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Top 2017 False Claims Act developments for aerospace, defense, and government services companies

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This year, Trump appointees took the helm at the Department of Justice (DOJ) and assumed responsibility for False Claims Act (FCA) enforcement. Although fighting waste, fraud, and abuse remains a DOJ priority, total FCA recoveries in fiscal year (FY) 2017 (US$3.7bn) fell from the US$4.7bn recovered in FY 2016. Because annual FCA recoveries can be swayed by one or two large settlements in any given year – a single, mammoth US$1.2bn recovery from a bank and mortgage lender in FY 2016 more than accounts for the drop in FY 2017 – it is not yet clear that the decline in FY 2017 signals a lasting downward trend. It is clear, however, that aerospace, defense, and government services (ADG) companies continue to be targeted by qui tam relators and should expect continued FCA scrutiny. In fact, FCA recoveries at the U.S. Department of Defense (DOD) climbed to US$220m in FY 2017 (up from US$122m in FY 2016, but down from US$282m in FY 2015).

The big cases in 2017 and implications for 2018

Recoveries from ADG companies this past year included a US$95m settlement with Agility Public Warehousing Co. KSC (Agility), which also agreed to forgo administrative claims against the United States that sought US$249m in additional payments. The settlement resolved allegations that the Kuwaiti company overcharged the government for food supplied to U.S. troops by failing to disclose and pass through rebates and discounts it obtained from other suppliers, as required by its contract.

The DOJ also recovered US$16m from defense contractor, ADS Inc., through a settlement that resolved allegations that ADS and its subsidiaries violated the False Claims Act by submitting claims for payment under fraudulently obtained small business set-aside contracts. The DOJ reported that the ADS settlement "ranks as one of the largest recoveries involving alleged fraud in connection with small business contracting eligibility." This settlement follows an FY 2016 investigation of an alleged scheme to defraud the Small Business Administration's (SBA) 8(a) Business Development Program, which resulted in multiple criminal pleas and fines. Together, these two settlements suggest that the DOJ is increasingly proactive at combatting small business contracting fraud. In the ADS settlement announcement, SBA General Counsel Christopher Pilkerton commented that "identifying and aggressively pursuing instances of civil fraud by

participants in these procurement programs and other set-aside contracting programs, is one of SBA's top priorities."

Contracts with agencies other than DOD also gave rise to some significant FCA recoveries. These included a US$125m settlement with several Department of Energy (DOE) contractors that resolved allegations that the contractors charged the DOE for deficient goods and services in the course of designing and constructing waste treatment facilities at DOE's Hanford nuclear waste facility. And, a leading provider of information technology software and services, agreed to pay US$45m to resolve allegations of defective pricing. Specifically, the government alleged that the contractor failed to accurately report its commercial sales practices as required by the General Services Administration (GSA) so that the GSA would be able to negotiate a fair price and benefit from reductions should prices fall in the commercial marketplace.

Other FCA recoveries from ADG companies involved allegations that contractors misclassified costs, overcharged the government for goods or personnel time, failed to disclose that products provided to the government did not function as required by contract, or falsely certified that the company tests its products as required by contract. While these examples in enforcement and significant settlements are important, key developments in FCA jurisprudence will also shape the extent to which ADG companies face FCA exposure in the near future.

Courts grapple with parameters of implied false certification liability after Escobar: When do half-truths become actionable under FCA?

In the wake of the Supreme Court's (the Court) decision in *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016), courts have issued a number of opinions shaping when an FCA claim based on an implied false certification theory of liability can proceed past the pleading stage, survive summary judgment, or result in liability at trial.

Escobar held that the implied false certification theory can be a basis for liability, "at least where two conditions are satisfied: first, the claim does not merely request payment, but also makes specific representations about the goods or services provided; and second, the defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths." *Id*. at 2001.

The Court found the relator had alleged a "specific representation" rendered false by omission and thus did not reach the issue of whether every submission of a claim for payment implicitly represents compliance with all applicable legal requirements. The Court analyzed claims for reimbursement of mental health services that referenced specific billing codes and identifiers concerning both the "types of treatment" and "specific job titles" held by the providers. The Court found that the use of the specific codes implied the personnel who provided the medical treatment had the requisite training and qualifications required for these jobs as identified by state regulations. *Id.* at 2000.

