

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 both to 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 raise these stakes dramatically: 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.

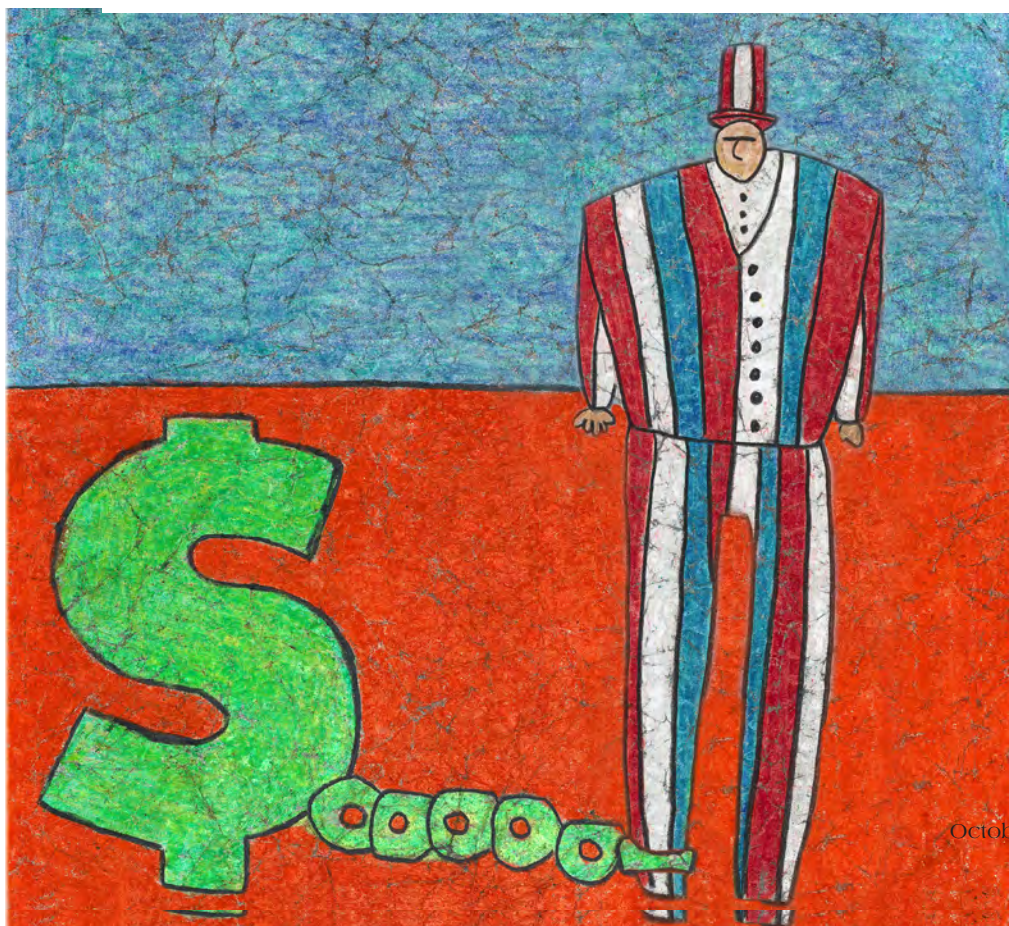
From its origins in Civil War price-gouging and cheating, the False Claims Act was aimed at economic loss. The Act was specifically designed to protect the “*funds and property*” of the Government from fraudulent claims,¹ and “to reach all types of fraud, without qualification, that might result in *financial loss* to the Government.”² To protect those funds and property, then, the Act authorized the recovery of “damages which the Government sustains because of the act of that person.”³ Such damages occurred when “the defendant made fraudulent claims that caused or would cause *economic loss* to the United States Treasury.”⁴ Given this purpose, the measure of that 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

With their sights on the treble damages authorized by the FCA, it is not surprising that DOJ lawyers aim for the largest actual damage number they can find. But their new FCA damages theory seeks to make economic loss essentially irrelevant. Indeed, DOJ claims it need not prove damages by showing what it would have paid for those goods and services without the fraud. Instead, it claims it need only prove what was paid under the contract. Thus, DOJ's position 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. The government claimed as damages the total value of the grant monies it had paid out. When it made that grant, of course, the government bargained for and received no goods or services in exchange for the grant monies. Instead, it expected to receive the intangible benefit of helping eligible small businesses. The Fifth Circuit noted the lack of tangible goods and services in the agreement at issue, and concluded it was “impossible” to measure the effect of the intangible loss. Therefore, the Court concluded that where the government had received nothing as the benefit of its bargain to award a grant, damages consisted of all the payments made under the grant. But in so holding, the Fifth Circuit explicitly distinguished the 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. *Longbi*, 575 F.3d at 473 (emphasis added)⁶

Thus, for damages purposes, the court distinguished between the benefit of the bargain in grant agreements and the benefit of the bargain in a "standard procurement matter where the government ordered a specific product or good" *Id.*

DOJ Seeks To Extend Longbi Contrary to its Explicit Reasoning

Notwithstanding the Fifth Circuit's clear distinction between grant cases and standard procurement cases, DOJ now posits the following: (a) *Longbi* was a fraudulent inducement case, (b) actual damages in *Longbi* consisted of the total payments made by the government, so therefore (c) actual damages in all fraudulent inducement cases consist of total payments made by the government. And it has gotten at least one Mississippi district court potentially to agree with it.

