. As a result of such illegalities, the surety is not obligated to pay. Most jurisdictions follow the equitable principles that courts do not recognize rights arising from illegal agreements, will consider such agreements void, will leave the parties as the court finds them, and will not lend the court's aid to a person who founds their cause of action upon an illegal or immoral act.[39]

In June 2019, a federal district court ruled in favor of a surety's denial of a claim based on illegality involving the FCA. In *Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC*, the surety became aware that its principal and the bond obligee violated the service-disabled veteran law[40] by subcontracting more than 85% of the work.[41] The obligee was a service-disabled veteran-owned business ("SDVOB"), and it subcontracted all of the work to the subcontract principal for an amount that equaled 87.6% of the SDVOB's contract price.[42] The obligee also hired one of the owners of the subcontract principal to act as the project manager for an additional $62,000.[43] The obligee eventually terminated the subcontract and made demand upon the surety to perform under the performance bond.[44] The surety denied the claim and filed a declaratory judgment action.[45]

On summary judgment, the court found that the subcontract between the principal and obligee violated federal law.[46] The court reasoned as follows: "[a]ny act which is forbidden, either by the common or the statutory law, whether it is *malum in se*, or merely *malum prohibitum*, indictable or only subject to a penalty or forfeiture, or however otherwise prohibited by a statute or the common law, cannot be the foundation of a valid contract; nor can anything auxiliary to or promotive of such act."[47] The court held that "[b]ecause the Subcontract is illegal, [the surety] is not obligated to fulfill its obligations under the Bond which ensured performance of the

39 *See In re* Dublin Sec., Inc., 133 F.3d 377, 380 (6th Cir. 1997) (quoting *In re* Dow, 132 B.R. 853, 860 (Bankr. S.D. Ohio 1991)); *In re* Fair Fin. Co., 834 F.3d 651, 676 (6th Cir. 2016). *See also* Gibbs v. Consol. Gas Co. of Baltimore, 130 U.S. 396, 410–11 (1889).

40 13 C.F.R. § 125.6(a)(3) requires that the SDVOB not pay more than 85% of the amount paid by the government to it to firms that are not SDVOBs.

41 Hanover Ins. Co. v. Dunbar Mech. Contractors, LLC, No. 3:18CV00054 JM, 2019 WL 2353046, at *1 (E.D. Ark. June 3, 2019).

42 *Id.*

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.* at 2.

47 *Id.* at 3 (quoting Eager v. Jonesboro, Lake City & E. Exp. Co., 103 Ark. 288, 147 S.W. 60, 64 (1912)).

Subcontract."[48] The court further noted that if the surety were to perform under its bond, it may have had liability under the FCA.[49] This is a great example of using the potential for FCA exposure as a shield against claims. Being mindful of the FCA may include finding ways to make it work for the surety.

Another scenario for a surety to consider is the typical books and records review conducted by a consultant for the surety. In the course of the review, the consultant can be exposed to a great deal of information that might reveal a violation of applicable laws in the prosecution of the work by the principal or might be of a sufficient nature to require further investigation. Is the surety liable for the knowledge of the consultant? Of course, the surety's position would be that a consultant is an independent contractor, performing a limited function and is not a general agent of the surety. But an argument could be made to the contrary. Does the surety need to "debrief" its consultant to determine if anything discovered in the books and record review could give rise to an FCA claim against the surety? Should the surety put provisions in its agreements with its consultants placing a duty on them to disclose such potentially significant information and perhaps indemnify the surety for failing to do so? Are consultants even qualified to make such determinations? The parameters of the duties and obligations of sureties and alleged agents of sureties has not been defined sufficiently in the FCA context to provide answers to these questions.

For now, it is enough to raise the questions and awareness so that sureties and their counsel can start looking at the issues and begin to plan responses and to alter activities. The takeaway here is that sureties need to start looking critically at what they routinely do with the eyes of a "whistleblowing relator."

