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FALSE CLAIMS ACT

This BNA Insights article by Kirsten Mayer and Timothy Cahill of Ropes & Gray LLP examines the rise in recent years of a new source of liability for false statements on customs documents: the federal False Claims Act (FCA). FCA actions based on customs violations have the potential for substantial statutory damages, the authors say. This article looks at the emergence of these lawsuits and their key characteristics, and considers how future FCA plaintiffs may seek to expand the use of the FCA to police compliance in this area.

False Claims Act Enforcement of Customs Duties—Emerging Trends

BY KIRSTEN MAYER AND TIMOTHY CAHILL

Companies that import products manufactured overseas must declare information about those goods, including the country of origin and transaction value, to U.S. Customs and Border Protection (Customs). Customs relies on this information to determine which duties to assess. Traditionally, a company that submits false declarations intended to reduce or avoid customs duties can face a penalty claim issued by Customs or an enforcement action in the Court of International Trade. But recent years have witnessed the rise of a new source of liability for false statements on customs documents: the federal False Claims Act (FCA).

FCA actions based on customs violations have the potential for substantial statutory damages—the government's loss is trebled and penalties apply—and have resulted in recent settlements up to $45 million. This article looks at the emergence of these lawsuits and their key characteristics, and considers how future FCA plaintiffs may seek to expand the use of the FCA to police compliance in this area.

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The False Claims Act. The FCA, at its most basic, prohibits knowingly making a false or fraudulent claim for payment from the government. 31 U.S.C. § 3729(a)(1)(A). Civil actions under the FCA can be brought either by the U.S. directly or by a private whistleblower, known as a ''relator,'' who files suit on behalf of the U.S. Because the FCA gives a successful relator a share of any judgment or settlement that results from her suit, the statute is designed to incentivize anyone with information about false or fraudulent claims to bring that information promptly to the attention of the government. The government may choose to ''intervene'' in a suit filed by a relator, in which case the Department of Justice (DOJ) assumes primary responsibility for litigating the case. If the government declines to intervene, however, the relator retains control of the case and may receive a relatively higher share of any eventual proceeds.

Although the FCA dates back to the Civil War, it was not until 1986 that the statute was amended to reach what are commonly called ''reverse'' false claims: fraudulent efforts to avoid or reduce payments owed to the government. The current standard for this kind of claim is at 31 U.S.C. § 3729(a)(1)(G). The recent FCA lawsuits seeking liability for customs violations have been based on this ''reverse false claims'' theory.

Differences from Traditional Customs Enforcement.

Although the Tariff Act of 1930 (the Tariff Act) provides for direct government enforcement of customs laws—e.g., 19 U.S.C. § 1304(l) (penalizing the importation of goods bearing false country-of-origin markings)—lawsuits under the FCA feature additional advantages for plaintiffs and concurrent risks for defendants. FCA violators are liable for treble damages (i.e., three times the loss suffered by the government), civil penalties of $5,000 to $10,000 for each violation, and the relator's attorneys' fees. 31 U.S.C. § § 3729(a)(1), 3730(d). The FCA also has a longer statute of limitations (six years) than actions under the Tariff Act (five years). 31 U.S.C. § 3731(b); 19 U.S.C. § 1592(a).

In contrast to direct customs enforcement actions—and FCA cases in other areas—it appears that a jurisdictional gap prevents the U.S. from commencing customs-based FCA lawsuits on its own; the DOJ must instead rely on relator-initiated claims. This lacuna is created in part by statute. The Court of International Trade (CIT) has been given exclusive jurisdiction over any action ''commenced by the United States . . . to recover customs duties.'' 28 U.S.C. § 1582(3). As a result of this exclusive grant, one Court of Appeals held that federal district courts cannot hear FCA cases brought initially by the government if damages are based on fraudulent evasion of customs duties. *United States v. Universal Fruits & Vegetables Corp.*, 370 F.3d 829, (9th Cir. 2004). The CIT, however, also disclaimed jurisdiction, concluding that the monetary remedies available under the FCA were more appropriately categorized as ''damages'' or ''penalties,'' rather than ''duties,'' which conflicted with limitations on the CIT's jurisdictional grant. *United States v. Universal Fruits & Vegetables Corp.*, 30 C.I.T. 706, 433 F. Supp. 2d 1351 (2006). All of the FCA cases discussed below were commenced by relators, although in most cases the government elected to intervene.

