CONSTRUCTION SUBCONTRACTING

A Comprehensive Practical and Legal Guide

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PART 5

Special Project Issues

CHAPTER 17

Public Projects (Federal, State, and Local)

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I. Introduction

Although subcontracting on a public project is in many ways the same as on any other project, there are some important legal differences. The most significant of these differences are discussed below. Further complicating matters are the many differences among federal, state, and local governments' requirements. While it would not be possible to list in this chapter every approach taken by every jurisdiction, the most prevalent and significant approaches that impact subcontracting on public projects are included.

II. What Is a "Public Project"?

Different jurisdictions define public projects differently. Courts have focused on (1) the nature of the ownership, (2) the source of funding, and (3) the use to which a project is put. Even within a jurisdiction, whether a project is public will typically vary depending on the legal requirements at issue. For example, jurisdictions may define a public project differently when the issue concerns the state's performance and payment bond requirments,[1] its prevailing wage requirments,[2] or its mechanic's lien laws.[3]

1. For further discussion, see chapter 14. *See also, e.g.*, CD 752, Standard Subcontract Agreement for Use on Federal Construction Projects, § 9.3.

2. For further discussion, see chapter 12.

3. *See, e.g.*, United States *ex rel.* Miller v. Mattingly Bridge Co., 344 F. Supp. 459 (W.D. Ky. 1972); W.T. Andrew Co. v. Mid-State Sur. Corp., 221 Mich. App. 438 (1997), *aff'd*, 461 Mich. 628 (2000); A.C. Legnetto Constr., Inc. v. Hartford Fire Ins. Co., 92 N.Y.2d 275 (Ct. App. 1998); T&R Dragline Serv., Inc. v. CNA Ins. Co., 796 F.2d 133 (5th Cir. 1986); L. Suzio

III. Who Is a "Subcontractor" Under Public Project Rules?

Some rules applicable to public projects apply only to prime contractors, others to primes and first-tier subs, and others still to contractors at all tiers. For example, both the federal Miller Act and its state counterparts (aka, Little Miller Acts) typically impose limited or no notice of claim requirements on first-tier subs, impose more significant notice requirements on second-tier subs, and limit or preclude claims from subcontractors below the second tier.[4] Federal and state prevailing-wage laws (i.e., the Davis-Bacon Act and its state counterparts), on the other hand, typically apply to subcontractors at all tiers.[5]

Finally, some jurisdictions' rules apply only to subcontractors that perform labor on or at a project, while others also apply to suppliers and service providers (like waste haulers and demolition contractors). For example, the definitions of "subcontract" and "subcontractor" under federal contracting regulations do not distinguish between subcontractors and suppliers, such that many federal requirements apply equally to both.[6] Exceptions are federal and state prevailing-wage laws, which generally apply only to subcontractors that provide labor at the site,[7] and several states' Little Miller Acts (but not the federal statute), which offer more limited protection to suppliers than to subcontractors that provide labor.[8]

IV. What Law Applies to Subcontracts for Federal Government Projects?

Subcontracts are likely to be governed by applicable state law, either under applicable state choice-of-law rules or according to the subcontract itself.[9] However, when the work is performed on a federal project, federal contract

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Concrete Co. v. New Haven Tobacco, Inc., 28 Conn. App. 622 (1992); James J. O'Rourke, Inc. v. Indus. Nat'l Bank of R.I., 478 A.2d 195 (1984).

4. *See, e.g.*, 40 U.S.C. § 3133 (former 40 U.S.C. § 270b); Cal. Civ. Code §§ 3247–3252. For further discussion, see chapter 14.

5. *See, e.g.*, 40 U.S.C. §§ 3141–3148 (former 40 U.S.C. §§ 276a–276a-5); Cal. Lab. Code § 1770, *et seq.* For further discussion, see chapter 12.

6. FAR 3.502-1, 19.701, 44.101, 52.244-2(a); 48 C.F.R. § 44.101; *see also* Richmond Eng'g Co., IBCA No. 426-2-64, 64 BCA ¶ 4465 (Oct. 1, 1964).

7. *See, e.g.*, 40 U.S.C. § 3141, *et seq.*; Mont. Code Ann. § 18-2-401, *et seq.*; Or. Rev. Stat. 279C § 800, *et seq.*; Alaska Stat. § 30.910.

8. *See, e.g.*, Ariz. Rev. Stat. Ann. §§ 34-222, 34-223, 34-224; Ala. Code § 39-1-1; Alaska Stat. § 36.25.010; Cal. Pub. Cont. Code §§ 10220–10232; 30 Ill. Comp. Stat. 550; N.Y. Fin. Law § 9-137; *see also* 5 Steven G. Stein, Construction Law § 17.03 (2013) (discussing the Little Miller Acts and some of the differences among them).

9. Westinghouse Elec. Corp. v. Garrett Corp., 437 F. Supp. 1301 (D. Md. 1977), *aff'd*, 601 F.2d 155 (4th Cir. 1979); Wallace Process Piping Co. v. Martin-Marietta Corp., 251 F. Supp. 411 (E.D. Va. 1965).

law and regulations, such as the Federal Acquisition Regulation (FAR),[10] may preempt state law. A few courts have analyzed the question and chosen applicable law based on the degree to which the outcome of the case will affect the interest of the federal government.[11] While a few courts have held that federal common law governs the interpretation of a subcontract on a federal project,[12] most decisions have, without discussion, applied state law.[13] A rare exception is when the federal government orders the prime to assign its subcontract to the government and sues the subcontractor; in such cases, courts are apt to apply federal law.[14] Due to courts' inconsistency in determining what law applies to subcontracts under government prime contracts,[15] many prime contractors include a choice-of-law clause in their standard form of subcontract, which incorporates federal contract law as the primary source, with a specified state law as backup in the absence of relevant federal law.[16]

V. Competitive Bidding

Competitive bidding has been and continues to be the cornerstone of the method by which a public entity procures construction contracts. The construction of public buildings, utilities, roadways, bridges, and other structures is usually governed by a well-defined contractual process of competitive bidding. The primary purpose of competitive bidding is to protect the public

10. 48 C.F.R. § 1.00, *et seq*.

11. Whittaker Corp. v. Calspan Corp., 810 F. Supp. 457 (W.D.N.Y. 1992); Northrop Corp. v. AIL Sys., Inc., 959 F.2d 1424 (7th Cir. 1992); *see also* Koppers Co. v. Brunswick Corp., 303 A.2d 32 (Pa. 1973); United States *ex rel.* U.S. Steel Corp. v. Constr. Aggregates Corp., 559 F. Supp. 414 (E.D. Mich. 1983).

12. Am. Pipe & Steel Corp. v. Firestone Tire & Rubber Co., 292 F.2d 640 (9th Cir. 1961); *see also* United States v. Taylor, 333 F.2d 633 (5th Cir. 1964); Grinnell Fire Prot. Sys. Co. v. Regents of Univ. of Cal., 554 F. Supp. 495 (N.D. Cal. 1982); *cf.* CEMCO, Inc., Subsidiary of E-Sys., Inc., ERDA BCA 4-2-75, 76-1 BCA ¶ 11,702.

13. Clifton D. Mayhew, Inc. v. Blake Constr. Co., 482 F.2d 1260 (4th Cir. 1973); Elte, Inc. v. S.S. Mullen, Inc., 469 F.2d 1127 (9th Cir. 1972); Peter Kiewit Sons' Co. v. Summit Constr. Co., 422 F.2d 242 (8th Cir. 1969).

14. Clearfield Trust Co. v. United States, 318 U.S. 363 (1943); *Taylor*, 333 F.2d 633.

15. *See, e.g.*, New SD, Inc. v. Rockwell Int'l Corp., 79 F.3d 953 (9th Cir. 1996) (state law displaced by federal law on subcontract under national security prime contract); *Whittaker Corp.*, 810 F. Supp. 457 (financial impact on the government not sufficient to overcome standard use of state law in prime-sub dispute where jurisdiction was based on diversity); United States v. Seckinger, 397 U.S. 203 (1970) (federal contract law will apply to issues arising under a prime contract with the government). *But cf*. Empire HealthChoice Assurance, Inc. v. McVeigh, 547 U.S. 677, 691 (2006) ("uniform federal law need not be applied to all questions in federal government litigation, even in cases involving government contracts").

16. *See* CD 752, § 12.1.

against the misuse of public funds and prevent abuses such as fraud, collusion, and favoritism.[17]

The public entity's award of a construction contract to a prime contractor is ordinarily regulated by statute or constitutional provision, and the prescribed method must be followed. Although the requirement for public bidding does not apply to all projects, if the project requires a significant expenditure of public funds, government entities usually must use a bidding process. In the awarding of construction contracts, the public entity invites prime contractors to submit bids. A prime contractor's bid must substantially and materially conform to the details contained in the bid specifications—generally referred to as the "responsiveness" requirement.[18] Failure to substantially comply with the bid requirements will result in rejection of the bid as nonresponsive. The other key component to public bidding is that the bid must be submitted by a "responsible" contractor, which generally relates to the contractor's ability to perform the work.[19]

The traditional "design-bid-build" project delivery method—in which the public entity provides a detailed, complete design, puts it out to bid, and awards the contract to the lowest responsive bid—continues to be the primary method of awarding public construction contracts. Through federal, state, and local legislation, however, other project delivery methods have been authorized, including design-build contracts, whereby the public entity provides the general design intent and performance standards rather than a complete design, and prime contractors' bids include the cost of completing the design to deliver the finished project.[20]

A. Protecting the Bidding Process for Subcontractors

1. Competitive Bidding Generally

While project delivery methods for public construction contracts have evolved and continue to evolve, the process of subcontractors submitting bids to prime contractors has experienced less change. As part of the bidding process, prime contractors will request bids from trade contractors—for example, concrete,

17. *See, e.g.*, John C. Grimberg Co. v. United States, 185 F.3d 1297, 1300–01 (Fed. Cir. 1999); Konica Bus. Machs. USA, Inc. v. Regents of Univ. of Cal., 206 Cal. App. 3d 449, 456–57 (1988); Datatrol Inc. v. State Purchasing Agent, 379 Mass. 679 (1980).