48 *Id.*
49 *Id.*

Payment... continued from page 8

Before reaching the issue that the payment bond claim was really a performance bond claim, the court recognized that there had not been sufficient notice of default related to the subcontractor that would have properly placed the surety on notice to remedy any default or delays and prejudiced the surety's right to perform.[8] As to the payment bond claim, both the surety and subcontractor argued the obligee did not qualify as a claimant on the payment bond, prohibiting recovery.[9] The court agreed.[10] While the general contractor couched its payment claims based upon the work it was forced to do to assist its subcontractor, the court determined that "[t]his is a performance bond claim masquerading as a payment bond claim," and, therefore, the claims failed.[11]

The court, in analyzing the issues, succinctly stated the nature of the general obligation under a payment bond: "[U]nder a payment bond, the surety promises the obligee to pay the principal's suppliers if the principal fails to do so.... The payment bond defines a claimant 'as one having a direct contract with the Principal for labor, material, or both, used or reasonably required for use in the performance of the contract.'"[12]

Florida Federal Court

In *Alleghany Casualty Co. v. Archer-Western/Demeria Joint Venture III*, the court, on a motion to amend, analyzed a proposed amendment to include a payment bond claim.[13] There, the general contractor retained a subcontractor to perform substantial drywall work on the project.[14] As the project progressed, the general contractor defaulted and terminated the subcontractor.[15] The general contractor then called upon the subcontractor's surety to complete the subcontractor's scope of work.[16] Eventually, the subcontractor's surety stated it had reached the penal sum of its bond and halted work on the project.[17]

The general contractor filed suit against the subcontractor's surety alleging that it had incurred substantial added labor costs and material expenses to complete its subcontractor's scope of work following default and termination of

8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*
12 *Id.*
13 Allegheny Cas. Co. v. Archer-W./Demaria Joint Venture III, No. 8:13-CV-128-T-24-TGW, 2014 WL 10915507, at *3–6 (M.D. Fla. June 16, 2014).
14 *Id.* at 1.
15 *Id.*
16 *Id.*
17 *Id.*

the subcontractor.[18] The general contractor moved to amend its pleadings in the litigation to make a payment bond claim for the surety's failure to reimburse the general contractor for the labor and material costs incurred to complete the subcontractor's scope of work.[19] According to the court, "[t]he dispositive issue is whether… the obligee under the payment bond, may sue as a bond claimant to recover the amount it paid for labor or material used in its completion of the project."[20] In denying the motion to amend, the court found that the general contractor's claim was "at odds with the traditional distinction between the two types of bonds, and it [was] not supported by the language of the payment bond."[21] The general contractor's "payment bond claim, in which it seeks to recover costs incurred in completing the subcontract, attempts to treat the payment bond like a performance bond."[22] As a result, the court found no basis for the obligee to be a claimant under the bond, and denied the general contractor's proposed amendment to include a payment bond claim.[23]

Illinois Federal Court

In *United City of Yorkville v. Ocean Service Corp.*, a developer acquired bonds to ensure performance of a subdivision project to protect the city of Yorkville.[24] Work started on the development; however, before the project was complete, the principal ran into financial difficulties and work ceased.[25] The subcontractors began filing liens on the property.[26] Over the course of the next several years, the city made repeated demands that the surety pay the liens.[27] The surety denied the demands, stating each time that the bonds were to ensure performance, not make payments to unpaid subcontractors.[28] The developer at one point even appeared to support the city's position, but the surety maintained its denial.[29] Nearly six years after the default, the city made a performance claim against the surety.[30]

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18 *Id.* at 3.
19 *Id.*
20 *Id.* at 4.
21 *Id.* at 5.
22 *Id.*
23 *Id.* at 6.
24 United City of Yorkville v. Ocean Atl. Serv. Corp., No. 11 CV 1984, 2013 WL 5433429, at *2 (N.D. Ill. Sept. 30, 2013).
25 *Id.*
26 *Id.*
27 *Id.* at 3.
28 *Id.*
29 *Id.*
30 *Id.*

While the city continued to maintain that the bonds also covered payment, the court readily distinguished the payment clauses as being tied to performance.[31] The court held that the bonds were indeed performance bonds only, and while the city made an eventual performance bond claim, that claim was beyond the statute of limitations related to the bonds.[32] The court then appeared to side with the city in finding that the city's claims could relate back to the initial filing of the lawsuit, thereby saving the claims from the statutory bar.[33] However, the court finally examined the surety's claim of laches, including the prejudice resulting from delay by the city.[34] According to estimates presented to the court, the cost of completion had skyrocketed from about $565,000 in 2007 to nearly $1.8 million in 2012.[35] The court ultimately agreed with the surety and found that laches barred the city's late attempt to seek performance under the bond, thus granting summary judgment to the surety.[36]

