FALSE CLAIMS ACT

Valley Engineers, Inc. v. City of Vernon

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

California False Claims Act

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

In summary, the CFCA was modeled after the Federal False Claims Act ("FFCA") originally enacted into law in 1863 by President Abraham Lincoln to stop fraud being perpetrated by contractors against the government during the Civil War.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

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

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

The Project

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

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

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

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

The Litigation

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

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

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

1. Valley allegedly received three progress payments for the two regulator stations where ERW instead of seamless pipe was installed, amounting to six false claims penalties of $10,000.00 each;

2. Valley allegedly made eight wrongful demands for labor costs detailed in the claim, for which the city sought penalties of $10,000.00 each, and treble damages for the labor cost differential;

3. Valley allegedly made wrongful quantity demands in six progress estimates for two off-haul items, amounting to 12 penalties of $10,000.00 each, plus treble damages for the quantity differential;

4. Valley allegedly improperly prepared four items in the claim at a penalty of $10,000.00 each; and

5. Valley allegedly requested two wrongful **<u>under billings</u>** in progress estimates at a penalty of $10,000.00 each.

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

> "Q Next bullet point says, "Two of the improper billings were net underbillings." What does that mean?
>
> A It means there was improperly reported time, but in those two instances, it was incorrect – it was an incorrect underbilling.
>
> Q So the contractor claimed less money than he was entitled to?
>
> A That's correct.
>
> Q As to those two improper billings where he claimed less than what he was entitled to, you still determined that the City is owed $10,000.00 for each of those billings under the False Claims Act; is that correct?
>
> A That's correct.
>
> Q How did you arrive at that conclusion?
>
> A It's an incorrect billing.
>
> Q So even if the billing is false in the sense that the contractor mistakenly cheated himself, he still has to pay the City $10,000 a pop. Is that your analysis?

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

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

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

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

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

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

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

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

A No. Where it said that.

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

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

A Yeah. The short answer is yes."

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

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

Lessons Learned

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

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

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

2. Make every attempt to resolve contract changes at the lowest possible bureaucratic level consistent with the contract documents. You may experience a situation in which the higher up you are required to go in an agency's hierarchy, the less likely a decision will be made.

3. Consider carefully whether you want to accept unilateral change orders, as doing so may run the risk of you not getting paid.

4. If you, as a contractor, find yourself in a differing site conditions or changed conditions dilemma, consider allowing the Owner to direct the resolution on a cost-plus basis. Continue with the other work in an efficient manner, while the Owner ponders over a solution. After all, it is the Owner's project. The Owner or its independent consulting firm designed the project. A contractor only has the obligation to build the project as presented in the contract documents. No more! Anything different should constitute a contractual change and be compensable. Be aware that changes to the contract most often divert the project management's attention away from the original work, to the detriment of the original budget.

5. On larger projects, consider consulting with an attorney specializing in construction law to prepare, review, modify and/or assess the contractor's claim for accuracy prior to submission to the public entity. Innocent mistakes occur during the course of the job. Yet, it is often these mistakes that an agency argues is "deliberate ignorance" or "reckless disregard" as proof of "knowledge" by the

contractor as to the falsity of a claim.

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

Conclusion

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

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