In that 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 obtained 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 *Longbi*, DOJ argued that *Longbi* 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*, it was undisputed 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, it was essentially undisputed that *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 of total payments by US under contract	\$116 million (100% of total payments)
Trebled (per FCA statute)	$\begin{array}{r} \underline{\hspace{1.5cm}} \\ \times 3 \\ \hline \end{array}$
	\$348 million (300% of total payments)
Minus the value of goods and services received by US under the contract	
	- <u>\$116 million</u> (100% of total payments)
Total "damages"	\$232 million (200% of total payments)

Without proving 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, the District Court appeared to agree with the government. Like DOJ, the court ignored the explicit grant-versus-procurement contract distinction in *Longbi*. Instead, the court cited a *Longbi* footnote in which the Fifth Circuit considered an amici argument that the court should subtract any potential benefit to the government (such as possible future government purchase of the batteries once they were developed) from actual damages before the trebling occurred. In *dicta*, the Fifth Circuit said that if there had been any such quantifiable extra-contractual benefit, it would be subtracted *after* trebling, and not before. The *Magee* District Court apparently equated the bargained-for, tangible, contractually-provided IT goods and services at issue there with the hypothetical, intangible, and extra-contractual "benefits"



referenced in the *Longhi* footnote. Thus, the court suggested that if liability were proved, damages would consist of all monies paid under the contract. Only after that amount was trebled would the court consider valuing and subtracting the actual contract performance the government had received.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 all such claims share the same measure of damages. But by that logic, you could argue that all blue cars are alike, so a blue SUV will get the same 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 the damages it did *because* the government received no goods and services in exchange for its payments. The same is true for all grants, which are essentially gifts and are not conditioned on providing ascertainable goods and services to the government. But that conclusion 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. Assume that contract 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 affected or damaged the government's *economic* interests, (though it may have affected other interest of the government, such as not doing business with fraudsters).⁹ On the other hand, if that contract were fraudulently induced through a bid-rigging conspiracy that resulted in the government paying a higher price, that higher price is an economic effect that clearly does damage the public treasury.¹⁰ Some fraudulently induced agreements may result in economic harm and some may not.

DOJ's theory is also flawed because although it claims it applies only in fraudulent inducement cases, no limiting principle cabins the theory to those cases. DOJ seems to propose that, because the new theory first arose in a fraudulent inducement case, it must therefore apply to all fraudulent inducement cases. And it argues that the rationale is that one who fraudulently induces a contract has no "right" to be paid any money for performance since the government would not have entered into the contract if it had known of the fraud. But one could just as logically conclude in a non-fraudulent-inducement case that a contractor who failed to conduct required tests also has no "right" to be paid, because the government would not have paid, and might have terminated the contract if it had known of the lack of testing. So if DOJ's damages argument were to prevail in fraudulent inducement cases, it would 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, and that the government's economic interests were not harmed. Yet DOJ claimed in that case that in addition to retaining the \$116 million worth of goods and services delivered, it was owed \$232 million more, plus mandatory statutory penalties.

When the government has received what it requested and what it paid for, such a windfall is neither anticipated nor authorized by the False Claims Act. That act requires the government to prove its damages—or financial loss—caused by the fraud before any damages may be trebled.¹¹ Indeed, 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 damage caused by 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 of an FCA lawsuit expands exponentially if economic loss is irrelevant to damages. The potential “damages” of at least 200% of the contract value—and this is *gross payments*, not profit—could easily spell financial ruin for companies who have delivered full value to the government, but where one or more employees engaged in some fraud that did not cause financial loss. 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 of its damages claim 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 fisc is only one of the government's interests. But the damages provision of the False Claims Act is designed to protect *that interest*. Other provisions of the Act, such as the mandatory penalties in 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, yet assess 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 a 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. Remedies for those actions include a variety of damages and even disgorgement. When Congress has already provided ample protection for the government's many interests, there is simply no need for courts judicially to redefine “damages” under the FCA.

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 also 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. For example, defendants can request calculations of damages, including valuations of what the government would have paid without the fraud. Defendants can also seek the government's valuation of the goods and services rendered and other detailed information. The government will need either to provide that information or to say it does not have the information. If it does not have the information, there can be no factual dispute, and the issue may be ripe for summary judgment. Alternatively, if the court is not willing to grant summary judgment, the issue may be raised by way of a motion in limine to preclude the government from presenting damages evidence since it has not produced the information in discovery. Both options allow defendants to resolve this critical issue before a jury 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. **TFL**

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cases, as well as in commercial procurement cases ranging from spent nuclear fuel contract claims against the government to contract and tort claims involving subcontractors, prime contractors, and disappointed bidders. © 2012 Julie M. Carpenter. All rights reserved.

Endnotes

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

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

³31 U.S.C. § 3729(a).

⁴*Hutchins v. Wilentz, Golman & Spitzer*, 253 F.3d 176, 185 (3d Cir. 2001) (emphasis added) (“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).

⁶Numerous 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) (the defendants were required to repay all payments under a Medicare agreement, because the defendants “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.

⁷Significantly, 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.

⁸Perhaps emboldened by such decisions, some agencies are seeking to establish a *presumption* of damages in a similar context. On Oct. 7, 2011, the SBA proposed rules seeking both to extend and to codify DOJ’s argument by creating an “irrefutable presumption of loss to the United States based on the total amount expended on the con-

tract” 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 that requires the government to prove “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.

⁹This 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.

¹⁰This 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.”

¹¹Although 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.

¹²Though 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 millions of dollars and may be struck down as unconstitutionally excessive. See, *supra*, note 11.