Nebraska Federal Court

In *Paul Reed Construction & Supply, Inc. v. Arcon, Inc.*, the general contractor on the project retained a subcontractor to complete a particular scope of work.[37] In turn, the subcontractor retained a sub-subcontractor to complete concrete crushing as its part of the scope of work. [38] The subcontractor requested that the sub-subcontractor provide a performance bond for its scope of work, which was provided.[39] While the sub-subcontractor's scope of work was completed and accepted, there were minor issues with an invoice as well as payment claims from suppliers to the sub-subcontractor which were directed to the general contractor's surety.[40] The subcontractor filed suit against the sub-subcontractor's performance bond, alleging a performance default related to the sub-subcontractor's failure to perform its contractual duties to pay its suppliers.[41] In granting the sub-subcontractor's surety's motion for summary judgment, the court recognized the distinction between a performance bond, which "guarantees that the contractor will perform the contract," and a payment bond, which "guarantees the owner that all bills for labor and materials contracted for and used by the contractor will be paid by the surety if the

31 *Id.* at 5.
32 *Id.* at 6.
33 *Id.* at 7.
34 *Id.* at 7–8.
35 *Id.* at 2, 8.
36 *Id.* at 8.
37 Paul Reed Const. & Supply, Inc. v. Arcon, Inc., No. 8:12CV48, 2012 WL 6086915, at *2 (D. Neb. Dec. 5, 2012).
38 *Id.*
39 *Id.* at 2–3.
40 *Id.* at 3–4.
41 *Id.* at 4–5.

contractor defaults."[42] The court determined that the subcontractor only requested a performance bond, the surety provided only a performance bond, and, therefore, the payment claim on the performance bond must fail.[43]

Rhode Island Federal Court

In yet another twist along this line of inquiry, a general contractor on a design-build project to produce a cogeneration facility brought payment claims, among others, against its subcontractor's sureties in *ADP Marshall, Inc. v. Noresco, LLC*.[44] In *ADP*, the subcontractor filed a lawsuit against the general contractor in federal court for unpaid labor, materials, and costs and a payment bond claim against the general contractor's surety.[45] In response, the general contractor filed counterclaims against the subcontractor, filed third-party payment bond claims against the subcontractor's sureties, and later attempted to bring performance bond claims against the subcontractor's sureties.[46]

The general contractor's theory against the subcontractor's payment bond sureties related to a claim for equitable subrogation.[47] Before the subcontractor filed its lawsuit against the general contractor in federal court, the lower-tier subcontractors on the project filed lawsuits for non-payment against the general contractor and its surety and the subcontractor and its sureties in state court.[48] In their defense, the subcontractor and its sureties relied on the pay-when-paid clauses in the various subcontracts and filed cross-claims against the general contractor and its surety.[49] Following a court award in favor of a lower-tier subcontractor, the general contractor made payments to the remaining lower-tier subcontractors on their lawsuits to settle the matters, though the general contractor's cross-claims against the subcontractor's sureties were still pending in state court.[50] The general contractor argued in federal court that because it paid the lower-tier subcontractors' claims, it was entitled to step into the shoes of the lower-tier subcontractors and seek subrogation from the subcontractor's payment bond sureties for the settlement payments.[51]

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42 *Id.* at 7.
43 *Id.* at 8.
44 *See* ADP Marshall, Inc. v. Noresco, *LLC*, 710 F. Supp. 2d 197, 200, 244–45 (D.R.I. 2010).
45 *Id.* at 200–01, 211.
46 *Id.* at 200, 242–43.
47 *Id.* at 245–46.
48 *Id.* at 211.
49 *Id.*
50 *Id.* at 211, 243–44.
51 *Id.* at 245.

