Reprinted from The Government Contractor, with permission of Thomson Reuters. Copyright © 2019. Further use without the permission of West is prohibited. For further information about this publication, please visit *http://legal.thomsonreuters.com*, or call 800.328.9352.

The Government Contractor®

Information and Analysis on Legal Aspects of Procurement

Vol. 61, No. 40 **October 30, 2019**

Focus

¶ 315

FEATURE COMMENT: The False Claims Act: Yesterday, Today And Tomorrow—What A Long Strange Trip It's Been—Part III—Tomorrow

This is the third (and final) installment in our three-part retrospective series of Feature Comments on the False Claims Act (FCA or Act), which has been occasioned by this year's 10th anniversary of the Fraud Enforcement and Recovery Act and the third anniversary of the U.S. Supreme Court's seminal FCA decision in *Universal Health Servs. Inc. v. U.S. ex rel. Escobar*, 136 S. Ct. 1989 (2016); 58 GC ¶ 219. Our first installment (61 GC ¶ 302) focused on the origins of the FCA dating back to 1863, surveyed the long period of dormancy following, and culminated in a review of the major 1986 amendments and early cases they spawned. Our second installment (61 GC ¶ 309) carried the baton forward from that point, focusing on major legislative and judicial developments that have made the FCA what it is today. This final installment—informed by the FCA's history and current state of existence—will explore trending developments and the ongoing and anticipated legislative and judicial evolution of the FCA into the near future.

Government Knowledge of Violations/Allegations?—Another burgeoning area of post-*Escobar* litigation concerns the effect of the Government's knowledge of the alleged violations—or of prior allegations of such violations. Specifically, does such knowledge and the Government's failure to act amount to evidence of immateriality? The Supreme Court denied certiorari in two cases last term, either of which would have put this issue back in play before the Court.

Gilead Scis., Inc. v. U.S. ex rel. Campie, No. 17-936, 2017 WL 6812110 (U.S. Dec. 26, 2017) (petition for cert.), involved the manufacturer of three drugs marketed by Gilead Sciences Inc. for use in HIV treatment. The record reflected the Food and Drug Administration's (FDA's) monitoring of Gilead's production of those drugs and even "warning letters" outlining potential regulatory violations, yet the FDA never rescinded its approval of Gilead's medicines. The Department of Justice never intervened (though it did file briefs in the district and appellate courts).

The Ninth Circuit found no actual Government knowledge of defendant's (later petitioner's) violations when the Government continued to pay. The Solicitor General (SG) agreed: "Most of the circumstances on which petitioner relies do not necessarily show relevant government knowledge." Br. for the U.S. as Amicus Curiae, 2018 WL 6305459 at 11. The SG encouraged the Court not to take the case.

The legal distinction forming, for materiality purposes, is often between Government knowledge of "allegations" versus "violations." Although the Supreme Court in *Escobar* addressed "actual knowledge that certain requirements were violated," one might argue that the "holistic inquiry" endorsed by the Government, Br. at 17, should at least include Government knowledge of allegations. In other words, while Government knowledge of allegations may not be enough to prove materiality, neither should it be per se insufficient; i.e., in some circumstances it should be enough to dismiss a case. The lack of elaboration by the Supreme Court is unfortunate, given how common it is in FCA cases for the Government to have heard of the alleged offending conduct at issue.

Both the Ninth Circuit and the SG emphasized that *Gilead Sciences* was at the "pleading stage." But a unanimous Supreme Court in *Escobar* said that materiality is not too fact-intensive to be examined at the pleading stage. If that is so, then courts must require more of sufficient, detailed allegations by FCA plaintiffs. For example, courts should not accept

 © 2019 Thomson Reuters

arguments that "the parties dispute exactly what the government knew and when." Br. at 10. That will, by definition, always be the case on a motion to dismiss. The question must always be whether the complaint has alleged, plausibly and particularly, facts supporting the materiality element. See *Escobar*, 136 S. Ct. at 2004 n.6.

