



FEDERAL CONTRACTS



REPORT

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False Claims Act

In 2001, FCR published an analysis by Paul F. Dauer & Jennifer L. Dauer addressing “Incipient Issues in State and Local False Claims Authority” (75 FCR 25).

Four years later, this analysis by Marcellus A. McRae, Monick Paul, and Gabriela E. Ryan focuses on one issue as it has evolved in case law under both the California and federal false claims acts—the impact of government knowledge or government approval upon a contractor’s potential liability.

Is Government Knowledge a Defense to False Claims Liability? A Discussion of the Role of Government Knowledge Under the California and Federal False Claims Acts

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You are in your office. The phone rings. It’s your favorite client, William B. Lucky, a government contractor who sells automotive supplies to an agency within the State of California. Mr. Lucky proceeds to tell you that his company’s recent internal audit revealed that, even though it has sold the state a variety of supplies—including solenoids, voltage regulators, and drive shafts—it has only used the billing code for transmissions. Mr. Lucky then tells you that this practice goes back at least five years and has involved several million dollars in supplies.

Mr. Lucky explains that the managers of the state agency were aware of and directed this misuse of bill-

ing codes because the state did not have price codes for many of the items it was purchasing. Proudly, he says that the government always received its supplies without any complaints, and was never overcharged.

As you process all of this, the little voice in your head asks: “Are his fortunes consistent with his name or does Mr. Lucky face considerable exposure for filing false claims?”

This is an overview of how some California courts and certain federal courts have viewed the role of “government knowledge” and/or “government approval” in assessing exposure under the California False Claims Act (“CFCA”) and the Federal False Claims Act (“FCA”).

It suggests that the prevailing trend is that while government knowledge of the falsity of a claim *may* be relevant in determining whether the defendant “knowingly” submitted a false claim, *it is not an automatic defense to a FCA case.*

A. Some Courts Have Held That Acting Pursuant to the Government’s Direction Precludes CFCA Exposure

The CFCA¹ prohibits “knowingly” presenting to the government “a false claim for payment or approval.”² Some California courts have held that, when the government directs a contractor to file a claim, the contractor cannot be said to have “knowingly” made a false claim *even if the direction violates applicable procedures.*³

For example, in *People v. Duz-Mor Diagnostic Laboratory, Inc.*⁴ (“*Duz-Mor*”), the California Court of Appeal found that there was no CFCA violation when a Medi-Cal provider acted at the direction of government officials. In *Duz-Mor*, the Attorney General alleged that the Medi-Cal provider’s practice of submitting unbundled invoices for certain tests amounted to false claims. However, the court upheld the trial court’s finding that the provider adopted the billing practice at the instruction of a Medi-Cal representative, and ruled that the provider did not knowingly make a false claim, even though it received greater compensation for unbundled billing than it did under the alternative billing method.

In *Laraway v. Sutro & Co.*⁵ (“*Laraway*”), the Court of Appeal affirmed the trial court’s dismissal of a CFCA complaint against Sutro & Co., which had a contract to provide financial advice to the Pasadena Unified School District (“PUSD”). Sutro went on two trips to New York on behalf of the PUSD, and, despite the fact that the school board’s policies required pre-approval for travel expenses, the PUSD directed Sutro to bill for expenses *after* the trip. A taxpayer brought a CFCA action against Sutro, the school superintendent, and the assistant superintendents, claiming that the travel expenses were improper and hence violated the CFCA. The Court of

Appeal held that because the trips were approved and *the PUSD suffered no damages from any technical lack of pre-approval,*⁶ the district court properly dismissed the complaint. The Court of Appeal also held that “there can be no false claim where a contractor has submitted a claim in accordance with government directions, even if the procedure was improper.”⁷

The case of *American Contract Services v. Allied Mold & Die, Inc.*⁸ (“ACS”), also illustrates the significance of acting pursuant to government direction. In ACS, the California Court of Appeal held that no CFCA violation resulted from submitting an invoice for payment under a contract allegedly entered into in violation of state contracting laws.⁹