The court, however, denied the general contractor's claim based upon equitable subrogation.[52] The court reasoned that if the subcontractor had performed its scope of work under the contract, the general contractor would have paid the subcontractor for its work, *and* the general contractor would have also paid the subcontractor for the work of the lower-tier subcontractors—all in an amount equal to the settlement payments the general contractor made.[53] Instead, the subcontractor failed to perform its scope of work under the contract, so the general contractor contracted with the lower-tier subcontractors to not only perform their originally subcontracted work, but also the subcontractor's remaining scope of work under the contract.[54] In other words, the general contractor just eliminated the middle man and directly paid the lower-tier subcontractors for their work plus the work they assumed for the subcontractor via the settlement payments.[55] Therefore, the court held that the general contractor was not entitled to equitable subrogation against the subcontractor's sureties for the settlement payments, but, instead, it was entitled to a credit against the subcontractor's balance in the amount of the settlement payments.[56] The general contractor also argued that it was entitled to equitable subrogation from the subcontractor's payment bond sureties for its legal expenses incurred in defending the lower-tier subcontractors' claims.[57] The court, again, denied the general contractor's equitable subrogation claim reasoning that the sureties' obligations under the payment bond were limited to paying the lower-tier subcontractors for undisputed claims or providing a basis for disputed amounts.[58] The court declined to extend the sureties' obligations to reimburse the lower-tier subcontractors for legal fees.[59] While no recovery was allowed in federal court from the subcontractor's sureties on the payment bond, the federal court noted that the general contractor may obtain a different result in the state court action still pending, should it proceed in that venue against the sureties.[60]

Finally, the general contractor argued that it was entitled to recovery from the performance bond for the subcontractor's failure to perform under the contract.[61] The subcontractor, however, failed to timely perfect its performance bond claim.[62] While the general contractor attempted to argue the statute of limitations on the

52 *Id.* at 246.
53 *Id.*
54 *Id.* at 230-32.
55 *Id.* at 246.
56 *Id.*
57 *Id.*
58 *Id.*
59 *Id.*
60 *Id.*
61 *Id.* at 242–44.
62 *Id.*

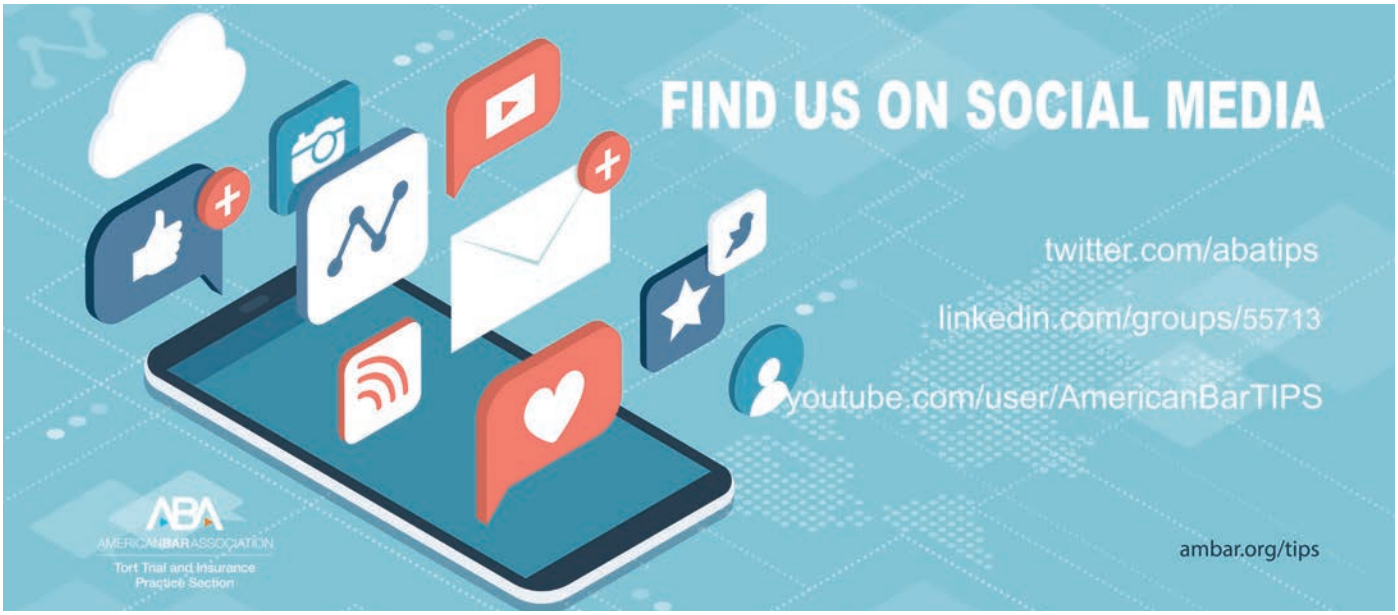
performance bond was tolled because its cross-claims against the subcontractor's sureties were still pending in state court, the federal court found that only payment bond claims were made in the still pending state actions.[63] Thus, tolling was unavailable for the general contractor's performance bond claims in the federal court proceeding.[64]

