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FEATURE COMMENT: Two Steps Forward, One Step Back—The D.C. Circuit Expands The False Claims Act's Reach, But Not For Mere Mistakes

U.S. v. Sci. Applications Int'l Corp., 626 F.3d 1257 (D.C. Cir. 2010)

For Government contractors, one of the most important cases of 2010 was the D.C. Circuit's unanimous decision in *U.S. v. Sci. Applications Int'l Corp.* The Court expanded the scope of the False Claims Act (FCA) not only by adopting the implied certification theory of liability (which it had previously only implicitly endorsed), but also by holding that FCA plaintiffs need only show that a contractor withheld information about its noncompliance with a material contractual requirement, regardless of whether that requirement was an express condition precedent to payment.

At the same time, however, the Court limited the reach of the FCA in other ways. The Court rejected "collective knowledge" as an appropriate vehicle for establishing corporate knowledge of employee wrongdoing. The Court also made it more difficult to prove damages in many FCA cases, thereby lessening the potential award against contractors even if the case is successful. So while *SAIC* may be viewed as expanding the FCA's reach, it just as surely added important safeguards to protect defendants from the quasi-criminal nature of FCA liability for what are more properly breach of contract matters.

Background—Science Applications International Corp. (SAIC) executed two contracts with the Nuclear Regulatory Commission (NRC), an independent federal agency that regulates the civilian use of nuclear materials—the first in 1992 and a second in 1999. Under these contracts, SAIC agreed to provide the NRC with technical assistance and expert analysis to support potential rulemaking that the NRC was undertaking on uniform national standards for recycling and release of radioactive material. SAIC's contracts with the NRC included provisions intended to identify and prevent potential conflicts of interest by, e.g., limiting SAIC's ability to work with other companies that were regulated by the NRC. In particular, SAIC agreed to "forego entering into consulting or other contractual arrangements with any firm or organization, the result of which may give rise to a conflict of interest with respect to the work being performed under [the] contract." 626 F.3d at 1262.

Under this organizational conflict of interest (OCI) provision, SAIC had a continuing duty to disclose any such conflicts to the NRC for the life of the contracts. It also certified such compliance at the time of contract award and each time the contract was modified. Importantly, however, none of SAIC's claims for payment included an express certification that SAIC was complying with the OCI requirements in its contracts. And nothing in SAIC's contracts conditioned payment on such a certification or on SAIC's compliance with its OCI requirements.

After the Government learned that SAIC had entered into contracts with two companies that placed SAIC in potentially conflicting roles and had not disclosed the contracts to the NRC, the Government sued SAIC for violating the civil FCA, 31 USCA §§ 3729(a)(1) & (a)(2), and for breach of contract.

The thrust of the Government's case was that SAIC had knowingly submitted false claims for payment because, at the same time that SAIC was working for the NRC, SAIC knew it had OCIs that were undisclosed and prohibited by its contracts with the NRC. Even though SAIC's claims for payment did not certify compliance with these contractual OCI provisions—and nothing in the contracts made compliance with these requirements a condition of payment—the Government argued

that SAIC's claims carried an implied certification of such compliance. According to the Government, because the implied certification was false, SAIC's claims were also rendered false.

The district court agreed with the Government. In denying SAIC's motion for summary judgment,

> the district court recognized that SAIC's payment invoices themselves made no factually false statements about the services performed and contained no false express certifications of compliance with legal requirements, [but] nonetheless concluded that the government could proceed on a theory of "implied false certification" because it had presented unrebutted evidence that SAIC's allegedly false certifications of compliance with no-conflict requirements "constituted 'information critical to the [government's] decision to pay.'"

Id. at 1264. In so holding, the district court concluded that a contractor could be held liable for an implied false certification even though the underlying statute, regulation or contractual provision breached was not a condition of payment under the contract.

After a four-week jury trial, SAIC was found liable on all counts. The jury awarded the Government more than $6 million on its FCA claims. However, the jury awarded only $78 in damages for the Government's breach of contract claim. The jury's award for the FCA claims was abnormally large in comparison to the breach of contract claim because the jury concluded that the NRC would not have awarded the contracts to SAIC had it known about the OCIs. This rendered each and every invoice that SAIC submitted a "false claim" under the FCA, making SAIC liable for the full value of each contract. The jury did not consider the value of SAIC's actual performance when determining damages.