18. *See, e.g.*, B-G Mech. Serv., Inc., B-265782, 96-1 CPD ¶ 6; Bishop Contractors, Inc., B-246526, 91-2 CPD ¶ 555; Tropabest Foods, Inc. v. State Dept. of Gen. Svcs., 493 So. 2d 50 (Fla. 1st Dist. Ct. App. 1986); Transit Team, Inc. v. Metro. Council, 679 N.W.2d 390 (Minn. Ct. App. 2004); AT&T Commc'ns, Inc. v. Nassau, 214 A.D.2d 666 (N.Y. 1995); Smith & Johnson Constr. Co. v. Ohio Dep't of Transp., 134 Ohio App. 3d 521 (1998); Valley Crest Landscape v. City Council, 41 Cal. App. 4th 1432, 1442 (1996); Ghilotti Constr. Co. v. City of Richmond, 45 Cal. App. 4th 897, 906 (1996).

19. *See, e.g.*, *John C. Grimberg Co.*, 185 F.3d at 1300–01; Great W. Contractors, Inc. v. Irvine Unified Sch. Dist., 187 Cal. App. 4th 1425, 1450–51 (2010); D.H. Williams Constr., Inc. v. Clovis Unified Sch. Dist., 146 Cal. App. 4th 757, 763 (2007).

20. For a discussion of alternative project delivery, see chapter 18.

steel, roofing, drywall, mechanical, electrical, and plumbing—to perform defined scopes of work the prime contractor cannot or is not licensed to perform.[21] Typically, the prime contractor will request bids from several subcontractors for the same scope of work to increase the likelihood it will secure the lowest price for that trade's scope of work and thereby increase the chance the prime contractor's bid will be lowest. Trade subcontractors also want to be part of the winning bid and therefore will submit bids to more than one bidding prime contractor.[22] For major scopes of work, subcontractors will wait as long as possible before committing to a final price, often not until bid day, and sometimes minutes before the prime contractor must submit its bid to the public entity. That results in a hectic and tense bid-day scramble, with prime contractors taking bids on cell phones and then handwriting the final prices and tallying them up for the total bid price to be submitted to the owner.

Subcontractors submitting bids for major scopes of work wait until the last minute to commit to a price because that is one of the few protections a subcontractor has to keep its bid confidential and limit the opportunity for the prime contractor to offer the contract to another competing subcontractor if that subcontractor will provide a lower price. Because the subcontractor's bid is only an offer, no contract is formed until the bid is accepted by the prime contractor, and that will occur only if the prime contractor submits the winning bid.

However, since the basic needs of the bidding process must prevent a subcontractor from withdrawing its bid to a general contractor, courts in many jurisdictions have applied the doctrine of promissory estoppel to create a binding legal relationship by the mere offer from the subcontractor when the prime contractor has relied upon that offer in submitting its bid. The offer remains binding for a reasonable time, even if the subcontractor's bid contains an error and regardless of whether the subcontractor has attempted to revoke its bid before the prime contractor has "accepted" it.[23]

Promissory estoppel is a one-way street, as the prime contractor does not have to accept the subcontractor's bid. That puts the prime contractor in a significantly better bargaining position with the subcontractors, especially if the prime contractor submits the winning bid. That superior bargaining position allows the prime contractor the opportunity to "shop" or "peddle" a subcontractor's bid, primarily for the sole benefit of the prime contractor.

2. Subcontractor Listing Laws

In an effort to protect the subcontractors from bid shopping/peddling, "subcontractor listing laws" have emerged in some states. The laws vary in details and procedures but have some general principles in common.

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21. For discussion of licensure issues in subcontracting, see chapter 15.

22. An alternative approach is the use of teaming agreements or joint ventures. For further discussion, see chapter 23.

23. Promissory estoppel is also discussed in chapter 2.

a. No Federal Subcontractor Listing Law

Currently, there is no subcontractor listing law for federal construction projects, but attempts to enact such listing law have been introduced. House bills titled the "Construction Quality Assurance Act" were introduced in 2000 and again in 2005. The stated purposes of the bills were no different from those supporting state listing laws—to eliminate the practices of bid shopping and bid peddling. Those bills died in committee. Yet another attempt has been made, in May 2013, through House Resolution 1942. That bill, like its unsuccessful predecessors, has been referred to the House Oversight and Government Reform Committee.

b. State Subcontractor Listing Laws

State legislatures, on the other hand, have had considerable success enacting anti-bid-shopping/-peddling statutes that require a listing of subcontractors on public construction projects.[24]

(1) Which Subcontractors Must Be Listed?

The prime contractor, either with its bid or shortly thereafter, must submit a list of subcontractors to which the prime contractor intends to award subcontracts. Although it varies by state, the common method of determining which subcontractors must be listed relates to the dollar value of the subcontractor's proposed subcontract as a percentage of the prime contractor's bid. For example, in California, all subcontracts with a value of one-half of 1 percent or greater of the prime contractor's bid must be listed.[25]

(2) What Information Must Be Listed?

The listing requires, at a minimum, enough information to identify the subcontractor and its general scope of work.[26] The value of the subcontractor's bid is not required by all statutes.[27]

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24. Alaska Stat. § 36.30.115; Ark. Code Ann. § 22-9-204; Cal. Pub. Cont. Code § 4104; Conn. Gen. Stat. § 4b-93; Del. Code Ann. tit. 29, § 6962; Fla. Stat. § 255.0515; Haw. Rev. Stat. § 103D-302; Idaho Code Ann. § 67-2310; Iowa Code § 8A.311(15); Kan. Stat. Ann. § 75-3741; La. Rev. Stat. Ann. § 38:2212; Mass. Gen. Laws ch. 149, § 44A; Nev. Rev. Stat. § 338.141); N.J. Rev. Stat. § 40A:11-16; N.M. Stat. Ann. § 13-4-34; N.Y. Gen. Mun. Law § 101; N.C. Gen. Stat. § 143-128; Or. Rev. Stat. § 279C.370; S.C. Code Ann. § 11-35-3020; Tenn. Code Ann. § 62-6-119; Utah Code Ann. § 63A-5-208; Wash. Rev. Code § 39.30.060; W. Va. Code § 5-22-1; Wis. Stat. § 66.0901; *see also* Sean Calvert, Preference Programs in Public Projects: The Future Is Now (2013), http://www.americanbar.org/content/dam/aba/directories/construction_industry_knowledge_base/dp_plenary_2_2.authcheckdam.pdf.

25. Cal. Pub. Cont. Code § 4104(a)(1).

26. See statutes cited in note 24.

27. *See, e.g.*, Cal. Pub. Cont. Code § 4104(a)(1) (requiring listing of only the "name and location of the place of business"); N.J. Stat. Ann. § 40A:11-16(b) (no requirement for subcontract amount).

(3) Can the Listed Subcontractor Be Replaced?

Another common feature of subcontractor listing laws is a specific procedure for substituting, with the public entity's approval, the listed subcontractor for specified reasons, such as the subcontractor's refusal to perform the work or the subcontractor's inability to perform the work due to bankruptcy.[28] Without these specifics, prime contractors have proven able to renege on their commitments to use subcontractors listed in their bids.[29]

B. Preference and Incentive Programs

Federal, state, and local governments provide billions of dollars to the construction economy. With this economic clout, the government has an opportunity to advance social and economic objectives through the preference and incentive programs governing procurements.

1. Typical Features

Disadvantaged business enterprise (DBE) programs target specific subcontractor groups that may not have the economic ability on their own to participate in large construction projects. Among the types of subcontractors that participate in these programs are businesses that are small, women owned, minority owned, veteran owned, or service-disabled-veteran owned, located in economically distressed areas, local, or combinations thereof.[30] Some programs result in artificially lowering a DBE prime contractor's bid price through credits or incentives, which increases the likelihood the DBE prime contractor will submit the winning bid. Other programs require the prime contractors as part of the bidding process to reach out to small or DBE subcontractors to encourage their participation. To participate in these programs, the subcontractors and suppliers typically must be certified by the governing agency or meet specific qualifications.

2. Federal Programs

The federal government has developed a variety of programs to provide better opportunities to small and disadvantaged businesses.

a. Federal Small Business Administration Programs

The Small Business Administration (SBA) administers the federal government's small-business program. As explained in the authorizing statute, the objective is to "ensure that a fair proportion of the total purchases and contracts

28. *See, e.g.*, Cal. Pub. Cont. Code § 4107; Utah Code Ann. § 208(3)(d).

29. *See, e.g.*, Finney Co. v. Monarch Constr. Co., 670 S.W.2d 857, 858, 863 (Ky. 1984).