The second case, *Trinity Industries*, involved guardrails meant for state highways, which were paid for, in part, by the Government. See *U.S. ex rel. Harman v. Trinity Indus.*, No. 17-1149, 2018 WL 949742 (U.S. Feb. 12, 2018) (petition for cert.). The defendants, producers of such guardrails, had sought a U.S. Federal Highway Administration (FHWA) safety certification, on which all 50 states relied in approving the guardrails for installation. The relator in *Trinity Industries* essentially alleged that the company had later modified the guardrails without telling the Government. Trinity and the relator met separately and repeatedly with FHWA, which was made aware of every alleged defect (before the qui tam case was filed). Ultimately, FHWA issued an official memorandum in which it "validated that the [relevant guardrail] was crash tested" and that it was "eligible for Federal reimbursement," such that there was "an unbroken chain of eligibility for Federal-aid reimbursement" during the relevant time period. Nonetheless, the district court refused to dismiss the case, the case went to trial, and the relator obtained a $575 million judgment in treble damages, $138 million in statutory penalties, and $19 million in attorneys' fees and costs.

The Fifth Circuit vacated the entire judgment, holding that the "continued approval of reimbursement" by FHWA both vitiated any claim of damages and, more fundamentally, precluded a finding of materiality.

These two cases do not necessarily suggest a circuit split or difference in approach. In fact, the Fifth Circuit in *Trinity Industries* drew "guidance" from the Ninth Circuit in *Gilead*. The principal difference is likely that the court in *Gilead* was at the pleading stage, whereas the *Trinity* court had the benefit of a record comprising full discovery and a jury trial's worth of evidence. As previously discussed, however, this is in tension with *Escobar*, where the Court went out of its way to say that materiality—which must be alleged with particularity under Rule 9(b)—is not too fact-intensive to resolve on a motion to dismiss. Thus, "discovery is needed" cannot be a "silver bullet."

Escobar* and *Touhy—In *Gilead*, after agreeing with the Ninth Circuit on the merits, the SG took an unexpected turn by promising the Supreme Court that, if the case is remanded, the Government will move to dismiss it under 31 USCA § 3730(c)(2)(A). This was based on the "merits" of the case, but also on the "burdensome discovery and *Touhy* requests" that might follow if the case proceeds. Br. at 15. With materiality cemented by *Escobar* as an essential element of liability, FCA cases should more increasingly involve some discovery into what the relevant agency knew and when they knew it.

While the notion that the Government might seek to dismiss cases where burdensome discovery might be involved is one relished by those on the defense side of FCA enforcement, the director of DOJ's Civil Fraud Section addressed attendees at the Federal Bar Association's Qui Tam Conference and offered: "Just because a case may impose substantial discovery obligations on the government does not necessarily mean it is a candidate for dismissal." He also cautioned defendants not to attempt such arguments: "Defendants should be on notice that pursuing undue or excessive discovery will not constitute a successful strategy for getting the government to exercise its dismissal authority," adding that DOJ "has, and will use, other mechanisms for responding to such discovery tactics."

Most FCA lawyers know what that means: simply refusing parties the discovery they seek. The only "mechanism" available uniquely to the Government is to hide behind the *Touhy* regulations. The "*Touhy* regulations," named after the progenitor case, *U.S. ex rel. Touhy v. Ragen*, 340 U.S. 462 (1951), prescribe the requirements that private parties must satisfy in order to obtain discovery from the Government. Each agency has its own regulations, and almost all courts review an agency's determination of whether to comply with discovery requests under the deferential Administrative Procedure Act framework. Until courts affirm that that the relevant scope of discovery should not differ based on whether the Government intervenes, the Government's position (and judicial deference thereto) will continue to disadvantage both defendants and relators seeking discovery.

Thus, the tension between *Escobar* and *Touhy*. Materiality is front-and-center after *Escobar*, and that element requires discovery into the Government's reaction (or likely reaction) to knowledge of allegations or violations. Yet at the same time, DOJ enjoys a discovery regime under which it can deny parties the ability to discover those reactions. More importantly, in our view, the Government should not be able to hide behind

© 2019 Thomson Reuters

the *Touhy* regulations when the Government—the real party in interest—possesses information relevant to the heart of the substantive issues in the case. When the Government intervenes in a case, there is no question that the defendants can use discovery to obtain all potentially relevant information—information necessary to assess the merits of the case. It is illogical to believe that such information is somehow unnecessary when the case is prosecuted by a relator rather than by the Government.