Implied False Certification Liability—At the time of SAIC's trial, before Congress enacted the Fraud Enforcement And Recovery Act of 2009 (FERA), P.L. 111-21, which amended the pertinent FCA liability provision, the FCA imposed liability on any contractor who "knowingly presents [to the Government] . . . a false or fraudulent claim for payment or approval." 31 USCA § 3729(a)(1). A "false" claim under the FCA may come in many forms. In a typical FCA case, the Government or qui tam relator will allege that a claim is false because it contains a facially inaccurate description of the goods or services provided to the Government or a request for reimbursement for goods that were never provided.

But this was not a typical case. The Government did not allege that SAIC inflated its claims for payment or failed to perform the work for which it was billing the NRC. It was undisputed that SAIC's claims were accurate reports of the services it rendered to the NRC and that the claims did not reference the OCI requirements that SAIC breached. Instead, the Government argued—and the jury found—that SAIC's claims were rendered *legally* false, despite being *factually* true, by SAIC's non-compliance with its contractual OCI requirements. Under this theory of liability, known as the false certification theory of liability, a claim for payment is false if it rests on a false representation of compliance with a federal statute, federal regulation or contractual regulation. Such a certification can be made either expressly or, as in SAIC's case, impliedly.

On appeal, SAIC conceded that its claims could be made false by an implied certification. However, SAIC argued that liability could only attach for an implied certification if the statute, regulation or contractual provision that was breached was an express condition of payment. The Government, on the other hand, argued that the statute, regulation or contractual provision at issue need not be a condition of payment to be actionable under the FCA so long as it is material to the Government's payment decision.

After noting that it had not squarely addressed this issue previously, the D.C. Circuit rejected SAIC's argument that only those requirements that are a precondition of payment are actionable. It did so because it feared that adopting SAIC's argument would create a liability-loophole for conduct that Congress intended to punish, which would allow contractors to willfully breach important contractual provisions with impunity as long as the provisions were not identified as a precondition of payment. Rather than look to whether the underlying requirement was a precondition of payment, the Court instead concluded that the proper test was materiality. To establish that a contractor's claims were false on the basis of an implied certification of a contractual provision, "the FCA plaintiff—here, the Government—must show that the contractor withheld information about its noncompliance with material contractual requirements." 626 F.3d at 1269. Thus, even though SAIC did not breach a contractual provision that was expressly made a precondition of payment, it could still be held liable for false claims if the provision was material to the Government, which trial testimony indicated it was.

Only a few weeks before the *SAIC* court reached this conclusion, however, the Fifth Circuit reached the opposite one. In *U.S. ex rel. Steury v. Cardinal Health, Inc.*, 625 F.3d 262 (5th Cir. 2010); 52 GC ¶ 398, the Fifth Circuit held that only those contractual provisions that are a precondition of payment are actionable under the FCA. It did so to protect the "crucial distinction . . . between ordinary breaches of contract" and true fraud. Id. at 268. "Not every breach of a federal contract is an FCA problem," it noted. Id. According to the Fifth Circuit, only when compliance with federal statutes, regulations, or contractual provisions is a precondition of payment is the FCA implicated. Id. at 269.

There is now a widening circuit split and considerable uncertainty as to the type of federal statutes, regulations, and contractual provisions that will, if breached, make a contractor vulnerable to FCA liability. In *SAIC*, the D.C. Circuit joined the Tenth and Ninth Circuits by adopting a materiality standard. See *U.S. ex rel. Lemmon v. Envirocare of Utah, Inc.*, 614 F.3d 1163, 1169 (10th Cir. 2010); *U.S. ex rel. Ebeid v. Lungwitz*, 616 F.3d 993, 998 (9th Cir. 2010). The Second and Fifth Circuits, by contrast, have applied the prerequisite-to-payment standard to implied certification claims, regardless of whether the breach was material to the Government's payment decision. See *Mikes v. Strauss*, 274 F.3d 687, 699 (2d Cir. 2001); 44 GC ¶ 2. Especially given the uncertainty as to whether a contract requirement is deemed to be "material," this circuit split will make it difficult for federal contractors to anticipate when a simple breach of contract, even of a seemingly minor provision, may render a claim false and violate the FCA, muddying a mandatory disclosure determination.

Despite the D.C. Circuit's rejection of the prerequisite-to-payment standard, eschewing a bright-line (or, perhaps more accurately, a relatively brighter line) rule in favor of materiality, the Court was very much aware that its decision could lead to abuses, noting that "without clear limits and careful application, the implied certification theory is prone to abuse by the government and qui tam relators who, seeking to take advantage of the FCA's generous remedial scheme, may attempt to turn the violation of minor contractual provisions into an FCA action." 626 F.3d at 1270. To lessen the risk that plaintiffs would misuse the FCA to punish ordinary breaches of contract, the Court favored "strict enforcement" of the FCA's materiality and scienter requirements. Id. at 1270.

