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Alleged TAA Non-Compliance Is Not "Material" Under The False Claims Act, Federal Court Holds

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Article By Justin M. Ganderson
Jason N. Workmaster Evan Sherwood
Covington & Burling LLP
Inside Government Contracts
Government Contracts, Maritime & Military Law
Litigation / Trial Practice
D.C. Circuit (incl. bankruptcy)

Contractors that must comply with the government's domestic preference laws should take note of *United States ex rel. Folliard v. Comstor Corp.*, __ F. Supp. 3d __, 2018 WL 1567620 (D.D.C. 2018) — a recent decision dismissing a country-of-origin fraud lawsuit initiated by serial relator Brady Folliard.

In *Comstor*, the relator alleged that two contractors violated the False Claims Act ("FCA") by selling end products on the General Services Administration ("GSA") Federal Supply Schedule ("FSS" or the "Schedule") that failed to comply with the Trade Agreements Act ("TAA"), as implemented by the Federal Acquisition Regulation ("FAR") and as incorporated into the contract through FAR 52.225-5 and -6. Under the FAR, a contractor subject to the TAA must deliver U.S.-made end products (*i.e.*, end products "manufactured" or "substantially transformed" in the U.S.) or "designated country end products" (*e.g.*, end products "wholly manufacture[d]" or "substantially transformed" in certain foreign countries with which the U.S. has negotiated a trade agreement). Notably, China, India, and Malaysia are not designated countries.

The court found that that the relator had failed to adequately plead that the alleged TAA non-compliance was "material" — a necessary element of an FCA case that requires a showing that an alleged non-compliance had an effect on the government's payment decisions. In this regard, the relator argued that the bare language of the statutes, regulations, and contract provisions at issue demonstrated that the non-compliance was material. The court, relying on the Supreme Court's landmark decision in *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016), rejected this legalistic argument and found that the relator had "not alleged sufficient ***facts*** to show that any sales of non-TAA compliant products by the defendants were material to the government's decision to pay" for those products. (Emphasis added).

This is a significant victory for contractors subject to domestic preference requirements because it demonstrates that the materiality analysis under the FCA requires a consideration of whether the government ***in fact*** has treated these provisions as material, and not just whether there has been a technical violation. The *Comstor* decision also provides further guidance on what is necessary to establish "falsity" and "scienter" — two other required elements of an FCA case.

The "Materiality" Analysis Requires Actual Facts Showing that the Alleged Non-Compliance Would Have Affected the Decision to Pay

Comstor is one of the first federal court decisions to discuss how the Supreme Court's *Escobar* decision impacts claims of fraud relating to domestic preference rules, although other recent decisions have discussed similar issues. In *Escobar*, the Supreme Court held that a mere violation of law or contract does not necessarily give rise to a "material" issue unless the violation would have "a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property." Accordingly, if the government would continue to pay claims even with full knowledge of a legal violation, the issue is not material and thus cannot serve as the basis of a false claim.

In *Comstor*, the relator attempted to demonstrate materiality by citing to the regulatory regime that implements

the TAA. Although the court agreed that the defendant was required to comply with this regulatory regime, the court held that the relator's simplistic view did not satisfy the FCA's materiality threshold for two critical reasons:

- ***First*,** the court held that the mere presence of FAR 52.225-5 and -6 in the defendants' contracts did not, without more, demonstrate materiality. The court's conclusion here is consistent with *Escobar*'s instruction that "statutory, regulatory, and contractual requirements are not automatically material, even if they are labeled conditions of payment." *Escobar*, 136 S. Ct. at 2001.

- ***Second***, the court found that "GSA's expressed willingness [in a 2006 GSA newsletter] to 'work with' vendors in order to address [TAA] compliance issues instead of outright rejecting claims" showed that GSA "may continue to make payments even when TAA violations are known," and therefore further supported the notion that an alleged TAA non-compliance may not be material to a condition of payment. The court's rationale again is consistent with *Escobar*, which held that the government's continued payment of claims after disclosure of a violation is strong evidence that the violation is immaterial. *Escobar*, 136 S. Ct. at 2003. In other words, if the government not only continues to pay, but also helps the contractor resolve its non-compliance issues, these actions strongly suggest that the materiality threshold under the FCA has not been satisfied.

The court also acknowledged that the "requirement of demonstrating materiality would seem especially crucial here where the government declined to intervene after almost five years of investigation[.]"