30. *See, e.g.*, FAR 19.702 (small business); Ala. Code § 39-3-5 (resident bidder); Cal. Gov't Code § 7118; Cal. Code Regs. tit. 2, § 1896.6 (small business); Fla. Admin. Code Ann. r. 25-25.025 (minority-owned company); S.C. Code Ann. § 12-28-2930(F) (disadvantaged ethnic minority or women owned).

or subcontracts for property and services for the Government (including contracts or subcontracts for maintenance, repair, and construction) are placed with small business concerns."[31] A small-business concern is defined as "one which is independently owned and operated and which is not dominant in its field of operation."[32]

The SBA's eligibility requirements vary by industry. In the construction industry, eligibility is based on annual receipts (rather than number of employees as in other industries). The eligibility requirements also vary among different areas of construction. For example, the SBA's eligibility requirements differ for subcontractors performing "Construction of Buildings" than for "Specialty Trade Contractors."[33]

(1) Section 8(a) Program

The SBA has also established a program to assist small, minority-owned businesses. The program is named "Section 8(a)" after Section 8(a) of the Small Business Act of 1953.[34] The Section 8(a) program is unique in that the SBA enters into direct contracts with the procuring agency, and then SBA contracts with participants of the Section 8(a) program. For a contractor to qualify for the Section 8(a) program, it must be a "socially and economically disadvantaged" small-business concern.[35] This means it must be owned (at least 51 percent) and operated on a daily basis by a qualifying individual. Initially, the owning individual must not have a net worth in excess of $250,000, and, for continuation in the program, the individual's net worth cannot increase above $750,000.[36] Additionally, the owner must show that reasonable prospects for competing in the private sector exist and, unless waived, must show the small business has been providing the specific services for at least the prior two years.[37]

(2) Small Disadvantaged Business Program

Like the Section 8(a) program, the small disadvantaged business (SDB) program assists socially and economically disadvantaged small businesses.[38] Businesses that qualify for the Section 8(a) program also qualify for the SDB program. In addition, since the SDB program has less restrictive eligibility requirements than the Section 8(a) program, other businesses may qualify for the SDB program as well. For example, the initial limit on the owner's net worth for the

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31. Irving Maness, *The Emergence of the Current Interest in the Defense Small Business and Labor Surplus Area Subcontracting Programs*, 18 Mil. L. Rev. 119 (1962) (citing 75 Stat. 666 (1961), 15 U.S.C. § 631(a) (Supp. 111, 1962)).
32. 72 Stat. 384 (1958); 15 U.S.C. § 632 (1958).
33. 13 C.F.R. § 121.201, sector 23.
34. 15 U.S.C. § 695, *et seq*.
35. 13 C.F.R. § 124.101.
36. 13 C.F.R. § 124.104(c)(2).
37. 13 C.F.R. § 124.107.
38. 13 C.F.R. §§ 124.1001–.1014.

SDB program is currently higher than that for the 8(a) program—$750,000 as opposed to $250,000.[39] Additionally, unlike the Section 8(a) program, the individual does not have to meet the same standards for reasonable prospects of business.

(3) Historically Underutilized Business Zones Program

The Historically Underutilized Business Zones (HUBZone) program seeks to assist certain small businesses that are "located in historically underutilized business zones in an effort to increase employment opportunities, investment, and economic development in such areas," and thereby to gain access to more federal contracting opportunities.[40] The program was authorized by the Small Business Reauthorization Act of 1997 and is administered by the SBA.[41] The benefits of the HUBZone program include competitive and sole-source contracting for members and a 10 percent price evaluation preference in open competitions. The HUBZone program applies to all federal agencies and establishes a goal of 3 percent prime and subcontractor HUBZone contracting for the agencies.

To be certified in the HUBZone program, a business must (1) qualify as a small business by SBA standards, (2) be at least 51 percent owned or controlled by U.S. citizens or a community development corporation, agricultural cooperative, or Indian tribe, (3) have its principal office located within a designated HUBZone, and (4) have at least 35 percent of its employees reside in a HUBZone.[42]

b. Other Federal Disadvantaged-Business Programs

There are other federal programs, both within the SBA and at other federal agencies, with similar goals of assisting the growth and development of small business. These include the Service-Disabled Veteran-Owned program, Women-Owned Small Business and Economically Disadvantaged Women-Owned Small Business programs, and various mentor-protégé programs.[43]

c. Federal Subcontracting Plan Requirements

The federal government generally requires that prime contractors that are not small businesses must provide for government approval a small business and small disadvantaged business subcontracting plan for most federal construction contracts. The threshold for this requirement is that the project has subcontracting possibilities and is expected to exceed $1.5 million.[44] The plan must include a number of items, such as participation percentages

39. 13 C.F.R. § 123.1002(c) (for SDB); 13 C.F.R. § 124.104(2) (for Section 8(a)).
40. 13 C.F.R. § 126.100.
41. Pub. L. No. 105-135 (Dec. 2, 1997).
42. *See* 13 C.F.R. § 126.200 (different requirements apply to certain identified groups).
43. 13 C.F.R. §§ 125.8–.10; 13 C.F.R. pt. 127; 13 C.F.R. § 124.520; 49 C.F.R. pt. 26.
44. FAR 19.702, 52.219-9.

by small and disadvantaged businesses, types and quantities of materials and labor to be supplied by these businesses, and other related information.[45] Prime contractors must flow down this requirement to subcontractors whose contracts meet the threshold requirements.[46]

d. Buy American Act

In addition to assisting small-business contractors, the federal government seeks to increase access to federal contracts for domestic suppliers through programs such as the Buy American Act.[47] The purpose of the Buy American Act is to ensure preferential treatment for domestic sources of construction materials, among other things, for public use unless a specific exemption applies. Under the government's required contract clause, a government "[c]ontractor shall use only domestic construction material in performing [the] contract."[48] Paragraph (b)(3) of that clause implements exceptions to the act's requirement if the government determines that—

> (i) The cost of the domestic construction material would be unreasonable. The cost of a particular domestic construction material subject to the requirements of the Buy American Act is unreasonable when the cost of such material exceeds the cost of foreign material by more than 6 percent;
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> (ii) The application of the restriction of the Buy American Act to a particular construction material would be impracticable or inconsistent with the public interest; or
>
> (iii) The construction material is not mined, produced, or manufactured in the United States in sufficient and reasonably available commercial quantities of a satisfactory quality.[49]

In order to meet its contract obligations to the government, the prime contractor must flow down these requirements to its subcontractors.[50] Similar requirements are contained in the federal Trade Agreements Act and American Recovery and Reinvestment Act of 2009.[51]

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45. FAR 19.704. The SBA's various small disadvantaged business programs, such as Section 8(a), HUBZones, and others, are located in title 13 of the Code of Federal Regulations.
46. FAR 52.219-9(d)(9). *See, e.g.*, CD 752, § 12.9.
47. 41 U.S.C. §§ 10a–10d.
48. FAR 52.225-9(b)(1).
49. FAR 52.225-9(b)(3)(i)–(iii).
50. CD 752, § 3.7.2.
51. 19 U.S.C. § 2501, *et seq.*; Pub. L. No. 111-5.

3. State and Local Programs

State and local public agencies have also developed statutes to encourage participation by small businesses and other classifications, such as minority- or women-owned businesses. For example, New Jersey requires contracting state agencies to make a good-faith effort to award public construction contracts to small businesses by authorizing the establishment of set-aside programs of at least 25 percent of the total dollar value of the state contract.[52]

In New York, the law requires in pertinent part:

> In every state agency, department and authority which has let more than ten million dollars in service and construction contracts in the prior fiscal year, the chief executive officer of that agency, department or authority shall develop a mentor-protégé program to foster long-term relationships between approved mentor firms, and small business concerns and minority and women-owned businesses certified pursuant to article fifteen-A of the executive law, in order to enhance the capabilities of small and minority and women-owned business concerns, improve their success in contracting with the state or receiving subcontracts under a state contract, and to create sources of reliable contractors and subcontractors ready to perform larger jobs and responsibilities.[53]

The interest in promoting the success of small-business interests is also found in local laws and regulations. Los Angeles, for example, has a minority subcontractor outreach program that does not require a prime-contractor bidder achieve any particular percentage of minority subcontractor participation, but does require documentation of its outreach efforts. Prior to being awarded a government contract, the bidder must establish that it has complied with the program by showing that it (1) made a good-faith effort to obtain the awarding authority's participation goals for minority business enterprises (MBEs), women business enterprises (WBEs), and other business enterprises (OBEs); (2) attended pre-solicitation or pre-bid outreach meetings; (3) made efforts to identify specific items of work and/or divide the work into smaller portions to permit maximum participation of MBEs, WBEs, and OBEs; (4) advertised in minority-oriented publications no less than 10 calendar days prior to bid submission; (5) provided written notice to MBEs and WBEs no less than 10 calendar days prior to submission; (6) documented its efforts to follow up the initial solicitation; (7) provided copies of plans and specifications to interested MBEs, WBEs, and OBEs or made them available for review; (8) requested assistance from MBE, WBE, and OBE organizations not less than 15 calendar days prior to bid submission; (9) negotiated in good faith; and (10) documented efforts

52. *See* Exec. Order No. 71 (2003).
53. N.Y. State Fin. Law § 147.

to advise and assist in obtaining bonds, credit, and insurance for the MBEs, WBEs, and OBEs.[54]

4. Constitutional Issues and Challenges

Classifications based on the owner's race or gender, among other factors, for the purposes of preferences have been scrutinized by the courts as an equal protection constitutional violation.[55] At the state and local levels, preference and incentive programs have also been challenged with varying results. For example, an Ohio court found that a state program that required approximately 15 percent of the state's purchasing contracts to be set aside for competitive bidding by MBEs only and that contained other provisions with explicit references to race was constitutional as applied.[56]

State and local public-entity preference programs that do not set strict quotas but require a showing of best efforts to be inclusive and provide opportunities for small and disadvantaged business generally fare much better in the courts. For example, a New York court found that a program that "demands only 'good faith' efforts on the part of each contractor" to voluntarily set aside a certain percentage of the total amount of state contracts awarded to small business DBE programs "represent[s] a constitutionally appropriate means of redressing identified discrimination against minority contractors."[57]

C. Bid Protests

In a competitive bid, it is not uncommon for the presumptive low bidder's bid to be challenged. The challenge usually comes from the bidder next in line for the award but can come from other bidders if there is a basis to challenge each of the bids above. Additionally, if the bid fails to comply with the material requirements of the invitation for bids, the public entity may determine the bid "nonresponsive" on its own.

