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Focus

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FEATURE COMMENT: Government Contractors Beware; Recent Federal Appellate Decisions Are Sure To Fuel Increased FCA Litigation

U.S. ex rel. Little v. Shell Exploration & Prod. Co., 2012 WL 3089777 (5th Cir. July 31, 2012)

U.S. ex rel. Hooper v. Lockheed Martin Corp., 2012 WL 3124970 (9th Cir. Aug. 2, 2012)

Two recent federal appeals court decisions are sure to fuel the already explosive growth of False Claims Act litigation and suggest that the courts are out of touch with the realities of today's Government contracting world. First, in *U.S. ex rel. Little v. Shell Exploration & Prod. Co*., the U.S. Court of Appeals for the Fifth Circuit held that a federal auditor, "even one whose job it is to investigate fraud," has standing to bring a qui tam lawsuit based on evidence uncovered during the course of his employment. In so holding, the court rejected the amicus curiae argument of the U.S., on whose behalf every qui tam action is brought, urging the court to construe the FCA as barring such actions. Second, in *U.S. ex rel. Hooper v. Lockheed Martin Corp*., the Ninth Circuit held, as a matter of first impression, that fraudulent underbids or false estimates used to procure Government contracts may violate the FCA. In that case, the U.S. in its amicus curiae brief acknowledged that "there are a number of legitimate reasons why a contractor could make an intentionally low bid," but nevertheless argued in favor of a broad fraud-in-the-inducement theory of FCA liability that penalizes fraudulent bids even in the absence of subsequent attempts to overcharge.

U.S. ex rel. Little v. Shell Exploration & Production Co.—*Relevant Background*: The FCA, 31 USCA §§ 3729–33, imposes treble damages and civil penalties on persons or entities who submit "false claims" for payment or commit certain acts of fraud against the U.S. The FCA contains unique enforcement mechanisms that enable private individuals (known as "relators") to bring "qui tam" actions on the Federal Government's behalf and share in up to 30 percent of any recovery.

There has been a precipitous increase in FCA litigation and enforcement following the passage of FCA amendments in 1986 that strengthened whistleblower powers, protections and incentives. According to recent statistics from the Department of Justice, since that time, total FCA recoveries have exceeded $33 billion, including more than $21 billion attributable to whistleblower or qui tam matters. In 2011 alone, whistleblowers initiated 638 new FCA matters (nearly 85 percent of all new matters) and received more than half of a billion dollars in relator share awards.

The text of the FCA contains few restrictions on the types of individuals who may bring a qui tam action. Courts, however, frequently have grappled with the issue of whether a Government employee has standing to bring a qui tam action based on information learned during the course of employment, particularly if the employee is obligated to investigate and disclose fraud by virtue of his or her job duties. Courts steadfastly have refused to create a per se rule banning Government employees from acting as relators. Several courts, however, effectively have precluded Government employees from serving as relators under the FCA's public disclosure bar.

Under the FCA's public disclosure bar, a private individual may not bring an action based upon allegations that already have surfaced in the public domain, unless he or she qualifies as an "original source." See 31 USCA § 3730(e)(4). The original source provision recently was amended, but for many years the statute required an individual seeking to qualify as an original source to prove that he voluntarily provided the information underlying the qui tam complaint to the Government prior to filing, and that he or she possessed direct and independent knowledge of the alleged violation.

In cases in which there had been a public disclosure, the majority of courts to address this issue held that a federal employee could not satisfy the original source exception because (1) the employee's preexisting duty to investigate and disclose fraud precluded him or her from "voluntarily" providing information to the Government, or (2) the putative relator's information could not be "independent" because it was derived from efforts to uncover fraud on behalf of the Government. See, e.g., *U.S. ex rel. Fine v. Chevron, U.S.A., Inc.*, 72 F.3d 740, 743–44 (9th Cir. 1995) (en banc) ("The district court is surely correct in its conclusion that [relator] was no volunteer. He was a salaried government employee, compelled to disclose fraud by the very terms of his employment.").

