Going From $0 To $232 Million With No Evidence Of Harm: DOJ's New Damages Theory In FCA Fraudulent Inducement Cases, And How To Fight Back.

by Julie M. Carpenter

The False Claims Act has long been a high-stakes tool for government to both deter fraud among government contractors and to repair damages to the public treasury caused by such fraud. A new damages argument by the Department of Justice is poised to dramatically raise those stakes: DOJ claims that in fraudulent inducement False Claims Act cases, every payment made under the fraudulently induced agreement constitutes actual damages, even when the government has not lost any money as a result of the fraud.

From its origins in Civil War price-gouging and cheating, the False Claims Act was specifically designed to protect the "funds and property of the Government from fraudulent claims."[1] The Act was designed "to reach all types of fraud, without qualification, that might result in financial loss to the Government."[2] To protect the funds and property of the government, then, in addition to penalties, the Act authorized the recovery of "damages which the Government sustains because of the act of that person."[3] Such FCA damages occur when "the defendant made fraudulent claims that caused or would cause economic loss to the United States Treasury."[4] And the measure of such economic loss has long been the difference between what was actually paid for the goods and services and what the government would have paid but for the fraudulent claim.[5] The statute then requires that those actual damages are trebled.

With their sights on treble damages, it is not surprising that DOJ lawyers aim for the largest actual damage number they can find before trebling. But this new damages theory seeks to re-define False Claims Act damages to make economic loss irrelevant. Indeed, the argument simply declines any government obligation to prove damages by showing what it would have paid for those goods and services without the fraud. The necessary corollary is that even where the government suffers *no* economic loss, it is entitled to recover damages based on the total of all payments made.

Fifth Circuit Decision in Longhi Grant Case Sets the Stage

The new theory has its genesis in the context of FCA cases involving government research grants. The best known of these is a Fifth Circuit case called *U.S. ex rel. Longhi v. Lithium Power Technologies*, 575 F.3d 458 (5th Cir. 2009). There, a small business misrepresented itself on a grant proposal to induce the government to award it a Small Business Innovation Research grant. When the false statements about the company were discovered, the government sued under the FCA and claimed damages consisting of the total value of the grant monies it had paid out. Because the agreement was a grant, the government had bargained for, and had received, no goods or services in exchange for the grant monies. The Fifth Circuit noted it was "impossible" to measure the intangible benefit of helping eligible small businesses to progress, which was the point of the bargain the government made with the company. Therefore, the Court concluded that where the government had not received anything as the benefit of its bargain, damages consisted of all the payments made under the grant. But the Fifth Circuit explicitly distinguished that research grant case before it from other "standard procurement contract" cases:

"The contracts entered into between the government and the Defendants did not produce a tangible benefit to the BMDO or the Air Force. *These were not, for example, standard procurement contracts where the government ordered a specific product or good*. The end product did not belong to the BMDO or the Air Force. Instead, the purpose of the SBIR grant program was to enable small businesses to reach Phase III where they could commercially market their products. The Government's benefit of the bargain was to award money to eligible deserving small businesses. The BMDO's and the Air Force's intangible benefit of providing an 'eligible deserving' business with the grants was lost as a result of the Defendant's fraud. . . .

In a case such as this, *where there is no tangible benefit to the government*, and the intangible benefit is impossible to calculate, it is appropriate to value damages in the amount the government actually paid to the Defendants."

Longhi, 575 F.3d at 473 (emphasis added).[6] Thus, the explicit basis of the Court's damages decision was that the benefit of the bargain for the government in that grant case was different from the benefit of the bargain in a "standard procurement matter where the government ordered a specific product or good." *Id.*

DOJ Seeks To Extend Longhi Contrary to its Explicit Reasoning

Notwithstanding the Fifth Circuit's clear distinction between grant cases and standard procurement cases, DOJ now posits the following: *Longhi* was a fraudulent inducement case; actual damages in *Longhi* consisted of the total payments made by the government; *ergo,* in all fraudulent inducement cases, actual damages are total payments made by the government. And it has gotten one court to at least potentially agree with it.

