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PERSPECTIVE

Another missed chance to strengthen California's False Claims Act

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For the second year in a row, the California State Assembly passed legislation to strengthen the California False Claims Act — the state's greatest tool for protecting taxpayer dollars against fraud and abuse — only to see the bill die in the Senate. Among other things, Assembly Bill 2570 would have closed a loophole that lets tax cheats off the hook and rebuffed defendants' attacks on the CFCA's longstanding materiality standard. The Assembly should pass these vital reforms again in 2021, and the Senate should not block yet another opportunity to recover hundreds of millions of dollars that have been stolen from the state's coffers by fraud — money California desperately needs during the budgetary crisis brought on by the COVID-19 pandemic.

Taking on Tax Frauds

The CFCA is California's foremost fraud-fighting statute. It encourages whistleblowers to come forward and expose fraud by allowing them to bring civil claims on behalf of the government and to keep a portion of damages collected from the defendant. California has recovered billions of dollars under the CFCA, largely due to these whistleblower provisions. See AB 2570 Assembly Floor Analysis at 2 (June 5, 2020). But a loophole prohibits the government and whistleblowers from bringing CFCA cases against entities that defraud the government by knowingly failing to pay taxes. See Cal. Gov't Code Section 12651(f).

California tax authorities lack the information and resources to pursue all tax cheats who defraud the government. As a result, the state's tax gap — the difference between what taxpayers owe and what they actually pay — is an estimated \$20-25 billion. See AB 2570 Assembly Judiciary Committee Analysis at 6 (May 7, 2020). AB 2570 sought to close this tax gap by

incentivizing whistleblowers to expose tax frauds that would otherwise go undetected.

This proposal is not novel. Several states already permit whistleblowers to bring claims based on tax fraud. Indeed, AB 2570 was specifically modeled on the highly successful tax provisions in the New York False Claims Act. See N.Y. State Fin. Law Section 189(4). Like the New York law, AB 2570 targeted only the largest tax frauds — those that exceed \$200,000 and where a defendant's annual taxable income, corporate net income, or sales exceeds \$500,000. Over the last ten years, New York has recovered hundreds of millions of dollars from tax cheats using its statute. For example, in December 2018, Sprint paid \$330 million to settle a whistleblower action alleging it knowingly failed to pay state sales taxes.

AB 2570's detractors argued that extending the whistleblower provisions to tax matters would invite a tidal wave of frivolous lawsuits against innocent taxpayers. But New York's experience shows this boogeyman isn't waiting around the corner. In the decade since expanding its law to cover tax frauds, New York has only seen about a dozen unsuccessful tax whistleblower lawsuits, and not one appears to have made it past a motion to dismiss. That's no surprise. Because FCA matters involve fraud, plaintiffs must plead their claims with particularity and show that defendants *knowingly* failed to pay the taxes they owe. Because of these high bars, spurious claims rarely, if ever, reach discovery. The CFCA also allows the government to dismiss a whistleblower's case, providing yet another safeguard against meritless lawsuits.

Eliminating the Materiality Catch 22

AB 2570 also would have strengthened the CFCA by rejecting a favored argument of defendants seeking a get-out-of-jail-free card. Only "material" false claims violate the CFCA, and both the CFCA and its federal

counterpart have long defined "material" as "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money." 31 U.S.C. Section 3729(b)(4); Cal. Gov't Code Section 12650(b)(4).

In 2016, however, the U.S. Supreme Court threw the *federal* materiality standard into disarray when it observed that the government's continued payment of claims, despite actual knowledge of their falsity, would be "very strong evidence" of immateriality. *Universal Health Services, Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989, 1995 (2016). Defendants have seized on this language. In the four years since *Escobar*, several federal courts have given continued payment inordinate weight when evaluating materiality. See, e.g., *U.S. ex rel. Harman v. Trinity Indus. Inc.*, 872 F.3d 645 (5th Cir. 2017).

In California, however, Defendants battling CFCA claims haven't gained much traction with this argument. That's because the leading CFCA case on materiality, *San Francisco Unified School District ex rel. Contreras v. First Student, Inc.*, 168 Cal. Rptr. 3d 832 (Cal. Ct. App. 2014), correctly acknowledged the myriad considerations the government faces when it decides whether to cut off payments to an alleged fraudster. Those include "fear of litigation with [a] defendant, or concerns about the possibility of disrupting services." *Id.* at 845. Take health care, for example. A defendant

may be the sole provider of a critical medical service in a community. If Medi-Cal stops paying, vulnerable patients may no longer have access to life-saving care. The government should not be forced into the intractable position of deciding between disturbing essential services and accepting theft of public funds.

AB 2570 sought to codify the central holding in *Contreras*, protecting this commonsense principal from defense attacks: "The materiality test shall focus on 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." AB 2570 Section 1 (2020); see *Contreras*, 168 Cal. Rptr. 3d at 844. In other words, AB 2570 would have prevented fraudsters from avoiding liability by placing the government between a rock and a hard place.

It's regrettable that the California State Senate has yet again missed an opportunity to strengthen California's most effective tool for combatting fraud against the government. These reforms are more important than ever, as the COVID-19 pandemic has wrecked the state budget and invited rampant fraud in government programs. In the next session, the Legislature must provide California and its local governments with the tools they need to root out fraud and return badly needed taxpayers dollars to the treasury. ■

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