But as the Fifth Circuit acknowledged in *Shell*, "only if a public disclosure has occurred ... will it become relevant whether the relator was an original source for the information." In other words, the original source issue arises only if there has been a public disclosure, such as a disclosure in the news media, prior litigation, or an administrative report or hearing. In *Fine*, for example, the parties agreed that the action was based upon information that had been publicly disclosed.

In many instances, however, federal employees will have access to nonpublic information, and there may never be a qualifying public disclosure. Unfortunately, although most courts have acknowledged the strong public policy concerns and federal conflict-of-interest regulations that might operate to bar federal employees from serving as relators even in the absence of a public disclosure, courts have refused to impose an outright ban.

The Federal Government, which stands to receive the lion's share of any FCA recovery, consistently has argued that employees, such as Government auditors, attorneys and investigators, should be precluded from maintaining qui tam actions. As the U.S. ably stated in its amicus curiae brief in *Fine,* Government employees have the following perverse incentives:

> [T]o spend work time looking for personally remunerative cases ... rather than doing their assigned work; to conceal information about fraud from superiors and government prosecutors so that they can capitalize on it for personal gain; to race the government to the courthouse to file ongoing audit and investigatory matters as *qui tam* actions before those cases have been sufficiently developed by the government to justify a lawsuit, thus prematurely tipping off the target, undermining the likely effectiveness of the case, and diverting unnecessarily up to 30% of the government's recovery to the government employee; and to use the substantial powers of the federal government conferred upon public investigators ... to advance their personal financial interests. Contractors will be deterred from cooperating with Inspector General investigations and audits because they fear, legitimately, that their confidential work papers will be appropriated by Inspector General employees for their personal use in filing *qui tam* actions, rather than for legitimate governmental functions. Criminal prosecutions will be seriously compromised, since IG employees are often the government's prime witnesses in criminal and civil fraud cases, and their personal interest in the outcome of their audits and investigations will make their testimony highly impeachable. Public confidence in the integrity and impartiality of government audits and investigations will necessarily decrease.

Fine at 745 (citing Amicus Brief of the United States in Support of Defendants-Appellees' Petitions for Rehearing and Suggestions for Rehearing En Banc at 8–9 (footnotes omitted)).

The U.S. echoed this sentiment in its recent amicus brief in *Shell*, adding,

> When a government employee uses information obtained in the scope of his employment to further his own financial interests in a *qui tam* suit, this conduct violates the federal conflict-of-interest statute and regulations regardless of whether there has been a 'public disclosure' of that information.
>
> Indeed, where there has been no public disclosure of the relevant information, a government employee's use of that information in a *qui tam* suit is an even more egregious violation of the conflict-of-interest rules because the information is non-public and was available to the employee solely by virtue of his employment.

The Fifth Circuit's Opinion in Shell: In *Shell*, the Fifth Circuit recently had the opportunity to bar Government employees who acquire information about false claims in the scope of their official Government duties from bringing qui tam actions even in the absence of a public disclosure. The Court, instead, held that two Department of the Interior auditors had standing to bring an FCA action against a Government contractor based on information they acquired during the scope of their official duties to audit royalty payments on federal oil and gas leases. The Court held that neither the statutory text of the FCA, federal conflict-of-interest statutes, nor federal ethics regulations prohibited federal employees from acting as relators.

The Court also determined that its ruling would not lead to "absurd" or unworkable results because the Government is free to intervene and move to dismiss qui tam actions, and can promulgate new (or enforce old) personnel guidelines ensuring employee fidelity to agency enforcement priorities (which, obviously, did not constrain the relators in *Shell*). Ultimately, the Court remanded the case to the district court to determine whether the action was based upon a public disclosure. The Court noted that a federal employee obligated to disclose fraud cannot be said to have voluntarily provided information to the Government prior to filing, and, thus, cannot qualify as an original source.