In a False Claims Act case filed in the Southern District of Mississippi, the government alleged that a contract was fraudulently induced because one bidding team had received more information about the upcoming project than another bidding team. *U.S. ex rel. Magee v. Knesel, et al.*, No. 1:09cv324 (S.D. Miss.). The contract was to provide IT goods and services (computers and other equipment, technicians, and a suitable building) to meet data storage needs for multiple government agencies. The awardee-defendants had performed under the contract for four years, obtaining six ratings of "excellent," one "above average," and one "average." For these goods and services, the government paid $116 million.

At summary judgment, defendants asked the Court to rule on the proper measure of damages. Without mentioning the distinction between grants and procurement contracts explicitly articulated in *Longhi*, DOJ argued that *Longhi* established this rule: "In a fraudulent inducement case, where the defendant had no right to perform the contract, the benefit of the bargain rule does not apply – since the Government would never have agreed to the contract but for the defendant's fraud." *Magee*, U.S. Opposition to Motion for Partial Summary Judgment at 11 (Dkt No. 491).[7] Thus, DOJ claimed that the new measure of damages for any fraudulently induced agreement was "the entire amount [the government] paid under an obligation that arose as a result of fraudulent inducement by defendants in violation of the False Claims Act." *Id.* at 2.

In *Magee*, the parties had all agreed that the government had paid approximately $116 million for the building, computers, servers, equipment, and IT services provided under the contract. DOJ argued that actual damages were therefore $116 million. In discovery, it admitted that it had not determined the price it would have paid if the fraudulent conduct had not occurred. And it admitted that it had received and retained the goods and services it had purchased under the contract. Thus, the government had no evidence it could have offered at trial that it would have paid another price for those goods and services had there been no fraud. In short, *the government lost $0 as result of the alleged fraud.* Nevertheless, based on these facts, the government's damages calculation went something like this:

"Actual" damages *(Total payments by US under contract)*	$116 million *(100% of total payments)*
Trebled *(per FCA statute)*	x 3
	$348 million *(300% of total payments)*
Minus the value of goods and services received by US under the contract	- $116 million *(100% of total payments)*
Total "damages"	$232 million *(200% of total payments)*

Without showing that the public treasury lost so much as a penny, DOJ therefore sought to leverage $0 in actual damages to $232 million in trebled damages.

In an oral decision from the bench (after denying argument on the issue), the District Court appeared to agree with the government. Like DOJ, the Court ignored the explicit grant-versus-procurement contract distinction in *Longhi*. Instead, the Court cited a *Longhi* footnote in which the Fifth Circuit considered whether and when any hypothetical and extra-contractual "benefit" to the government resulting from the research into batteries (such as possible future government purchase of the batteries once they were developed) should be considered in the damages calculation. In *dicta*, the Fifth Circuit said that if there were any quantifiable benefit, it would be subtracted after actual damages were trebled. In *Magee,* the District Court apparently equated the bargained-for, tangible, contractually-provided goods and services provided by the *Magee* defendants with the hypothetical, intangible, and extra-contractual "benefits" referenced in the *Longhi* footnote. Accordingly, the Court seemed to conclude that if liability were shown, the Court would treble the damages–all monies paid under the contract–and only then subtract the value of the goods and services the government had received through contract performance.[8]

It will surprise few companies to hear that, facing potential damages of $232 million instead of $0, the *Magee* case settled shortly before trial. The primary defendant agreed to pay approximately $21 million to the United States – less than 10% of what DOJ claimed in damages. Few companies would risk that significant level of exposure in a jury trial, even when fully convinced that the underlying claim of fraudulent inducement was specious. Obviously, by dramatically upping the ante for damages, DOJ has created significant settlement leverage for the government, regardless of the merits of the claim.

