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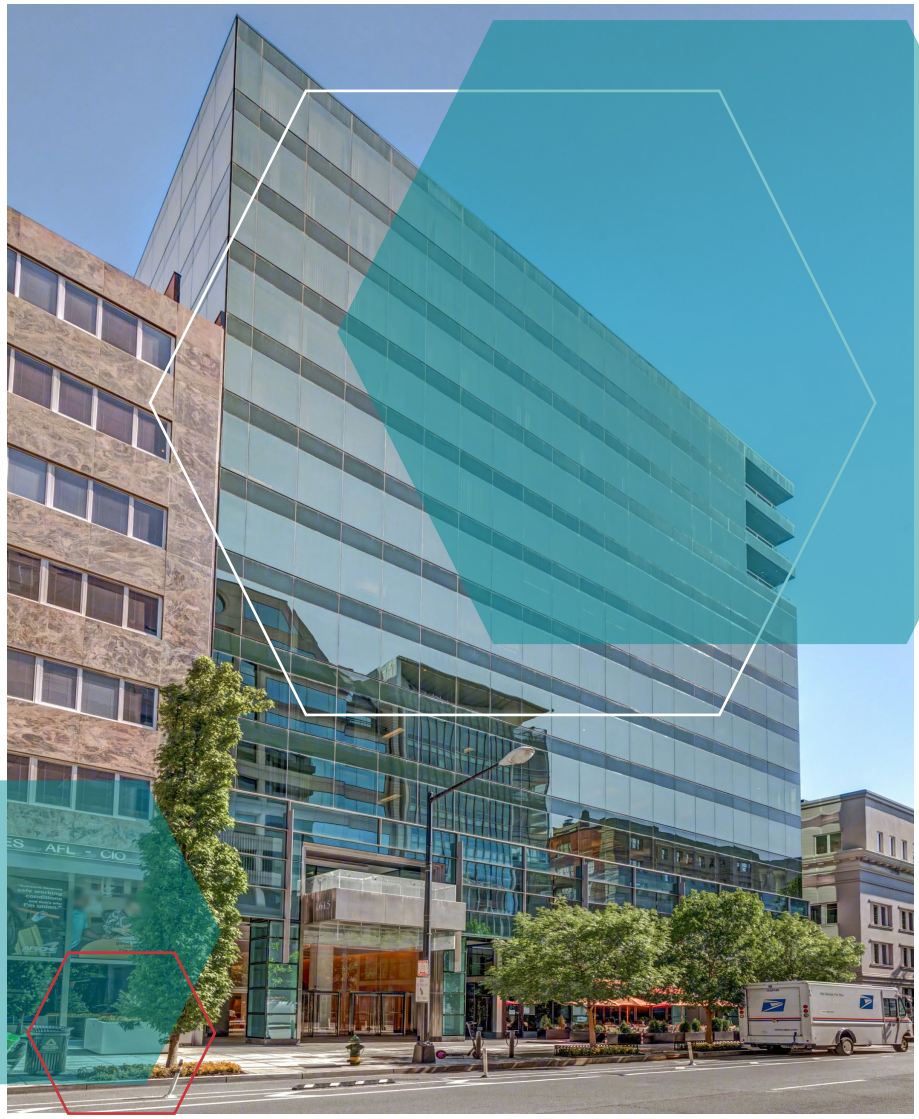
CONSTRUCTION AND PROCUREMENT LAW NEWSLETTER



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PROCUREMENT FRAUD RECOVERIES SUBSTANTIAL FOR DOJ IN FY 2023

ARON C. BEEZLEY

The Department of Justice (DOJ) recently announced that it obtained more than $2.68 billion in False Claims Act (FCA) settlements and judgments in the fiscal year ending September 23, 2023. Notably, DOJ reports that "procurement fraud" recoveries again comprised one of the largest categories of recoveries for DOJ this past year.