Conclusion

In order to avoid difficulties with the misclassification of claims as demonstrated above, practitioners should thoroughly analyze each claim. In analyzing each claim, be sure to review the status of each claimant and its course of proceeding to bring each claim. Check the dates related to the project and proceedings for default and termination to determine the proper classification of each claim as either a payment claim or a performance claim. If you represent the surety, be sure to timely respond to each claim and, if denying a claim because it is a performance claim rather than a payment claim, expressly state that the claim is not a payment claim. If you represent the claimant, when you get the specific denial of a payment claim, immediately return to the facts and details of the claim to see if indeed the claim should be characterized as a performance claim. Do not wait to make or re-characterize claims, as many of the cases discussed above relate to lengthy delays as a result of misclassification and resultant losses due to missing statutory deadlines.

63 *Id.* at 244.

64 *Id.* at 243–44.



Consistent... continued from page 9

alteration of a 'Financial Instrument' committed by a 'Third Party.'[12]"[13] "'Computer Fraud Coverage' purports to provide protection for ***'direct loss'*** of 'Money,' 'Securities' or 'Property' sustained by an 'Insured' resulting from 'Computer Fraud'[14] committed by a 'Third Party.'"[15]

Notably, the term "direct loss" was not defined in the policy.[16]

The insurer denied the claim under each coverage part, asserting that the damages resulting from the voucher scheme(s) did not qualify as a "direct loss" within the meaning of the policy.[17] Rather, the insurer maintained that any loss realized by rePlanet was sustained when the vouchers were "cashed in," which ostensibly resulted in an indirect loss in the form of a concomitant obligation on the part of rePlanet to reimburse the participating vendors for the amount of the voucher.[18]

The insured filed suit against the insurer in a California state court, alleging claims for breach of contract and breach of the covenant of good faith and fair dealing.[19] The insurer removed the case, and, soon thereafter, the insured sought leave to amend to add claims that the insurer's interpretation of the phrase "direct loss" meant that there could never be any coverage for the loss of "Securities" and/or for loss due to alteration of a "Financial Instrument."[20] While "illusory coverage" contentions are often used as grounds to argue that an insured's coverage position is in fact the correct one, the insured here went a step further, alleging—upon information and belief—that the insurer relied on its purportedly improper interpretation of "direct loss" to "deny all or the vast majority of first-party claims made" in California.[21] On that basis, the insured alleged that the insurer had committed fraud by selling valueless crime insurance policies.[22]

The insurer opposed the requested amendment, the propriety of which was determined under Fed. R. Civ. P. 15(a)(2).[23] The court weighed the traditional Fed.

12 *See id.* for the policy's definition of "Third Party."

13 *Id.* (emphasis added).

14 *See id.* for the policy's definition of "Computer Fraud."

15 *Id.* (emphasis added).

16 *Id.* at *2.

17 *Id.*

18 *See id.*

19 *rePlanet Holdings, Inc. v. Fed. Ins. Co.*, No. 119CV00133LJOEPG, 2019 WL 4917751, at *1 (E.D. Cal. Oct. 4, 2019).

20 *Id.*; *rePlanet Holdings, Inc.*, 2019 WL 3337907, at *2.

21 *See rePlanet Holdings, Inc.*, 2019 WL 4917751, at *3.

22 *rePlanet Holdings, Inc.*, 2019 WL 3337907, at *2.

23 *Id.* at *3.

R. Civ. P. 15(a)(2) factors, including whether the proposed amendment was offered in bad faith; the potential for delay and/or prejudice to the defendant if amendment were permitted; and whether the amendment itself was futile.[24] These factors served as a proxy for the particularity and plausibility analyses normally presented under a motion to dismiss, as the insurer had already answered prior to the motion for leave and was thus constrained from otherwise challenging the sufficiency of the allegations under traditional pleading standards.