The DOJ Theory Is Flawed

The theory the government proposes may be good for the public treasury, but it is bad for the development of the law. First, the argument originates in a flawed analogy: DOJ proposes that all fraudulently induced agreements are alike, so one damages measure covers all liability arising from such agreements. But by that logic, you could argue that all blue cars are alike, so a blue SUV will get as good gas mileage as a blue hybrid compact. The common element in a true analogy must be causally related to the conclusion. The *Longhi* Court assessed damages of total payments made *because* the government received no goods and services, and no other quantifiable benefit in exchange for those payments. The same is true for all grants, which are essentially gifts not conditioned on providing ascertainable goods and services to the government. But it is not true for procurement contracts, in which the government does receive goods and services in exchange for its payments. Just as the color of a car does not logically determine its gas mileage, the fact that an agreement was fraudulently induced does not logically determine the economic effect of the fraud on the public treasury.

An example may help illustrate the issue. Consider a procurement contract to provide the government with airplane parts, which has been fraudulently induced by a lie about a contractor's previous experience. If, despite that lie, the contractor provided airplane parts that fully complied with the contract specifications, and the government used the airplane parts in airplanes just as they were intended to be used, the fraud would not have damaged the government's economic interests.[9] However, if that contract were fraudulently induced through a bid-rigging conspiracy in which the conspirators agreed to charge higher prices than they would have done without the agreement, the public treasury would be damaged because the fraud caused the government to pay a higher price.[10] Thus, the fact of fraudulent inducement does not necessarily lead to economic loss for the government.

Second, no limiting principle would cabin this new damages theory to fraudulent inducement cases. DOJ proposes that because the theory first arose in a fraudulent inducement case, it applies to all fraudulent inducement cases. Its explanation is that that no one who fraudulently induces a contract has a "right" to be paid any money for performance because if the government had known of the fraud, it would not have made any of the payments. But one could just as logically conclude in a non-fraudulent-inducement case that a contractor who failed to conduct a required test for a particular product also had no "right" to be paid any money, because if the government had known that the contractor was not performing the proper testing, it would not have made any payments. So if DOJ's damages argument were to prevail in fraudulent inducement cases, it will shortly begin to migrate to all other FCA cases.

Third, the DOJ theory would create significant and unjustified windfalls for the government. Again, the *Magee* case stands as an illustration. There, the government received $116 million worth of highly-evaluated IT goods and services. When the alleged fraud came to light, the agency re-competed the contract, and then re-awarded the contract back to the same company. That evidence strongly suggests that the *performance* under the contract was well worth the $116 million the government paid. Yet DOJ claimed that in addition to retaining the $116 million worth of goods and services it had received, it should be paid 200% more ($232 million), plus mandatory statutory penalties. This, despite the fact that the government could not show it lost any money because of the alleged fraud. That kind of windfall is neither anticipated nor authorized by the False Claims Act, which requires the government to prove its financial loss caused by the fraud as a prerequisite to trebling that loss (though not as a prerequisite to penalties).[11] Indeed, the treble damages may serve to compensate the government for amounts "beyond the amount of the fraud," *Cook County, Illinois v. U.S. ex rel. Chandler*, 538 U.S. 119, 130-32 (2003), but only after the amount of the fraud—that is, the financial effect of the fraud on the government—has been proved.

The DOJ theory would also dramatically tilt the playing field for potential settlement. Especially for small companies, whose entire business may consist of one or two government contracts, the worst case scenario expands exponentially under the DOJ theory that economic effect on the public treasury is irrelevant to damages. The possibility of being assessed at least 200% of the contract value—and this is gross payments, not profit—could easily spell financial ruin. Few trial lawyers would ever predict a less-than 10% risk of an adverse jury verdict, even in a slam-dunk case. So, even the small risk of a ruinous verdict translates into a willingness to settle for substantially more than the merits of the case might dictate. And given the huge potential downside for defendants, DOJ can afford to offer to settle for cents on the dollar, and still chalk up significant dollar values in settlement. The result will be that fewer of the dubious FCA claims will likely be litigated, which will simply encourage the filing of more dubious claims in the hopes of obtaining a quick but lucrative settlement.