The Court found the claims to be "clearly misleading in context" and fell "squarely within the rule that half-truths – representations that state the truth only so far as it goes, while omitting critical qualifying information – can be actionable misrepresentations." *Id.*

Because the Court limited its holding to those facts, relators and the government continue to argue that the *Escobar* standard is just one way to prove implied false certification liability. Defendants, on the other hand, argue that, at the very least, an *Escobar*-style half-truth must be alleged and proven.

Since the Court's holding in *Escobar*, some courts have held that a specific representation about goods or services provided is not always required to state a claim for implied false certification. In *United States ex rel. Badr v. Triple Canopy, Inc.*, 857 F.3d 174 (4th Cir. 2017), the Fourth Circuit held that a "misleading half-truth" could establish liability even in the absence of a clear, specific representation. The invoices at issue in *Triple Canopy* sought payment for guards providing security services at an airbase in Iraq. The contract under which the services were provided required that Triple Canopy ensure that all employees were qualified on a U.S. Army marksmanship qualification course, but Triple Canopy's guards were unable to meet the marksmanship requirement – "they couldn't shoot straight." *Id.* at 175.

Triple Canopy made no specific representation about the qualifications of the guards in its invoices, and it was not required to certify compliance with the contract's requirements when submitting invoices for payment. *Id.* at 175–76. Nevertheless, the Fourth Circuit held that Triple Canopy's actions were exactly the type of "half-truth" contemplated by *Escobar*: *Id.* at 178. The Fourth Circuit noted that as in *Escobar*, anyone reviewing Triple Canopy's invoices would probably – but wrongly – conclude that Triple Canopy had complied with core contract requirements. *Id.* Thus, Triple Canopy's actions were sufficient to support an implied false certification claim.

Several other courts have reached similar conclusions. *See United States v. DynCorp Int'l LLC*, No. 16-1473, 2017 WL 2222911 at *100 (D.D.C. May 19, 2017) (knowingly billing for unreasonable costs in violation of Federal Acquisition Regulation cost principles that require cost-reimbursable charges to be "reasonable," can give rise to an implied false certification claim even absent a specific representation); *See also United States ex rel. Wood v. Allergan, Inc.*, 246 F. Supp. 3d 772, 816 (S.D.N.Y. 2017), *appeal filed*, *United States ex rel. Wood v. Allergan*, (2d Cir. July 17, 2017); *United States ex rel. Landis v. Tailwind Sports Corp.*, No. 10-cv-00976, 2017 WL 573470 (D.D.C. Feb. 13, 2017).

In contrast, the First, Seventh, and Ninth Circuits have, to varying degrees, read *Escobar* to require a specific representation that is rendered false by the defendant's omission. The Seventh Circuit recently affirmed summary judgment after finding that the relator failed to establish that the defendant made any specific representations in connection with its claims for payments. *See United States v. Sanford-Brown, Ltd.*, 840 F.3d 445, 447 (7th Cir. 2016).

In the highly-publicized *United States ex rel. Campie v. Gilead Scis., Inc.*, 862 F.3d 890, 895 (9th Cir. 2017), the Ninth Circuit reached the complementary conclusion that the relators' allegations were sufficient because they alleged a specific representation rendered false by an omission. Specifically, relators alleged that defendant Gilead had used an active ingredient from an unapproved source in its production of certain HIV drugs and made related false statements to the FDA. The Ninth Circuit held that these allegations were sufficient under the implied false certification theory because by submitting claims for payment or reimbursement for "FDA-approved" drugs that were identified by name, Gilead impliedly certified that its drugs were those "specific drugs under the FDA's regulatory regime."

In a recent First Circuit decision, the court also suggested that a specific representation is required. In *United States ex rel. Nargol v. DePuy Orthopaedics, Inc.*, 865 F.3d 29, 37 (1st Cir. 2017), the court declined to uphold the lower court's decision to grant a motion to dismiss on the ground that the relator had not alleged that the defendant made a specific representation. However, the court did not contradict the lower court's assertion that a specific representation is

required. Rather, it took pains to find that the defendant had indeed made specific representations and went on to uphold the lower court decision on other grounds.