The insurer first took issue with the insured's attempt to plead "upon information and belief" that the insurer systematically denies crime insurance claims based on its interpretation of the undefined phrase "direct loss."[25] The insurer cited the lack of any factual specificity supporting them to argue that these allegations were necessarily brought in bad faith.[26] Arguably inverting traditional pleading burdens, the court pretermitted any further analysis into the basis for these allegations, noting simply that the facts upon which they were based—presumably, the number of claims submitted under similar policies that were denied based on a similar interpretation of "direct loss"—were "peculiarly within the possession and control of the defendant."[27]

Even more interesting was the court's observation that "it is plausible that Defendant interprets 'direct loss' uniformly across all its crime insurance policies. Thus, there would never be coverage when an insured claims direct loss of 'Securities,' or money due to 'Forged' 'Financial Instruments,' resulting in systematic denial of such claims."[28] In other words, the court suggested that a carrier's consistent interpretation of a policy term, alone, could serve as the basis for a fraud claim—without regard to whether that interpretation was correct or not. This sentiment was echoed later in the opinion, where the court noted "[e]ven if Defendant did not breach the contract, its conduct could still amount to fraud if it issued a policy without the intention of providing any coverage and did so with the requisite fraudulent intent."[29]

The court also ignored the insurer's argument that proof of the allegedly systemic coverage denials would require a "circus" requiring the parties to essentially litigate the merits of unrelated claims.[30] Similarly, the court gave little weight to the insurer's argument that the volume and breadth of discovery necessary to evaluate the "systematic denial" allegations would require an inquiry into hundreds—maybe even

24 *Id.* at *3–8.
25 *Id.* at *4.
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.* at *7.
30 *Id.* at *5.

thousands—of unrelated claims. Instead, the court noted that the issues related to the scope of discovery could be dealt with in future motion practice.[31]

The court's "futility" analysis provided a last stand for the court to pass judgment on the propriety of the insured's "illusory coverage as fraud" theory. The court found that the lack of authorities squarely addressing the propriety of fraud claims premised on the terms of an illusory insurance policy was not an impediment to their assertion.[32] Nor was the court concerned that previous state and federal courts had interpreted the term "direct loss" in the same manner now urged by the insurer.[33] Again, the court was of the mindset that the mere consistent denial of claims, even if well-founded under policy language and existing law, such that the policy provided no coverage—and thus no value—for loss of "Securities" or "Forgery" of "Financial Instruments" was sufficient to support a fraud claim at the pleading stage. The proposed amendment was therefore not futile, although the court did observe that a consistent pattern of coverage interpretations similar to that taken here by the Defendant-insurer could undercut the reasonableness of the insured's claimed reliance on expectations of coverage.[34]

Analysis

The *rePlanet* decision presents a number of potential issues to unpack.

While perhaps not a true issue of first impression, it is one of only a handful of cases addressing the intersection between so-called "illusory coverage" and fraud.[35] *Glazewski,* for example, involved allegations that a state-mandated uninsured/underinsured motorist policy defined "underinsured" in such a way that coverage would never exist under state minimum policies, thus rendering the entire policy without value.[36] *rePlanet* arguably extends *Glazewski's* rationale to cases where a part of a policy, or even a subset of a particular coverage part, may not provide coverage, even if the policy on the whole provides some undeniable value.

The potential fallout from a ruling on the merits of the fraud claim is significant. If the insured in *rePlanet* is ultimately successful, does every insured who purchased the

31 *See id.*

32 *See id.* at *6-8.

33 *Id.* at *7.

34 *Id.* at *7–8.

35 *See, e.g.,* Glazewski v. Coronet Ins. Co., 483 N.E.2d 1263, 1266 (Ill. 1985). ("We are of the opinion that the issuance of coverage by an insurance company in return for a premium is a tacit representation to the consumer that the coverage has value. Assuming for purposes of a motion to dismiss that plaintiffs' allegations that the coverage has no value are true, we find that the insurance company defendants have made a false representation as to the value of the coverage by issuing it without disclosing that it had no value.").

36 *Id.* at 1264–65.

policy have a cause of action against the carrier that issued it? How would damages be measured for an insured who purchased one of these "valueless policies," particularly where no claim has been made under the policy but could be in the future? When would statute of limitations periods on these claims begin to run?