Finally, the DOJ's expansionist theory is not necessary to protect the government's interests. Certainly the public treasury is not the government's only interest. But the damages provision of the False Claims Act is designed to protect *that interest*. Other provisions, such as the mandatory penalties of 31 U.S.C. § 3729(a) protect other interests like punishing fraud. Indeed, "penalties are authorized by the False Claims Act to address the broad range of ancillary harms–harms apart from the fraud itself–that the Government may have suffered because of the deception practiced against it." *Ab–Tech Construction, Inc. v. United States,* 31 Fed.Cl. 429, 435 (1994). For this reason, it is not uncommon for a court to find no damages in a case while also assessing penalties.[12] Nor is the False Claims Act the only remedy for contractor fraud. In addition to criminal sanctions and administrative actions up to and including debarment, the government has the full arsenal of civil actions available to redress its wrongs. It is the rare False Claims Act complaint that lacks these other claims. In the *Magee* case, for example, DOJ alleged (1) breach of contract, (2) unjust enrichment, (3) payment by mistake, (4) common law recoupment, (5) inducement of breach of fiduciary duty, and (6) fraudulent procurement. There is no need for courts to judicially re-define "damages" under the FCA when the government's interests are already so thoroughly covered.

How Defendants Can Fight Back

So what can companies do to respond to this new theory of damages? Obviously, avoiding fraudulent inducement (or anything that looks like it) is not only good corporate citizenship, it makes FCA claims somewhat less likely. But allegations from disgruntled employees and treasure-seeking whistleblowers can and will arise even in the most compliant of companies. When they do, and when that surprise letter arrives from the Justice Department, companies should engage actively and early on DOJ's new damages theory. One strategy is to raise the issue early as a legal matter, perhaps through a partial summary judgment motion. Since resolution of the issue will strongly influence settlement, judges may be willing to decide it sooner rather than later. And resolving that question as a legal issue, apart from factual liability, may ensure that the issue is fairly decided as the question of law that it is. A second strategy is to use discovery – Rule 30(b)(6) depositions of the government, interrogatories, and requests to admit – to set up the damages issue as cleanly as possible. By requesting calculations of damages and valuations of what the government would have paid without the fraud, for example, and by eliciting other detailed damages information (or, alternatively, by eliciting that the government lacks that information), defendants can avoid potential factual disputes while effectively focusing the court on the DOJ theory. Finally, if you cannot get the matter resolved on summary judgment, consider raising the issue through a motion *in limine* to preclude the government from introducing evidence on its damages theory. This motion will at least tee up the issue for a decision before the trial begins.

The reach of DOJ's new damages theory will grow to the extent it is raised only in secret settlement discussions with defendants. But testing that theory with open and vigorous advocacy, and allowing for thoughtful judicial resolution among several courts will allow for a fair resolution of the claim. That result will allow both the government and defendants to return to assessing litigation risk based on the merits of the case, rather than on the fear of a ruinous damages theory.

Endnotes

[1] *Rainwater v. United States,* 356 U.S. 590, 592 (1958).

[2] *United States v. Neifert-White Co.*, 390 U.S. 228, 232 (1968).

[3] 31 U.S.C. § 3729(a).

[4] *Hutchins v. Wilentz, Golman & Spitzer,* 253 F.3d 176, 185 (3d Cir. 2001) ("The False Claims Act seeks to redress fraudulent activity which attempts to or actually causes economic loss to the

United States government. As the Supreme Court held in *Hess*, the purpose of the False Claims Act 'was to provide for restitution to the government of money taken from it by fraud.'" 317 U.S. at 551, 63 S.Ct. 379.)

[5] "The Government's actual damages are equal to the difference between the market value of the [product] it received and retained and the market value that the [product] would have had if [it] had been of the specified quality." *United States v. Bornstein*, 423 U.S. 303, 316 n.13 (1976). *See also, e.g., United States ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 933-23 (4th Cir. 2003); *United States v. Woodbury*, 359 F.2d 370 (9th Cir. 1966); *United States v. Co-op Grain & Supply Co.*, 476 F.2d 47, 61-65 (8th Cir. 1973); *United States ex rel. Stearns v. Lane*, No. 08-cv-0175, 2010 WL 3702538 (D. Vt. Sept. 15, 2010); *Coleman v. Hernandez*, 490 F. Supp. 2d 279, 281 (D. Conn. 2007).

