Materiality Concerns For CARES Act Enforcement Cases

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With the Department of Justice’s (DOJ) decision to drop charges against Michael Flynn, materiality has come to the forefront of popular legal discourse. At the same time, prosecutors and whistleblowers will carefully consider enforcement/false claims actions against entities who may have wrongfully received relief funds under the Coronavirus Aid, Recovery, and Economic Stability Act (CARES Act). Such actions likely will turn on whether alleged misrepresentations were materially false. Those applying for CARES Act funds, such as those under the Paycheck Protection Program (PPP), must ensure all of their representations and certifications are truthful. However, those accused of making misrepresentations in order to receive government funds may find refuge in a more narrow view of the materiality requirement.

Michael Flynn pleaded guilty to making false statements in violation of 18 U.S.C. § 1001 based on a January 24, 2017 interview with the FBI. At the time of the guilty plea, both the government and the defense agreed that Flynn’s false statements were material. Then, on May 7, 2020, the DOJ moved to dismiss its charges against him, and allowed Flynn to withdraw his guilty plea, arguing that his statements were not materially false. While these circumstances are unusual, those accused of making false statements to the government now have a better basis to argue that the government has failed to show that the alleged false statements were material. Materiality is a common element in many types of false statement charges,
including 18 U.S.C. § 1001 (false statements to the government), 18 U.S.C. § 1341 (mail fraud), 18 U.S.C. § 1343 (wire fraud), 18 U.S.C. § 1344 (bank fraud), and more. Materiality also is an element of the False Claims Act (FCA). As the government and whistleblowers prepare to pursue cases against businesses and individuals for falsely taking CARES Act funds, it is important to review the standard for materiality and how it may impact these cases.

**CARES Act Fraud Enforcement**

Misrepresentations when applying for CARES Act funds may subject businesses and individuals to severe civil and criminal liability.

Among other possible charges, misrepresentations on loan applications may subject potential wrongdoers to prosecution under 18 U.S.C. § 1341 (mail fraud), 18 U.S.C. § 1343 (wire fraud), and 18 U.S.C. § 1344 (bank fraud). Each of these crimes is punishable by up to $1,000,000 in fines and/or up to 30 years imprisonment.

Businesses or individuals also may be civilly liable for knowingly or recklessly submitting false loan applications under the civil FCA (31 U.S.C. §§ 3729–33). FCA claims may be brought by the government or private whistleblowers acting on behalf of the government. Liability under the FCA is severe, including both penalties for each false claim submitted and treble the amount of loss sustained by the government. All of these charges include an element of materiality.

Federal cases for fraudulently claiming CARES Act funds have already begun percolating around the country. Recently, an Arkansas man was charged with fraudulently claiming PPP funds by submitting fake payroll documentation and falsely stating that his business was in operation as of February 15, 2020.[1] The U.S. Attorney’s Office for the Northern District of Oklahoma charged the man with wire fraud, bank fraud, making false statements to a financial institution, and making false statements to the Small Business Administration (SBA). Similarly, the U.S. Attorney’s Office for the Eastern District of Virginia recently charged a man with wire fraud, theft of government property, making false statements to the SBA, and money laundering for applying for PPP and Economic Injury Disaster (EIDL) loans while misrepresenting his income, employment, claimed business entities and prior criminal record.[2]

While these criminal cases represent “low hanging fruit,” as the country emerges from the pandemic, we can expect many more investigations and civil FCA cases to emerge that are not nearly as “low hanging”—similar to what happened in the wake of the 2008 financial crisis.

**The Materiality Standard**

In a non-FCA context, courts generally have defined materiality as whether a false statement had the tendency or ability to influence the decision of the intended victim. The Supreme Court in *United States v. Gaudin*, 515 U.S. 506, 509 (1995) confirmed the definition of materiality as having “a natural tendency to influence, or [be] capable of influencing, the decision of the decisionmaking body to which it was addressed.” Though *Gaudin* originally defined materiality under 18 U.S.C. § 1001,
the definition has been applied to other false statement statutes, such as wire fraud, mail fraud, and bank fraud. In the context of false statement cases involving government funds, this naturally leads to the question of whether the false statement caused, or had the potential to cause, the government to make a payment it otherwise would not have made.

Under the FCA, one who knowingly makes or uses a false document or statement in support of a false claim for payment to the government only violates the FCA if the misrepresentation was material to the false or fraudulent claim. The FCA defines the term “material” as “having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property.” 31 U.S.C. § 3729(b)(4). A claim for payment may be false under the FCA if it makes an express false certification of compliance with an applicable statute, regulation, or contractual requirement. In what is known as “implied certification theory,” a claim may also be false if it fails to disclose that the claimant violated an applicable statute, regulation, or contractual requirement.