The presumptive low bidder ordinarily is entitled to reasonable notice and a hearing prior to rejection of its bid. Additionally, unsuccessful bidders can protest the public entity's determination of the winning bid through the administrative process, typically set forth in the invitation for bids. In many jurisdictions, if unsuccessful in protesting the proposed award, the unsuccessful bidder can initiate a lawsuit for an injunction to prevent the award.

The subcontractor generally does not fall into the category of those that have standing to submit a protest and challenge the award of the prime contract. Moreover, except for very limited circumstances, the subcontractor cannot protest the prime contractor's award of a subcontract to another subcontractor. For example, the federal Competition in Contracting Act (CICA)

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54. L.A. City Charter, Office of the Mayor, Exec. Directive No. 2001-26 (2001), http://bca.lacity.org/site/pdf/soe/Executive%20Directive%202001-26.pdf.

55. *See* City of Richmond v. J.A. Croson Co., 488 U.S. 469 (1989).

56. Ritchey Produce Co. v. State Dep't of Admin. Servs., 707 N.E.2d 871, 928 (Ohio 1999) (re: Ohio Rev. Code Ann. § 125.081).

57. Rex Paving Corp. v. White, 531 N.Y.S.2d 831, 839 (App. Div. 1988).

limits its definition of "interested parties" that may protest a federal contract award to actual or prospective bidders,[58] and the Government Accountability Office, which hears many federal bid protests, states in its rules that it "will not consider a protest of the award or proposed award of a subcontract except where the agency awarding the prime contract has requested in writing that subcontract protests be decided. . . ."[59] There have been a few state court decisions allowing subcontractors to protest subcontract awards,[60] but these are exceptions to the general rule.

In some cases, the subcontractor's qualifications may be the issue being protested. For example, the protest may concern reduced scoring or disqualification of the portion of the prime's bid due to the subcontractor's lack of required qualifications or certifications. In those cases, the subcontractor should, and often will, play an active role in support of the prime's bid. Finally, because public contracts are matters of public interest, some jurisdictions allow citizen suits or taxpayer suits to contest proposed contract awards; in those jurisdictions, a subcontractor for a disappointed bidder may have standing to bring such suits.[61]

VI. Government Approval Issues

Generally, the public entity does not interject itself into the contractual dealings between the prime contractor and its subcontractors. There are, however, exceptions.

A. Consent Required for Certain Subcontracts

For federal projects, if the prime contract is based on a fixed price, the prime contractor does not need the consent of the contracting officer to enter into subcontracts. However, for contracts where the price is not fixed—for example, cost-reimbursement, time-and-materials, labor-hour, and letter contracts—the contracting officer must consent to the subcontract.[62] The purpose of requiring consent in these situations is to allow the contracting officer (i.e., the government) to protect itself against cost overruns by having the opportunity to review the proposed subcontractor and the general form of the subcontract. The contracting officer's consent, however, usually is not given as to the subcontract's price, costs allowed, or other specific subcontract terms.[63]

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58. 31 U.S.C. § 3551(2)(A).

59. 4 C.F.R. § 21.5(h).

60. *See, e.g.*, Orion Tech. Res., LLC v. Los Alamos Nat'l Sec., LLC, 287 P.3d 967 (N.M. Ct. App. 2012); New England Insulation Co. v. Gen. Dynamics Corp., 522 N.E.2d 997, 998 (Mass. App. Ct. 1988).

61. *See, e.g.*, Cal. Civ. Proc. Code § 526a; Ind. Code § 34-13-5-1; N.Y. Gen. Mun. Law § 51.

62. *See* FAR 44.201-1, 52.244-2.

63. FAR 44.203(a).

B. Government-Directed Subcontractors

While the regulations are not clear, it is likely that the federal government may direct the prime contractor to use a specific subcontractor when there is a compelling justification for doing so.[64] A number of federal tribunals have adopted the view that when the government, as the owner, designates a particular subcontractor as a sole source, the government necessarily warrants the performance by that subcontractor.[65] At least one federal tribunal (the Armed Services Board of Contract Appeals) has chosen not to follow this view, finding that the government warrants only that the source exists and has the ability to produce the product, not that it will do so without defect.[66]

VII. Subcontractor Claims on Public Projects

A. Claims Against the Prime Contractor

On public projects, as with private projects, the ability of the subcontractor to assert claims against the prime (or, for lower-tier subcontractors, against the subcontractor at the next higher tier) is governed primarily by the terms of the subcontract. On federal projects, the prime will often flow down a modified version of the standard FAR clause in its prime contract relating to claims.[67] Flow-down of these provisions is permissive, not mandatory,[68] and primes and subcontractors may and often do agree on different claims provisions.[69]

B. Direct Claims Against the Government

In most cases, when a subcontract has a claim for increased costs or other damages arising from the action or inaction of the government on a public project, its only avenue of recovery is through a claim against the prime contractor, rather than against the public owner. This is due to lack of "contractual privity" between the subcontractor and the public entity; that is, the subcontractor cannot claim the government failed to honor its contract because the subcontractor is not a party to that contract. Thus, in effect, the subcontractor must make its claim against the prime contractor, and then the prime must pursue that claim against the government on behalf of the subcontractor.

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64. *See* Office of Inspector Gen., Dep't of Def., Audit Report D-2000-129, Air Force Contract for Installation of Radios and Antennae (May 22, 2000); U.S. Gov't Accountability Office, GAO-04-206, Satellite Communications—Strategic Approach Needed for DoD's Procurement of Commercial Satellite Bandwidth (2003).

65. Franklin E. Penny Co. v. United States, 524 F.2d 668 (Ct. Cl. 1975); Kaplan Contractors, Inc., GSBCA 2747, 70-2 BCA ¶ 8511; Electro-Nav, Inc., DCAB No. NOAA-1-74, 75-1 BCA ¶ 11,162; Engineered Sys., Inc., B-184098, 76-1 CPD ¶ 144.

66. Salisbury Special Tool Co., ASBCA 37530, 89-2 BCA ¶ 21,838.

67. FAR 52.233-1. For further discussion of subcontractor claims, see chapter 8.

68. See section X.

69. *See, e.g.*, CD 752, §§ 3.5, 7.1–7.7.

There are exceptions, however. In rare circumstances, a subcontractor may pursue claims directly against the government. The two most common are (1) when the government takes assignment of the subcontract from the prime contractor and (2) when the subcontractor is a third-party beneficiary under the prime contract. Both exceptions are extremely narrow.

Federal government regulations expressly recognize the government's ability to accept assignment of subcontracts from primes in certain limited circumstances. For example, the government may do so when it has terminated for convenience the portion of the prime contract that includes the subcontract work.[70] Although the government rarely accepts such assignments, when it does, the subcontractor has the same rights to pursue claims against the government as the federal prime contractor.[71] At least one court has recognized this rule under state law as well.[72]

In the absence of an assignment, the subcontractor may still be able to pursue a direct claim against the government if it can show that the government and prime contractor intended the subcontractor to be a third-party beneficiary under their prime contract, but this is very difficult to do.[73] Many states have evaluated this issue in the context of subcontractor claims against government owners that did not require their prime contractors to obtain statutorily required payment bonds. Some states have allowed such claims under the third-party beneficiary theory;[74] others have not,[75] nor have they been allowed in this context for federal projects.[76]

C. Pass-Through Claims

1. Where Allowed

Generally, pass-through claims are allowed for subcontractor claims on federal construction projects.[77] Most states that have considered pass-through claims have allowed them. For example, in *Interstate Contracting Corp. v. City of Dallas*, a Texas court allowed such a claim, finding that 18 of 19 states that have

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70. FAR 49.108-8, 52.249-2(b)(4); *see also* Clearfield Trust Co. v. United States, 318 U.S. 363 (1943); United States v. Taylor, 333 F.2d 633 (5th Cir. 1964). For discussion of terminations, see chapter 9.

71. Nw. Bank Ariz., NA v. United States, 37 Fed. Cl. 605, 610 (1997); K&S Elec., Inc., ASBCA 30759, 85-2 BCA ¶ 18,088.

72. Topco, Inc. v. Mont. Dep't of Highways, 912 P.2d 805 (Mont. 1996).

73. Winter v. Floorpro, Inc., 570 F.3d 1367 (Fed. Cir. 2009) (theory recognized but claim not allowed); D&H Distrib. Co. v. United States, 102 F.3d 542 (Fed. Cir. 1996) (claim allowed).

