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FEATURE COMMENT: Seven Takeaways From Recent FCA Decisions On Domestic Preference Requirements

Federal contractors navigating the Government's domestic preference and sourcing requirements—including those under the Buy American Act (BAA), 41 USCA §§ 8301–8305, and the Trade Agreements Act (TAA), 19 USCA §§ 2501–2581—often are faced with a difficult prospect.

These laws and their implementing regulations are fraught with exceptions and not necessarily a model of clarity. Contractors must not only keep track of Federal Acquisition Regulation pt. 25 and pertinent clauses in FAR pt. 52, but also agency supplemental regulations, executive orders, and decisions from the Government Accountability Office, Customs and Border Protection and various courts. Additionally, contractors must be aware of potential legislative/regulatory changes, as any tweaks to the current rules could have significant ramifications downstream.

In this complex environment, even dutiful companies working in good faith to comply with applicable requirements can make a mistake. As a result, contractors must do their best to ensure compliance with these rules because one misstep—whether a result of an honest mistake made in good faith or intentional misconduct—could result in the Government or a qui tam relator pursuing a fraud claim under the False Claims Act, 31 USCA §§ 3729–3733. In fact, contractors should not be surprised to encounter increased scrutiny of BAA and TAA compliance as a result of President Trump's "Buy American" policy announced in Executive Order 13788 (April 18, 2017); see 59 GC ¶ 115.

Nonetheless, contractors can take solace in a series of recent FCA decisions, many of which have noted that not every alleged BAA or TAA noncompliance can support an FCA case. These decisions have significant implications not only for contractors embroiled in a fraud investigation or an FCA litigation, but for contractors seeking guidance about how best to comply with these complex requirements and to avoid potential FCA exposure.

In this Feature Comment we will first provide a brief overview of the BAA, TAA and FCA frameworks, and then provide seven key takeaways from recent FCA decisions focusing on alleged BAA and TAA noncompliances.

Brief Overview of the BAA and TAA—Enacted in 1933, the BAA established certain Government contract procurement restrictions intended "to create jobs for American workers and protect American industry." *U.S. v. Rule Indus., Inc.*, 878 F.2d 535, 538 (1st Cir. 1989). The BAA generally applies to (a) items of supply that are acquired from a contractor for public use in the U.S. (known as end products), and (b) items that a contractor incorporates into the construction of a public work located in the U.S. (known as construction materials).

The BAA is implemented under the FAR (and applicable supplemental agency regulations) by providing an evaluation preference to contractors offering to sell "domestic end products" or offering to perform construction services using "domestic construction materials." Domestic end products and domestic construction materials include (1) unmanufactured items that are "mined or produced" in the U.S., and (2) items that are "manufactured" in the U.S. If a manufactured item is not commercially available off-the-shelf, it must also satisfy a component test. Under this test, the cost of a manufactured item's domestic components must exceed 50 percent of the cost of all of its components.

The TAA, on the other hand, "provides the authority for the president to waive the Buy American statute and other discriminatory provisions for eligible products from countries that have signed

an international trade agreement with the U.S., or that meet certain other criteria, such as being a least developed country."

As implemented under FAR pt. 25, the TAA waives the BAA restrictions for procurements that equal or exceed certain specified dollar thresholds. For example, the TAA adds the following categories of eligible items for acquisitions that equal or exceed the dollar threshold associated with the World Trade Organization Government Procurement Agreement (WTO GPA): (a) "U.S.-made end products" (i.e., end products that are "mined, produced or manufactured" or "substantially transformed" in the U.S.), and (b) "designated country end products" and "designated country construction materials" (e.g., end products or construction materials that are "wholly the growth, product, or manufacture" of or "substantially transformed" in certain foreign countries with which the U.S. has negotiated a trade agreement). The test used to determine an item's country-of-origin under the TAA is called "substantial transformation." To satisfy this test, the item must be "transform[ed] . . . into a new and different article of commerce, with a name, character, or use distinct from the original article."