Courts may not abide this for long and may revisit either (1) whether the Government really is a "third party" for discovery purposes in declined cases or (2) even if so, whether to keep deferring to agencies' determinations under their *Touhy* regulations. Whether and how often the Government moves to dismiss cases in which discovery might be sought from its agencies will be closely watched and will impact tactical decisions at the outset of many FCA cases.

Is the Government's Discretion to Dismiss Qui Tam Cases Unfettered?—DOJ has long had the authority to dismiss cases brought by private individuals under the qui tam provisions of the FCA. See 31 USCA § 3730(c)(2)(A) ("The Government may dismiss the action notwithstanding the objections of the person initiating the action if the person has been notified by the Government of the filing of the motion and the court has provided the person with an opportunity for a hearing on the motion."). As discussed in our prior installment of this article, the Government's willingness to seek dismissal, and the grounds therefor, were recently published as DOJ guidance in what is commonly referred to as the "Granston memorandum." The Granston memo provides a non-exclusive list of grounds for seeking dismissal of part or all of a relator's case, including "Curbing meritless *qui tams* that facially lack merit (either because the relator's legal theory is inherently defective, or the relator's factual allegations are frivolous)"; "Preventing parasitic or opportunistic *qui tam* actions that duplicate a preexisting government investigation and add no useful information to the investigation"; and "Preventing interference with an agency's policies or the administration of its programs."

Regardless of the reason why DOJ moves to dismiss, there is a circuit split over the deference given to the Government when it files a motion under § (c)(2)(A). The Ninth and Tenth Circuits require the Government to justify its decision by showing that dismissal is related to a valid Governmental purpose, whereas the D.C. Circuit gives the Government an "unfettered right" to dismiss. Compare *U.S. ex rel. Sequoia Orange Co. v. Baird-Neece Packing Corp.*, 151 F.3d 1139, 1145 (9th Cir. 1998) with *Swift v. U.S.*, 318 F.3d 250, 252 (D.C. Cir. 2003). With the Granston memo, and the Government's recent decisions to dismiss or seek to dismiss several cases, this circuit split and the contours of the Government's rarely tested authority to dismiss have now taken center stage. The courts' struggles with whether the Government's authority is "unfettered" has been highlighted in a nationwide series of 11 cases brought by a company called the "National Healthcare Analysis Group" (NHAG), all of which the Government sought to dismiss. These cases have produced conflicting results, with one motion to dismiss denied and others granted. DOJ has been accused of hostility toward "professional relators," while rejoining that this "professional relator" developed its case by deceiving potential witnesses in a bare effort to turn a profit. One judge has ordered relator's counsel to show cause why he should not be sanctioned "for prosecuting this action without sufficient factual and legal support," *U.S. ex rel. SMSF, LLC v. Biogen, Inc.*, No. 1:16-cv-11379 (D. Mass.), and another judge called the Government's investigation less than "minimally adequate." *U.S. ex rel. CIMZNHCA, LLC v. UCB, Inc.*, 2019 WL 1598109 (S.D. Ill. April 15, 2019).

The NHAG web comprises 11 FCA cases spanning seven judicial districts and ensnaring 58 defendants. The cases have three unifying traits. First, they all allege the same basic theory of fraud, premised on violations of the Anti-Kickback Statute, 42 USCA § 1320a-7b(b). Second, NHAG, or a member of its corporate family, is a relator in all of them (sometimes alongside other relators). Third, DOJ has sought to dismiss *all* of them.

Regardless of how those courts decide the matter, the die has been cast: there are serious differences among the lower courts about how to decide these motions. Given the advent of the Granston memo, there is a good chance that the longstanding circuit split on whether the Government's authority to dismiss qui tam suits is unfettered will ultimately be resolved by the Court … unless Congress acts to clarify the ambiguity in the FCA.