74. *See, e.g.*, Lake Cnty. Grading Co. v. Antioch, 935 N.E.2d 638 (Ill. 2013); Electrical Electronic Control, Inc. v. L.A. Unified Sch. Dist., 126 Cal. App. 4th 601 (2005).

75. *See, e.g.*, Imperial Mfg. Ice Cold Coolers, Inc. v. Shannon, 101 P.3d 627 (Alaska 2004); O&G Indus., Inc. v. Town of New Milford, 640 A.2d 110 (Conn. 1994).

76. Dep't of the Army v. Blue Fox, Inc., 525 U.S. 255, 264 (1999).

77. E.R. Mitchell Constr. Co. v. Danzig, 175 F.3d 1369 (Fed. Cir. 1999); J.L. Simmons Co. v. United States, 304 F.2d 886 (Ct. Cl. 1962); Severin v. United States, 99 Ct. Cl. 435 (1943), *cert. denied*, 322 U.S. 733 (1944).

considered the viability of pass-through claims have allowed them: Alaska, California, Florida, Georgia, Kansas, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New Jersey, New York, North Carolina, Oregon, Rhode Island, and Virginia (though only for Virginia Department of Transportation contracts).[78] One state, Connecticut, has expressly rejected the ability of the prime contractor to pass through the subcontractor's claim.[79]

2. Severin *Doctrine*

From the 1943 decision in *Severin v. United States* emerged a substantial limitation on the ability of the subcontractor to pass through its claim to the public entity. Known commonly as the *Severin* doctrine, it provides that unless the subcontractor has a valid recoverable claim against the prime contractor, the prime contractor cannot pass through the subcontractor's claim, even when the subcontractor's damages result from the action or inaction of the public entity. In the *Severin* case, the prime contractor brought suit against the project owner for recovery of both its damages and the damages claimed by its subcontractor. The court allowed recovery for the prime contractor but disallowed recovery for the subcontractor's portion of the claim, reasoning that, since the subcontract provided that the prime would not be liable to the subcontractor for any "loss, damage, detention or delay caused by the owner," there was no liability to pass through to the government.[80]

The *Severin* doctrine has been limited by later cases. The government now has the burden to show that the sponsoring contractor has no liability to the subcontractor that is making the claim. A contingent liability (to pay over sums recovered) is usually sufficient to defeat the government's defense.[81]

3. *Procedure*

Typically the prime contractor and subcontractor enter into a liquidating agreement wherein the prime contractor takes on the obligation to pursue the subcontractor's claims against the owner. In exchange for sponsoring the claim, the prime contractor often negotiates a limit to its liability. This may entail a waiver of other claims unrelated to the pass-through claim and/or a limit of the recovery on the pass-through claim to the amount received from the public owner. Due to the *Severin* doctrine, it is important for the liquidating agreement to state that the subcontractor retains its right to recover against the prime

78. 135 S.W.3d 605 (Tex. 2004).

79. FDIC v. Peabody, NE, Inc., 680 A.2d 1321 (Conn. 1996); *see also* Wexler Constr. Co. v. Hous. Auth. of Norwich, 183 A.2d 262 (Conn. 1962); Walter Kidde Constructors, Inc. v. Connecticut, 434 A.2d 962 (Conn. Super. Ct. 1981).

80. *Severin*, 99 Ct. Cl. at 445.

81. *See* Beacon Constr. Co. v. Prepakt Concrete Co., 375 F.2d 977 (1st Cir. 1967); Fanderlik-Locke Co. v. United States *ex rel.* Morgan, 285 F.2d 939, 942 (10th Cir. 1960), *cert. denied*, 365 U.S. 860 (1961); S. Constr. Co. v. United States, 364 F.2d 439 (Ct. Cl. 1966); Folk Constr. Co. v. United States, 2 Cl. Ct. 681 (1983); Alamo Cmty. College Dist. v. Browning Constr. Co., 131 S.W.3d 146, 158 (Tex. App. San Antonio 2004); Aetna Bridge Co. v. Dep't of Transp., 795 A.2d 517, 524 (R.I. 2002).

contractor, at least for those sums recovered from the owner. This will help to avoid the harsh results suffered by the subcontractor in *Severin* and its progeny.

VIII. False Claims Laws

False claims laws apply to an increasing number of publicly owned and publicly funded projects and, when they apply, significantly impact subcontracting on those projects.[82] They apply to federal government projects and projects with federal funding.[83] They apply to state-owned or state-funded projects in a growing number of states and, in some of those states, to projects owned or funded by local governments as well.[84] A few municipalities have their own false claims laws.[85]

The federal False Claims Act and state and local government equivalents generally provide that a "person," which includes business entities, will be liable if it "knowingly" submits, or causes to be submitted, a false request for payment of public funds.[86] Thus, a subcontractor may be liable under these laws for causing a prime contractor to submit a false claim to the public owner or any owner that has received public funds.[87] Under these laws, a person acts

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82. *See generally* Aaron P. Silberman, *False Claims Issues in Subcontracting*, Briefing Papers, 2d Series, July 2006.

83. 31 U.S.C. §§ 3729–3733; *see* Thompson Pac. Constr., Inc. v. City of Sunnyvale, 155 Cal. App. 4th 525 (2007); United States *ex rel.* Plumbers & Steamfitters Local Union No. 38 v. C.W. Roen Constr. Co., 183 F.3d 1088 (9th Cir. 1999); United States *ex rel.* Perry v. Hooker Creek Asphalt & Paving, LLC, No. 08-6307-HO, 2011 U.S. Dist. LEXIS 144522 (D. Or. Dec. 13, 2011); United States *ex rel.* Totten v. Bombardier Corp., 380 F.3d 488 (D.C. Cir. 2004).

84. For a link to 29 states' false claims laws, go to False Claims Act Resource Center, http://www.falseclaimsact.com/states-municipalities-fcas. *See, e.g.*, Cal. Gov't Code § 12650 (state and local); N.J. Stat. Ann. § 2A:32C-1; N.Y. State Fin., art. 13, §§ 187–194 (state and local); Del. Code Ann. tit. 6, § 1201, *et seq.* (retrieved June 6, 2013); D.C. Code § 2-308.14, *et seq.* (1986); Fla. Stat. § 68.081 (1994); Haw. Rev. Stat. § 661-21, *et seq.*; 740 Ill. Comp. Stat. § 175, *et seq.* (1992); Ind. Code § 5-11-5.5, *et seq.* (2005); La. Rev. Stat. Ann. § 46:437.1, *et seq.* (1997); Mass. Gen. Laws ch. 12, § 5, *et seq.* (2000); Mont. Code Ann. § 17-8-401 (2005); Nev. Rev. Stat. § 357.010, *et seq.* (1999); N.M. Stat. Ann. § 27-14-1, *et seq.* (1978); Tenn. Code Ann. § 4-18-101, *et seq.* (2001) (state and local); Va. Code Ann. § 8.01-216.1, *et seq.* (2002).

85. N.Y.C. Local Law 34 of 2012 (amended Local Law 53 of 2005); Chi. Ill., Mun. Code §§ 1-21-010 to -22-060 (2005); D.C. False Claims Act § 2-308.14 (retrieved June 6, 2013).

86. *See, e.g.*, Pub. L. No. 111-21, § 4(A)(1)(a), (b) (amended 31 U.S.C. § 3729(a)(1)(A), (B)); Ab-Tech Constr., Inc. v. United States, 31 Fed. Cl. 429 (1994), *aff'd*, 57 F.3d 1084 (Fed. Cir. 1995); Cal. Gov't Code § 12651(a)(1); D.C. Code § 2-308.14(a)(1); Fla. Stat. § 68.082(2)(a).

87. *See, e.g.*, United States *ex rel.* Sanders v. Allison Engine Co., 471 F.3d 610 (6th Cir. 2006), *vacated and remanded by* Allison Engine Co. v. United States *ex rel.* Sanders, 553 U.S. 662 (2008) (Court ruling concluded that a defendant itself must intend that the government itself pay the claim and thereby excluded subcontractors from liability where evidence only showed that they intended to defraud the general contractor); *see also* Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 4, 123 Stat. 1617 (enacted May 20, 2009) (Congress amending 31 U.S.C. § 3729 in response to Supreme Court ruling by siding with the Sixth Circuit; changes the definition of "knowingly" and expands the definition of claim used in the FCA to ensure that the definition is more in line with the intent of the

"knowingly" if it does so with actual knowledge of, or recklessness as to, the truth of a payment request (referred to as "scienter").[88]

Other false claims violations of particular relevance to subcontracting include conspiring to submit such a claim and benefiting from the submission of a false claim and failing to disclose that benefit. A subcontractor may be liable under the false claims laws if it participates in a scheme with the prime to submit a false claim—that is, conspiracy.[89] Some state false claims laws, but not the federal act, also provide for liability when a person does not knowingly submit or cause submission of a false claim, but the person later learns that a false claim was submitted and that it has benefited from that false claim.[90] This type of liability could apply to subcontractors to the same extent as prime contractors. A prime is particularly subject to potential liability under such laws when, at the time it requests payment, it has no reason to know that a subcontractor is causing it to submit a false claim but later learns of the falsity and fails to disclose this to the government or government-funded owner.[91]

Prime contractors should be aware of ways in which they may be liable for false claims arising from subcontracting on their public projects. Generally speaking, a prime's duty under false claims laws to ensure any claims for payment it submits are true includes the duty to take reasonable steps to verify claims based in whole or in part on its subcontractor's work.[92] Thus, a prime may violate these laws by requesting payment for a subcontractor's work without confirming that the work has actually been performed and complies with contract requirements.[93] This may arise through normal invoicing or when the prime submits a pass-through claim on behalf of one of its subcontractors.[94]

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law); United States v. Sequel Contractors, Inc., 402 F. Supp. 2d 1142, 1150–51 (C.D. Cal. 2005); City of Pomona v. Superior Court, 89 Cal. App. 4th 793, 795 (2001).