[6] Numerous cases have referenced and agreed with the *Longhi* grant/subsidy versus standard procurement contract distinction, *e.g., U.S. v. SAIC*, 626 F.3d 1257 (D.C. Cir. 2010); *U.S. ex rel. Feldman v. Wilfred Van Gorp and Cornell Univ. Med. College*, 2010 U.S. Dist. Lexis 47039 (S.D.N.Y. 2010); *U.S. v. Karron*, 750 F. Supp. 2d 480 (S.D.N.Y 2011). *See also United States v. Rogan*, 517 F.3d 449, 453 (7th Cir. 2008) (defendants required to repay all payments under Medicare agreement, because defendant "did not furnish any medical services to the United States" where the US payment was a subsidy that provided no benefit to the United States). Despite significant research, the author is aware of no cases that consider but reject that distinction.

[7] Significantly, there was no discussion in *Longhi* that remotely related to a defendant's "right to perform" as a basis for government damages (or as a basis for any other conclusion). Nor did that court distinguish fraudulent inducement cases from other kinds of FCA cases for damages purposes.

[8] Perhaps emboldened by such decisions, some agencies are seeking to establish a *presumption* of damages in a similar context. On October 7, 2011, the SBA proposed rules seeking to both extend and codify DOJ's argument by creating an "irrefutable presumption of loss to the United States based on the total amount expended on the contract" when a small business misrepresents its size in connection with any contract—not just a grant—reserved to small businesses. *See* 76 Fed. Reg. 62313, 62316 (proposed rule issued Oct. 7, 2011). This proposed rule essentially adopts a strict liability standard under the False Claims Act, with ill-defined exceptions for "unintentional errors." And it establishes a presumption of damages in conflict with the False Claims Act which requires the government to proves "damages which the Government sustains because of the act of that person." 31 U.S.C. § 3729(a). Should the proposed rule become a final rule, civil litigation over its significant conflict with the False Claims Act—which requires at least a knowing violation—as well as concerns over the constitutionality of irrefutably *presuming* damages seems inevitable.

[9] This hypothetical reflects the situation in *Harrison*, 352 F.2d at 923. There, the Fourth Circuit held that "[a]lthough Westinghouse ran afoul of the fair bidding requirements," the fraudulent inducement did not affect performance of the contract. There was "no evidence . . . that the government did not get what it paid for or that another firm could have performed the work for less," so there were no damages proven, although the wrongdoing obviously triggered FCA penalties.

[10] This was the case in *United States ex rel. Marcus v. Hess*, 317 U.S. 539 (1943). There, collusive bidding resulted in higher prices than would have existed without the collusive bidding. The damages assessed there were "the difference between the contract price paid the contractor therefore in excess of the amount which the United States would have been obliged to pay for the same work, had there been open, competitive and uncontrolled bidding."

[11] Although the government need not prove economic harm to justify the mandatory penalties, whether there is such harm may affect the penalty determination. Recently, mandatory FCA civil penalties of $50 million were struck down as violating the Eight Amendment prohibition on excessive fines where the Government had suffered no proven economic harm and where the defendants had realized only $150,000 in profit from their illegal activity. The penalties stemmed from an FCA claim of fraudulent inducements, where subcontractors had allegedly conspired to rig bids and fix prices under a 2001 Department of Defense contract. *United States ex rel. Bunk v. Birkart Globistics GmbH & Co., et al.*, No. 1:02-cv-01168 (E.D. Va. 2012); slip copy 2012 WL 488256.

[12] Though often dismissed by the government as inadequate to deter, those penalties can seriously add up. The FCA provides that a person who violates the False Claims Act "is liable to the United States Government for a civil penalty of not less than $5,000 and not more than $10,000." 31 U.S.C. § 3729. Some courts have interpreted the FCA to impose a civil penalty for each false claim, and each claim for payment made under a fraudulently induced contract to be a separate false claim. When interpreted in that manner, fines can quickly rise to the millions of dollars, and may be struck down as unconstitutionally excessive. *See, supra*, note 11.

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