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Third Circuit Holds eBay-Based Allegations Sufficient to Plead Reverse False Claim For Failure to Pay Import Duties

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In October, the Third Circuit held in *United States ex rel. Customs Fraud Investigations, LLC v. Victaulic Co.*, 839 F.3d 242 (3rd Cir. 2016), that the 2009 amendments to the False Claims Act ("FCA") allowed a relator to pursue a reverse false claims action against an importer who allegedly failed to properly mark its imported products with a country-of-origin label. The Third Circuit further concluded, over a vigorous dissent, that the relator had satisfied both Rule 8 and Rule 9(b) by pleading a detailed statistical analysis supported by an attached expert declaration purporting to show that the fraud alleged had occurred.

Background

The subject of this qui tam case is pipe fittings, specifically, the country-of-origin markers that appear (or are supposed to appear) on these fittings. Under the Tariff Act of 1930, 19 U.S.C. § 1304(c), pipe fittings must carry the name of their country of origin. If a customs official discovers unmarked or improperly marked goods, the importer has three options: re-export the goods, destroy the goods, or properly mark the goods. If an importer releases unmarked or improperly marked goods into the stream of commerce, then the importer owes a 10 percent ad valorem "marking duty" on those goods. The duty is deemed accrued at the time of importation and must be paid.

The qui tam relator, Customs Fraud Investigations, LLC ("CFI"), is a company composed of former insiders in the pipe fittings industry; the defendant, Victaulic, is a global manufacturer and distributor of pipe fittings. CFI alleged that Victaulic illegally imported and distributed millions of pounds of unmarked or improperly marked pipe fittings throughout the United States, and therefore owes millions of dollars in unpaid marking duties. The failure to pay these marking duties, CFI alleged, violated the FCA's "reverse false claims" provision.

CFI used a two-step analysis to support the allegations in its amended complaint. First, CFI examined shipping data and applied certain assumption to conclude that between 54 percent and 91 percent of Victaulic's pipe fittings were manufactured overseas. Second, CFI spent six months researching Victaulic pipe fitting offers on eBay and selected 221 such listings for analysis. CFI then concluded, by looking at the pictures accompanying the listings, that approximately three-quarters of the pipe fittings had no country-of-origin markings and less than two percent had foreign country-of-origin markings.

After the United States declined to intervene, the United States District Court for the Eastern District of Pennsylvania granted Victaulic's motion to dismiss the complaint with prejudice for failure to state a plausible claim. The Court reasoned that CFI's bare-boned allegations failed to allege anything more than possible fraud. The District Court also commented that it did not believe that the FCA's reverse false claims provision covered failure to pay marking duties. CFI moved for relief from judgment and for leave to amend its complaint, attaching a proposed First Amended Complaint that included additional details regarding the methodology CFI adopted in determining that an FCA violation had occurred.

The District Court denied CFI's motions for relief from judgment and for leave to amend on two grounds. First, the Court concluded that CFI unduly delayed its motion for leave to amend because the court's comments during the motions hearing should have placed CFI on notice of the inadequacies in its complaint. Second, the Court concluded that a failure to pay marking duties could not, as a matter of law, violate the reverse false claims provision. CFI

appealed. In the appeal, the United States, as *amicus curiae*, filed a brief arguing that the FCA's reverse false claim provision allows claims based on a failure to pay marking duties.

The Third Circuit's Holding

A divided panel vacated the District Court's order. First, the three-judge panel unanimously agreed that the failure to pay marking duties can give rise to a reverse false claim under the 2009 amendments to the FCA. Before 2009, the reverse false claims provision stated that a party was liable if it "knowingly makes, uses, or causes to be made or used, a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the Government." 31 U.S.C. § 3729(a)(7) (1994). The statute did not define "obligation." The 2009 amendments, however, defined "obligation" as "an established duty, whether or not fixed, arising . . . from statute," and clarified that liability attaches if a person "knowingly and improperly avoids . . . an obligation to pay or transmit money or property to the government." 31 U.S.C. §§ 3729(b)(3), 3729(a)(1)(G) (2009). The Court concluded that CFI's allegations—Victaulic knowingly avoided a statutory obligation to pay a "marking duty"—satisfied the plain language of the reverse false claims provision. The Court noted this was consistent with the legislative history of the 2009 amendments to the FCA. Finally, the court observed that the FCA's treble damages are necessary to enforce marking duties, because a company would otherwise have no incentive to self-disclose improperly marked items.