Among the more notable procurement fraud recoveries from fiscal year 2023 that DOJ reports are:

- In one of the largest procurement settlements ever, a large government contractor paid $377 million to resolve allegations that it improperly billed its government contracts for costs incurred in its non-governmental commercial and international contracts. The government alleged that the contractor improperly allocated to government contracts indirect costs associated with its non-government contracts that either had no relationship to the government contracts or were allocated to those contracts in disproportionate amounts. Further, the government alleged that the contractor failed to disclose to the government the method by which it accounted for costs supporting its commercial and international businesses. As a result, the contractor was alleged to have obtained reimbursement from the

government for the costs of non-governmental activities that provided no benefit to the government.

- A government contractor agreed to pay $21.8 million to resolve allegations that in contract proposals for equipment provided to the military, the contractor included the cost of certain items, such as nuts and bolts, twice.
- A federal contractor agreed to pay $8.1 million to resolve allegations that it submitted false claims and made false statements in connection with U.S. Navy contracts to manufacture a military aircraft. The government alleged that the contractor failed to comply with certain contractual manufacturing specifications in fabricating composite components for the aircraft, including failing to perform monthly testing on autoclaves used in the composite cure process.

COURT HOLDS THAT CONTRACTOR HAS DUTY TO DISCLOSE INFORMATION RELATED TO THE VIABILITY OF PASS-THROUGH CLAIMS WHEN NEGOTIATING PASS-THROUGH SETTLEMENT AGREEMENT

JOHN MARK GOODMAN

A Utah federal court recently held that when negotiating a pass-through settlement agreement, a contractor has a duty to disclose information to its subcontractor regarding the viability of the claims to be passed through. See *Ludvik v. Vanderlande, 2023 WL 8789379* (D. Utah, Dec. 19, 2023). If it breaches that duty, the contractor may be held liable notwithstanding release language included in the settlement agreement.

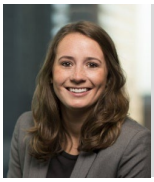
The Ludvik case involved construction work at the Salt Lake City International Airport. The prime contractor subcontracted installation of the bag handling system to Vanderlande, which subcontracted the mechanical and electrical portion to Ludvik. Towards the end of the job, Ludvik notified Vanderlande that it had pass-through claims to assert against the prime contractor for changes in scheduling that caused nearly $10 million in unanticipated losses. Vanderlande and Ludvik subsequently entered a pass-through settlement agreement whereby Vanderlande agreed to pass through Ludvik's $10 million delay claims to the prime contractor. As is common for such pass-through agreements, Vanderlande would cooperate in presenting Ludvik's claims to the prime contractor and would pass through any recovery to Ludvik. Ludvik agreed to release Vanderlande of any liability if the pass-through claims were rejected by the prime contractor.

Ludvik subsequently submitted its pass-through claims and as agreed, Vanderlande passed them upstream. The prime contractor rejected the claims as untimely and waived by a prior change order between itself and Vanderlande. Ludvik filed suit against Vanderlande seeking to recover its $10 million in losses for alleged fraud, negligent misrepresentation, and breach of contract by Vanderlande. Ludvik claimed it was fraudulently induced to enter the pass-through settlement agreement by Vanderlande's misrepresentation that its pass-through claims were viable when in fact Vanderlande knew they were not. As evidence that Vanderlande knew the claims were not viable, Ludvik pointed to a letter that Vanderlande had received before entering the settlement agreement that made clear that Ludvik's claim would be rejected. Although the letter was shared with Ludvik, Ludvik argued that Vanderlande's conduct after sharing the letter led Ludvik to believe that its pass-through claims remained viable and might succeed prior to executing the settlement agreement.

Vanderlande sought summary judgment on Ludvik's negligent misrepresentation claim arguing that it did not owe Ludvik a duty to disclose and that its provision of the letter from the prime contractor detailing the basis for the rejection of the Ludvik's claims satisfied its duty to disclose as a matter of law. The court disagreed.