88. *See, e.g.*, 31 U.S.C. § 3729(b); Cal. Gov't Code § 12650(b)(2); Mass. Gen. Laws ch. 12, § 5A(a); N.Y. State Fin. Law, art. 13, §§ 187–194; N.J. Stat. Ann. § 2A:32C-1.

89. *See, e.g.*, 31 U.S.C. § 3729(a)(3); Cal. Gov't Code § 12651(a)(3).

90. Cal. Gov't Code § 12651(a)(8); D.C. Code § 2-308.14(a)(8); Mass. Gen. Laws ch. 12, § 5B(9); Nev. Rev. Stat. Ann. § 357.040(1)(h).

91. *See, e.g.*, Armenta *ex rel.* City of Burbank v. Mueller Co., 142 Cal. App. 4th 636 (2006).

92. *See, e.g.*, Lamb Eng'g & Constr. Co. v. United States, 58 Fed. Cl. 106, 110 (2003).

93. *See, e.g.*, *id.*; Press Release, Office of Pub. Affairs, U.S. Dep't of Justice, Lockheed Martin Corporation Reaches $15.85 Million Settlement with U.S. to Resolve False Claims Act Allegations (Mar. 23, 2012), http://www.justice.gov/opa/pr/2012/March/12-civ-367.html (settlement reached in case where subcontractor inflated cost; government sued prime contractor for reckless and inadequate oversight).

94. *See, e.g.*, Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 793 (4th Cir. 1999); *Sequel Contractors, Inc.*, 402 F. Supp. 2d at 1150–51; United States *ex rel.* Ervin & Assocs., Inc. v. Hamilton Secs. Grp., Inc., 370 F. Supp. 2d 18, 41 n.12 (D.D.C. 2005); United States *ex rel.* Wilkins v. N. Am. Constr. Corp. (*Wilkins I*), 101 F. Supp. 2d 500, 523–24 (S.D. Tex. 2000).

Other common ways in which a prime contractor may violate false claims laws based on its subcontracting include false certification that it has paid its subcontractors and false certifications of its subcontracting with disadvantaged business entities. Under many public contracts, and in some jurisdictions under prompt payment statutes, the prime expressly or impliedly certifies that it has promptly paid its subcontractors.[95] If a prime has not done so and submits a request for payment, it may violate the false claims law.[96] Likewise, many public projects require use of DBEs or give bid preferences based on DBE utilization.[97] If a prime contractor falsely certifies in its bid that it will utilize a DBE subcontractor and that certification qualifies the prime for award or, due to application of bid preferences, puts it ahead of other bidders for a public contract, it may have tainted the entire contract.[98] Under the "fraud in the inducement" theory of false claims liability, the prime may be liable for multiple violations of the false claims laws for all requests for payment it submits under that contract.[99]

If a prime or subcontractor violates a false claims law, it will be liable for the government's actual damages, tripled ("trebled"), and a penalty for each violation.[100] The penalty amount varies by jurisdiction.[101] When the violation is committed by the subcontractor, an issue arises concerning how to count violations for the calculation of penalties. The question is which governs: the number of requests the subcontractor makes to the prime or the number the prime

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95. *See, e.g.*, 31 U.S.C. § 3901; CD 752, § 8.1; Cal. Bus. & Prof. Code § 7108.5. For further discussion, see chapter 4.

96. *See, e.g.*, *Lamb Eng'g*, 58 Fed. Cl. at 110; United States *ex rel.* Told v. Comtrol, Inc., No. 2:02CV593DAK, 2005 WL 2177225 (D. Utah Sept. 6, 2005); United States v. Gatewood, 173 F.3d 983 (6th Cir. 1999); *see* United States *ex rel.* Wall v. Circle, No. 3:07-0091, 2010 WL 1170468, at *9 (M.D. Tenn. Mar. 15, 2010) (prime contractor certified that payments were made to subcontractor's employees); United States *ex rel.* Wall v. Circle Constr., LLC, 697 F.3d 345 (6th Cir. 2012) (federal contractor violated the False Claims Act when its subcontractor failed to pay prevailing wages to its employees).

97. See section V.B.

98. *See, e.g.*, *Ab-Tech*, 31 Fed. Cl. 429; S. Cal. Rapid Transit Dist. v. Superior Court, 30 Cal. App. 4th 713 (1994).

99. *See, e.g.*, United States v. Gen. Dynamics Corp., 19 F.3d 770, 772, 775 (2d Cir. 1994); United States v. Ehrlich, 643 F.2d 634 (9th Cir. 1981), *cert. denied*, 454 U.S. 940 (1981); United States *ex rel.* Durcholz v. FKW, Inc., 997 F. Supp. 1143 (S.D. Ind. 1998); United States *ex rel.* Fallon v. Accudyne Corp., 880 F. Supp. 636, 639–40 (W.D. Wis. 1995); Fassberg Constr. Co. v. Hous. Auth. of L.A., 152 Cal. App. 4th 720 (2007); *City of Pomona*, 89 Cal. App. 4th 793.

100. *See* 31 U.S.C. § 3729(a); Cal. Gov't Code § 12651(a); Mass. Gen. Laws ch. 12, § 5B(a).

101. *See, e.g.*, 31 U.S.C. § 3729(a); 28 C.F.R. § 85.3 (although the False Claims Act provides for penalties in the range of $5,000 to $10,000, the Department of Justice has adjusted the penalties to $5,500 and $11,000 pursuant to other statutory authority); Ariz. Rev. Stat. Ann. § 13-2311 ($5,500 to $11,000); Cal. Gov't Code § 12651(a) (same); Mont. Code Ann. § 17-8-402, *et seq.* ($5,000 to $10,000); N.Y. State Fin. Law, art. § 189 ($6,000 to $12,000); tit. 7, ch. 8, § 7-801, *et seq.*, tit. 46, ch. 3, § 3-10, *et seq.* ($5,000 to $15,000).

makes to the owner? A court evaluating this question under the federal statute has held that the number of requests to the government should be used.[102]

When parties negotiate a subcontract for work on a public project subject to a false claims law, certain provisions should be included. One provision should require the subcontractor to certify the truth and correctness of any requests for payment it submits with regard to the completeness and compliance of the work for which payment is sought; a second should require that the subcontractor's own subcontractors and suppliers have been paid for their portions of prior payments received. A third provision should give the prime the ability to take reasonable steps to ensure the truth and correctness of a subcontractor's claim before it will be obligated to pass it on to the government or government-funded owner.

When a subcontract provides for arbitration of disputes,[103] the parties should be aware that it may not be enforceable for resolution of alleged false claims. While courts have enforced such provisions in direct actions by government owners against prime contractors,[104] at least one decision has stated in dicta that they would not apply in *qui tam* actions.[105] Additionally most subcontracts contain indemnification provisions, most commonly requiring the subcontractor to defend and indemnify the prime for claims arising out of the subcontractor's work;[106] the courts are unlikely to enforce such provisions if the prime is sued by the subcontractor (as a *qui tam* relator) for false claims, even if the alleged false claims are based on the conduct of that subcontractor.[107] Courts are more likely, however, to enforce contractual indemnity when the indemnitor is not a party to the false claims action.[108] Finally, many subcontracts require the subcontractor to obtain specific types and levels of insurance and to name the prime as an additional insured.[109] Whether these provisions will be effective to provide

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102. United States v. Bornstein, 423 U.S. 303, 312–13 (1976) (Supreme Court held that a subcontractor was liable for penalties for three violations based on three false subcontractor requests that were submitted to the government in 35 prime-contractor invoices); *see also* United States *ex rel.* V.I. Hous. Auth. v. Coastal Gen. Constr. Servs. Corp., 299 F. Supp. 2d 483 (D.V.I. 2004) (district court found a contractor liable for penalties for 10 violations based on 10 subcontractor requests that were submitted to the government in one prime request for payment).

103. See chapter 16.

104. United States v. Bankers Ins. Co., 245 F.3d 315, 317 (4th Cir. 2001) (compelling United States to arbitrate all claims arising out of contract, including those for federal False Claims Act violations); Cnty. of Solano v. Lionsgate Corp., 126 Cal. App. 4th 741, 749 (2005).

105. *Cnty. of Solano*, 126 Cal. App. 4th at 749.

106. *See, e.g.*, CD 752, § 9.1. For further discussion, see chapter 11.

107. *See, e.g.*, United States *ex rel.* Head v. Kane Co., 668 F. Supp. 2d 146, 154 (D.D.C. 2009).

108. *See, e.g.*, Cell Therapeutics, Inc. v. Lash Grp., Inc., 586 F.3d 1204, 1209 (9th Cir. 2010); United States *ex rel.* Pub. Integrity v. Therapeutic Tech., 895 F. Supp. 294 (S.D. Ala. 1995).

