Government Contracts Blog

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Could You Be The "Beneficiary" Of The "Inadvertent" Submission Of A False Claim?

By Charles L. Kreindler and Barbara E. Taylor

Are you a parent corporation with a subsidiary that does business with a state or local government? Are you a manufacturer or supplier whose products end up down the distribution chain with a state or local government? If so, you could be the "beneficiary" of a false claim and could be liable for penalties and treble damages.

Since the 1986 amendments to the federal False Claims Act ("FCA"), 31 U.S.C. § 3729, *et seq.*, added a *qui tam* provision, an increasing number of states have enacted similar FCA statutes. Currently, twenty-nine states and the District of Columbia have general and/or health care FCA statutes with *qui tam* provisions, and another six have FCA statutes without *qui tam* provisions. California led the way in 1987, and in doing so departed from the federal FCA to include a unique provision that makes liable a person who:

1. is a beneficiary;
2. of an inadvertent submission of a false claim;
3. who subsequently discovers the falsity of the claim; and
4. fails to disclose the false claim to the government within a reasonable time.

Cal. Gov't Code § 12651(a)(8). The following states have followed California's lead to include similar provisions in their general and/or health care FCA statutes: District of Columbia; Hawaii; Kansas; Massachusetts; Montana; Nebraska; Nevada; New Hampshire; New Mexico; Oregon; Tennessee; and Wisconsin.[1] These peculiar "beneficiary" provisions are little understood, and therefore are increasingly being used by clever relator's counsel to include a whole host of "deep pocket" defendants who had nothing to do with the submission of the false claim.

First, the term "beneficiary" is not defined in any of the statutes. As a result, the term could be read broadly enough to reach anyone who somehow benefitted from the false claim. For example, could a prime contractor on a public works project be liable as a beneficiary when a subcontractor mistakenly, negligently, or intentionally inflates labor rates? Could a manufacturer who mistakenly, negligently, or intentionally does not state the true price or quality of a product supplied to a customer be liable as a beneficiary if that customer in turn sells the product to the government? Could a parent corporation or shareholder be liable as beneficiaries when a subsidiary mistakenly, negligently, or intentionally submits false claims under its contracts with the government?

Second, these statutes extend liability to this amorphous contingent of potential “beneficiaries” based merely on later acquired knowledge that a false claim was made. By definition, the “beneficiary” need not have had any role in the submission of the false claim. Under federal law, however, mere knowledge of a false claim has never been enough to impose liability, regardless of whether the person with knowledge benefitted from the false claim. *See U.S. ex rel. Piacentile v. Wolk*, 1995 WL 20833 (E.D. Pa.); *U.S. v. President & Fellows of Harvard College*, 323 F.Supp.2d 151 (D. Mass. 2004); *U.S. v. Safe Environment Corp.*, 2002 WL 976033 (N.D. Ill.).[2]

Making matters worse, there are only two published decisions on this provision—which differ wildly from each other—one disregarding principles of statutory interpretation to expand liability in an alarming manner, and the other adhering to those principles to limit liability in a sensible manner.[3]

City of Burbank ex rel. Armenta v. Mueller Co.

In 2006, the California Court of Appeal issued the first reported decision interpreting the scope of a beneficiary provision, *City of Burbank ex rel. Armenta v. Mueller Co.*, 142 Cal.App.4th 636, 645-49 [47 Cal.Rptr.3d 832] (2006) (reversing summary judgment in favor of defendants).[4] *Mueller* held, notwithstanding a scathing dissent, that the parent and great-grandparent corporations of a subsidiary corporation that allegedly intentionally submitted false claims could be liable as beneficiaries. In reaching this holding, the Court of Appeal made several pronouncements regarding statutory interpretation: (1) “third persons who did not submit the false claims themselves” can be liable, *i.e.*, “the statute does not require that the beneficiary have submitted the false claim”; and (2) the statute’s reference to the “‘inadvertent submission of a false claim’ does not preclude the imposition of liability on the beneficiary of a false claim where the claim has been submitted intentionally.” 142 Cal.App.4th at 647-48. The Court of Appeal did not discuss the manner in which a beneficiary had to benefit from a false claim, and apparently did not appreciate the consequences of conferring beneficiary status solely based on the parent-subsidiary relationship. By extending liability to a beneficiary who did not submit the claims, the *Mueller* majority set up the potential for an absurd result under the statute where a beneficiary could be liable for an “inadvertent” submission, but not an “intentional” submission. The *Mueller* majority’s solution was to, in effect, define the word “inadvertent” as including “intentional”!

Recognizing that the majority had flouted long-settled tenets of corporate law, Justice Vogel wrote a scathing dissent:

> I dissent because the majority opinion eviscerates corporate law and opens a supersize can of worms by attaching liability to parent, grandparent, and great-grandparent corporations for the acts of their direct and indirect subsidiaries based solely on status—the existence of the relationships.

142 Cal.App.4th at 655. Justice Vogel accused the majority of “ignor[ing]” two “rule[s]”: (1) “that the only basis on which the parent and grandparent could be liable for the subsidiary’s wrongdoings is under an alter ego theory based on evidence that would permit [relator] to pierce the corporate veil”; and (2) that alter ego liability can never be based on the mere fact of the parent-subsidiary relationship, or on the mere existence of common directors and officers.” *Id.* at 652 [citations omitted]. Justice Vogel then turned to what she termed “the majority’s whimsical interpretation of ‘beneficiary’ as that word is used in the [statute].” *Id.* Justice Vogel cogently explained, based on the words of the statute, legislative history, and a comparison with the federal FCA, what conduct and persons beneficiary provisions are meant to address:

> [B]y its plain language, subdivision (a)(8) of section 12651 does not apply to third persons who do not themselves submit claims. To the contrary, it applies to a person who *inadvertently* submits a false claim to a government entity, receives a benefit (hence the use of the word

> "beneficiary"), then discovers the falsity of the claim and fails to disclose it. The only difference between the California and federal acts is that, for liability to attach under the federal act, the person submitting the claim must know at the time of submission that the claim is false, whereas liability can attach under the California False Claims Act if the submission is inadvertently false *and* the beneficiary later learns of the falsity *and* fails to report it to the victim.