Customs Violations Alleged in FCA Cases. The following are the most common types of false or fraudulent statements alleged by relators in recent customs-based FCA cases:

a. Misrepresenting the Country of Origin

Antidumping duties and countervailing duties are both assessed based on an imported product's country of origin. These duties are aimed at protecting U.S. industries from unfair trade practices. ''Dumping'' occurs when a foreign producer sells products in the U.S. below the market price or cost of production in its home country. ''Countervailable subsidies'' are benefits provided by a foreign government to producers in its own country in the form of payments, credits or favorable loans. If the U.S. market suffers from either of these practices, Customs will impose additional duties on the affected products to offset any unfair pricing advantage. These duties can sometimes be two to three times the stated value of the item. As of May 2014, forty countries were subject to at least one antidumping or countervailing duty, although almost half of the active duties were targeted at products manufactured in China. The most targeted types of goods were iron and steel products, but there were also duties for chemicals and pharmaceuticals, electronics, agricultural products, textiles and consumer goods.

Companies engaged in international importation could benefit from efforts to identify key products at higher risk of being subject to antidumping and countervailing duties, particularly goods produced in frequently targeted countries such as China, India, Taiwan and Korea.

There have been two recent significant FCA settlements involving allegations that importers misrepresented countries of origin. In *United States ex rel. Dickson v. Toyo Ink Manufacturing Co.*, 3:09-cv-00438 (W.D.N.C.), the relator alleged that a Japanese ink manufacturer falsely declared Japan and Mexico as the countries of origin for violet pigment in order to avoid antidumping duties applicable to China and India, the true sources of the product. According to the relator's theory, a finishing process performed on the pigment in Japan and Mexico was insufficient to change the country of origin for customs purposes. In December 2012, Toyo agreed to a $45 million settlement, the largest to date for an FCA lawsuit based on a customs violation. More recently, in November 2013, Basco Manufacturing Company paid $1.1 million to settle claims that it had transshipped aluminum extrusions manufactured in China through Malaysia, then falsely declared Malaysia to be the country of origin to avoid duty payments. *United States ex rel. Valenti v. Tai Shan Golden Gain Aluminum, Ltd.*, 3:11-cv-00368 (M.D. Fl.).

Companies engaged in international importation could benefit from efforts to identify key products at higher risk of being subject to antidumping and countervailing duties, particularly goods produced in frequently targeted countries such as China, India, Taiwan and Korea. In Tai Shan Golden Gain Aluminum, a 137 percent increase in duties on aluminum from China left the defendants facing potentially massive short-term losses, which they allegedly sought to avoid through fraudulent customs declarations. Companies would, of course, be better served by anticipating such scenarios and developing contingency plans that do not violate customs laws.

b. Misreporting the Value of Goods

A number of recent FCA lawsuits have alleged that importers fraudulently undervalued goods in order to reduce ad valorem duties, which are calculated as a percentage of the declared transaction value of a product.

In *United States ex rel. Tu v. Kuo*, 3:12-cv-04166 (N.D. Ca.), Bizlink Technology, an importer of computer cable assemblies from China, allegedly used two separate sets of invoices to avoid duty payments. True invoices were sent to customers, while false invoices submitted to Customs understated the products' prices. Bizlink settled the claims for $1.2 million in March 2014. Allegations of similar schemes led to settlements by importers of women's apparel in April 2014 for $10 million, *United States ex rel. Krigstein v. Siouni and Zarr Corporation*, 1:11-cv-04247 (S.D.N.Y.), and by a jewelry importer in 2011 for $3.85 million, *United*

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States ex rel. Karlin v. Noble Jewelry, 1:08-cv-07826 (S.D.N.Y.).