Safety Moment for the Construction Industry

This year, Construction Safety Week placed its emphasis on fall prevention. More than 70 contractors around the US and Canada, in coordination with OSHA, highlighted hazards associated with working in elevated areas. Falls are one of the leading causes of injury or death in the construction industry. The construction industry historically more deaths annually than almost any other industry. Falls, slips, and trips from elevated work areas account for hundreds of fatalities each year. Statistically, about 40% of on-the-job fatalities at construction sites are the result of a fall. There are a number of resources available to stay current with respect to fall prevention measures and information from OSHA that may be helpful to your or your colleagues can be found here: https://www.osha.gov/stop-falls-stand-down/resources



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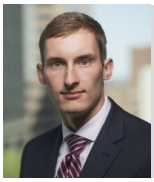

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Under circumstances where Vandervelde was in a superior position to know material facts regarding the viability of the pass-through claims, the court held that Vanderlande had a duty to disclose such facts to the subcontractor. The court further held that a reasonable jury could find that Vanderlande breached that duty by conduct suggesting those claims remained viable. The court also rejected Vandervelde's argument that Ludvik's claims were barred by the release in the settlement agreement, since that release was itself procured by the alleged misrepresentation. The court therefore denied summary judgment on Ludvik's negligent misrepresentation claim, which remains pending.

BRADLEY LAWYER ACTIVITIES AND NEWS

2024 Edition of Chambers USA Ranks 151 Bradley Attorneys and 48 Practice Areas; Six Practice Areas and 10 Attorneys Ranked Nationally

Bradley is pleased to announce that Chambers and Partners has ranked nationally Bradley's Construction and Government Contracts practice areas.

Ten Bradley attorneys received *national rankings*, including **Aron Beezley** in Government Contracts and Government Contracts: Bid Protests.

Bradley's Construction Group is ranked among the top firms in Alabama, Washington, D.C., Florida, Mississippi, North Carolina, Tennessee, and Texas

The following 18 attorneys have been ranked in their respective states: **Jim Archibald, David Owen, David Pugh, Mabry Rogers, Aron Beezley, Lee-Ann Brown, Doug Patin, Bob Symon, Ben Dachepalli, Tim Ford, Debbie Cazan, Jon Spangler, Ralph Germany, Ryan Beaver, Matt Lilly, David Taylor, Ian Faria,** and **Jon Paul Hoelscher.**

Chambers and Partners, an independent professional legal research company, determines its rankings of leading U.S. firms, legal departments and attorneys through in-depth research and interviews with law firms, clients and third parties. Chambers assesses attorneys on attributes valued most by clients including capabilities, achievements, and sector presence.

EMPLOYEE STOCK OWNERSHIP PLANS FOR CONSTRUCTION COMPANIES

DAVID JOFFE & EMILY HORN

In recent years, a growing number of construction companies have established employee stock ownership plans (ESOPs). The interest in an ESOP is often generated by the need for an exit strategy for one or more of the owners of a closely held business, a common scenario in the construction industry. In fact, the construction industry, more than most industries, seems particularly drawn to ESOPs. A few reasons for this are that private equity buyers are rarely interested in construction companies and construction companies seem less likely to sell to competitors than companies in other industries. In circumstances where the business is not easily sold to a third party and/or the owners desire to provide for continuity, an ESOP can be a great solution for the owners and the company; they can obtain liquidity, and the company can operate with improved cash flow.

There are some unique issues that construction companies need to address in implementing an ESOP, particularly with regards to sureties and any new debt that is incurred by the company to complete the ESOP transaction. This post provides a brief overview on ESOPs. In future blog posts, we will address key issues relating to ESOPs for construction companies.

Brief Background on ESOPs

An ESOP is a type of tax-qualified retirement plan that primarily invests in employer stock. Like other retirement plans, the ESOP is governed by the terms of a formal plan and trust documents. The ESOP buys shares from selling shareholders, the company, or some combination of both. In a leveraged transaction, the shareholders typically sell their stock to the ESOP. The ESOP will usually purchase the stock through a combination of seller notes and cash borrowed from the company, which in turn will borrow money from a bank.