The Ramifications of Shell *in Today's World of Government Contracting and FCA Enforcement*: Following *Shell*, Government employees, including auditors and others specifically tasked to detect fraud, now have a huge financial incentive to misuse their jobs for private gain. Some might argue that *Shell* merely preserves the status quo and should not cause more Federal Government employees to act as relators. But the landscape is vastly different now than it was at the time of *Fine* and other relevant appellate court decisions.

First, since Dec. 12, 2008, under the Federal Acquisition Regulation, Government contractors have been legally obligated to investigate and self-report "credible evidence" of FCA violations or significant overpayments to the Federal Government. See 73 Fed. Reg. 67064 (Nov. 12, 2008); 48 CFR § 52.203-13. Contractors who fail to do so are subject to suspension or debarment (in addition to FCA liability), which for many Government contractors can be the equivalent of a corporate death sentence. "Credible evidence" and other key terms are not defined in the FAR, and as a result some contractors may err on the side of disclosing any possible overbilling, overpayment or FCA violations.

And if a contractor does not have internal policies and procedures that include a reasonable definition of credible evidence and set forth a reasonable time frame for disclosure once credible evidence is obtained, or if a contractor fails to disclose a violation in an undefined "timely manner," this may lead to an audit finding of an "an internal control deficiency," which may lead to the suspension of payments under a contract. See, e.g., Defense Contract Audit Agency Contract Audit Manual (DCAM) § 5-306.3(6). In addition, under the FAR, covered contractors must provide "full cooperation with any government agencies responsible for audits, investigations, or corrective actions." 48 CFR § 52.203-13. Full cooperation includes disclosure "of the information sufficient for law enforcement to identify the nature and extent of the offense and the individuals responsible for the conduct ... [and] providing timely and complete response to Government auditors' and investigators' request for documents and access to employees with information." Id.

In other words, contractors are required to disclose evidence of possible FCA violations to federal employees, who have virtually unfettered access to the contractor's files and personnel, but who are (under *Shell*) apparently free to turn around and use that information against the contractor in a qui tam action—even if others within the relevant contracting agency or DOJ determine that the alleged misconduct does not warrant further investigation or enforcement under the FCA.

Second, Government auditors wield more power and have greater access to nonpublic information about Government contractors than ever. DCAA, for example, now employs nearly 4,200 auditors. See *www.dcaa.mil*. DCAA and other federal agencies have the authority to audit most aspects of a contractor's operations and performance, including accounting, pricing and billing processes, and DCAA assists in determining whether contract costs are allowable, allocable and reasonable.

Significantly, even though DCAA auditors admittedly are not trained to investigate fraud or illegal acts, they are obligated to design and carry out audit procedures to detect fraud or false claims. See, e.g., DCAM § 1-102(c) ("Although the detection of fraud or similar unlawful activity is not the primary function of contract audit, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the contractor submissions and supporting data are free of material misstatement, whether caused by error or by fraud."). DCAA auditors are instructed to detect, report, and immediately (prior to completion of the audit if necessary) refer "fraud indicators" or suspicions to the proper authorities, including DOJ (via the DCAA justice liaison). DCAA also assists in developing evidence for use during FCA and other fraud actions.

On Dec. 19, 2008, shortly after the effective date of the FAR rules discussed above, DCAA issued revised audit guidance that demands greater contractor responsiveness than ever.

> When an auditor requests supporting data/documentation from a contractor (either verbally or informally in writing), the … contractor should be provided a reasonable time period to provide the data given the specific circumstances. … [U] nless the request requires analysis by the contractor, or there are extenuating circumstances … the contractor should provide the data upon request.

See DCAA Audit Guidance on Denial of Access to Records Due to Contractor Delays, 08-PAS-042(R) (Dec. 19, 2008). A contractor must provide access to personnel, and auditors generally must obtain supporting documentation directly from the person responsible for the information. If a contractor does not provide requested information or fully cooperate, this may lead to a finding of an "an internal control deficiency," and DCAA may follow procedures to suspend or withhold payments.