In ACS, the Department of General Services (“DGS”) issued an invitation for bids to produce infant training cups for a Women and Infant Children program administered by the Department of Health Services. The invitation included a detailed set of specifications for the cups. The DGS received three bids: one from ACS, the plaintiff; one from Allied, the defendant; and one from a business named Comade. The lowest bidder was Comade, but its cup design was not in accordance with the specifications. Allied had the next lowest bid. Its bid was in compliance with the technical requirements, except that the cups did not come in neon colors. ACS’s bid was the highest and the only bid in perfect compliance. In its bid, ACS indicated that it planned to obtain the cups from Allied or another company. Rather than accept any of the bids, the DGS cancelled its solicitation and contracted directly with Allied as the “sole source” of the conforming product. Allied delivered the cups and submitted an invoice for payment. ACS then filed a claim for violation of the CFCA on the basis that the claim was brought on a void contract.

In their motion to dismiss, defendants argued that “if the government knows and approves of the particulars of a claim for payment before the claim is presented, the presenter cannot be said to have knowingly presented a fraudulent or false claim. In such a case, the government’s knowledge effectively negates the fraud or falsity required by the CFCA.”¹⁰ The Court of Appeals agreed, and affirmed the trial court’s dismissal.¹¹

⁶ Though the court mentions that the government suffered no damages from the lack of pre-approval, this does not appear to be a necessary element for the court’s dismissal of a CFCA violation. See, e.g., *People v. Duz-Mor Diagnostics Lab. Inc.*, 68 Cal. App. 4th 654, 673 (1998). In *Duz-Mor*, the contractor received greater compensation for unbundled billing than it did under the alternative method; nevertheless the court held that there was no CFCA violation.

⁷ 96 Cal. App. 4th at n.4.

⁸ *American Contract Servs. v. Allied Mold & Die, Inc.*, 94 Cal. App. 4th 854, 856 (2002) (77 FCR 50).

⁹ *Id.*

¹⁰ *Id.* at 864.

¹¹ See also *DeWitt v. Tutor-Saliba Corp.*, 2003 WL 156603 (Cal. App. 2003) (“*DeWitt*”). In *DeWitt*, the California Court of Appeal, in an unpublished decision, found that there can be no false claim violation for an invoice brought on a contract entered into at the direction of the government even if that contract has been judicially determined to be improper. In *DeWitt*, a taxpayer brought an action against the Los Angeles County Metropolitan Transportation Authority (“MTA”) and its contractor, Tutor-Saliba Corporation (“TSC”), to require TSC to return all the fees it received under the subway station contract, as the MTA failed to award the contract to the lowest bidder. The plaintiff brought this case shortly after a trial court

¹ Cal. Gov’t Code § 12650 *et seq.*

² Cal. Gov’t Code § 12651(a)(1). “Knowing” means acting with actual knowledge of falsity or with deliberate ignorance or reckless disregard of the truth or falsity of the information. See *American Contract Servs. v. Allied Mold & Die, Inc.*, 94 Cal. App. 4th 854, 858 (2001).

³ See, e.g., *Laraway v. Sutro & Co.*, 96 Cal. App. 4th 266, 277 n.4 (2002) (“There can be no false claim where a contractor has submitted a claim in accordance with government directions, even if the procedure was improper.”) (internal citation omitted).

⁴ 68 Cal. App. 4th 654 (1998).

⁵ 96 Cal. App. 4th 266 (2002).