Congress Steps in: the Grassley Letter—It has been a largely open question what lasting effect, if any, the Granston memo would have. The FCA has always had a staunch supporter in Sen. Chuck Grassley (R-Iowa), who calls himself the

© 2019 Thomson Reuters

spearhead of the 1986 FCA amendments we covered in our previous article. He recently wrote DOJ a letter (*www.grassley.senate.gov/sites/default/files/documents/2019-09-04 CEG to DOJ (FCA dismissals).pdf*) to inquire about its recent use of 31 USCA § 3730(c)(2)(A) to dismiss certain declined qui tam cases. Although one might characterize this administration's FCA enforcement policies as less aggressive than its predecessors', this letter demonstrates that FCA plaintiffs will still have a friend on the Hill so long as Sen. Grassley holds office.

Ostensibly, Grassley's primary concern was the "preservation of Government resources" rationale included in the Granston memo and cited by DOJ in its motion to dismiss *Gilead.* In the Senator's view, this is an "attempt[] to dismiss a claim by citing litigation costs." We think this ignores the second half of the Government's argument in *Gilead*, however: "In this matter, the government has a legitimate purpose for dismissal: to avoid the additional expenditure of government resources on a case *that it fully investigated and decided not to pursue*." *Gilead*, No. 3:11-cv-00941-EMC, ECF No. 183 at 12 (March 28, 2019) (emphasis added). It also ignores the full rationale articulated in the Granston memo itself: "Preserving government resources, *particularly where* the government's costs (including the opportunity costs of expending resources on other matters) are *likely to exceed any expected gain*." Justice Manual § 4-4.111 (emphasis added).

This sounds like precisely the cost-benefit analysis that Grassley repeatedly admonishes the Government for failing to conduct. DOJ is not saying simply that litigation is expensive, but that *these* costs are not justified *when compared to* the findings of DOJ's investigation *in this case*. Indeed, the intervention decision itself largely serves as the cost-benefit analysis that Grassley finds lacking. The question for DOJ attorneys at the expiration of the investigatory period is whether the costs of pursuing that case are worth bearing in relation to the merits of the case, including the damages recoverable. And when it comes to motions to dismiss, we are unaware of any case where DOJ has framed the Government's interest(s) solely in terms of cost (without relation to merit).

Grassley acknowledges that even in *Cimznhca*—the rare case where DOJ's motion to dismiss was denied—"DOJ moved to dismiss the claim arguing that the case lacked merit, but also because continued litigation would be costly." Notwithstanding a perhaps inarticulate expression at the hearing on that motion, seized upon by the district court in its opinion, DOJ has always maintained that the costs of litigation were assessed in relation to the merits of the case. See Mot. to Alter or Amend Order, *U.S. ex rel. Cimznhca v. UCB, Inc.*, ECF No. 85 at 4 (S.D. Ill. April 29, 2019) (reiterating the primary basis for dismissal: "the Relator's *unsupported allegations* do not justify the further expenditure of government resources" (emphasis added)).

Finally, Grassley neglects to mention the *courts'* take on DOJ motions to dismiss under 31 USCA § 3730(c)(2)(A). The predominant, though not universal, view comes from *Sequoia Orange Co*. In the Ninth Circuit and jurisdictions that have followed suit, the courts will ask merely whether the Government has *any* rational basis for dismissal. Conservation of Government resources has been accepted as such a basis. So, while Grassley may not approve of that legal standard, if he can't convince DOJ to change course through political pressure, it may take legislative amendment to change it.

The FCA and Tax Deductibility—Settling an FCA case has implications beyond the amount paid. One such implication is the tax treatment of said payment. Can a defendant deduct some or all of the settlement from its taxes? This topic, too, has been brought to the fore by a recent statute and implementing regulation. The outcome of that regulatory process is not over and is far from certain.

The statute is simple enough when it comes to damages and penalties: a person who violates the FCA "is liable to the United States Government for a civil penalty of not less than $5,000 and not more than $10,000 [as adjusted over time] plus 3 times the amount of damages which the Government sustains because of the act of that person." 31 USCA § 3729(a)(1). Yet calculating the "damages" can prove anything but straightforward. "There is 'no set formula for determining the government's actual damages' for an FCA claim." *U.S. v. Anghaie*, 633 F. App'x 514, 518 (11th Cir. 2015) (quoting *U.S. v. Killough*, 848 F.2d 1523, 1532 (11th Cir. 1988)).