The panel then split over whether CFI had plausibly alleged fraudulent conduct under Rule 8 and with the specificity required by Rule 9(b). Both the majority opinion and dissent expressed skepticism at CFI's methodology, but the majority was comfortable with a certain degree of skepticism at the Rule 12(b)(6) stage. The majority, citing the requirement to take all facts as true and to make all reasonable inferences in favor of CFI, concluded that CFI's methodology, while "unusual," supported the plausible inference that Victaulic was importing improperly marked pipe fittings. 839 F.3d at 257. In particular, the majority focused on CFI's calculation that, as a baseline, between 54 percent and 91 percent of all pipe fittings are of foreign origin. The majority then concluded that CFI's second step—its calculation of the percentage of properly marked pipe fittings in the secondary market—was sufficient here to demonstrate the plausibility of CFI's claims. CFI merely needed to demonstrate, through its review of the secondary market, that there was a discrepancy between the percentage of properly marked items in the secondary market and the "significant majority" of Victaulic pipe fittings that were imported. *Id.*

Turning to Rule 9(b), the majority concluded that CFI's methodology satisfied the Rule's particularity requirements by showing that "far more Victaulic pipe fittings on the secondary market should have country-of-origin markings, that the way marking duties are assessed provides an opportunity for fraud, and that only Victaulic has access to the documents that could prove or disprove CFI's well-pled allegations." *Id.* at 258.

By contrast, the dissent argued strongly that the court should not be willing to allow a plaintiff to "allege a ten-year scheme to defraud the government on the basis of 221 eBay postings." *Id.* at 258 (Fuentes, J. dissenting). The dissent provided a point-by-point critique of CFI's methodology and concluded that the majority had been "fooled by the numbers." *Id.* at 262. The dissent also characterized CFI's expert declaration as nothing more than a "sleight of hand" that repeated "CFI's conclusory allegations back to the reader in more technical-sounding terms." *Id.* at 268-69. The dissent recognized that CFI had a "powerful inkling" that Victaulic committed fraud, but concluded that a federal lawsuit is not the proper mechanism to "confirm a vague suspicion that fraudulent conduct occurred." *Id.* at 270. The dissent also concluded that CFI failed to comply with Rule 9(b) by not including details describing "which shipments, during which time periods, at which ports, were supposedly unlawful." *Id.* at 272. Instead, CFI merely suggested that "there must be fraud there—somewhere." *Id.*

Finally, the Court also split over whether the District Court abused its discretion by not permitting CFI to amend its complaint pursuant to Rule 15. The majority cited Rule 15's low "when justice so requires" standard and reasoned that a few comments from the bench during oral argument were insufficient to put CFI on notice that it needed to amend the complaint immediately after oral argument rather than after a ruling. The dissent reasoned that the Court sufficiently warned CFI during oral argument that its complaint was "just too barebones." *Id.* at 273.

Implications of the Court's Decision

This is the first time that the Third Circuit has addressed whether the failure to pay marking duties can give rise to a false claim under the 2009 amendments, and this decision will affect future import duty cases. The plausibility and particularity reasoning, however, applies beyond this subject, and the majority's willingness to overlook serious flaws in CFI's methodology at the pleading stage, if it is applied beyond the facts of this specific case, could deepen differences among the circuits on the role statistics may play to replace actual insider knowledge at the pleading stage of an FCA case.

Finally, it is noteworthy that the majority took pains to urge the District Court on remand and the parties to tightly manage discovery. Citing the 2015 amendments to the Federal Rules, the Court emphasized that under the new requirements, the limited facts alleged in this complaint should not open defendants to the burden of broad multi-year discovery.

Although a limited discovery plan will provide some protection to Victaulic, the Third Circuit's opinion is a major victory for CFI and for relators who rely on statistics to overcome a 12(b)(6) challenge.

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