It also stated that although “it appears that government officials, wanting to expedite the project and still choose the method of performance, may have stretched the contracting regulations to or beyond their limits,”¹² the “FCA is not an appropriate vehicle for policing technical compliance with administrative regulations”¹³ (emphasis added).¹⁴

The ACS court adopted the reasoning of the U.S. Court of Appeals for the Seventh Circuit in *United States ex rel. Durchholz v. FKW, Inc.*¹⁵ (“Durchholz”), a federal FCA case with facts analogous to those in Mr. Lucky’s case. In *Durchholz*, a government military facility needed a sedimentation pond to be dredged quickly. The Unit Price Book (“UPB”) did not contain line items for dredging. To speed the process, a facility official instructed the contractors to price the dredging project using the UPB excavation line items.¹⁶ The contractor complied, dredged the pond, submitted a claim using the excavation line items, and was paid by the facility.¹⁷ *Durchholz* brought suit as relator for the United States, alleging that the contractor knowingly submitted false claims to the government. The Seventh Circuit upheld the district court’s summary judgment for the contractor, reasoning that:

[i]f the government knows and approves of the particulars of a claim for payment before that claim is presented, the presenter cannot be said to have knowingly presented a fraudulent or false claim. In such a case, the government’s knowledge effectively negates the fraud or falsity required by the FCA.¹⁸

Furthermore, the court “decline[d] to hold [the contractor] liable for defrauding the government by following the government’s explicit directions.”¹⁹ Even though the claims were factually inaccurate, the con-

awarded the lowest bidder damages for lost profits in another action. The Court of Appeals, in summarily dismissing the plaintiff’s complaint, held that plaintiff had failed to allege facts to suggest that TSC submitted false information to the MTA or to anyone. *Id.* at n.3. The court cited *Laraway* and *ACS* and restated the rule that “even if the procedure is improper, there can be no false claim where a contractor has submitted a claim in accordance with government directions.” *Id.*

¹² 94 Cal. App. 4th at 865.

¹³ *Id.* (emphasis added).

¹⁴ In *ACS*, plaintiffs cited *United States ex rel. Kreindler & Kreindler v. United Techs. Corp.*, 985 F.2d 1148, 1156 (2d Cir. 1993) (59 FCR 143) and *United States ex rel. Hagood v. Sonoma County Water Agency*, 929 F.2d 1416, 1427 (9th Cir. 1991) (55 FCR 764) for the proposition that government knowledge does not necessarily preclude a FCA violation and that dismissal was improper under the circumstances. The *ACS* court distinguished *Hagood* by saying that in *Hagood*, unlike the *ACS* case, there were allegations of fraud or collusion. This raises the question, however, whether a California court might be receptive to the argument that California should follow the federal trend, in which, following the 1986 amendments to the FCA, government knowledge of the falsity of a claim *may* be relevant in determining whether the defendant “knowingly” submitted a false claim; however, *it is not an automatic defense to a FCA case. See* fn 34, *infra*.

¹⁵ 189 F.3d 542 (7th Cir. 1999).

¹⁶ *Id.* at 544.

¹⁷ *Id.*

¹⁸ *Id.* at 545.

¹⁹ *Id.*

tractor did not “knowingly” present a false claim, the court said.²⁰

B. Even in the Absence of Express Directions to Submit the Billings, a Defendant Might Avoid False Claims Liability Where the Government Approved the Billings Prior to Their Submission

The Court of Appeals in *ACS* stated that when the government knows and approves of violations or defects in a claim *before* it is submitted, a court cannot find that the contractor knowingly submitted a false claim.²¹ We can also look to federal FCA cases for guidance.²²

For instance, in *United States ex. rel. Costner v. United States*²³ (“*Costner*”), plaintiff claimed that defendants concealed operational problems and regulatory violations from the Environmental Protection Agency (“EPA”). Plaintiff contended that in light of this concealment defendant’s requests for payment constituted false claims under the FCA. The U.S. Court of Appeals for the Eighth Circuit affirmed the trial court’s grant of summary judgment for the defendant because all of the evidence suggested that the EPA was aware of the operational difficulties. In holding that defendants did not have the requisite intent under the federal FCA, the appeals court noted:

“[i]f the government knows and approves of the particulars of a claim for payment before the claim is presented, the presenter cannot be said to have knowingly presented a false or fraudulent claim. A contractor that is open with the government regarding problems and limitations and engages in a cooperative effort with the government to find a solution lacks the intent required by the Act.”²⁴

