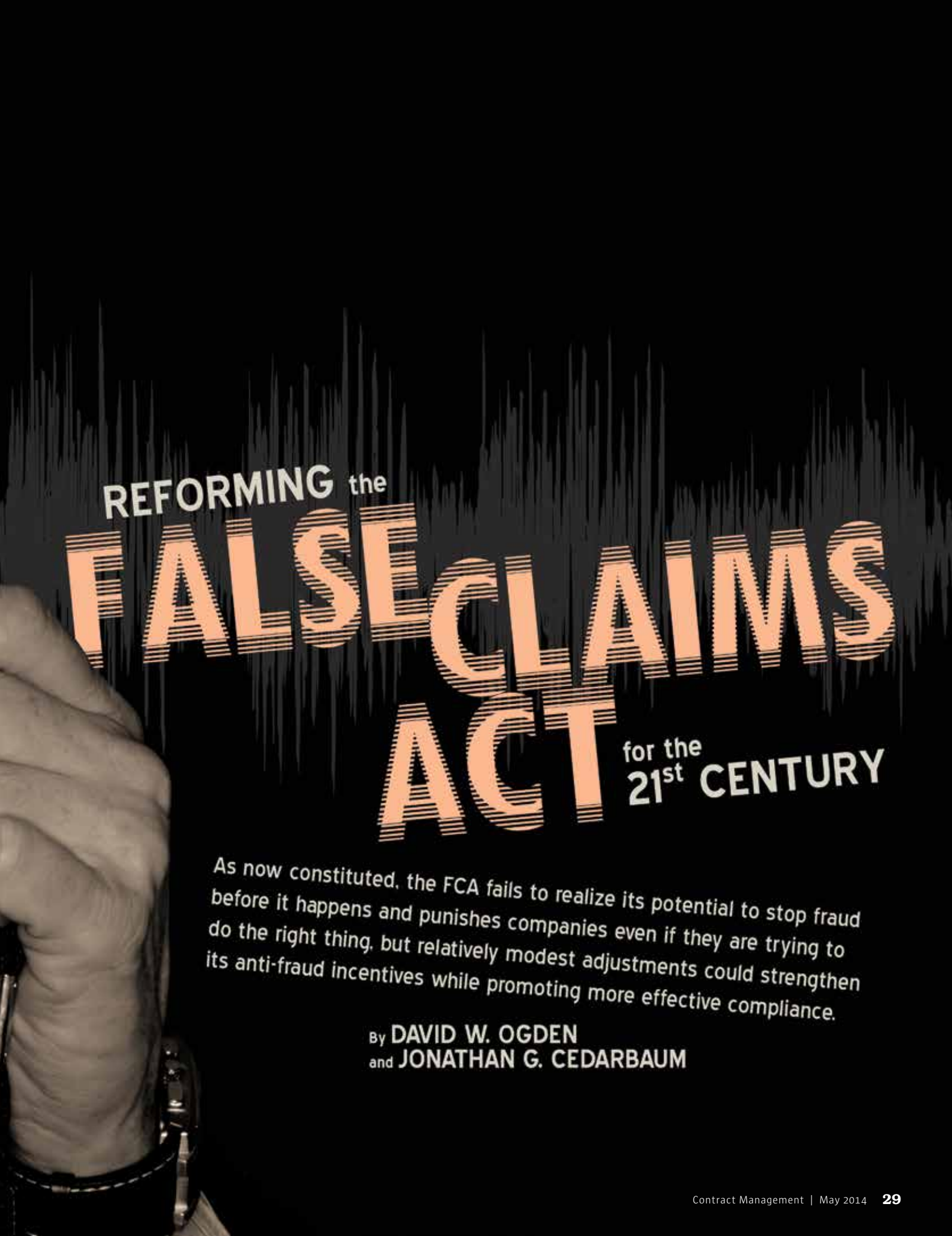

# REFORMING the FALSE CLAIMS ACT for the 21st CENTURY

As now constituted, the FCA fails to realize its potential to stop fraud before it happens and punishes companies even if they are trying to do the right thing, but relatively modest adjustments could strengthen its anti-fraud incentives while promoting more effective compliance.