Government action or inaction is key to materiality after Escobar

In addition to holding that the implied false certification theory of liability is a valid basis for FCA liability, the *Escobar* court emphasized that the FCA's "rigorous" scienter and materiality requirements provided an important check on FCA liability. The Court did not offer a bright line test to determine when misrepresentations or omissions are material. It did, however, indicate that a falsity is likely material if the government in fact denied payment because of the falsity or if there is evidence that the government would have refused payment had it known of the alleged falsity at the time payment was made. *Escobar*, 136 S. Ct. at 2002-03. The Court further explained that the fact that the government paid a claim despite actual knowledge of the alleged noncompliance was "very strong evidence" that the noncompliance was *not* material. *Id.* at 2004. Not surprisingly, since *Escobar*, lower courts have examined the effect an alleged misrepresentation has had, or is likely to have, on the actual behavior of the government. In doing so, courts have scrutinized not only the government's decisions to pay claims and award contracts, but also decisions not to intervene in a qui tam.

The Fifth Circuit pointed to government inaction in the face of an alleged falsity when it overturned a US$663m judgment against a manufacturer of highway guard rail end-cap systems (the largest judgment ever imposed under the FCA). *United States ex rel. Harman v. Trinity Indus. Inc.*, 872 F.3d 645 (5th Cir. 2017). The Fifth Circuit explained that the relator's allegations that the defendant had not disclosed material design modifications to the guard rail systems had been presented to the government prior to the lawsuit. Even after being briefed on the allegedly material design changes, the government concluded that payment for the system was proper. In fact, the Federal Highway Administration issued a memorandum explaining that the challenged guard rail end-cap design had been tested and that there was "an unbroken chain of eligibility for Federal-aid reimbursement." Despite this memorandum, Trinity lost on summary judgment, at trial, and on post-trial motions. The Fifth Circuit, however, concluded that continued government payment under these circumstances raised the materiality burden for the relator and the relator had not carried this burden. *Id.* at 650, 667.

The District of Columbia (D.C.) Circuit recently ruled that agency *inaction* was "very strong evidence" against materiality. In *United States ex rel. McBride v. Halliburton Co.*, 848 F.3d 1027, 1034 (D.C. Cir. 2017), the court affirmed summary judgment for the defendant in a suit that alleged the defendant inflated headcounts of military personnel using the recreation centers it operated under contract. The court found this alleged falsity was not material where: (1) the Defense Contract Audit Agency had investigated the relators' allegations and did not disallow any charged costs; and (2) the defendant continued to receive an award fee for exceptional performance even after the government learned of the allegations. *Id.*

Similarly, in *United States ex rel. Kelly v. Serco, Inc.*, 846 F.3d 325 (9th Cir. 2017), a relator had asserted that Serco violated material contract requirements by submitting monthly cost reports that did not comply with guidelines issued by the American National Standards Institute/Electronic Industries Alliance (ANSI). The Ninth Circuit affirmed summary judgment in the defendant's favor after noting that the government (1) did not rely upon Serco's cost reports in deciding whether to pay claims; (2) accepted the cost reports despite knowing that they did not comply with ANSI standards; and (3) paid the claims. *Id.* at 334. *See also Abbott v. BP Exploration & Production*, 851 F.3d 384, 388 (5th Cir. 2017) (affirming summary judgment for

the defendant after finding that the Department of the Interior's decision to allow an oil production facility to continue operating after investigating the relators' allegations that it was constructed without compliance with various regulations was "strong evidence" that these allegations are not material).

Legally ambiguous requirements can preclude proof that a defendant's knowledge meets the FCA's rigorous scienter requirement

Last year we reported that in *United States ex rel. Purcell v. MWI Corp*. the D.C. Circuit found that the term "regular commissions" was ambiguous and that the defendant's objectively reasonable interpretation of that ambiguous term could not form the basis of FCA liability. 807 F.3d 281, 290 (D.C. Cir. 2015), *cert. denied*, 137 S. Ct. 625 (2017). The D.C. Circuit reached this conclusion despite evidence that some of the defendant's employees believed the company was applying an incorrect definition of "regular commissions." Relying on the Supreme Court's decision in *Safeco Insurance Co. v. Burr*, the D.C. Circuit indicated that the defendant's subjective intent, even assuming bad faith, did not matter if its interpretation was objectively reasonable. *Id*. at 290 (citing *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 70 n. 20 (2007)).