The U.S. Court of Appeals for the Ninth Circuit, in *United States ex rel. Butler v. Hughes Helicopters, Inc.*²⁵ (“*Butler*”), also found that where the contractor completely cooperated and shared all information with the government and the government approved all deviations from the specifications, the contractor was entitled to summary judgment. *Butler* involved the work of defense contractor McDonnell Douglas Helicopter Co. (“MDHC”) in the development of a new product, the Apache Advanced Attack Helicopter, prior to delivery to the government for use in the field. The contract called for certain testing at different phases; however, the Army decided to accelerate the process and move to the production phase before completion of all the prototype-stage testing required by the contract.²⁶ The

²⁰ If the facts strongly support a “government knowledge” defense, this decreases the prospect that a defendant will be subject to California criminal liability. California Penal Code § 72 has a higher scienter requirement than the CFCA. To be criminally liable for submission of a false claim, there needs to be an “intent to defraud” under § 72.

²¹ *ACS*, 94 Cal. App. 4th at 864 (“If the government knows and approves of the particulars of a claim for payment before that claim is presented, the presenter cannot be said to have knowingly presented a fraudulent or false claim.”) (internal citation omitted).

²² The CFCA is patterned on the federal FCA. *Laraway v. Sutro & Co.*, 96 Cal. App. 4th 266, 274 (2002). Federal decisions are thus persuasive on the meaning of the FCA. *State ex rel. Bowen v. Bank of America Corp.*, 126 Cal. App. 4th 225, 240 (2005).

²³ 317 F.3d 883 (8th Cir. 2003) (79 FCR 250).

²⁴ *Id.* at 887-88 (internal citations omitted).

²⁵ 71 F.3d 321 (9th Cir. 1995) (64 FCR 489).

²⁶ *Id.* at 324.

relator contended that MDHC's test plan did not conform to contract requirements and, therefore, that MDHC's claims for payment for testing were false.²⁷

The Ninth Circuit upheld a directed verdict where the district court had found the only reasonable conclusion a jury could draw from the evidence was that MDHC and the Army had so completely cooperated and shared all information during the testing that MDHC did not "knowingly" submit the false claims.²⁸ Accordingly, the claims, even if false, were not "knowingly" so.²⁹ The Ninth Circuit affirmed that the Army was aware of and approved any discrepancies in the test reports as the result of an ongoing dialogue with MDHC.³⁰

In *Wang ex rel. United States v. FMC Corp.*,³¹ the plaintiff alleged, among other FCA claims related to a weapons project, that the defendant's engineering work was poor and its design was faulty. The Ninth Circuit affirmed a summary judgment dismissing the FCA claim and held that because the defendant shared with the Army all of the mistakes and limitations that later became the subject of Wang's FCA allegations, Wang had not produced the required evidence to establish that the defendant had knowingly submitted false claims.³² The Ninth Circuit stated:

the fact that the government knew of [the defendant's] mistakes and limitations, and that [defendant] was open with the government about them, suggests that while [defendant] might have been groping for solutions, it was not cheating the government in its effort. Without more, the common failings of engineers and other scientists are not culpable under the [FCA].³³

It should be noted that the prevailing trend among federal courts interpreting the FCA is the recognition that government knowledge of the falsity of a claim *may*

²⁷ *Id.* at 324-25.

²⁸ *Id.* at 327.