By DAVID W. OGDEN
and JONATHAN G. CEDARBAUM

**Originally enacted during the American Civil War, the False Claims Act (FCA)[1] is one of the most venerable statutes in the U.S. federal code. A century and a half later, after a series of amendments in the last 30 years, it has become a very important tool for redressing fraud in U.S. federal contracting (and other dealings with the U.S. federal government) and a vehicle for significant recoveries of funds to the U.S. Treasury.**

The FCA authorizes huge penalties—larger in proportion to the commerce at issue even than the treble damages authorized by the antitrust laws. Yet central to its operation is the incentivizing of private citizens—so-called "*qui tam* relators"—to come forward with evidence of fraud, permitting them to bring enforcement actions in the government's name and to retain sometimes enormous shares of the government's recovery. The FCA has promoted an increasing tidal wave of claims and litigation, and federal officials often trumpet the size of recoveries under the FCA as signs of its success. But as now constituted, the FCA's unique features have unintended harmful consequences, and it fails to realize its potential to stop fraud before it happens.

Relatively modest adjustments could preserve the FCA's incentives to come forward with evidence of fraud while promoting more effective compliance. This will mean less fraud and thus less need for litigation that distracts both the government and the companies that contract with it from efficiently serving the needs of the American people. The authors of this article helped design amendments to the FCA, recently proposed by the U.S. Chamber Institute for Legal Reform (ILM), which would strengthen the FCA's core fraud-fighting purposes while promoting the highest levels of compliance by those who deal with the federal government. We describe a number of them in this article and the problems they are designed to remedy.

## The FCA Should Reward Companies that Do Everything They Can to Comply With the Law in the First Place

### What's Wrong?

As structured and interpreted today, the FCA prioritizes the filing of lawsuits—often weak or meritless ones—over encouraging and rewarding effective corporate efforts to avoid and root out fraud internally. Most of the hundreds of new FCA suits filed each year are filed by relators—private citizens who are required to share their allegations and evidence with the government. The government then decides whether to intervene and join the litigation or decline intervention and leave the case to be pursued by the relator. Ninety percent of the cases in which the government declines to intervene are dismissed or abandoned, reflecting the fact that most of the hundreds of new *qui tam* suits filed each year are meritless.[2]

But defending against those meritless claims imposes real, and unnecessary, costs on private enterprise. Many of the proposed reforms by the ILR are designed to:

- Reduce the number of meritless FCA suits,
- Improve incentives and protections for genuine whistleblowers, and
- Ensure that FCA litigation is focused

on genuine cases of fraud rather than statutory and regulatory defaults that do not involve fraud and have their own enforcement mechanisms.

Even more important, nothing in the FCA (apart from the sort of generalized deterrence that any punitive statute may bring) encourages companies to develop the most sophisticated kinds of compliance systems or encourages the employees of companies to help them comply with the law. Compliance—not after-the-fact, jackpot recoveries for employees who run to the government rather than fixing the problem before it starts—should be the first line of defense against fraud in government programs.

As Stuart F. Delery, the head of the Justice Department's Civil Division, explained recently, "Litigation to recover the costs of fraud is a far inferior option to preventing fraud in the first place."[3] Businesses should adopt "forward-looking compliance measures,"[4] he urged, and "join with the [government] in establishing structures that help prevent fraud—and the need for lawsuits to combat it—in the first instance."[5] We agree completely.

## How Can We Fix the Problem?

The FCA should encourage companies to adopt effective compliance programs that encourage early detection and prompt internal reporting of potential fraud. Companies that adopt independently certified, state-of-the-art compliance programs would get the benefit of the package of reforms that are outlined as follows.

### ➢ Jurisdictional Bar on *Qui tam* Actions after a Defendant's Disclosure to the Government

Under the current FCA, a *qui tam* plaintiff who files suit after the defendant has already

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> If an employee of a company with a certified compliance program (or any other individual with a contractual or legal obligation to make reports to such a company) fails to report the alleged misconduct internally at least 180 days before filing a *qui tam* suit, the ILR proposes that the court would be required to dismiss the action.

disclosed the same conduct to an agency inspector general is still entitled to proceed with the suit and receive a full bounty. This possibility exists even though the disclosure has been made to the government authority responsible for investigating fraud and even though the party making the disclosure is typically required to cooperate fully in the investigation. When a corporation has made a disclosure of fraud to an agency inspector general or other investigative office, *qui tam* actions based on the same allegations of fraud should be foreclosed.

The self-disclosure provision advocated here would not foreclose actions filed by whistleblowers who provide the government with information about fraud before a corporation makes a self-disclosure.