There are several tax advantages to an ESOP. One such advantage is that repayments of the principal amount of an ESOP loan can be tax deductible. To elaborate, contributions by the company to the ESOP to enable the ESOP to repay the ESOP's promissory note are tax deductible (up to certain limits); thus, a loan used to finance an ESOP transaction can be repaid with pre-tax dollars. Another advantage is that a selling shareholder of a C-corporation may be able to elect Code Section 1042 tax deferral treatment and defer the capital gains associated with the sale of his or her shares, subject to certain requirements. Finally, the most important tax advantage is that, for companies that elect S-corporation status, the ESOP's share of recognized earnings is ordinarily exempt from income taxes. The goal for most ESOP-owned companies is to eventually become a 100% ESOP-owned S-corporation, thereby achieving the best possible tax status.

To start the ESOP process, companies will usually obtain a feasibility study that will consider valuation, transaction size, financing, surety program impact, and the expected benefits delivered to employees over time. The ESOP process will also ordinarily consider the long-term goals and related incentives for management, including any management transition issues.

Bradley is ranked the No. 1 construction practice in the nation by **Construction Executive** in its list of "The Top 50 Construction Law Firms" for 2024.

Debbie Cazan was sworn in as the new Chair of the Construction Section of the Atlanta Bar Association.

Kevin Mattingly was named a Rising Star in Construction Litigation by Washington, D.C. SuperLawyers.

David Taylor's article "10 Mistakes Lawyers Make in Commercial Mediations" was published in ABA Dispute Resolution magazine.

Jared Caplan was on the committee and spoke on a panel at the Houston Bar Association / Houston Bar Foundation's 2024 Bench Bar Conference.

Debbie Cazan Moderated 5th Annual Women in Construction Roundtable for the State Bar of Georgia.

Axel Bolvig and **Chris Selman** presented to the AL Chapter of the Construction Financial Management Association ("CFMA") on "Project Dispute Resolution - the Role of the Financial Professional."

Kyle Doiron and **David Taylor** presented "Owner's Ways to Avoid Contractor Disputes" at Bradley's 22nd Annual Commercial Real Estate Conference on May 8.

In May, **Kevin Mattingly** presented at a webinar entitled "Recent Updates in Construction Law – Cases and Legislation," sponsored by the Maryland State Bar Association's Construction Law Section.

Satisfying Surety Bond Requirements

Construction companies are typically required to obtain surety bonds to guarantee a project owner that the contractor will comply with the terms and conditions of the contract. Surety companies will ordinarily conduct an extensive underwriting review of the contractor and continue to do so periodically while the bond is in place. The underwriting review will consider the contractor's financial condition, structure, experience, and capacity to meet the requirements of the contract. The surety company will typically focus on the maintenance of a certain amount of working capital and sufficient net worth to support the construction company's business. Sureties may require financial statements from a construction-oriented CPA firm on a reviewed or audited basis. They will be interested in work in progress and the status on projects. A construction company will usually be required to execute an indemnity agreement, which may include a personal indemnity/guaranty by one or more of the company's owners that obligates the indemnitors to protect the surety from losses. Existing surety bonds likely limit the ability of the company to incur debt and therefore almost definitely will require the consent of the surety for a leveraged ESOP transaction.

Construction companies considering an ESOP should begin discussions with their surety in the early stages of the transaction. Depending on the surety's familiarity with ESOPs, this education process can take time and is best done with the help of professionals who specialize in ESOPs and can adequately communicate the ESOP deal structure and the benefits of ESOPs.

Maintaining Continuity

Many construction companies are closely held companies that do not have a business continuity plan. They may be owned by the founder or a small number of shareholders who are not working for the company. An ESOP can provide continuity by establishing a market for the purchase of shares from the controlling shareholders.

Incentivizing Employees

An ESOP is designed to provide employees with "skin in the game," thereby hopefully incentivizing them to increase the value of the company stock and their beneficial ownership. Given labor shortages in the construction industry, an ESOP can provide an important retention tool and incentive for employees to remain employed with the company and pursue long-term growth. An ESOP may also reduce employee interest in unionization.

Increasing Cash Flow

In certain settings, an ESOP can be an effective tool for increasing a company's cash flow. A contractor can reduce its corporate income taxes and increase its cash flow and thereby its net worth through an ESOP structure. If the contribution to the ESOP is made in lieu of contributions to a 401(k) plan, the cash flow savings are even greater. The additional cash can be used to finance projects and the growth of the business.