Another improper method of avoiding duties is failing to account for ''assists'' when declaring a product's value. Under the Tariff Act, the transaction value of imported goods includes any materials and services provided free of charge by the buyer of the merchandise for use in its production; these are defined as ''assists.'' 19 U.S.C. § 1401a(b), (h)(1)(A). In *United States ex rel. Jimenez v. Otter Products, LLC*, 1:11-cv-02937 (D. Colo.), Otterbox, an importer of protective cases for electronic devices, allegedly failed to include engineering and design services when declaring the value of its imports. Otterbox settled for $4.3 million in April 2014.

The two-invoice scheme alleged in Kuo involved alleged institutional fraud that companies obviously should avoid. Ensuring the proper accounting of ''assists,'' on the other hand, may require active oversight of major suppliers' operations to ensure that any goods and services received from buyers for use in production are included in declarations of value.

c. Misclassifying Goods

Some customs duties are based on the declared nature or status of imported goods. Companies must classify merchandise according to the Harmonized Tariff Schedule of the United States, published and maintained by the U.S. International Trade Commission. In *United States ex rel. Ludlow v. CMAI Industries, LLC*, 2:09-cv-14860 (E.D. Mich.), CMAI, an importer of automotive parts, allegedly misclassified certain products as ''unfinished'' in order to exempt them from a 2.5 percent customs duty. CMAI purportedly compounded this offense by passing the duty (which it did not pay) on to customers and pocketing $2.5 million in proceeds. CMAI settled the lawsuit in 2012 for $6.3 million.

Companies that believe they wrongfully face similar allegations should consider the defendant's successful tactics in *United States ex rel. Winslow v. PepsiCo., Inc.*, No. 05-Civ-9274, 2007 U.S. Dist. LEXIS 40024 (S.D.N.Y. May 31, 2007). The relator, a former employee, alleged that Pepsi misclassified more than $1 billion of soft drink concentrate to avoid customs duties. After denying the defendant's motion to dismiss, the trial judge agreed to stay the proceedings pending direct input from Customs, which later submitted a letter confirming that Pepsi's imports had not been improperly classified. The case was promptly dismissed.

Common Types of Relators in Customs Cases. One question that is critical for companies that import products from overseas is who are the people bringing these claims? The following represent the most common categories of relators who have brought recent customs-based FCA lawsuits:

- *Current and former employees*: The largest group of relators has been current and former employees of the defendant companies. For example, the relator in Otter Products was the former supply chain manager at Otterbox; the relator in Kuo was the former director of operations at Bizlink; and the relator in Noble Jewelry was the former general manager of the defendant's wholly owned subsidiary. In CMAI Industries, the relator was still the company's acting program and sales account manager at the time he filed the lawsuit.

- *Industry participants*: Other relators have been participants in the same industry who learned of the alleged fraud through direct or indirect dealings with the defendant. For example, the relator in Tai Shan Golden Gain Aluminum was the owner and CEO of a company that aided U.S. companies in finding sources of aluminum extrusions abroad.

- *Competitors*: Relators affiliated with defendants' competitors have an additional incentive to bring FCA lawsuits, since success would put an end to the defendants' allegedly unfair competitive advantages. In Toyo Ink Manufacturing, for example, the relator was an executive for a company that produced and sold the same ink pigment that Toyo was importing. In fact, the relator's company had petitioned the Commerce Department and U.S. International Trade Commission to investigate the economic practices in China and India that prompted the imposition of antidumping and countervailing duties on the ink pigment in the first place.