➢ **Incentives for Potential Relators to Report Internally to their Employers**

The FCA currently provides no incentive for employees to report concerns about potential fraud to their employers. To the contrary, the FCA contains a structural disincentive to internal reporting in the form of the "first-to-file" bar, which specifies that only the first relator who files suit is eligible for a bounty. This provision creates a "race to the courthouse," with the problematic effect that a potential relator has no incentive to take the extra step of reporting internally first since doing so might reveal information to other employees, one of whom might beat the initial discoverer of the problem to court. The FCA thus encourages employees to "circumvent internal reporting channels altogether."[6]

The FCA's disincentives for prompt internal reporting are out of sync with modern statutory and regulatory mechanisms that encourage internal reporting and more robust corporate compliance programs. If an employee of a company with a certified compliance program (or any other individual with a contractual or legal obligation to make reports to such a company) fails to report the alleged misconduct internally at least 180 days before filing a *qui tam* suit, the ILR proposes that the court would be required to dismiss the action. The 180-day window would afford the employer sufficient time to investigate the allegations and make a determination whether to disclose a violation to the government itself and/or take corrective action. In order to ensure that a person who uses the internal reporting mechanism is not disadvantaged, the reforms would also provide that a person who reports internally and triggers a prompt disclosure by the company to the government would still be eligible for up to 10 percent of any government recovery that results from the company's disclosure. If the whistleblower reports internally, but the company does not promptly self-disclose and the whistleblower proceeds with a *qui tam* action, then the whistleblower would be deemed to have filed an action for purposes of the FCA's "first-to-file" bar dating back to the time of the internal report.

➢ **No Mandatory or Permissive Exclusion or Debarment**

For government contractors, the threat of suspension or debarment based on FCA violations has become a tool for pressuring companies into substantial settlements. In 2011 alone, over 3,300 federal contractors were suspended or debarred as a result of increased contract monitoring by federal agencies.[7]

Exclusion or debarment may be necessary to protect federal programs from entities or individuals who present a particularly high risk of recidivism. But when a company has implemented a certified compliance program, the rationale for exclusion or debarment no longer applies. ILR has proposed eliminating the threat of exclusion for such companies. Doing so would create a powerful incentive for companies to adopt state-of-the-art compliance programs while also affording such companies the ability, where appropriate, to seek the guidance and protection of the courts.

## The Disconnect Between Actual Harm or Culpability and the FCA's Enormous Monetary Sanctions and Pressured Settlements Rather Than Court-Tested Evidence and Development of the Law

### What's Wrong?

One fundamental problem with practice under the FCA today is the huge discrepancies it often creates between the amount of actual harm caused to the government by the conduct of investigated companies and the enormous financial penalties companies are compelled to pay. Two elements of the FCA, more than any others, contribute to these irrational and unjust outcomes. First, the FCA requires *both* treble damages—themselves three times the harm actually done to the public fisc—*and* civil penalties without regard to the extent of actual damages in a range currently set at $5,500–$11,000 per "claim." Second, courts have interpreted a "claim," for purposes of the penalty provision, as each invoice or request for payment submitted to the government, even if there was only one arguably false statement made to the government and even if each request for payment was for a small sum. Thus, an invoice for, say, an individual pharmaceutical prescription or a part in a complex good

worth just $20 could bring a mandatory penalty of $11,000, and 5,000 such invoices with a total value of just $100,000 could generate a mandatory fine, over and above treble damages, of more than $50 million.

The risk of facing treble damages plus exorbitant penalties deters virtually every company threatened with an FCA suit from taking the government to court, even when the claims are weak or meritless. Especially with the government's and relators' increasing reliance on false certification theories, liability can turn on the meaning of ambiguously worded regulations or contractual provisions. Thus, companies often feel almost irresistible pressure to settle, even when their odds of ultimate success may be substantial.

The rising frequency of settlements not only exacts a financial toll on the settling companies. By keeping cases out of court, settlements spare the government the effort of testing its evidence in front of a detached judge. Also, settlements frustrate the development of the clearer legal rules that emerge through frequent interpretation of a statute in light of different sets of facts.

The prospect of large penalties, coupled with the increasing frequency of suits, has led companies to settle FCA claims rather than contest them. As one court explained, "[b]ecause the risk of loss in [an FCA] case carries potentially devastating penalties, unlike most litigation or even an administrative recoupment action,"[8] companies are discouraged from even attempting to defend themselves in court.