Pros

ESOPs provide a tax-advantaged path for an exit strategy, and they can provide liquidity for owners that may not be easy to obtain in a sale to a third party. ESOPs help build an ownership culture and incentivize employees to grow the company. As a related matter, they can be a useful retention tool. The increased cash flow generated by reducing or eliminating taxes can be critical to the sustainability of the company.

Cons

If a company borrows money and then lends this money to the ESOP to purchase company stock, the loan will be a liability that will reduce the company's net worth, and this loan could also affect surety bond requirements. However, these issues can largely be addressed through

seller financing and subordinated notes. Companies do have to be mindful of repurchase liability, but the right distribution policy and repurchase liability plan can address this issue.

Conclusion

ESOPs can be the right solution for construction companies, particularly closely held businesses where the selling shareholders have a need for liquidity and a desire to continue the business legacy to benefit employees.

CBCA ISSUES ANNUAL REPORT

ARON C. BEEZLEY & OWEN E. SALYERS

The Civilian Board of Contract Appeals (CBCA) recently published its annual report providing key statistics on cases filed at and adjudicated by the CBCA in Fiscal Year (FY) 2023. Of note, the CBCA found in favor of the contractor, either in whole or in part, in 45% of its decisions on the merits in FY 2023.

Among the other noteworthy statistics from this year's report are the following:

- 409 new cases were docketed at the CBCA in FY 2023.
- Of those 409 cases, 246 cases were Contract Disputes Act (CDA) appeals, and 163 cases were "other cases," including 46 FEMA arbitrations requests, 38 travel and relocation cases, and 15 debt cases.
- 358 cases were resolved by the CBCA in FY 2023, with 141 of those on the merits.
- The net change in the CBCA's total docket count from the end of FY 2022 to the end of FY 2023 was +51.
- Of the decisions on the merits in FY 2023, the CBCA granted the appeal in 10 instances, granted the appeal in part 11 times, and denied the appeal in 26 instances, which, as noted above, resulted in a finding of merit in whole or in part approximately 45% of the time.
- In FY 2023, the CBCA dismissed 174 cases, 154 of which were voluntarily dismissed and 20 of which were dismissed by decision.
- 17 FEMA hearings were conducted by the CBCA in FY 2023.
- 16 total CDA, Federal Motor Carrier Safety Administration, and debt hearings were conducted by the CBCA in FY 2023.

43 alternative dispute resolution sessions were held by the CBCA in FY 2023, 39 of which resolved the dispute and 13 of which did not.

MISTAKE NO. 2 OF THE TOP 10 HORRIBLE, NO-GOOD MISTAKES CONSTRUCTION LAWYERS MAKE: NOT EDUCATING CLIENTS ON THE PROS AND CONS OF ARBITRATION

DAVID K. Taylor

I have practiced law for 40 years, with the vast majority of that time spent as a "construction lawyer." I have seen great… and bad… construction lawyering, both when on the other side of a dispute, as well as when serving well over 300 times as a mediator or arbitrator in construction disputes. To be clear, I have made my share of mistakes. I learned from my mistakes and was lucky enough to have great construction lawyer mentors to lean on and learn from, so I have tried to be a good mentor to young construction lawyers. Becoming a great construction lawyer is challenging, but the rewards are many. The following is mistake No. 2 of the top 10 mistakes I have seen lawyers make in construction disputes, and yes, I have been guilty of making all of them.

Mistake No. 2: Not Educating Clients on the Pros and Cons of Arbitration

There are scores of articles debating the pros and cons of arbitrating versus litigating legal disputes. This article does not discuss mediation (to come later). Find four construction lawyers at a conference, buy them drinks, broach the topic, and then stand back and watch the fun. Many times, there isn't a choice when the transactional lawyers include an arbitration clause in any kind of construction contract or recommend checking the arbitration "box" in the frequently used AIA series of construction contracts.