With respect to proving materiality, the Court held that it was incumbent upon an FCA plaintiff to show that the legal requirement breached was "material to the Government's decision to pay." This would ensure that "minor contractual provisions" that were merely "ancillary" to the contract would not form a basis for FCA liability. Id. at 1271. The Court then had no difficulty finding that the OCI requirements SAIC breached were material. Several NRC contracting officers and employees testified that they would not have awarded the contract to SAIC or paid its claims had they known about the OCIs. These claims were material to the Government, in other words, because the Government would not have paid SAIC's claims had it known about the OCIs.

With respect to proving scienter, the Court held that an FCA plaintiff had to establish not only that the contractor knew that it had violated a contractual obligation but also that it knew its compliance with that obligation was material to the Government's payment decision. By strictly enforcing this two-part scienter requirement, "ordinary breaches of contract" would not be "converted into FCA liability." Id. at 1271. Applying this two-part standard to SAIC, the Court found that there was sufficient evidence from which the jury could have reasonably concluded that SAIC employees knew they were providing consulting assistance to organizations that were regulated by the NRC.

Under *SAIC*¸ the Government now must not only prove knowledge of the underlying contractual breach, as in the typical FCA case, it must also prove that the contractor knew the provision was material to the Government. Although in theory this heightened-scienter standard could give contractors comfort that they will not be held liable for breaches of minor contractual provisions that were, unbeknownst to them, material to the Government, such comfort is not assured given the uncertainty inherent in the subjective materiality standard. Ironically, this materiality standard may prove to be more difficult for the Government to satisfy, in practice, than the prerequisite-to-payment standard that it opposed, which usually involves a pure question of law that can be answered by looking to the contract or applicable regulatory or statutory framework. Now, the Government must prove that the contractor knew the provision breached was material to the Government—which in many situations may be difficult to do.

Collective Knowledge—Before a contractor can be held liable under the FCA, the Government or

qui tam relator must prove that the contractor acted "knowingly." The FCA defines "knowingly" in expansive fashion, however; the term is not limited to instances in which a contractor acts with a specific intent to defraud the Government. Instead, a contractor acts knowingly when it is has actual knowledge that its claims are false or when it acts with "deliberate ignorance" or "reckless disregard" of the truth or falsity of the information in its claims.

Following SAIC's trial, the district court gave the jury a collective-knowledge instruction. The jury was told that SAIC could be held "liable for the collective knowledge of all agents and employees within the corporation so long as those individuals obtained their knowledge acting on behalf of the corporation." Thus, if:

> that collective pool of information here gives a reasonably complete picture of . . . false or fraudulent claims or false statements, you may find that SAIC itself possessed a reasonably complete picture of the false or fraudulent claims . . . and acted knowingly.

On appeal, SAIC challenged this instruction, arguing that it conflicted with the FCA's knowledge requirement because it allowed the jury to find knowledge without the Government having to demonstrate that any single SAIC employee knew that the company's claims were false or that SAIC employees acted in deliberate ignorance or reckless disregard of their truth or falsity.

The D.C. Circuit agreed. The Court found that the instruction provided "an inappropriate basis for proof of scienter because it effectively impose[d] liability, complete with treble damages and substantial civil penalties, for a type of loose constructive knowledge that is inconsistent with the Act's language, structure, and purpose." 626 F.3d at 1274. Although the FCA was designed to punish contractors for intentionally burying their heads in the sand with respect to false claims being submitted to the Government, Congress had no intention to turn the FCA into a vehicle for punishing honest mistakes.

In SAIC's case, for instance, the collective knowledge instruction allowed the Government to establish that SAIC acted knowingly "by piecing together scraps of innocent knowledge" held by corporate employees, even though those individuals may never have had contact with one another or have known what the others were doing in connection with a claim seeking Government funds. Id. at 1275. In other words, "even absent proof that corporate officials acted with deliberate ignorance or reckless disregard . . . the fact-finder could determine that the corporation knowingly submitted a false claim." Id. at 1275. In a corporation as large as SAIC, the collective pool of knowledge that could be imputed to the corporation was too great.

The *SAIC* court's rejection of the collective-knowledge jury instruction is a landmark decision because, to date, no court of appeals has squarely addressed the issue in an FCA case.