In summary, *Comstor* confirms that alleging a mere technical violation of the TAA will not satisfy the materiality requirement under the FCA. Rather, the unique factual circumstances of each case must be considered, including whether the government has expressed a willingness to work with contractors to resolve compliance issues instead of simply rejecting claims, as GSA did in *Comstor*.

The *Comstor* Court Refused to Infer that "Open Market" Sales and Sales of "Configurable Option" Items Were Non-Compliant and Therefore "False" Within the Meaning of the FCA

In addition to dismissing the case for lack of materiality, the court also found that the relator had failed to properly allege "falsity" with respect to "open market" and "configurable option" items sold by the defendant (notably, the court concluded that the relator did sufficiently allege "falsity" for other sales, although it dismissed those claims for lack of materiality as described above).

Regarding open market items (*i.e.*, end products not listed in a Schedule contract, but sold through a Schedule order), the relator alleged that the defendant sold open market items that were not TAA-compliant. The court flatly rejected that allegation, holding that FAR 8.402(f) did not require TAA compliance for open market items, because it did not cross-reference the TAA. Further, the court found that the defendant's sales were all below the TAA's dollar-value thresholds in FAR 25.402(b), which meant that the TAA would not apply in any event.

Regarding configurable option items (*i.e.*, items generally incorporated into an end product sold through the Schedule), the relator alleged that certain option items originated from non-designated countries and that these items were listed in purchase orders. As a result, the relator argued that these items must be TAA non-compliant and must have been sold to government "on an *a la carte* basis . . . before being incorporated into end products" — thereby demonstrating "falsity." The court rejected this argument because the relator failed to provide any "additional information" supporting these general allegations, and simply "ignore[d] the possibility" that the government ordered the option items "solely for incorporation . . . into . . . end products prior to delivery to the government." Under that scenario, the option item would be incorporated into the *end product* by the contractor, and TAA compliance would hinge on whether the end product was substantially transformed by the contractor in a designated country.

Merely Selling a Large Volume of Products Is Insufficient to Show "Scienter"

Finally, the court found that the relator failed to adequately allege that the defendant had knowledge of the relevant facts, and therefore had not properly pled the "scienter" element of an FCA case. On this point, the relator argued merely that because the defendant sold a large volume of products, it must have known about potential non-compliance with the TAA. The court disagreed, finding that "merely alleging a time period, the volume of items sold and total sales value involved" was "not enough to show" that the defendant in fact knew about any non-compliance with law.

Key Takeaways for Contractors

- **Consider a Proactive Approach —** *Comstor* reveals that an agency's willingness to "work with" a contractor to resolve a TAA compliance problem after a claim for payment is submitted may help

demonstrate that the non-compliance was not material. With that in mind, contractors who discover a potential TAA issue (or any domestic preference issue for that matter) may want to consider raising the matter promptly with the agency and documenting how the parties are working together to resolve the potential issue. A proactive approach may pay dividends down the road, even if mandatory disclosure under FAR 52.203-13 is not required.

- **Work to Reduce the Chance that the Government Will Intervene —** *Comstor* demonstrates why it is important to encourage the government not to intervene in a *qui tam* matter. As discussed above, the government's decision not to intervene may affect the way the court views the relator's case.

- **Be on the Lookout for Enhanced Enforcement and Scrutiny of Domestic Preferences and Its Impact on the "Materiality" Analysis Going Forward —** Since the time period at issue in the *Comstor* case, there have been significant developments regarding domestic preference laws. First, in May 2016, GSA issued a letter in response to FOIA requests and congressional inquiries, asking myriad contractors on the FSS to "[s]ubmit a spreadsheet that verifies the COO for each product approved on your GSA contract," and noting that "GSA Schedule contract holders have a fiduciary duty to determine compliance with the TAA and to ensure that all COO representations in GSAdvantage are accurate regardless of any information provided by your suppliers or manufacturers if you are a distributor or reseller." Second, since taking office in January 2017, President Trump has revealed a "Buy American" policy and action plan that reflects increased scrutiny of domestic preference laws, and there has been recent bipartisan congressional action related to strengthening "Buy American" laws like the Buy American Act and the Berry Amendment. As a result, executive agencies and the Department of Justice may be more likely to take an aggressive stance when faced with a potential non-compliance related to domestic preferences, which could affect the determination of materiality in future cases.