For settlement purposes, the task is made harder still. Where the plaintiff alleges 100 false claims causing $1 million in damages, and the case settles for $2 million, how much of that $2 million are "single" damages and how much are the trebled component? How much of it represents the per-claim penalties that would have been imposed had there been a judgment finding the 100 claims to be false? The answers have implications for tax purposes.

 © 2019 Thomson Reuters

One component of the 2017 tax legislation was to reform the deductibility of business expenses under the Internal Revenue Code, 26 USCA § 162. Specifically, § 13306 of P.L. 115-97 amended the deductibility of "fines and penalties" under 26 USCA § 162(f). Previously, the Code prohibited deductions for "any fine or similar penalty paid to a government for the violation of any law." Id. (2016). The section now provides an elaborate "[e]xception for amounts constituting restitution or paid to come into compliance with law" for any amount that the taxpayer can establish either:

> (1) constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law; or
> (2) is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry [hereinafter "compliance payment"].

26 USCA § 162(f)(2)(A)(i).

The amount must also be *identified* as such in the court order or settlement agreement, although labeling it as restitution or a compliance payment "alone shall not be sufficient to make the establishment required under clause (i)." Id. § 26(f)(2)(A)(ii). Finally, the new law makes clear that there is no exception for "any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation." Id. § 26(f)(2)(B). The upshot is that restitution may be deductible, but reimbursement of investigation/litigation costs will not be.

The law also added a new reporting requirement, codified at 26 USCA § 6050X, which requires the "appropriate official" at the relevant agency to report (1) the amount of the settlement/judgment that is non-deductible under the broad prohibition against fines and penalties, (2) any amount that qualifies for the exception as restitution, and (3) any amount that qualifies for the exception as a compliance payment. This report (or "return") is to be made "in such form as determined by the Secretary [of the Treasury]." Id. § 6050X(a)(1). The same information must be provided in writing "to each person who is a party to the suit or agreement." Id. § 6050X(b).

The legislation will have immediate and important impact. First, it requires DOJ to enter the fray of dissecting and labeling money paid through FCA settlements and judgments. Second, the breakdown will have to be memorialized in the settlement agreement or judgment itself, which will allow the public to begin tracking the "multiples" at which DOJ and relators are settling cases. Particularly with regard to DOJ, this might allow defendants to make more sophisticated settlement pitches, citing recent settlements on analogous facts and arguing that they should receive a similar multiplier.

New Frontiers: Cybersecurity and the FCA—The *Aerojet Rocketdyne* Opinion and *Cisco* Settlement—We have long warned that failure to abide by the Government's growing regulatory cybersecurity requirements could lead to potential FCA liability. Two recent cases demonstrate that this prediction has now come true. The ever-changing and hard-to-implement requirements portend more cyber-based FCA suits for years to come.

In *U.S. ex rel. Markus v. Aerojet Rocketdyne Holdings, Inc.*, 381 F. Supp. 3d 1240 (E.D. Cal. 2019), defendants' former senior director of cybersecurity, compliance and controls alleged that defendants fraudulently misrepresented their compliance with the Department of Defense's and NASA's minimum security requirements for safeguarding unclassified controlled technical information. The relator alleged that, as a result, the Government was fraudulently induced to award contracts to the defendants.

The Government declined to intervene in the case, and the defendants moved to dismiss the complaint for failure to plead materiality. The court disagreed, holding that the relator's allegations that defendants did not "fully" disclose the extent of their noncompliance with relevant regulations was sufficient to survive a Rule 12(b)(6) motion. While the court did not find that compliance with cyber requirements is, in fact, material, the *Markus* decision is significant because of the ease by which a relator can plausibly plead a cybersecurity-based FCA case.

One of the defendants' more interesting arguments was that the defense industry's general non-compliance with these regulations weighed against a finding of materiality. As an aside, and as recently reported on, for example, a survey of small and medium-sized defense contractors surveyed by the National Defense Industrial Association found that less than 60 percent of respondents had even read the Defense Federal Acquisition Regulation Supplement requirement documentation, and over 45 percent had not read the National Institute of Standards and Technology publication that forms the foundation for the DFARS requirements. See *nicholsliu.com/cybersecurity-as-an-insecurity-in-the-fca-space/#_ftn2*. Without conceding the point, the court held that

© 2019 Thomson Reuters

"[e]ven if the government never expected full technical compliance, relator properly pleads that the extent to which a company was technically compliant still mattered to the government's decision to enter into a contract." If this reasoning takes hold, relators would need only allege that some misrepresentation or omission was made in describing one's cybersecurity safeguards in order to survive a motion to dismiss.