In addition, revised audit guidance exposes contractors to greater risk of "inadequate" internal control systems audit findings, which in turn could be used as evidence of a "knowing" FCA violation. In the past, Government auditors could issue an opinion that an internal control system was inadequate *in part* and could make suggestions for improvement. The revised guidance eliminated the ability to issue an "inadequate in part" opinion and now prohibits suggestions for improvement. See DCAA Audit Guidance on Significant Deficiencies/Material Weaknesses and Audit Opinions on Internal Control Systems, 08-PAS-043(R) (Dec. 19, 2008).

Finally, not only is it good practice to fully cooperate with federal auditors, *it is a crime* for a person or corporation to influence, obstruct or impede a federal auditor in the performance of his or her official duties. 18 USCA § 1516; DCAM § 4-708. In this audit environment, few contractors who suspect an auditor has ulterior, personal motives to seek evidence in support of a possible a qui tam action are willing to resist production and risk the threat of being found nonresponsive to the auditor's demands.

Similarly, Government contractors regularly negotiate with contracting officers over contract terms, billing rates and cost proposals. Indeed, as was the case in *Hooper* (discussed below), many Government contractors have daily interactions with such employees to discuss or resolve legitimate disagreements over contract terms, rate setting and cost accounting (which involves uncertainties due to the complexity of governing regulations and unique cost accounting provisions). Under *Shell*, virtually every disagreement over allowable costs, contract performance or billing rates could lead to a qui tam action by an overzealous CO motivated or biased by the prospect of receiving a relator share award. In the current economic environment, the potential for huge FCA bounties may be a temptation that few Government auditors are able to resist.

Third, *Shell* is the first appellate decision on point since Congress amended the FCA's public disclosure bar. Recent amendments narrowed the types of disclosures that may constitute a "public disclosure," eliminated what was an absolute jurisdictional bar in favor of providing DOJ with veto power, and eliminated the "direct and independent knowledge" requirement in favor of "knowledge that is independent of and materially adds to the publicly disclosed allegations or transactions." 31 USCA § 3730(e)(4)(B).

It is thus far harder now to obtain dismissal of a Government employee's lawsuit under the FCA's public disclosure bar. And unlike a per se rule banning federal auditors from bring qui tam actions based on information learned during the course of employment, a possible public disclosure dismissal places the burden on the FCA defendant to establish that the action is based upon a public disclosure, and necessitates motion practice, possibly accompanied by discovery into the relevant issues, at great expense to FCA defendants and burden to the judiciary.

Finally, the *Shell* Court's statement that the Government is free to intervene and move to dismiss a qui tam action brought by a federal employee is little comfort to most Government contractors, as it requires an already overburdened DOJ to take affirmative action. In many cases, the Government may decide it is in its best interest not to intervene and to wait on the sidelines while the federal employee (and his or her private counsel) litigates the case. After all, in such a case, the Government has virtually nothing to lose, and at least 70 percent of any possible recovery to gain.

***U.S. ex rel. Hooper v. Lockheed Martin Corp.*—**In *Hooper*, the Ninth Circuit endorsed a broad fraud-in-the-inducement theory of FCA liability when it reversed the dismissal of an FCA case against a Government contractor based on the qui tam relator's allegation that the contractor submitted a falsely understated bid to improve its chances of winning a contract with the Air Force. The contractor argued, in relevant part, that bids or estimates inherently are subjective and uncertain, and, thus, are not actionable "false statements" within the meaning of the FCA.

The Ninth Circuit rejected the argument, ultimately holding that the district court erroneously applied the scienter element of an FCA violation. See 31 USCA § 3729(b)(1) (defining "knowingly"). The Ninth Circuit, unlike the district court, concluded that the relator had proffered sufficient evidence to create a genuine issue of material fact whether the contractor acted with "reckless disregard" or "deliberate ignorance" of the truth when it submitted its bid. The decision is remarkable (and alarming) for several reasons.

