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## PERSPECTIVE

## Bill aims to clarify the CFCA

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This session, the California Legislature will consider Assembly Bill 1270, which would amend the California False Claims Act to clear up confusion over two of the law's key elements: materiality and damages. The proposed legislation makes plain that the U.S. Supreme Court's 2016 *Escobar* decision did not alter the CFCA's materiality requirement. It also adds language to expressly include consequential damages to the liability calculus. Importantly, the bill states that both amendments are declaratory of existing law.

### Materiality

Courts have long required that false claims be "material" to be actionable under either the federal False Claims Act or the CFCA. In *Universal Health Services, Inc. v. United States ex rel. Escobar*, the U.S. Supreme Court appeared to upend years of FCA jurisprudence by placing significant weight on the government's decision to continue to pay claims despite full knowledge of their falsity, calling continued payment "very strong evidence" of immateriality. 136 S. Ct. 1989, 1995 (2016). Since then, some federal courts have functionally rendered the government's continued payment of false claims dispositive of materiality. See, e.g., *U.S. ex rel. Spay v. CVS Caremark Corp.*, 875 F.3d 746 (3d Cir. 2017); *U.S. ex rel. Harman v. Trinity Indus. Inc.*, 872 F.3d 645 (5th Cir. 2017); *U.S. ex rel. D'Agostino v. ev3, Inc.*, 845 F.3d 1 (1st Cir. 2016).

Although materiality had never been established by mere ipse dixit, courts previously applied the "natural tendency to influence" test currently codified in the both statutes. *See, e.g., U.S. ex rel. Jones v. Brigham and Women's Hosp.*, 678 F.3d 72, 93 (1st Cir. 2012). Senator Chuck Grassley — a champion of the FCA and sponsor of the many amendments that have strengthened it over the years — has expressed

materiality standard in *City of Pomona v. Superior Court* in 2001, adopting the 4th U.S. Circuit Court of Appeals' "natural tendency to influence" test derived from the analogous federal requirement. 107 Cal.Rptr.2d 710, 717 (Cal. Ct. App. 2001), *as modified* (June 29, 2001). More than a decade later, after amendments to both the federal FCA and CFCA codified the test, the Court of Appeal elucidated the

payment might reflect, among other things, "fear of litigation with defendant, or concerns about the possibility of disrupting services." *Id.* at 845. Senator Grassley has echoed these pragmatic concerns in his critique of post-*Escobar* caselaw, particularly in the health care context, where continued payment can mean ensuring access to critical care.

If enacted, Assembly Bill 1270 will amend the CFCA to state what should already be clear: *Contreras*, not any misapplication of *Escobar*, governs the materiality analysis. The proposed language expressly states that "Materiality is determined by the potential effect of the false record or statement when it is made, not on the actual effect of the false record or statement when it is discovered." Assembly Bill 1270 Section 1.

This standard appropriately recognizes that the government often finds itself in an intractable position when a contractor asks for forgiveness rather than permission. In many circumstances, the government simply cannot risk the consequences of cutting off payment, which could cause disruptions to patient care or delays to infrastructure projects. In codifying the *Contreras* standard, Assembly Bill 1270 ensures that a defendant cannot avoid liability simply because its misconduct placed the government between a rock and a hard place.

### Consequential Damages

Assembly Bill 1270 also makes an important clarification to the CFCA's damages provision by explicitly including con-

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cern that courts are "trying to outdo each other in applying [*Escobar*'s] analysis inappropriately or as strictly as possible." 164 Cong. Rec. S893 (2018). He has aptly explained that *Escobar*, in fact, did not change the materiality standard. The "natural tendency" definition remains in the federal statute and *Escobar* did not hold that a government contractor is "automatically off the hook" because the government pays a false claim. *Id.*

Over the objections of the California attorney general, one California court has extended this misguided application of *Escobar* to the CFCA, albeit in an unpublished opinion. *Los Angeles Cty. Metro. Transportation Auth. v. Parsons-Dillingham Metro Rail Constr. Manager Joint Venture*, 2018 WL 1044521, at \*6 n.11 (Cal. Ct. App. Feb. 26, 2018). In doing so, the court set aside existing California precedent.