Determining whether an item is manufactured or substantially transformed is fact-specific and subject to nuance. See, e.g., *U.S. v. Rule Indus., Inc.*, 878 F.2d 535, 538 (1st Cir. 1989) (commenting that the determination of whether an end product was manufactured in the U.S. under the BAA "call[s] for an individualized, fact-specific inquiry rather than the application of a definite rule to known facts," which "originates in the rather arbitrary standards and uncertain wording of the Act itself"); *U.S. ex rel. Kress v. Masonry Solutions Int'l, Inc.*, 2015 WL 3604760, at *5 (E.D. La. June 8, 2015) (noting that "[o]ver the years, the Comptroller General has adopted different, and sometimes conflicting, standards as to what constitutes 'manufacturing' under the Buy American Act") (citation and quotation omitted); *Energizer Battery, Inc. v. U.S.*, 190 F. Supp. 3d 1308, 1316–17 (Ct. Int'l. Trade 2016) ("Regardless of the applicable statutory provision, substantial transformation analysis is fact-specific."). As a result, a meticulous analysis often is needed.

This, of course, is only the *basic* regime, and there are myriad exceptions and nuances to the BAA and TAA rules—especially for Department of Defense procurements—that require careful consideration.

Brief Overview of the FCA—Under the FCA, any person who knowingly or recklessly presents a false or fraudulent claim seeking U.S. funds—or who causes one to be presented—may be liable for three times the damages caused by that claim, plus monetary penalties. 31 USCA § 3729(a)(1). FCA matters can be asserted directly by the Government, but they are more commonly asserted by third-party whistleblowers, known as "relators," on behalf of the Government.

When FCA lawsuits are filed by relators, the Department of Justice performs an investigation and has the option of joining the case, but it is not required to do so. See, e.g., *U.S. ex rel. Michaels v. Agape Senior Cmty., Inc.*, 848 F.3d 330, 334 (4th Cir. 2017); 31 USCA § 3730(b)(4).

Some FCA cases rely on assertions that a contractor's claims are factually false. For example, if a contractor delivers 1,000 widgets to the Government, but knowingly sends the Government a bill for 2,000 widgets, then that contractor may have submitted a factually false claim.

In *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*, 136 S. Ct. 1989, 2001 (2016), the U.S. Supreme Court recently clarified that FCA matters may also be asserted under an "implied certification" theory, in which a contractor's claims may be false if they make specific representations about the goods or services provided, but knowingly fail to disclose noncompliance with a material statutory, regulatory or contractual requirement. To succeed under any theory of FCA liability, the relator or DOJ must prove that the alleged misrepresentation was "material" to the Government's decision to pay the claim. The Supreme Court explained that the materiality standard is "rigorous" and "demanding"—particularly in implied certification cases—because the FCA is not meant to target mere regulatory or contractual violations.

Seven Key Takeaways for Government Contractors—*Takeaway #1, A TAA Noncompliance Is Not Automatically "Material" to the Government's Payment Decision*: Courts are beginning to make clear that, under *Escobar*, a violation of a domestic preference requirement is not automatically material to a contractor's claim for payment, even if the requirement is specifically incorporated into the contract.

In *U.S. ex rel. Folliard v. Comstor Corp.*, 2018 WL 1567620 (D.D.C. 2018), the relator argued that the contractors' alleged TAA noncompliance was material to their claims for payment under their General Services Administration Federal Supply Schedule contracts simply because the contracts contained FAR 52.225-5 and FAR 52.225-6, which implement TAA

requirements. The *Comstor* court squarely rejected that argument, holding that the mere presence of these FAR clauses in the defendants' contracts did not, without more, demonstrate materiality. As the court explained, "[w]ithout more than citations to the regulatory framework, the relator has failed to show that any alleged false claim was material to the government's decision to pay."

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 (emphasis added).

Takeaway #2, The Best Defense Is a Good Offense: As the old saying goes, an ounce of prevention is worth a pound of cure. That saying applies well to TAA and BAA FCA cases, in which an established and robust compliance plan can help a contractor counter an alleged FCA violation.

In *U.S. ex rel. Kress v. Masonry Solutions Int'l, Inc.*, 2015 WL 3604760 (E.D. La. June 8, 2015), a relator claimed that certain construction materials delivered to the project sites by a subcontractor violated the BAA because they were sourced from China. Pursuant to FAR 52.225-11, Buy American—Construction Materials under Trade Agreements, only "domestic construction material" or "designated country construction material" can be delivered to the construction site, unless otherwise permitted by the contracting officer pursuant to an exception.

To defeat that claim, the subcontractor responded with a robust set of documents and a declaration showing that the enhancement anchors delivered to the site were compliant domestic construction materials even though they were manufactured from Chinese materials. (The subcontractor demonstrated that the enhancement anchors were manufactured in the U.S. by a cold-forging process, and that the cost of the anchors' domestic components exceeded 50 percent of the total cost of all components.)