Historically, the interpretation of “material” under the FCA was so broad that challenges based on materiality were few and far between, and almost always unsuccessful. Then came Universal Health Servs., Inc. v. United States ex rel. Escobar, 136 S. Ct. 1989, 1996 (2016). In Escobar, the Supreme Court affirmed that false certifications must be material for the conduct in question to fall under the FCA. The Court further found the materiality requirement to be “rigorous” and “demanding,” explaining that “[a] misrepresentation cannot be deemed material merely because the Government designates compliance with a particular statutory, regulatory, or contractual requirement as a condition of payment.” Id. at 2003. The Escobar Court listed several factors relevant to applying the materiality standard. For example, (1) the fact that the government could decline to pay if it knew of the claimant’s noncompliance is insufficient to prove materiality, (2) the noncompliance or falsity must not be “minor or insubstantial,” and (3) courts may consider whether the government expressly identified a provision as a condition of payment and whether the government routinely refuses to pay claims based on noncompliance with a particular requirement. Finally, the Escobar Court noted that “if the Government regularly pays a particular type of claim in full despite actual knowledge that certain requirements were violated, and has signaled no change in position, that is strong evidence that the requirements are not material.” Id. at 2003–04.

Since the Supreme Court’s decision in Escobar, materiality has been a hotly litigated issue in FCA cases. The DOJ’s recent actions and statements in the Flynn prosecution will no doubt fuel the fire and likely will be a central focus of defense in FCA cases that arise under the CARES Act.

Materiality Under CARES Act Enforcement Cases

Enforcement actions concerning fraud under the CARES Act likely will depend on whether representations or certifications were materially false. The following are some areas that may implicate the issue of materiality:

1. Certification Concerning Necessity Of A PPP Loan
Applicants for PPP funds must make several express certifications when applying for loans and loan forgiveness. While recent prosecutions for PPP have involved misrepresentations that obviously were material, such as applications for non-existent businesses, other misstatements may straddle the line of materiality.

For example, PPP applicants must certify that “[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.” Despite the fact that the PPP was intended for small businesses, many apparently large businesses, such as publicly traded fast food and technology companies or companies backed by Private Equity firms, have claimed PPP funds while making this certification. In response, the SBA and the Treasury Department announced that they would audit all loans greater than $2 million.

These regulations beg the (two-) million-dollar question—what does it mean for a PPP loan to be “necessary?” Enforcement agencies and accused PPP applicants likely will grapple over the degree of economic impact that causes a PPP loan to be necessary. Given that the SBA requires an express certification of necessity, and thoroughly discussed the certification in recent guidance[3], a false certification of necessity most likely will be considered material.

However, other misrepresentations related to the necessity certification may be immaterial if they would not have affected the SBA’s decision to approve a loan. For example, PPP applicants must provide documentation of certain expenses, such as payroll, rent, mortgages, and utilities. A business may inadvertently omit documents or submit inaccurate documents related to these expenses, which may affect the business’s assessment of the impact—and economic necessity of a loan—caused by COVID-19. If inaccuracies in documents were small and inconsequential, a business accused of fraud may argue that its misrepresentations were immaterial, and that it still made the necessity certification in good faith.

2. **Size and Affiliation Rules**

The SBA’s size and affiliation rules could be another potential hotbed of liability for PPP applicants. The CARES Act expressly limits PPP loans to businesses with less than 500 employees, or otherwise qualifying as a small business concern under other SBA standards, with exceptions. The “alternative size standard” for PPP loans also allows businesses to qualify if, as of March 27, 2020, the maximum tangible net worth of the business is not more than $15 million, and their average net income after federal income taxes for the two full fiscal years before the date of the application was not more than $5 million. Businesses must include the employees of affiliate businesses in its size determinations, according to the SBA’s affiliation rules.

Enforcement agencies and whistleblowers may argue that miscalculating or misrepresenting a business’s employee-count or net worth may constitute false statements to the government. Businesses may be able to respond that certain misrepresentations were immaterial if the miscalculations would not have affected the SBA’s decision to approve loans. For example, if an application stated that a business had 400 employees where it actually had 450, a court may consider this misrepresentation to be immaterial because the business would still fall under the
500-employee threshold. The bigger “materiality” question may be whether a business had just over 500 employees, but otherwise fully qualified for the loans.

### 3. Unauthorized Use Of CARES Act Funds

PPP applicants must use the loan for authorized purposes, such as payroll expenses, rent, mortgages, and utilities. Applicants for PPP loan forgiveness must provide documents accounting for the use of PPP funds and must expressly certify that the amount of funds sought to be refunded were used for eligible purposes. If a business uses some funds for purposes other than the approved purposes, but still applies for loan forgiveness, government enforcement agencies or whistleblowers may argue that the applicant’s certification was false. The businesses may attempt to argue that only a minimal amount of funds were used for other purposes, and that the certification was thus immaterial. However, given the novelty of PPP fraud prosecutions, it remains to be seen how courts may resolve this defense.

### Conclusion

While the CARES Act funds will likely lead to a wave of enforcement actions against those perceived as wrongfully taking government funds, accused recipients may find refuge in the evolving materiality standard of many of the relevant statutes. It remains to be seen from early CARES Act enforcement cases how courts will treat this defense.

### FOOTNOTES


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