The California Court of Appeal first defined the CFCA's

materiality standard in San Francisco Unified School District ex rel. *Contreras v. First Student, Inc.*, 168 Cal.Rptr.3d 832 (Cal. Ct. App. 2014).

*Contreras*, which remains the leading California decision on the subject, followed federal FCA precedent to conclude that materiality "focuses on the potential effect of the false statement when it is made, not on the actual effect of the false statement when it is discovered." *Id.* at 844. As the court explained, focusing the materiality inquiry on the time the false statement was made prevents the requirement from being "construed as immunizing conduct the CFCA sought to sanction." *Id.*

Moreover, *Contreras* expressly held that "the government contracting entity's actual reaction upon learning of a false claim is not dispositive of the issue of materiality." *Id.* In doing so, the court acknowledged the reality of government contracting, where continued government

sequential damages. *Id.* Section 2. In its present form, the CFCA is silent on the issue. It merely states that the government shall recover “three times the amount of damages that the state or political subdivision sustains because of” the violation. Cal. Gov. Code Section 12651. Interpreting analogous language, several courts have found that the federal FCA excludes consequential damages. *See, e.g., Cook Cty. v. U.S. ex rel. Chandler*, 538 U.S. 119, 131 n.9 (2003) (“The treble damages provision was, in a way, adopted by Congress as a substitute for consequential damages.”); *United States v. Aerodex, Inc.*, 469 F.2d 1003, 1011 (5th Cir. 1972); BMY—Combat Sys. Div. of Harsco Corp. v. United States, 44 Fed. Cl. 141, 148 (1998).

Unfortunately, courts occasionally confuse direct damages with consequential damages, limiting the government’s right to a complete recovery. For example, in *United States v. Aerodex*, the 5th U.S. Circuit Court of Appeals held that replacement costs

were unobtainable consequential damages under the federal FCA. 469 F.2d 1003, 1011 (5th Cir. 1972). The *Aerodex* defendant sold the government deficient engine bearings that were incorporated into Navy aircraft. When the Navy discovered the fraud, it removed and replaced the deficient goods, but the 5th Circuit considered the replacement costs to be consequential damages and limited the government’s recovery to the price paid for the defective bearings. As a result, the taxpayers footed the bill for the much larger repair costs.

Assembly Bill 1270 forecloses any possibility of a court reaching the anomalous result in *Aerodex*. To be sure, most courts have correctly held that repair and replacement costs are direct damages recoverable under the federal FCA, but the issue remains open under California law. *See, e.g., U.S. ex rel. Roby v. Boeing Co.*, 302 F.3d 637, 648 (6th Cir. 2002); BMY—Combat Sys. Div. of Harsco Corp., 44 Fed. Cl. at 148–49 (“Costs of inspection

and repair incurred by the government as a result of a contractor’s false representation that a product passed inspection pursuant to the contract are recoverable as FCA single damages.”); *Commercial Contractors, Inc. v. United States*, 154 F.3d 1357, 1372 (Fed. Cir. 1998). Expressly incorporating consequential damages guarantees that contractors who knowingly supply the government with defective parts will be liable for all foreseeable damages, including replacing or repairing those parts. At the end of the day, taxpayers will not be left holding the bag. At least two other state FCAs explicitly include consequential damages to prevent such outcomes. N.Y. State Fin. Law Section 189.1; Mass. Gen. Laws ch. 12, Section 5B(a).

With the largest budget in the nation, California is particularly susceptible to fraud and abuse from government contractors. Passing Assembly Bill 1270 in its current form will ensure that California continues to have one

of the most robust False Claims Acts in the country. The bill heads to the Assembly Judiciary Committee on April 9.

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