Determining Damages—For Government contractors, one of the most alarming aspects of the Government's case was that it sought—and the jury awarded—treble damages based on the full amount of SAIC's contracts, despite the fact that the NRC did not find anything wrong with SAIC's work. Indeed, the jury awarded the Government a mere $78 on its breach of contract claim for SAIC's failure to disclose the OCIs, yet still found SAIC liable for $6 million for violating the FCA. How could this be?

Under the FCA, a contractor is liable for "3 times the amount of damages which the Government sustains" because of any false claims. 31 USCA § 3729(a). FCA damages are calculated using a benefit-of-the-bargain analysis: When a contractor agrees to provide goods or services to the Government, the proper measure of damages is the difference between the value of the goods or services provided and the value the goods or services would have had to the Government had they been delivered as promised. See *U.S. v. Bornstein*, 423 U.S. 303, 316 n.13 (1976); 18 GC ¶ 62. In a false certification case, the measure of damages is ordinarily the amount that the Government "paid out by reason the false statement over and above what it would have paid if the claims had been truthful." *U.S. v. Ekelman & Assoc., Inc.*, 532 F.2d 545, 550 (6th Cir. 1976).

At trial, however, the Government was able to side-step this traditional benefit-of-the-bargain analysis. It instead argued that SAIC was liable for the full amount of its contracts, regardless of whether the NRC received anything of value, because SAIC would not have been awarded the contracts if the NRC knew of the OCIs. The district court, in its damages instruction to the jury, implicitly approved the Government's approach to damages because it instructed the jury to *ignore* the value of SAIC's work, stating: "Your calculation of damages should not attempt to account for the value of services, if any, that SAIC conferred upon the Nuclear Regulatory Commission." Prevented from

looking at the actual value of SAIC's work, the jury credited the Government's evidence that the NRC would not have awarded SAIC the two contracts had it known about the OCIs. The NRC's damages were therefore the entire value of the contracts because, *but for* SAIC's falsity, the contracts would have been awarded to another contractor.

The D.C. Circuit rejected this approach to damages. It concluded that the district court's instruction, which barred the jury from considering the value of SAIC's work, distorted the benefit-of-the-bargain analysis. Although the Government in some situations might be able to recover the full value of payments made to a contractor, the Government had to first prove that it received no value from the goods or services delivered. But it had not done that here. The instruction therefore compelled the jury to find that SAIC's work had no value, even though it did have an ascertainable market value. On remand, the district court was told that it "should instruct the jury to calculate the government's damages by determining the amount of money the government paid due to SAIC's false claims over and above what the services the company actually delivered were worth to the government." If the jury's decision to award only $78 for the Government's breach of contract claim is any clue, however, the actual damages suffered by the Government were not much.

While the Court's holding comports with the language of the FCA, calculating the value of goods and services actually provided will be difficult in many cases. For example, what are the damages in a case involving a set-aside contract for widgets that was awarded to an ineligible contractor where the widgets were fully compliant with all requirements? The Court in *SAIC* recognized the potential difficulty in valuing such goods but saw no way around it, noting that the plaintiff bears the burden of proving damages.

Summary—Aside from its important holdings, the *SAIC* case is instructive in a number of ways. For example, it serves as a reminder that the FCA continues to be a trap for the unwary. Contractors may be exposed to FCA liability if they violate a statute, regulation or contractual provision that is material to the Government's payment decision. This is so even if nothing expressly makes compliance with that statute, regulation or provision a precondition of payment. Sometimes what seems to be a simple contractual breach may, in the Government's eyes, be fraud.

The decision also highlights the difficulty that contractors face in determining whether or not they have to make a disclosure to the Government under the Mandatory Disclosure Rule, Federal Acquisition Regulation 9.406-2(b)(1)(vi). Conduct that may violate the FCA in one jurisdiction, requiring disclosure, may not in another. For example, the case against SAIC would likely not have resulted in any finding of liability if initiated in the Second or Fifth Circuits, because the OCI requirements were not an express condition of payment, meaning that disclosure might not be mandatory.

Moreover, it is a reminder that it is important for contractors to ensure that they have proper controls in place to ensure compliance with contractual provisions, such as the OCI requirements in *SAIC*, that are integral to the contract and material to the Government. A company that can prove that it did not act recklessly, which can be done by highlighting proper controls, can go a long way towards defeating liability, and discouraging the Government or a whistleblower from initiating the case to begin with. Increasingly, future FCA cases may focus on whether a contractor buried its head in the sand with respect to false claims—having proper controls can help show that, even if mistakes were made, they were not made recklessly. This will help prevent a contractor's mere mistakes and ordinary breaches of contract from turning into FCA liability.

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