In a brief opinion, the court dismissed the action with only a cursory analysis of the remaining FCA elements, finding the defendant's evidence of compliance to be convincing. *Kress* goes to show that the most efficient defense in an FCA case is often to *demonstrate* compliance, and thus the absence of any "falsity." And demonstrating compliance is easier if there is a strong compliance program in place.

Takeaway #3, It's OK to Be Proactive and Ask for Help: If a contractor identifies a possible domestic sourcing issue, it often is helpful to address the potential problem by working with the agency proactively, rather than taking a wait-and-see approach in the hopes of forestalling an FCA case.

For example, informing the Government of a potential problem may serve as a gesture of good faith, which may encourage the agency to take a more sympathetic (and lenient) view of a contractor's mere honest mistake.

Providing notice to the Government also can help demonstrate a lack of materiality. If a contractor informs the Government of a potential problem, and the Government either ignores the problem or attempts to help resolve the issue rather than withhold payment, then the Government's action is evidence that the potential violation did not affect the Government's payment decision. *Escobar*, 136 S. Ct. at 2001. *Comstor*, cited above, is instructive on this point.

In *Comstor*, the court noted that after GSA became aware of the potentially TAA-noncompliant deliverables being sold under the GSA schedule, GSA took no action to cancel the contracts and send a notice of noncompliance. In the court's view, the lack of Government action was significant because "[a]ny of those steps by the government could have supported a plausible claim that compliance with regulatory or contractual obligations is material to the government's decision to pay in this case."

Additionally, the *Comstor* court cited a GSA newsletter indicating that the agency desired to " 'work with' vendors in order to address [TAA] compliance issues instead of outright rejecting claims," which supported the notion that GSA "may continue to make payments even when TAA violations are known." As a result, the court found that the alleged falsity was not material to GSA's decision to pay. The *Comstor* court's rationale 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.

Accordingly, if a contractor identifies a potential BAA or TAA issue, it should consider immediately assessing the issue, notifying the agency, and providing an action plan, regardless of any separate mandatory disclosure obligations. Likewise, it also can be helpful for contractors to openly and transparently discuss their compliance posture with an agency, even if there is no apparent compliance problem.

Takeaway #4, You Can Reasonably Rely on Your Supply Chain's Representations: It can be difficult for

prime contractors to ensure compliance with domestic sourcing requirements because they often do not have complete oversight of their supply chain, which may change over time.

Because of that challenge, contractors often request that suppliers certify their compliance with applicable requirements. But what happens if a lower-tier contractor does not provide an accurate certification? Could the prime be subject to liability?

Thankfully, the D.C. Circuit has addressed this problem. In a 2014 decision involving a GSA schedule contract, the court held that a contractor "is ordinarily entitled to rely on a supplier's certification that the product meets TAA requirements." *U.S. ex rel. Folliard v. Gov't Acquisitions, Inc.*, 764 F.3d 19, 29 (D.C. Cir. 2014); 56 GC ¶ 301. In the court's view, a contractor's reliance on a lower-tier contractor's representation can serve to disprove "knowledge" of a regulatory violation under the FCA. If a lower-tier supplier certifies its compliance, then a higher-tier contractor arguably cannot act knowingly, or with reckless disregard, of a problem in the lower-tier contractor's supply chain.

This general rule likely is not absolute, however. If a higher-tier contractor has actual knowledge that a lower-tier supplier's representation is incorrect, or if there are obvious red flags, a court might look skeptically at a higher-tier contractor's reliance on that representation. Bottom line: It is prudent to ask suppliers for certifications, but do not bury your head in the sand.

Takeaway #5, Offering a Noncomplaint Product for Sale Is Not a False "Claim": Some relators have brought FCA cases based on a contractor's online representations about products offered for sale. For example, in *U.S. ex rel. Crennen v. Dell Mktg., L.P.*, 711 F. Supp. 2d 157, 164 (D. Mass. 2010), the relator alleged that the defendant's country-of-origin representations for products on the *GSA Advantage!* website differed from the representations for identical products in retail stores.

As an initial matter, the court found that the allegations did not suffice to show that any false claims were submitted to the Government, because the relator did not allege that any products with allegedly false country-of-origin representations were in fact sold to the Government. However, the court went on to hold that even if the country-of-origin representations on the *GSA Advantage!* site were wrong, merely "posting a false statement on a website in the expectation that a claim will be submitted does not trigger liability without pleading a claim or a 'planned' claim."