109. *See, e.g.*, CD 752, § 9.2. For further discussion, see chapter 13.

insurance coverage for the prime or the subcontractor for false claims defense and liability will depend on the terms of the policy, the applicable law, and the alleged conduct.[110] For example, if the insured allegedly had actual knowledge of the falsity, coverage may be excluded, whereas if the only allegation is recklessness, the exclusion may not apply.[111]

The federal false claims law and state laws modeled after it provide for two types of enforcement actions: direct actions brought by the government and *qui tam* actions brought by whistle-blowers, aka "relators."[112] Where false claims arise from a subcontractor's work or conduct, the government may, and often does, sue both the prime and sub.[113] This may implicate subcontract indemnity and defense provisions.[114] Indemnity or defense claims, when enforceable, generally will not be allowed as counterclaims in a false claims lawsuit; rather, they must be brought in a separate action.[115] When both the prime and subcontractor are sued for false claims, they may be held jointly and severally liable.[116] Their interests will often be aligned, in whole or in part, such that joint defense privileges may apply. A joint defense agreement is often worth considering.

In *qui tam* actions, may a subcontractor sue a prime as a relator, even in cases arising out of the subcontractor's own work? It has been held that false claims laws define who may sue as a relator broadly enough to include subcontractors.[117] A whistle-blower action by a subcontractor, however, may be of limited value. The false claims laws discourage such lawsuits by limiting the recovery of a relator that is found to have been a participant in the fraud.[118]

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110. *See, e.g.*, Health Care Indus. Liab. Ins. Program v. Momence Meadows Nursing Ctr., 566 F.3d 689 (7th Cir. 2009); Zurich Am. Ins. v. O'Hara Reg'l Ctr. for Rehab., 529 F.3d 916, 921–22 (10th Cir. 2008); Watts Indus., Inc. v. Zurich Am. Ins. Co., 121 Cal. App. 4th 1029 (2004).

111. *See, e.g.*, M/G Transp. Servs., Inc. v. Water Quality Ins. Syndicate, 234 F.3d 974, 978–79 (6th Cir. 2000) (held that, under Ohio law, an insurer had no duty to defend its insured against a False Claims Act lawsuit because the insured's policy contained exclusions of coverage for willful negligence, misconduct, fines, penalties, and punitive and exemplary damages); New Mem'l Assocs. v. Credit Gen. Ins. Corp., 973 F. Supp. 1027 (D.N.M. 1997) (New Mexico law); Int'l Ass'n of Chiefs of Police, Inc. v. St. Paul Fire & Marine Ins. Co., 686 F. Supp. 115 (D. Md. 1988).

112. *See, e.g.*, 31 U.S.C. § 3730(b); Cal. Gov't Code § 12652(a)(1); N.Y. State Fin. Law, art. 13, § 190.

113. *See, e.g.*, United States v. Kellogg Brown & Root Servs., 800 F. Supp. 2d 143 (D.D.C. 2011); United States v. Cabrera-Diaz, 106 F. Supp. 2d 234, 242 (D.P.R. 2000).

114. For further discussion, see chapter 11.

115. *See, e.g.*, Mortgs., Inc. v. U.S. Dist. Court, 934 F.2d 209, 213 (9th Cir. 1991); United States v. Nardone, 782 F. Supp. 996, 999 (M.D. Pa. 1990); United States v. Kennedy, 431 F. Supp. 877 (C.D. Cal. 1977).

116. *Cabrera-Diaz*, 106 F. Supp. 2d at 242.

117. *See, e.g.*, 31 U.S.C. § 3730 (b)(1), (d)(1); *Told*, 2005 WL 2177225; Del. Code Ann. tit. 6, § 1203; Fla. Stat. § 68.083.

118. *See, e.g.*, 31 U.S.C. § 3730(d)(3); Del. Code Ann. tit. 6, § 1205; Fla. Stat. § 68.085(6).

Subcontractors also should consider that, by filing against the prime, they will be drawing government attention to the alleged false claims. Once a relator files a *qui tam* action, the government may intervene in the case and, even if it does not intervene, retains certain rights (for example, to approve of or object to dismissals or settlements).[119] By filing suit, a subcontractor may lead the government not only to intervene but also to sue the subcontractor as an additional defendant.

A subcontractor also may be concerned that, if it sues its prime for false claims, the prime will retaliate against the subcontractor (e.g., by terminating its subcontract, refusing to do further business with the sub, "black balling," etc.). There may be contractual or common law remedies for certain acts (e.g., suing for breach of contract or defamation), and at least some false claims laws themselves provide protection against retaliation. For example, the federal act provides that any contractor "shall be entitled to all relief necessary to make [it] whole, if [it] is discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against in the terms and conditions of employment because of lawful acts done by the . . . contractor . . . in furtherance of" either a *qui tam* action or "efforts to stop 1 or more violations" of the act.[120]

IX. Improper Pricing Practices

A. Bid Rigging

Both federal and state governments prohibit efforts to eliminate competition or restrain trade. The FAR specifically lists a number of anticompetitive practices as antitrust violations that must be reported to the attorney general: collusive bidding, follow-the-leader pricing, rotated low bids, collusive price estimating systems, and sharing of business.[121] The Federal Acquisition Regulation (FAR) requires rejection of offers suspected of being collusive.[122]

Prime contractors on federal projects also are not permitted to enter into agreements restricting their subcontractors' ability to provide their goods or services directly to the government. Contractors may not unreasonably preclude subcontractors from making direct sales to the government.[123] This restriction is implemented through the contract clause at FAR 52.203-6, Restrictions on Subcontractor Sales to the Government. That clause prohibits entering

119. *See, e.g.*, 31 U.S.C. § 3730(b); United States *ex rel.* Badr v. Triple Canopy Inc., 950 F. Supp. 2d 888 (E.D. Va. 2013); Cal. Gov't Code § 12652(3); N.Y. State Fin. Law, art. 13, § 190.

120. 31 U.S.C. § 3730(h).

121. FAR 3.301, 3.303(c); *see* FAR 3.303(a); 41 U.S.C. § 253b(i); 10 U.S.C. § 2305(b)(9).

122. FAR 3.103-2(b)(2).

123. 10 U.S.C. § 2402; 41 U.S.C. § 253g.

> into any agreement with an actual or prospective subcontractor, nor otherwise act in any manner, which has or may have the effect of restricting sales by such subcontractors directly to the Government of any item or process (including computer software) made or furnished by the subcontractor under this contract or under any follow-on production contract.[124]

These prohibitions do not preclude a contractor from asserting rights that are otherwise authorized by law or regulation.[125] This clause also has to be flowed down to subcontractors.[126]

B. Subcontractor Kickbacks

Federal and state law prohibit prime contractors from accepting and subcontractors from offering anything of value as consideration for the prime using or proposing the subcontractor on a public project. The federal Anti-Kickback Act of 1986[127] prohibits providing or accepting kickbacks, or attempting to do so. It also prohibits including the amount of any kickback either in the price of any prime contract with the federal government or in any price of a subcontract charged to a prime contractor or a higher-tier subcontractor.[128] Many state laws prohibit similar conduct.[129]

The federal statute defines kickbacks broadly to include

> any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.[130]

In *Morse Diesel International, Inc. v. United States*,[131] the Court of Federal Claims held that the Anti-Kickback Act covers any kind of benefits that might be provided to a prime contractor in return for participation on a federal government contract. According to the court, "Congress intended the language 'favorable treatment' be construed broadly to reach all conduct analogous

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124. FAR 52.203-6(a).
125. FAR 3.501-1, 52.203-6(b).
126. FAR 52.203-6(c).
127. 41 U.S.C. §§ 51–58.
128. FAR 3.502-2(a), 52.203-7(b).
129. *See, e.g.*, Cal. Bus. & Prof. Code § 650; Mass. Gen. Laws ch. 175H, § 3 (amended 2012); Tex. Occ. Code § 102.001(a).
130. FAR 3.502-1, 52.203-7(a).
131. 66 Fed. Cl. 788 (2005).

to commercial bribery . . . even if it did 'not directly [impact] the federal treasury.'"[132] In that case, a bond broker's sharing of commissions with a prime contractor was determined to be a kickback under the act.[133] In the same opinion, the court also emphasized that the Anti-Kickback Act creates "a presumption that any kickback was included in the price of an affected federal contract or subcontract and therefore increased costs to the Government."[134]

Knowing and willful violations of the Anti-Kickback Act are subject to criminal liability.[135] Knowing violations can lead to double damages and per-occurrence civil penalties.[136] The act also authorizes a government to withhold the amount of a kickback and to direct a prime contractor to withhold the amount of a kickback from a subcontractor.[137]

The act creates an obligation not only to avoid kickbacks but also to prevent, detect, and report them. A contractor is required to have and follow "reasonable procedures designed to prevent and detect violations of the Act in its own operations and direct business relationships."[138] Specific examples of reasonable procedures are listed:

- company ethics rules prohibiting kickbacks by employees, agents, or subcontractors
- education programs for new employees and subcontractors, explaining policies about kickbacks, related company procedures, and the consequences of detection
- procurement procedures to minimize the opportunity for kickbacks
- audit procedures designed to detect kickbacks
- periodic surveys of subcontractors to elicit information about kickbacks
- procedures to report kickbacks to law enforcement officials
- annual declarations by employees of gifts or gratuities received from subcontractors
- annual employee declarations that they have violated no company ethics rules
- personnel practices that document unethical or illegal behavior and make such information available to prospective employers