It is challenging enough to keep up with the ever-evolving federal regulatory landscape on cyber. The prospect of having to face qui tam suits based on any perceived misrepresentations regarding compliance only raises the stakes. But the task is made harder still by the differing degrees to which agencies demand protection. This is exemplified in *Markus*, where DOD's regulations define "adequate security" as "protective measures that are commensurate with the consequences and probability of loss, misuse, or unauthorized access to, or modification of information" (48 CFR § 252.204-7012(a)), but NASA's regulations rigidly required contractors "to protect the confidentiality, integrity, and availability of NASA [information] and protect [it] from unauthorized disclosure" (48 CFR § 1852.204-76(a)). On top of these technical and legal challenges, Ellen Lord, DOD Undersecretary for Acquisition and Sustainment, stated in January that DOD will begin auditing the cybersecurity procedures of companies that seek to do business with the Government.

In what may be the first settlement of an FCA case involving cybersecurity fraud, Cisco Systems agreed this year to pay $8.6 million to settle a whistleblower's claim that it improperly sold video surveillance software with known vulnerabilities to federal and state governments. The whistleblower, James Glenn, was a Cisco subcontractor who claimed that even a person with "moderate knowledge of software/network security" could gain access to Cisco's video feeds, access users' passwords, access all stored data on the system, modify or delete video feeds, and even grant themselves "administrator" privileges within the system. Glenn alleged that Cisco had known for years about these critical security flaws in its "Video Surveillance Manager" (VSM) program but had never told its Government customers and continued selling to them.

This case connects the dots from cybersecurity noncompliance to FCA liability. The theory of the case was that Cisco's non-disclosure of known cyber vulnerabilities rendered its federal and state claims false or fraudulent. Specifically, the complaint alleged that (1) VSM was "worthless," tainting all claims submitted for that product; (2) VSM did not comply with Federal Information Security Management Act or other federal requirements, which rendered false Cisco's express and implied representations of compliance; and (3) because its contracts entailed a duty to repair or replace nonconforming goods, Cisco's failure to do so was a knowing avoidance of an obligation to the Government, i.e., a reverse false claim. Although the settlement agreement may not admit liability on these theories, the settlement and its price tag demonstrate how exposed cyber companies are when they deal with the Government.

We expect to see many other cyber-FCA cases unsealed in the coming years. The *Cisco* case is the culmination of a whistleblower complaint filed more than eight years ago. DOJ intervened in the suit for the purpose of settlement, joined by 18 states and the District of Columbia.

Conclusion—The FCA has had a long and storied history since its humble beginnings in the latter half of the 19th century. It has been a history embroidered legislatively and judicially and both bolstered and emasculated at times through various fits and starts. If its history teaches us anything, it is that the only prognostication that is certain is its uncertainty. It is clear, however, that industries such as Government contracting and healthcare will almost always remain in the Government's FCA crosshairs. But it is equally clear, however, that such industries will not be alone. The new battlegrounds of FCA enforcement will likely include financial services, higher education, natural resources, energy and beyond and, as Government programs change, spending imperatives are adjusted, and technology evolves, the types of enforcement actions are virtually limitless. With that said, understanding the FCA's history and development, understanding the important role it plays in American law, and anticipating its potential impacts are essential for any FCA practitioner now, and in the future.

This Feature Comment was written for The Government Contractor by* Robert "Bob" T. Rhoad *and* Andy Liu, *partners at Nichols Liu LLP, a boutique firm serving Government contractors. Bob and Andy focus their practices on False Claims Act investigations and litigation. ***The authors would like to acknowledge Andrew Victor, a Nichols Liu associate, and Jason C. Lynch, their former colleague, for their significant contributions.***

 © 2019 Thomson Reuters