



APPEALS COURT DISCREDITS WEIGHT OF GOVERNMENT'S ENFORCEMENT ACTIONS FOR FALSE CLAIMS ACT'S MATERIALITY STANDARD

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The U.S. Court of Appeals for the Second Circuit recently clarified two important facets of the False Claims Act's (FCA) materiality inquiry: (1) in the fraudulent inducement context, courts must consider both "the [government's] decision to award contracts ... and the decision to ultimately pay claims under these contracts" in assessing materiality; and (2) "[a]llowing the government to rely on post hoc enforcement efforts to satisfy the materiality requirement would [improperly] allow the government to engage in ... materiality manufacturing, and at relatively low cost." *United States v. Strock*, 982 F.3d 51, 60, 63 (2d Cir. 2020).

As the Supreme Court has explained, the False Claims Act imposes a "demanding" materiality standard for all claims that "looks to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation." *Id.* at 59 (quoting *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*, 136 S. Ct. 1989, 2002-03 (2016)). Fraudulent inducement is one potential theory of FCA liability. Such a theory alleges that a government contract was "procured by fraud" and contends that the alleged "fraud does not spend itself with the execution of the contract but instead taints every claim [for payment] subsequently brought under" it. *Id.* at 60 (internal quotations and alterations omitted).

In 2015, the government sued Lee Strock and his company, Strock Contracting, alleging, among other things, that defendants had fraudulently induced the government to enter into certain contracts in violation of the FCA. The government contracts at issue were reserved for so-called "service-disabled veteran-owned small businesses," or SDVOSBs. *Id.* at 56. To qualify for these contracts, a company must certify that it is majority-owned, managed, and operated by a service-disabled veteran. In this case, the government had awarded \$21 million in SDVOSB contracts to a company called Veteran Enterprises Company, Inc. (VECO), which was ostensibly owned by Terry Anderson, a service-disabled veteran. *Id.* at 57-58. According to the complaint, however, VECO's SDVOSB status was a sham—in reality, Strock owned and controlled VECO and was not a service-disabled veteran. *Id.* at 58. Had the government known the truth, the complaint alleged, "it would either not have awarded the contracts or would have terminated them." *Id.*

The case came to the Second Circuit on appeal from a dismissal of the government's complaint. The central issue was whether the government had adequately alleged that Strock's misrepresentations were "material to the Government's payment decision." *Id.* at 59. The Second Circuit held that the allegations were sufficient to get past the pleading stage but, in doing so, made two important points about the scope of the FCA's materiality standard.

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First, the court of appeals rejected the government's constrained view of the relevant "payment decision." According to the government, in the fraudulent-inducement context, the "relevant 'payment decision' is the decision to award the contract, not the decision to ultimately pay a claim under the contract." *Id.* at 60. That is so, the government argued, "because the falsity of the claims in a fraudulent inducement case is imported from the falsity of statements made to obtain the contract in the first instance"—the initial fraud in entering into the contract "taints" all subsequent claims under it. *Id.* (internal quotations and alterations omitted). The Second Circuit, however, declined to extend that same logic to the FCA's materiality prong, holding that *Escobar* "precludes" such a "narrow[]" "understanding" of the government's "payment decision." *Id.* Instead, "the government's conduct after claims arise under a contract" is also "highly relevant." *Id.* at 61. The relevant "payment decision" therefore comprises "both the decision to award contracts in the first instance *and* the decision to ultimately pay claims under these contracts." *Id.* at 60 (emphases added).

Second, the court of appeals rejected the government's argument that prosecutions against other parties for similar misconduct—namely, criminal and civil prosecutions against "parties that fraudulently obtain SDVOSB set-aside contracts"—supported a finding of materiality. *Id.* at 63. In fact, for the Second Circuit, "the more fundamental question" was "whether post hoc enforcement actions are relevant to FCA materiality analysis *at all*." *Id.* (emphasis added). Applying *Escobar*'s warning that "the government may not manufacture materiality by alleging it had an option not to pay after the fact," the court held that the government could not "rely on post hoc enforcement efforts to satisfy the materiality requirement." *Id.* Were the rule otherwise, the government could too easily game the system and "engage in ... materiality manufacturing" by bringing prosecutions to prop up an FCA materiality argument with little risk or cost. *Id.*

As a result, "purely post hoc enforcement actions can carry some weight in a materiality analysis, [but] they are less probative than allegations that the government actually refuses to make payments" after determining noncompliance. *Id.* at 63-64. Applied to Strock's case, the government's allegations of other prosecutions were "at best only neutral with regard to a finding of materiality, particularly in light of the complaint's failure to allege even a single instance in which the government actually refused to pay a claim or terminated an existing contract based on a false SDVOSB representation." *Id.* at 64.

The Second Circuit's decision provides additional fodder for FCA defendants going forward. To start, rather than focusing exclusively on the government's initial decision to enter into the contract, defendants facing fraudulent-inducement claims can and should develop arguments and evidence about payments made under the relevant contract. Even more broadly, the decision should blunt the government's attempts to rely on other enforcement actions to prove materiality and should help defendants refocus the inquiry on the *actual* payment decisions at issue. As the Second Circuit appropriately put it, "*Escobar* indirectly indicates that allegations of post hoc prosecutions or other enforcement actions do not carry the same probative weight as allegations of nonpayment." *Id.* at 63.