Most recently, a court followed the same rationale, explaining that even if evidence shows that a defendant "knew it was *listing* TAA non-compliant products for sale, [such evidence does] not necessarily show that the defendant knew it had *sold* any TAA non-compliant product when it submitted the relevant claim for payment." *U.S. ex rel. Scutellaro v. Capitol Supply, Inc.*, 2017 WL 1422364, at *23 (D.D.C. April 19, 2017) (emphasis in original).

Takeaway #6, Claims of "Implied" Domestic Preference Fraud Should Be Harder to Make: As discussed above, some FCA actions are based on the theory that a contractor's invoices can serve as implied certifications of compliance with material contractual provisions or federal laws and regulations. To properly plead such a theory, however, an FCA plaintiff's complaint must make these allegations with "particularity" under Federal Rule of Civil Procedure 9(b).

In *U.S. ex rel. Berkowitz v. Automation Aids*, 2017 WL 1036575, at *7 (N.D. Ill. March 12, 2016), a federal district court threw out a relator's case that did not plead fraud with sufficient particularity. In *Berkowitz*, the relator alleged that the defendants' invoices impliedly certified compliance with the TAA under a GSA schedule contract, although the defendants were not compliant.

Citing *Escobar*, which confirmed the viability of the implied certification theory, the court explained that "simply alleging" a fraud based on an implied certification theory without "specific allegations about the fraud scheme" will not satisfy the Rule 9(b) pleading requirements. The court opined that "it is safe to say that satisfying Rule 9(b) often will be tougher to do in implied certification cases than in cases with an outright affirmative misrepresentation. Tougher *not* because the implied certification theory of liability is disfavored as a matter of law in any way, but only because Rule 9(b) is ... sensitive to the factual context of each case." With that principle in mind, the court held that the relator had failed to plead an implied certification claim adequately. The court noted that the allegations were more reminiscent of a breach of contract claim.

The court also commented that "[t]he closest that [the relator] comes to nudging the claim away from a breach of contract to a fraud" was when it alleged that the defendants received notices from the Government that certain of the defendants' catalogs may have contained improper country-of-origin listings. Notwithstanding, the court explained that "in the context

of *the sprawling federal procurement statutory and regulatory framework* [of the TAA], inferring fraud from those few general notices is *not reasonable*" (emphasis added).

Other courts are in accord, indicating that the Rule 9(b) standard is a more demanding hurdle in implied certification cases. See, e.g., *U.S. v. Safran Grp.*, 2017 WL 3670792, at *9–10 (N.D. Cal. Aug. 2, 2017); *U.S. ex rel. Lambert v. Elliott Contracting, Inc.*, 2015 WL 1097381, at *12 (S.D. W. Va. March 11, 2015). Notwithstanding, some courts have been more inclined to accept broad allegations under Rule 9(b) when the relator claims to be a first-hand witness. See *U.S. ex rel. Cox v. Smith & Nephew, Inc.*, 749 F. Supp. 2d 773, 785 (W.D. Tenn. 2010) (finding relator's broad allegations satisfied Rule 9(b), and noting that relator was allegedly a first-hand witness); *U.S. ex rel. Scott v. Actus Lend Lease, LLC*, 2011 WL 13177635, at *8 (C.D. Cal. April 22, 2011) (finding allegations sufficient, and noting that the relators were insiders at the defendant company). In contrast, the relator in *Berkowitz* was a competitor of the defendants, not an insider with first-hand information.

Takeaway #7, Diligently Maintain Records: As discussed before, the best defense is often to *prove* that your products are compliant with domestic sourcing requirements. To do that, contractors should maintain diligent records and be prepared to provide them, or a representative summary of them, in the event of a dispute.

Contractors who do not keep adequate records not only may have a difficult time defending against a TAA-based FCA suit, but also may face additional hurdles. For example, in *Scutellaro*, the defendant had a practice of purging old records, including country-of-origin information, despite contractual provisions requiring it to maintain records. *Scutellaro*, 2017 WL 1422364, at *11. Because the defendant failed to comply with the recordkeeping requirements of its contract, the court granted the plaintiffs "an adverse inference that the unavailable [country-of-origin] information would show that the relevant products came from non-designated countries."

Conclusion—Courts have rightly been skeptical of attempts by relators to allege liability under the FCA based on contractors' purported BAA and TAA violations. Heeding the teachings of these recent cases will help contractors avoid, and if necessary defeat, such lawsuits.

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