This year, the Ninth Circuit reached a similar conclusion. In *United States ex rel. McGrath v. Microsemi Corp.*, 690 Fed. Appx. 551, 552 (9th Cir. 2017), cert. denied sub nom. *McGrath v. Microsemi Corp.*, 17-412, 2017 WL 4155715 (U.S. Oct. 30, 2017), the Ninth Circuit held that even if the words "ITAR controlled" printed on the defendant's receipts could constitute a false representation that Microsemi was in compliance with International Traffic in Arms Regulations (ITAR), the relator failed to plead facts sufficient to support an inference that Microsemi *knew* it had failed to comply with ITAR at the time of that representation. This, the court explained, was because Microsemi had adopted a good faith interpretation of the term "disclose" in ITAR regulations that was at the time reasonable. *Id.* at *1. Although the *Microsemi* court does not state whether this interpretation must be objectively or subjectively reasonable, it also cites the *Safeco* language indicating that that subjective bad faith is irrelevant when a defendant's interpretation is objectively reasonable. *Id.* (citing *Safeco*, 551 U.S. 47, 70 n.20).

Benefit of the bargain and proximate causation cabin FCA damages

The FCA provides for penalties equal to three times the government's damages "because of" a false claim. 31 U.S.C. § 3729(a)(1). Because many FCA cases are settled out of court, there are few court opinions addressing how FCA damages should be calculated. However, two Courts of Appeals decisions issued in 2017 address this important issue.

The *Trinity Industries* decision discussed above vacated the lower court's judgment on materiality grounds. However, the court also noted an alternative ground for that result, i.e., that the proper measure of the damages in that case was zero. The court reached this conclusion because the record indicated that the agency reimbursed for purchases of the allegedly faulty guard rail units at the same rate it reimbursed for units without the allegedly material design flaws. This, the court held, strongly suggested the government valued those units equally and the government suffered no loss even if the defendant had caused materially false claim to be presented to the government. *United States ex rel. Harman v. Trinity Indus. Inc.*, 872 F.3d 645, 653 (5th Cir. 2017) (also noting that penalties could be available in the absence of damages).

The court reached a similar conclusion in *United States ex rel. Wall v. Circle C Constr., LLC*, 868 F.3d 466 (6th Cir. 2017). That case involved government allegations that the contractor paid two of its electricians about $9,900 less than the wages required by the Davis-Bacon Act in relation to

a construction contract. The DOJ pursued "nearly a decade" of litigation, demanding US$1.66m in treble damages, based on the proposition that all of the contractor's work was "tainted" by the contractor's false certifications of compliance with the Davis-Bacon Act. The Sixth Circuit, in an earlier opinion, reversed a US$763,000 judgment in favor of the government, and remanded for entry of an award of US$14,748, or less than 1% of the government's demand. In its recent decision, the Sixth Circuit again rejected the defendant's theory that the "tainted" warehouses were worthless because the government "turns on the lights every day" in those very warehouses. *Id.* at 468. The court also found the government's demand for damages was unreasonable and thus the defendant was a "prevailing defendant" under the Equal Access to Justice Act, 28 U.S.C. § 2412(d) and was eligible to be awarded its attorney's fees. *Id.* at 470. The court bluntly expressed its hope that a fee award would have a chilling effect on the government's efforts to vigorously enforce the FCA in similar cases. *Id.* at 472. A recent trend involves the continual adoption of "proximate causation" in lieu of the "but for" test. The Seventh Circuit abandoned its own precedent and joined other circuits to hold that "proximate causation" is the proper standard to determine what government losses can be attributed to an FCA defendant's fraud. *See United States v. Luce*, 873 F.3d 999 (7th Cir. 2017) (reversing and remanding the case for a damages determination under the appropriate standard). In *United States v. Quicken Loans Inc.*, 239 F. Supp. 3d 1014 (E.D. Mich. 2017), a district court also applied the proximate causation standard and emphasized that "foreseeability" is the key to adequately alleging that a false claim caused the government damages. *Id.* at 1041.

Conclusion and key takeaways

There is no indication that FCA litigation will be subsiding in 2018 and ADG companies continue to be targets for such actions. However, several legal developments may help companies defend against such claims:

- Some courts have ruled that an implied false certification theory of FCA liability must include allegations of "specific representations" that are rendered false — or a misleading half-truth — by undisclosed instances of material noncompliance with contract or regulatory requirements.
- Government action and inaction in the face of knowledge about an alleged instance of non-compliance or an alleged product defect is increasingly shaping materiality analysis.
- The Ninth Circuit has joined the D.C. Circuit in recently indicating that an objectively reasonable interpretation of an ambiguous contract or regulatory requirement may not give rise to FCA liability.

Recent court decisions have emphasized that FCA damages should be limited to the diminution in value of the product or services the government received. Alleged FCA damages must also have been proximately caused by the alleged false statement.

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