142 Cal.App.4th at 654 [citations omitted]. In other words, as stated by Justice Vogel, a beneficiary provision is meant "to apply only to the 'negligent claimant,' and not to a third party." *Id.*

<u>In re Pharmaceutical Industry Average Wholesale Price Litigation</u>

The *Mueller* decision focused on whether a third-party who did not submit claims could be a beneficiary and whether a third-party beneficiary could be liable where the person submitting claims did so intentionally, as opposed to inadvertently, and answered both questions yes. The only other reported case addressing the same provision, *In re Pharmaceutical Industry Average Wholesale Price Litigation*, 478 F.Supp.2d 164 (D. Mass. 2007) (granting motion to dismiss), did not even cite *Mueller*, and it is not apparent from the decision whether the district court agreed with *Mueller's* statutory interpretation. In fact, the district court was faced with a much different factual scenario—defendants (pharmaceutical manufacturers) alleged to have intentionally caused non-parties (pharmacies and physicians) to submit false claims. This conduct fits the classic definition of a violation of the substantive provisions under federal and state FCA statutes making liable a person who "knowingly presents or causes to be presented, a false or fraudulent claim" and "knowingly makes, uses, or causes to be made or used, a false record or statement." *See* 31 U.S.C. § 3729(a)(1)(A) & (B); Cal. Gov't Code § 12651(a)(1) & (2). The district court dismissed the beneficiary count and essentially gave meaning to the term "inadvertent," holding that a defendant who is alleged to have "intentionally induced" a false claim cannot have "subsequently discovered" that the claim was false:

> While the FCA should be liberally read, plaintiff's claim is a round peg in a square hole. The alleged fraud is that the manufacturers intentionally induced doctors and other providers to submit false claims to get inflated reimbursements. Thus, even if drug manufacturers are considered beneficiaries in a broad sense because they profit from increased market share, these manufacturers cannot be said to be beneficiaries of an inadvertent submission of a false claim they "subsequently discovered." The count is dismissed.

In other words, a person involved in the misconduct from the beginning cannot "subsequently discover" it. In contrast to *Mueller*, *In re Pharmaceutical Industry* focused on the *mens rea* of the beneficiary, and a beneficiary intentionally causing a false claim to be made would not escape liability – the person would just be liable under a different provision. Although the holding of *In re Pharmaceutical Industry* is favorable to defendants, as a practical matter, it does not ameliorate the negative aspects of the *Mueller* decision.

<u>Conclusion</u>

Given the current economic climate and budget deficits, state and local governments have a compelling incentive to devise inventive ways to generate revenue. Members of the *qui tam* bar are ready to assist them in any way they can, and have taken to heart the oft-repeated platitude that "[t]he False Claims Act must be construed broadly so as to give the widest possible coverage and effect to its prohibitions and remedies." *LeVine v. Weis*, 90 Cal.App.4th 201, 210 (2001), citing *Southern Cal. Rapid Transit Dist*. v. *Superior Court* (1994) 30 Cal.App.4th 713, 724. Consequently, we foresee that beneficiary provisions will be invoked more often, and additional states may amend their FCAs to include them, in an effort to cast a wider net over potentially liable parties.

If you find yourself sued under a beneficiary provision, it is important to aggressively address the proper statutory interpretation at the earliest stage, since the opportunity to shape how this little understood provision will be construed in the future is still available.

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[1] Oregon's statute uses different language: "Fail to disclose a false claim that benefits the person within a reasonable time after discovering that the false claim has been presented or submitted for payment or approval." (Or. Stat. § 180.755(1)(i).) Wisconsin's statute does not use the term "inadvertent." (Wisc. Stat. § 20.931(2)(h).)

[2] At the time of the 1986 amendments, a beneficiary provision was proposed by the proponent of the California False Claims Act, but ultimately rejected. Thus, even though federal jurisprudence can be relied on as persuasive authority when there is a lacunae in state FCA case law regarding a particular statutory provision, the absence of a beneficiary provision in the federal FCA can make federal cases inapposite.

[3] Partners Bryan Daly and Charles Kreindler presently represent J-M Manufacturing Company, Inc. ("JM Eagle") in an FCA case, *U.S. ex rel. Hendrix v. J-M Manufacturing Company, Inc.*, Case No. EDCV 06-55-GW (C.D. Cal.) ("*Hendrix*"), brought under the federal FCA and twelve state FCA statutes, five of which include beneficiary provisions. In that case, JM Eagle and co-defendant Formosa Plastics Corp. U.S.A. (JM Eagle's former parent) successfully challenged the application of beneficiary provisions on a motion to dismiss under Fed.R.Civ.P. 12(b)(6). In an unreported ruling filed December 1, 2010, albeit with leave to amend granted, Judge Wu held that the relator had failed to plead the elements of claims under the beneficiary provisions. How Judge Wu will ultimately handle beneficiary claims is unclear at this time.

[4] Partners Bryan Daly and Charles Kreindler represented three of the defendants in this case.