²⁹ *Id.*

³⁰ *Butler* can be distinguished from cases where government knowledge did not negate the required intent on the part of the contractor because such knowledge was based on partial (rather than full) disclosure of the underlying facts. See, e.g., *Shaw v. AAA Eng'g & Drafting, Inc.*, 213 F.3d 519 (10th Cir. 2000) (73 FCR 611). In *Shaw*, a former employee of a government photography contractor brought suit against the contractor under the FCA. The employee claimed that defendants falsely inflated production quantities on some work orders and failed to practice silver recovery as required under the contract. The evidence suggested that the contractor "was not forthcoming about silver recovery and repeatedly evaded government employees' questions on the subject." *Id.* at 534. In addition, the government was unaware that work orders may have been falsely inflated. The government's alleged knowledge therefore did not, "as a matter of law, negate the evidence of the defendants' intent to submit false records in support of a claim." *Id.* at 535. See also *United States ex rel. Jordan v. Northrop Grumman Corp.*, 2002 U.S. Dist. LEXIS 26674, *65 (C.D. Cal. 2002) (80 FCR 203) (holding that summary judgment was inappropriate where evidence suggested that contractor had only partially disclosed deficiencies to government); *Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 920 (4th Cir. 2003) (81 FCR 36) (government knowledge was not a defense where the Department of Energy ("DOE") did not have "full knowledge of the material facts" and the contractor was not following DOE instructions when it allowed the subcontractor unrestricted access to procurement sensitive information); *United States v. Incorporated Village of Island Park*, 888 F. Supp. 419, 442 (E.D.N.Y. 1995) (government's knowledge not a bar to a FCA claim if the knowledge is incomplete or acquired too late in the process).

³¹ 975 F.2d 1412 (9th Cir. 1992) (58 FCR 340).

³² *Id.* at 1420.

³³ *Id.* at 1421.

be relevant in determining whether the defendant "knowingly" submitted a false claim; however, *it is not an automatic defense to a FCA case.*³⁴

C. Even If the Government Approved the Client's Billings After Their Submission, a Defendant Might Still Avoid False Claims Liability

At least one federal court faced with such post-submission government approval of the allegedly false claim held that the defendant was not liable under the federal FCA because, among other things, there was full and open communication between the contractor and the government regarding the deficiencies that made the claim false.

In *United States ex rel. Lamers v. City of Green Bay*³⁵ ("Lamers"), Green Bay filed a grant application with the Federal Transit Administration ("FTA") for transporting local school children on public buses. As required by the grant application, the city provided assurances of compliance with all applicable federal statutes and regulations. After the FTA received the grant application, an FTA inspector came out to inspect the city's program. Although the inspector found ongoing violations of the applicable statutes, the FTA approved the city's annual grant.

The U.S. Court of Appeals for the Seventh Circuit held that there was no FCA violation because there was no evidence that the FTA was duped into approving the application even after it knew of the statutory violations. Also, there were significant questions regarding whether the statements at issue were "false" or "material," and the defendant extensively cooperated with the FTA in an effort to achieve compliance.³⁶ For all of

³⁴ See, e.g., *United States ex rel. Kreindler v. United Techs. Corp.*, 985 F.2d 1148, 1157 (2d Cir. 1993) (59 FCR 143); *United States ex rel. Becker v. Westinghouse Savannah River Co.*, 305 F.3d 284, 289 (4th Cir. 2002) (78 FCR 415); *United States ex rel. Durcholz v. FKW, Inc.*, 189 F.3d 542, 545 (7th Cir. 1999); *United States ex rel. Hagood v. Sonoma County Water Agency*, 929 F.2d 1416, 1421 (9th Cir. 1991) (55 FCR 764); *Shaw v. AAA Eng'g & Drafting, Inc.*, 213 F.3d 519, 534 (10th Cir. 2000) (73 FCR 611). See also *United States v. Southland Mgmt. Corp.*, 288 F.3d 665 (5th Cir. 2002) (77 FCR 470), *rev'g*, 95 F. Supp. 2d 629 (S.D. Miss. 2000), *vacated on reh'g en banc*, 307 F.3d 352 (5th Cir. 2002) (rejecting government knowledge defense but noting that such a defense would be viable "where the falsity of the claim is unclear and the evidence suggests that the defendant actually believed his claim was not false because the government approved and paid the claim with full knowledge of the relevant facts"). See also *United States v. Southland Mgmt. Corp.*, 326 F.3d 669 (5th Cir. Miss. 2003) (79 FCR 427), *aff'g en banc on other grounds*, 95 F. Supp. 2d 629 (S.D. Miss. 2000). Before the 1986 amendments to the FCA, the court had no jurisdiction if the government already possessed the information underlying the *qui tam* action. 31 U.S.C. § 3730(b)(4) (1982) provided "[u]nless the Government proceeds with the action, the court shall dismiss an action brought by the person on discovering the action is based on evidence or information the Government had when the action was brought." The 1986 amendments eliminated this language which left open what would be the effect of government knowledge of the facts underlying a suit. But see *United States ex rel. Boisjoly v. Morton Thiokol, Inc.*, 706 F. Supp. 795, 809 (N.D. Utah 1988) (noting that "courts have disallowed FCA claims where the Government knew, or was in possession at the time of the claim, of the facts that make the claim false").