When there's an opportunity to do so or the client requests your input, you should take the time to advise the client on the potential pros and cons of arbitration. Ultimately, the decision of whether to arbitrate or not is a business decision for the client, but you can add value to that decision by providing information on how arbitration or litigation may better suit your client's needs. If a client decides to utilize

arbitration as the dispute resolution mechanism in its contracts, you should work with the client to develop an arbitration clause that is enforceable, functional, and can be practically applied. I often encounter arbitration provisions that are mangled and unworkable.

Even fervent believers in arbitration acknowledge that this method of "alternative dispute resolution" is not a panacea for all that ails the trial system. The role of a lawyer/counselor is to present the pros and cons to the client. And there are two sides of the sword on every single arbitration "pro" and "con." Never forget arbitration clauses are contract clauses. For most every "con" there can be, if drafted carefully, language to counteract that specific "con."

Will your client need to make a claim against another company not a party to the contract or transaction if a dispute arises or obtain vital documents from a third party? There is no third-party practice in arbitration absent another arbitration clause in that other contract. And while the arbitrator has subpoena power and can sign a pre-hearing third-party document subpoena, those subpoenas may not always be enforceable.

In a failed retaining wall dispute years ago, when representing the owner (who nicely told me if we lost, he wouldn't be able to send his kids to college), the experts said that the failure was a combination of design and construction errors. The problem? There was an arbitration clause with the contractor (which wouldn't waive arbitration), but not with the engineer (who would not agree to join in any arbitration). The result? We went to arbitration first, the other side pounded "design," and the panel agreed. Zero recovery. On to the engineer in court, who pounded construction. The settlement with the engineer was not very good. You remember your losses much more than your victories. If I could have advised the client before he entered the relevant contracts with the engineer and contractor, I would have recommended that he utilize the same dispute resolution procedure in both contracts and include a robust consolidation/joinder provision in each contract allowing the owner to litigate against the engineer and the contractor in the same proceeding.

Does your client's very survival depend on getting to a quick resolution in the event of a dispute? Setting aside mediation, a large and complicated construction dispute may need weeks of testimony. Good luck in getting a quick trial date in court. Years ago, I represented an engineering company that was owed substantial monies from a manufacturer on a chemical plant. No arbitration clause. A month of hearings were needed. After the lawsuit was filed on a motion to establish a scheduling order, the judge (in a rural state county) said he could work us in in three years, which by then my client (and its 100 employees) would have been bankrupt. The good news is that even the manufacturer wanted to get the dispute over with, so we agreed to submit the disputes to private arbitration with hearing dates in a year. The matter was eventually settled, and my client survived.

What about pre-hearing depositions, which can be abused by one side and of course are incredibly expensive? Arbitration rules do not always allow for or contemplate depositions, and many arbitrators rule that they do not have the power to order depositions over objections. Many times, in my scheduling conferences with counsel when I serve as an arbitrator in smaller cases, I get incredulous indignation from one side (many times appointed insurance lawyers) when they learn they cannot take the depositions of every single potential fact witness. The remedy for those parties? Go back to the drafting of the arbitration clause: A company can certainly include in the clause the ability to take full blown pre-hearing discovery.

Should some portions of a claim, or a defense, get resolved quickly, "as a matter of law," via a pre-hearing motion like a state or federal civic procedure "summary judgment"? But… the rules of "civil procedure" do not apply to arbitrations. Are summary judgment or dispositive motions more difficult to win in arbitrations? The general consensus is yes. Much depends on the arbitrator, but the same can be said for judges. Sometimes success on summary judgment in either forum may depend on the nature of the summary judgment argument. For example, you may have more success pursuing summary judgment on arguments based on waiver or release in a court proceeding.

Finally, what about advising the client about the best of both worlds? There are presently many large developers, owners and contractors that include dispute resolution clauses that give one party the right, once a dispute arises, to choose arbitration or litigation. Although results may vary by jurisdiction, these clauses are often found enforceable.

So, the moral of this mistake is pretty simple: Don't be swayed by those that hate or love arbitration. Decide what is in the best interest for your client in the specific project considering all of the circumstances. Provide your best advice, and let the client make the final call on whether or not to arbitrate a construction dispute.