Although companies are clearly limited in the extent to which they can influence outside industry participants and competitors, they may be able to reduce exposure from FCA cases brought by current and former employees by instituting effective in-house procedures to safely report potential customs violations internally. This may include anonymous ''hotlines,'' for example. Companies should also implement policies to ensure that management investigates and seeks to resolve any credible employee reports of potentially fraudulent misconduct.

Potential FCA Defenses for Importers. Although the FCA can be a powerful tool for relators and the government to pursue alleged customs violations, defendants have sought to challenge these suits on a number of grounds. The following are potential defenses to customs-based FCA claims that have been raised by importer defendants with varying degrees of success:

- *Relator's claims are based on publicly disclosed information*: To prevent windfalls by opportunistic relators who lack any firsthand knowledge of fraud, the FCA bars claims where ''substantially the same allegations or transactions as alleged in the action or claim were publicly disclosed'' in certain channels ''unless . . . the person bringing the action is an original source of the information.'' 31 U.S.C. § 3730(e)(4)(A). In *United States ex rel. Doe v. Staples, Inc.*, 932 F. Supp. 2d 34 (D.D.C. 2013), the relator claimed that defendants had falsely declared the country of origin for lead pencils manufactured in China to avoid antidumping and countervailing duties. The defendant successfully moved to dismiss by showing that all essential elements of the relator's allegations were available from public sources before the complaint was filed, including: (i) the website of PIERS Global Intelligence Solutions, which compiles information from shipping manifests; (ii) the online United States Customs Border Protection Automated Manifest System; (iii) reports of the United States International Trade Commission; and (iv) the physical appearance of the pencils on shelves in U.S. stores. The case is on appeal before the D.C. Circuit.

- *Defendant previously filed a voluntary disclosure to Customs*: Similar to the public disclosure bar, the FCA prohibits claims ''based upon allegations or transactions which are the subject of a civil suit or an administrative penalty proceeding in which the Government is already a party.'' 31 U.S.C. § 3730(e)(3). The defendant in Otter Products moved for dismissal on this basis, contending that one year prior to the relator's complaint, it had utilized the voluntary disclosure procedure described in 19 U.S.C. § 1592(c)(4) and 19 C.F.R. § 162.74 to self-report the very same alleged customs violations (i.e., failing to account for "assists" in declarations of value). The government, which had not intervened, filed a Statement of Interest, arguing that the only benefit from a company's voluntary disclosure was a reduction in potential penalties under the Tariff Act, not a blanket safe harbor from FCA liability. The government noted that the 1986 FCA amendments had eliminated the broader "government knowledge" bar, and argued that mere self-reporting of a potential violation did not qualify as a "penalty proceeding" for purposes of the statute. The case settled before the court ruled on the defendant's motion, and it does not appear that any other court has confronted this issue.

- *Defendant was a mere buyer*: Two defendants in Tai Shan Golden Gain Aluminum moved to dismiss on the theory that they had been mere buyers of imported aluminum and played no role in the importation process. The trial judge agreed that if defendants were indeed mere buyers they would have lacked any obligation to pay customs duties, thereby undercutting the relator's claims. However, for purposes of the motion to dismiss, the judge accepted the relator's allegation that the private customs broker who coordinated the shipment acted at the defendants' behest and was their agent with respect to the alleged customs violations.

- *Customs penalties arising from false statements or requiring the exercise of discretion*: Prior to 2009, courts consistently rejected FCA claims where the asserted damages derived not from customs duties, but from certain types of customs penalties. A reverse false claim requires the plaintiff to show the defendant avoided an existing "obligation" to the government. That element is not met if the payment became due only as a result of the defendant's false statement, see *United States ex rel. American Textile Mfrs. Inst., Inc. (ATMI) v. The Limited, Inc.*, 190 F.3d 729, 734 (6th Cir. 1999) (penalty for goods with false country-of-origin markings), or could be assessed only after the exercise of discretion by a government actor, see *Zelenka v. NFI Industries, Inc.*, 436 F. Supp. 2d 701 (D.N.J. 2006) (fees from potential inspections). As discussed below, the 2009 amendments to the FCA may affect future rulings on these issues.