³⁵ 168 F.3d 1013 (7th Cir. 1999) (71 FCR 336).

³⁶ *Id.* at 1019-20.

these reasons, the court concluded that the city did not “knowingly submit a false statement.”³⁷

D. What Position Must a Government Employee Have Before the Government Is Said to Have Knowledge of the Contested Action?

At least two federal courts have found that “government knowledge” is not the sole province of contracting officers, and that the knowledge of lower-level government officials may be considered in determining whether the defendant “knowingly” submitted a false claim.

In *Butler*, *supra*, plaintiffs argued that even though Army technical representatives knew and approved of the contractor’s deviations from specifications in the planned tests, the Army’s knowledge was not a defense to an action under the FCA because the “wrong” Army personnel knew.³⁸ Plaintiff argued that only a contracting officer had the power to modify a government contract. The Ninth Circuit rejected this argument and held that the knowledge of government “technical representatives” may also be considered by the court in deciding if the government’s knowledge negates a FCA violation.³⁹ The court found that the issue was one of contract interpretation rather than false claims.⁴⁰

In *United States ex rel. Stone v. Rockwell International Corp.*,⁴¹ defendants appealed the lower court’s finding of an FCA violation on the ground that the jury instruction only allowed the jury to consider the knowledge of contracting employees. The U.S. Court of Appeals for the Tenth Circuit found that the jury instruction—which allowed the jury to consider the knowledge of all “government employees with authority to act under the contract”—did not limit the pool of relevant employees to contracting officers. The Tenth

Circuit then noted that its ruling was consistent with the opinion in *Butler*.⁴²

In summary, in assessing the role of “government knowledge,” we start with the basic principle that a central focus of a CFCA or FCA violation is whether the defendant “knowingly” submitted a false claim for payment or approval.⁴³ Accordingly, “government knowledge” is only relevant insofar as it impacts the defendant’s knowing submission of false claims. Even in the face of a statement that is in fact false, several courts appear to recognize that a defendant may legitimately hold the subjective belief that its statement is not false as a result of: (i) the government’s express directions, or (ii) the government’s approval and payment of a claim with full disclosure of the underlying facts prior to its submission. Many courts have concluded that, under these circumstances, the defendant cannot be said to have “knowingly” submitted a false claim.

Courts have further recognized that government knowledge of deviations and mistakes acquired via candid, ongoing dialogues with defendants may signal a modification or clarification of contract terms such that the underlying statement is **true rather than false**. And while intent to deceive is not an element of a federal FCA violation, it is certainly not lost on the courts that defendants who engage in cooperative efforts to provide services are not trying to cheat the government.

Finally, an argument can be made that there should be only three scenarios where government knowledge should not negate an FCA violation: (i) the defendant is unaware that the government knows that the claim is false yet submits it in any event; (ii) the defendant is engaged in fraud or collusion with the government employee who knows the statement is false; or (iii) the government’s knowledge of the false claim came “too late in the process.”⁴⁴

³⁷ *Id.* at 1020.

³⁸ 71 F.3d at 326.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ 282 F.3d 787 (10th Cir. 2002)

⁴² *Id.* at n.12.

⁴³ Cal. Gov’t Code § 12651(a)(1).

⁴⁴ See *United States ex rel. Durcholz v. FKW, Inc.*, 189 F. 3d 542, 544-45. See also *Southland Mgmt. Corp.*, 326 F3d at 628 n.9 (Jones, J. specially concurring).