First, the defendant produced a memorandum from the Government (i.e. the real party in interest and the allegedly defrauded party), demonstrating that the Air Force *knew* at the outset that the contractor's cost estimate and risk analysis was "optimistic," "unrealistic," "understated," and "result[ed] in an overstated potential for cost savings," but awarded the contract anyway "knowing that it was possible that there were 'risks' that might 'lead to cost growth beyond target cost.' " The Government awarded the contract and accepted the offer (which was not the lowest offer) because it provided "the best overall value." In other words, the Government was not *fraudulently* induced to award the contract to the lowest bidder.

Although this type of "Government knowledge" frequently does—and logically should—preclude a finding of an attempt to defraud, the Court never even addressed the issue with respect to the fraudulent underbidding claim. Yet, just a few pages later in the opinion, the Court upheld dismissal of a separate claim (based on alleged fraudulent testing) because the Air Force was aware of and approved the defendant's testing procedures. This internal inconsistency is difficult to reconcile.

Second, this scenario is quite common in the Government contracting world. Costs often are unpredictable, which is a primary reason why the Government awards cost-reimbursement contracts like the one at issue in *Hooper*. See 48 CFR § 16.301-2 (the Government awards cost-reimbursement contracts if "[u] ncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.").

Private individuals should not be permitted to second-guess the motives of contractors in this "uncertain," pre-award environment, in which the Government fully expects future discussion, negotiation, proof and agreement about *actual* costs and reimbursement. Actual costs frequently exceed initial estimates, and Government contracts frequently experience cost overruns for entirely legitimate reasons. *Hooper*, however, increases the likelihood that Government contractors will be forced to defend FCA actions whenever actual costs exceed initial projections.

Third, there are many legitimate reasons for contractors to submit intentionally low bids. A contractor may decide to forgo profit or even incur a loss on certain contracts in order to satisfy a Government agency customer. Indeed, as the Government recognized in its amicus brief, a "bidder might believe that performing a certain project will lead to future, profitable business opportunities; or a contractor might decide it is in its interests to do a project at a loss in order to keep its employees employed, rather than having to lay them off (and later rehire them)." And the Government should be free to take advantage of such offers.

The Government Accountability Office, in fact, repeatedly has concluded that "a protester's claim that another firm submitted an unreasonably low price—or even that the price is below the cost of performance—is not a valid basis for protest." See *Gov't Contracts Consultants*, Comp. Gen. Dec. B-294335, 2004 CPD ¶ 202. GAO routinely rejects bid protests premised on alleged underbidding because, as it recognizes, "[a] firm, in its business judgment, properly may decide to submit a price that is extremely low." Id. Following *Hooper*, a disappointed competitor who cannot provide a legally cognizable basis for rejection of an understated bid may choose instead to pursue a qui tam action.

Fourth, a false claims action, as the title of the statute implies, requires proof of a false or fraudulent "claim." An estimate, bid or proposal is not itself a demand for payment. The Ninth Circuit focused solely on the scienter issue, and never discussed this "falsity" element—i.e., whether relator offered evidence sufficient to show that the defendant's understated cost proposal—even assuming it was intentionally understated—somehow resulted in a demand for money the Government did not owe. In contrast to the typically objective falsity element, it can be far more difficult to resolve the scienter issue prior to trial, as scienter may be a fact-intensive inquiry into subjective areas, such as a contractor's motives or knowledge.

Conclusion—Government oversight has never been more intense, Government auditors have never had more power, whistleblower activity and FCA recoveries are at record high levels, and FCA enforcement has never been more effective. And Congress in the past three years already has strengthened the FCA through statutory amendments removing court-imposed constraints. These recent appellate cases, encouraging Government auditors to pursue qui tam actions, expanding the fraudulent inducement theory of FCA liability, and increasing the likelihood that qui tam actions cannot readily be resolved via pre-trial motions, add fuel to a fire that already is raging out of control. Government contractors should be aware of these decisions and should implement and maintain robust internal control systems to monitor and manage these FCA risks.

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