Conversely:

> *Qui tam* relators are also incentivized to file suit even if their case is weak and unlikely to succeed at trial. FCA suits frequently end in settlement because of the heavy penalties and potential for disqualification from federally funded programs.... The potential for the imposition of significant penalties is enough to cause many defendants to think twice about taking a case to trial, even if the plaintiff's case is unlikely to succeed. Thus, many *qui tam* cases are not adjudicated before a judge, but decided in negotiations between lawyers....[9]

The result is that companies "lack the benefit of precedent and reliable information on which to base decisions about the legitimacy of the [Department of Justice's] use of the [FCA against them]."[10]

> The FCA is an essential tool for fighting fraud in government contracting—a goal that is all the more urgent at a time of enormous federal deficits

### How Can We Fix the Problem?

Several simple changes in the FCA could help bring its sanctions back in line with the harm actually suffered by the government and the culpability of investigated parties. Companies that adopt effective compliance programs should get the benefit of these changes. First, rather than tripling damages in every case, the statute should calibrate the damages multiplier to the defendant's culpability. A defendant would be liable for treble damages only when it acted with specific intent to defraud; double damages when it acted with knowledge, reckless disregard, or deliberate ignorance; and a maximum of 1.5 times damages when it made a disclosure to the government of the conduct. This would bring the FCA in line with other fraud statutes, which recognize gradations of punishment based on the defendant's level of culpability.

Second, statutory penalties should be available only when no damages are awarded. There is no reason to impose penalties when the defendant has already been assessed damages times a multiplier. Application of the multiplier already serves the purposes of the penalty: to punish the defendant and to ensure that there is a sufficient financial liability to deter future misconduct.

Third, penalties should be capped at an "amount equal to the sum sought in the claim in addition to all costs to the government attributable to reviewing the claim."[11] The proposed cap is designed to permit an appropriate punishment, and to provide compensation for any harm suffered by the government, but to avoid the possibility of penalty awards that are so excessive as to violate the Eighth Amendment. The proposed cap is loosely derived from the antifraud provision in the Contract Disputes Act,[12] which provides that the penalty for submission of a false claim is an "amount equal to the unsupported part of the claim plus the federal government's costs attributable to reviewing the unsupported part of the claim."[13]

## Turning Regulatory or Contractual Breaches into Frauds

### What's Wrong?

One of the most controversial expansions of FCA liability in the past two decades has been the court-created "false certification" theory of liability, and especially the notion of *implied* false certification. Under the false certification theory, violation of any fine-print regulatory requirement can provide a basis for treble damages and penalties. And under the *implied* false certification theory, the regulatory requirement need not even be stated in the contract or invoice. It may simply be found somewhere in the government program's regulations, with the contractor's promise to avoid any defaults taken to be implicit in its participation in the government program. But, as the Seventh Circuit has explained, "the FCA is not an appropriate vehicle for policing technical compliance with administrative regulations. The FCA is a fraud prevention statute."[14] Violations of federal regulations should not be treated as fraud "unless the violator knowingly lies to the government about them."[15] Still, many courts have permitted FCA liability without such clear, knowing falsehoods.

Premising FCA liability on technical violations, rather than on falsely seeking payments for goods or services not provided as promised, relieves relators of the need to prove, or even to allege, actual falsity in a claim for payment submitted in connection with providing goods or services. This is particularly troubling because of the large and rising number of potential regulatory requirements that may be used to ground false certification claims:

> Government contractors…are required to submit certifications related to everything from how they dispose of hazardous materials to their affirmative action plan, and they frequently enter into contracts requiring compliance with other statutory and regulatory provisions.[16]

### How Can We Fix the Problem?

Liability for false certifications should only be permissible if the triggering certification is clearly and expressly stated and if compliance with it is explicitly identified as a condition of the government's paying on the contract. The first of these requirements is a matter of simple fairness: It ensures that the contracting party knows the promises for which it may be held accountable. The second goes to the basic purpose of the FCA. If the requirement at issue would have made no difference in the government's paying, then any noncompliance caused no economic harm to the government.

To ensure that the statute remains focused on true fraud on the government, ILR proposes a new definition of "false or fraudulent claim" that would impose FCA liability

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only when a claim is "materially false or fraudulent on its face," or when a claim is presented or made "when the claimant has knowingly violated a requirement that is expressly stated by contract, regulation, or statute to be a condition of payment of the claim."[17] Liability could be based on a false "certification" only when "the claimant has violated a requirement that is expressly stated by contract, regulation, or statute to be a condition of payment of the claim."[18] This approach would reserve FCA liability for true frauds on the government and not apply them to contractual, regulatory, or statutory violations that do not rise to that level. Of course, such violations would be punishable under existing administrative or judicial regimes that establish proportional and appropriate penalties for such violations.

## Conclusion

The FCA is an essential tool for fighting fraud in government contracting—a goal that is all the more urgent at a time of enormous federal deficits. But as currently drafted and enforced, the FCA is much less effective at preventing and thus reducing fraud than it could be, while it imposes unfair and unnecessary costs on companies that are trying to do the right thing. Commonsense reforms of the sort described in this article can and should make the FCA both fairer and more effective. **CM**


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