Looking Forward, Could Liability Expand? Companies engaged in international importation should also be alert to avenues that FCA plaintiffs may pursue in the future to try to expand liability in the customs context.

a. The 2009 FCA Amendments Defined "Obligation"

Prior to 2009, the FCA did not define the term "obligation," even though "an obligation to pay or transmit money or property to the Government" was an essential element of a reverse false claim. Courts recognized different interpretations of the term, including the Eighth Circuit, who concluded that an obligation "must be for a fixed sum that is immediately due." *United States v. Q International Courier, Inc.*, 131 F.3d 770, 774 (8th Cir. 1997). In 2009, Congress amended the FCA, defining an "obligation" more broadly as: "an established duty, *whether or not fixed*, arising from an express or implied contractual, grantor-grantee, or licensor-licensee relationship, from a fee-based or similar relationship, from statute or regulation, or from the retention of any overpayment." 31 U.S.C. § 3729(b)(3) (emphasis added). The legislative history confirms that Congress wanted to bring "contingent, non-fixed obligations" within the scope of the statute. Senate Judiciary Committee Report, S. Rep. No. 111 10 (March 23, 2009) at 14.

The amendment clarifies that a duty to pay the government may qualify as an "obligation" under the FCA even if the amount of the obligation is not "fixed." It is unlikely, however, that Congress intended the FCA to cover obligations that are themselves contingent on discretionary enforcement, such as fines or penalties for other offenses. One Court of Appeals cautioned against interpreting the FCA to have such "incredible scope" that it could reach the statements of a hypothetical motorist who, to avoid a ticket, insisted he was not speeding in a federal park. ATMI, 190 F.3d at 739. Even the government has agreed the FCA should not extend quite so broadly, see *United States ex rel. Bain v. Ga. Gulf Corp.*, 386 F.3d 648, 657 (5th Cir. 2004) (quoting amicus brief), and some post-2009 cases have continued to reject FCA claims based on purely contingent obligations, see *United States ex rel. Potra v. Jacobson Cos.*, No. 12-01600, 2014 U.S. Dist. LEXIS 40692, at *7 8 (N.D. Ga. March 27, 2014).

Nonetheless, so long as the new definition remains the subject of very little case law, it is likely that FCA plaintiffs will press for as broad of an interpretation of a defendant's "obligations" as courts will reasonably allow.

b. Express or Implied Certification Claims

Relators may also seek to bring certification claims related to the non-payment of customs duties. These types of claims allege that a defendant expressly or impliedly certified compliance with certain regulations or policies as a condition to receiving benefits from a government program. In *Zelenka v. NFI Industries, Inc.*, 436 F. Supp. 2d 701 (D.N.J. 2006), the defendant was alleged to have falsely certified compliance with security procedures required for participation in the Customs-Trade Partnership Against Terrorism. The claim was dismissed because the defendant's alleged benefit—paying fewer fees for inspections of its merchandise—was too speculative to qualify as an "obligation" for purposes of a reverse false claim. But a similar theory of liability may be more viable in cases where a company made false certifications in an application for customs documents, such as carnets or temporary importation bonds, that allow the reduction or elimination of specific customs duties.

Conclusion. With the increase in FCA lawsuits based on customs violations, companies that import products from overseas face a new source of potential liability and risk. These lawsuits may involve damages much higher than those available in traditional customs enforcement actions, and they have prompted a number of settlements in recent years, topped by the $45 million payment by Toyo Ink Manufacturing in December 2012. In light of these developments, companies should make efforts to ensure reasonable compliance policies are in place, and would also be well advised to monitor emerging strategies by FCA plaintiffs in this area.