If the contractor has reasonable grounds to believe the Anti-Kickback Act has been violated, it is obliged to "promptly report in writing the possible violation . . . to the inspector general of the contracting agency, the head

132. *Id*. at 800 (quoting United States v. Purdy, 144 F.3d 241, 244 (2d Cir. 1998)).
133. *Id.* at 801.
134. *Id.* at 800.
135. FAR 3.502-2(b).
136. 41 U.S.C. § 55(a)(1); *see also* FAR 3.502-2(c); United States *ex rel.* Vavra v. Kellogg Brown & Root, 727 F.3d 343 (5th Cir. 2013).
137. FAR 3.502-2(d), 52.203-7(c)(4).
138. FAR 3.502-2(i)(1); *see also* FAR 52.203-7(c)(1).

of the contracting agency if the agency does not have an inspector general, or the Department of Justice."[139]

The Anti-Kickback Act is enforced through a contract clause, FAR 52.203-7, Anti-Kickback Procedures. The Anti-Kickback clause must also be flowed down to all subcontracts worth more than $100,000.[140]

X. Flow-Downs

Generally speaking, a prime contractor will include a provision in each subcontract that incorporates or "flows down" some or all of the requirements of the prime contract.[141] Many prime contracts require that the prime contractor flow down certain prime contract provisions—that is, mandatory flow-down clauses—while others are permissive. Even when not mandatory, the prime contractor will have a practical reason for flowing down many prime-contract provisions because the prime contractor cannot be in a position where it has promised certain performance that it did not secure from its subcontractor(s). However, without careful drafting, flow-down clauses can result in conflicts between the prime contract and subcontract requirements. Generally these conflicts are resolved through an order of precedence clause in the subcontract that sets a hierarchy to the documents in the event of a conflict.[142] General flow-down provisions also may be contrary to the prime and subcontractor's intent, or, at least, they will not make the parties' intent clear. For this reason, courts, particularly state courts, may decline to enforce such general provisions.[143]

A. Mandatory Flow-Down Clauses

For federal contracts, FAR part 52 contains contract clauses to be included in prime contracts. Depending on the type and value of the subcontract, only certain clauses must be included, or flowed down, to the subcontract agreement. Often, mandatory flow-down clauses specifically require that they also be included in all subcontracts or at least certain specified subcontracts (e.g., those over a certain dollar value). Some examples include Anti-Kickback (52.203-7); Audit and Records (52.214-26); Subcontractor Cost and Pricing Data (52.214-28); Davis-Bacon Act (52.222-6); Apprentices and Trainees (52.222-9); Equal Opportunity (52.222-26); Contract Termination—Debarment (52.222-12);

139. FAR 52.203-7(c)(2); *see* FAR 3.502-2(g).

140. FAR 52.203-7(c)(5).

141. *See, e.g.*, CD 752, §§ 2.4, 12.14, and ex. H.

142. *See, e.g.*, CD 752, § 13.1.5.

143. *See, e.g.*, Performance Control v. Seaboard Sur. Co., 163 F.3d 366 (6th Cir. 1998) (holding that a general clause incorporating the prime contract's obligations did not flow down an exhaustion of administrative remedies clause).

Employment Eligibility Verification (52.222-54); and Prompt Payment for Construction Contracts (52.232-27).[144]

B. Permissive Flow-Down Clauses

In general, the prime contractor may choose to flow down other clauses that are not specifically mandated by the FAR to be included in those subcontracts. For example, the FAR clauses for changes and terminations are not mandatory flow-down clauses,[145] but the prime contractor would be wise to include them to bring continuity between the prime and subcontracts regarding these important contract terms.[146]

C. The *Christian* Doctrine

The *G.L. Christian & Associates v. United States*[147] case provides that in prime contacts where the government failed to specifically include a contract clause required by the governing regulations, the clause will be read into the prime contract. In the *G.L. Christian* case, the contracting officer omitted the "terminations for convenience" clause that would have limited the prime contractor's damages. The governing regulations at the time required the inclusion of the termination for convenience clause in the prime contract, and therefore the court, as a matter of law, read it into the contract. This holding has long been known as the *Christian* doctrine. It has since been refined, limiting its application to omitted clauses that express "a significant or deeply ingrained strand of public procurement policy."[148] While the *Christian* doctrine has not traditionally been applied to subcontracts, a recent District Court for the District of Columbia decision, *UPMC Braddock v. Harris*,[149] rejected an argument that the *Christian* doctrine applied only to prime contracts. The court found that "the subcontractor helps the contractor to fulfill its agreement with the government, and indirectly reaps benefit from that agreement," and, as a result, there was no reason why the government could impose terms on government prime contracts by operation of law but not on government subcontracts.[150]

144. CD 752, ex. H.

145. FAR parts 43, 49.

146. For further discussion on changes and terminations, see chapters 6 and 9, respectively. *See also* CD 752, arts. 7, 10.

147. 312 F.2d 418 (Ct. Cl. 1963).

148. S.J. Amoroso Constr. Co. v. United States, 12 F.3d 1072, 1075 (Fed. Cir. 1993) (citing *G.L. Christian & Assocs.*, 312 F.2d 418).

149. 934 F. Supp. 2d 238 (D.D.C. 2013).

150. *Id* at 258.

XI. Mandatory Disclosure and Internal Control Systems

Contractors holding major subcontracts on federal projects, defined as worth more than $5 million and lasting more than 120 days, are required to disclose to the appropriate agency's Office of Inspector General (OIG) all "credible evidence" related to a government contract of (1) violations of criminal law involving fraud, conflict of interest, or bribery; (2) violations of the federal civil False Claims Act;[151] or (3) significant overpayments. In addition, to make sure that contractors do not try to avoid making disclosures by ignoring potential problems, federal regulations also require most contractors to establish internal control systems that actively seek disclosable evidence to be passed on to agency OIGs.[152]

The federal government has three separate tools to enforce mandatory disclosure. First, a contract clause must be included in all prime contracts and flowed down to all major subcontracts.[153] That clause requires the prime contractor and major subcontractors to disclose to the agency's OIG any criminal violations or civil false claims violations that relate to that contract and any subcontracts.

Second, the same FAR clause also imposes specific obligations on the prime contractor and each major subcontractor to establish and maintain an elaborate internal control system, unless the contract is with a small business or is for commercial items. As a baseline, contractors must have a written code of business ethics and conduct.[154] All contractors should have an employee business ethics and compliance training program and an internal control system that—

(1) Are suitable to the size of the company and extent of its involvement in Government contracting;
(2) Facilitate timely discovery and disclosure of improper conduct in connection with Government contracts; and
(3) Ensure corrective measures are promptly instituted and carried out.[155]

If a contractor has a contract containing FAR 52.203-13, the contractor takes on the additional obligation to "(i) Exercise due diligence to prevent and detect criminal conduct; and (ii) Otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."[156] These internal control obligations require the contractor to implement the Justice Department's corporate compliance standards established in the U.S. Sentencing Guidelines. To meet those standards, the internal control system must actively look for potential violations of criminal law and the civil

151. 31 U.S.C. §§ 3729–3733. For further discussion of FCA issues, see section VIII.
152. *See* 73 Fed. Reg. 67,064 (Nov. 12, 2008).
153. FAR 3.1004(a), 52.203.13(d); *see also* CD 752, § 12.7.
154. FAR 3.1002(b)(2).
155. *Id.*
156. FAR 52.203-13(b)(2).

False Claims Act. Violations that are uncovered related to *any* of the contractor's federal contracts or subcontracts must then be disclosed to the relevant agency's OIG.

Third, separate FAR provisions make the failure to disclose any violations and overpayments on any federal contract or subcontract grounds for suspension or debarment.[157] There is no dollar threshold for the debarment and suspension provisions: they apply to all contractors and subcontractors on any federal government contracts that have not been closed out for more than three years. The definition of "contractor" for purposes of the debarment and suspension applies to any party that submits an offer or is awarded a contract with the federal government and any subcontractors to such a party, of any tier.[158] It also applies to anyone who "[c]onducts business, or reasonably may be expected to conduct business, with the Government as an agent or representative of another contractor."[159]

Taken in combination, these FAR provisions essentially establish a mandatory disclosure system applicable to all companies that do business—including construction—with the federal government, including small businesses, commercial contractors, and companies who do all of their work outside the United States.

A prime contractor is required to disclose credible evidence of violations by and overpayments to not only itself but also its subcontractors.[160] But it is required only to disclose known violations by the subcontractor, and the prime contractor is not required to review or approve subcontractor internal control systems.[161]

A major subcontractor on a government construction contract can take on an independent mandatory disclosure requirement, even if it has no direct contracts with the federal government. The clause at FAR 52.203-13 must be flowed down to all subcontracts that meet the same threshold as the prime contract: a value in excess of $5 million and performance period of more than 120 days.[162] When subcontractors are required to make disclosures, they are required to disclose directly to the agency's OIG and not through the prime contractor.[163]

157. FAR 9.403.
158. *Id.*
159. *Id*. at 9.403(2).
160. *Id.*
161. 73 Fed. Reg. 67,064, 67,084.
162. FAR 52.203-13(d)(1).
163. FAR 52.203-13(d)(2).