Expanding the analysis a step further, *rePlanet* also presents a new spin on the concept of illusory coverage. Many are familiar with the doctrine as a rule of construction used to evaluate the propriety of a coverage position in a particular case. On occasion, courts also use the doctrine to "effectively reform unambiguous language to protect policyholders from the unfairness of illusory coverage."[37] The analysis in *rePlanet* essentially repackages the doctrine: even if the insurer's position is the legally correct one such that the policy will be enforced as written to deny coverage, the insured may ***still*** be able to assert a claim for compensation in the form of damages for having been defrauded into purchasing an "illusory policy." Based on the reasoning in *rePlanet*, insureds now arguably have a mechanism for using an insurer's coverage arguments as both a "sword and shield." Either the policy's terms and provisions should be construed against the insurer and reformed to provide coverage consistent with the insured's reasonable expectations (the shield), or the insured should be awarded damages, maybe even in excess of the covered claim, for purchasing a policy that failed to live up to those expectations (the sword). Pleading these theories in the alternative could provide settlement leverage, particularly on smaller dollar value claims, under a cost-of-defense rationale. Under this framework, the insurer with a legally sound coverage defense may have some economic incentive to settle the claim, lest it be hit with a fraud claim that would significantly expand the scope of discovery and potentially cause a domino-effect undermining the success of its coverage defenses in similar claims by disgruntled policyholders.

Consistent with the foregoing, the insured and insurer in *rePlanet* are already engaged in motion practice regarding the scope of discovery, with the insured seeking to compel information regarding not only all claims, but all settlements made under similar policies in the state of California over the past five years.[38]

While expressing no opinion on the merits of its analysis, *rePlanet's* recognition of a cause of action for fraud seems to contradict, or at least undermine, some well-known coverage principles. For example, an insured is presumed to know the contents of its policy, yet now may have a cause of action to sue the insurer who issued it, even where the coverage terms are expressed in clear and unambiguous

37 Ian Weiss, *The Illusory Coverage Doctrine: A Critical Review*, 166 U. Pa. L. Rev. 1545, 1552 (2018).

38 *See rePlanet Holdings, Inc.*, 2019 WL 4917751.

language and have been uniformly interpreted by the insurer and courts alike. And what about instances where the disputed policy language appears in a state- or otherwise-approved policy form? Presumably the insurer's participation in and reliance upon that process provides a safe harbor on the merits of the fraud claim. At a minimum this seemingly undercuts any intent to defraud.

Finally, as a matter of procedure and as noted above, *rePlanet's* analysis fell under a Rule 15(a)(2) framework. While portions of that framework (*e.g.*, the futility of the proposed amendment) arguably intersect with concepts under Rule 12 (pleading of defenses) and Rule 9 (pleading of special matters, like fraud), it remains to be seen whether a fraud claim against an insurer premised solely upon the insured's belief that the insurer has "systematically denied" similar claims would survive more rigorous scrutiny. It is likely that different courts will have different views not only of the legal merits of these claims, but also of the level of detail required to plead them.

Conclusion

rePlanet provides what many will view as a troubling analysis. Whether any of the issues discussed above are brought to a head remains to be seen.

Calendar

January 16-18, 2020	**Life Health & Disability** Contact: Danielle Daly – 312/988-5708	Hotel Van Zandt Austin, TX
January 29-31, 2020	**Fidelity & Surety Law Midwinter Conference** Contact: Janet Hummons – 312/988-5656 Speaker Contact: Juel Jones – 312/988-5597	Grand Hyatt New York New York, NY
February 12-16, 2020	**ABA Midyear Meeting** Contact: Juel Jones – 312/988-5597 Janet Hummons – 312/988-5656	JW Marriott Austin, TX
February 20-22, 2020	**Insurance Coverage Litigation Midyear Conference** Contact: Janet Hummons – 312/988-5656 Danielle Daly – 312/988-5708	Arizona Biltmore Resort Phoenix, AZ
March 5-6, 2020	**Cyber Security Conference** Contact: Janet Hummons – 312/988-5597	Georgia State University Atlanta, GA
March 14-18, 2020	**20th National Trial Academy** Contact: Janet Hummons – 312/988-5656 Danielle Daly – 312/988-5708	National Judicial College Reno, NV
March 27-28, 2020	**Workers Compensation Conference** Contact: Danielle Daly – 312/988-5708	Westin New Orleans Canal Place New Orleans, LA
April 2–3, 2020	**Motor Vehicle Products Liability Conference** Contact: Janet Hummons – 312/988-5656 Danielle Daly – 312/988-5708	Hotel Del Coronado Coronado, CA
April 3–4, 2020	**Toxic Torts & Environmental Law Conference** Contact: Juel Jones – 312/988-5597	Hotel Del Coronado Coronado, CA
April 29-May 3, 2020	**TIPS Section Conference** Contact: Janet Hummons – 312/988-5656 Speaker Contact: Juel Jones – 312/988-5597	JW Marriott Nashville Nashville, TN