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REPORT

False Claims Act

The recent decision by the U.S. District Court for the Eastern District of Virginia in the False Claims Act whistleblower action against Iraq reconstruction contractor Custer Battles LLC was anxiously awaited as the first one to address the applicability of the FCA to contracts with the Coalition Provisional Authority.

While the decision has obvious ramifications for similar law suits involving CPA contracts, this analysis suggests that it also raises questions regarding the application of the FCA to another group of contracts—those involving Foreign Military Sales.

Custer Battles: Rolling Back the Frontiers of the False Claims Act

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An important decision limiting the reach of the federal civil False Claims Act (''FCA'') was recently announced in the case of *United States ex rel. DRC Inc. v. Custer Battles LLC*.[1] The FCA allows the U.S. government, or private individuals who sue on its behalf— known as *qui tam* relators—to recover civil penalties and treble damages for ''false or fraudulent claims'' submitted to the government for payment.[2] The central issue in the *Custer Battles* decision was whether bills submitted by contractor Custer Battles to the Iraqi Coalition Provisional Authority (''CPA'') were ''claims'' within the meaning of the FCA.

Custer Battles argued that its bills were not ''claims'' because they were paid with Iraqi funds rather than U.S. government funds. The relator and government countered that the bills were in fact ''claims'' because, regardless of who owned the money at issue, the U.S. government controlled the money that was used to pay Custer Battles. The U.S. District Court for the Eastern District of Virginia ruled that although the FCA reaches only claims for U.S. government funds, the case could

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[1] *United States ex rel. DRC Inc. v. Custer Battles LLC*, 2005 U.S. Dist. LEXIS 13743 (E.D. Va. July 8, 2005) (84 FCR 46).

[2] 31 U.S.C. § 3729-3730.

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go forward because some of the funds at issue were in fact U.S. government property.

The decision obviously has important implications for all contractors who did business with the CPA. Indeed, there may well be other FCA cases under seal that involve this very same issue. Perhaps of broader import, the case calls into question the application of the FCA to Foreign Military Sales (''FMS'') contracts since many of those contracts are paid from foreign government funds administered by the U.S. government. The decision also highlights the coming battle over the award of damages in cases that involve the payment of funds which, while perhaps technically ''owned'' by the United States, in economic reality belong to foreign governments.

The Wild East

The aptly named Custer Battles, LLC is a McLean, Va.-based company formed by Scott Custer, a descendant of George Armstrong Custer of Little Bighorn fame, and Michael Battles, a former CIA operative. In 2003, it entered into two contracts with the CPA to provide security and other services in Iraq after the downfall of the Saddam Hussein regime.[3] The money used by the CPA to pay Custer Battles came from three sources: (1) Iraqi funds confiscated by the president of the United States and vested in the U.S. Treasury, known as ''Vested Funds''; (2) Iraqi state assets, primarily in the form of currency and negotiable instruments, seized by the Coalition Forces occupying Iraqi territory, known as ''Seized Funds''; and (3) funds from the Development Fund for Iraq, known as ''DFI Funds.''[4]

In 2004, Custer Battles, its founders, and some of its employees and affiliated entities were sued under the FCA by its former contractual partner DRC, Inc. and two of DRC's employees. The relators claimed that Custer Battles had overbilled the CPA for tens of millions of dollars. Custer Battles moved for summary judgment, arguing that even if the allegations of overbilling were true, the FCA did not apply because only Iraqi money was involved.

What's in a Claim?

Although the FCA has always required a ''claim'' for liability, the term was not statutorily defined until 1986 when Congress amended the act to define ''claim'' to include a request or demand for payment presented ''to a contractor, grantee, or other recipient if the United States Government provides any portion of the money or property which is requested or demanded.''[5] The relators and the government argued that because the FCA's 1986 definition of ''claim'' included any request for payment where the U.S. government ''provides'' any portion of the money requested or demanded, ''even if the government is merely a custodian of the property, a request for that property triggers the FCA.''[6] Thus, the relators and government concluded ''that even if Seized Funds, Vested Funds, and DFI Funds were 'Iraqi Funds'—so long as the United States administered these funds—then [Custer Battles] may be held liable'' under the FCA.[7]

The court rejected the government's argument, finding that while ''the statutory language, by itself, does not definitively exclude either argument,'' there was a ''long history'' of precedent rejecting ''the argument that a 'claim' includes a demand for money or property that does not belong to the government, but is merely in the government's possession.''[8] That history began in 1926 when ''the Supreme Court held that a knowingly false and fraudulent request to obtain the release of cigars held in the possession of U.S. customs officials, but owned by a third party in the Philippines, did not constitute a 'claim upon or against the Government.' ''[9] Subsequent Supreme Court decisions confirmed that the FCA applied only when there was ''a fraudulent attempt 'to cause the Government to part with *its [own]* money or property,' '' but not when the government acted ''only as a 'bailee' of goods that did not belong to the United States.''[10]

The 1986 amendment to the FCA defining the term ''claim'' did not ''overturn the rule that a claim requires a request or demand for payment from government funds.''[11] The *Custer Battles* court found that ''at best, the government and relators identify some degree of ambiguity in the term which is resolved by noting that if Congress intended to announce such a new rule . . . it should have been more explicit.''[12] For example, Congress ''could have stated that the FCA applies whenever the United States *processes,* rather than *provides,* the money requested or demanded,'' but since ''Congress did not do so'' ''the rule that a 'claim' requires a request or payment for government property plainly survives the 1986 FCA amendment.''[13]

Moreover, the conclusion that a claim must involve the U.S. government's own money is ''consistent with every post-1986 decision to consider the definition of 'claim' within the meaning of the FCA.''[14] Accordingly, the court concluded that liability under the FCA requires ''a request or demand for payment that if paid would result in economic loss to the government fisc, *i.e.* a request for payment from government funds,'' but ''does not extend to cases where the government acts solely as a custodian, bailee, or administrator, merely holding or managing property for the benefit of a third party.''[15]

Whose Ox is Gored?

The court next set out to determine whether the money at issue was in fact owned by the U.S. govern-

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[3] Neil King Jr. and Yochi J. Dreazen, *Amid Chaos in Iraq, Tiny Security Firm Found Opportunity*, Wall St. J., Aug. 13, 2004, at A1.

[4] 2005 U.S. Dist. LEXIS 13743, at *19.

[5] 31 U.S.C. § 3729(c).

[6] 2005 U.S. Dist. LEXIS 13743, at *55.

[7] *Id.*

[8] *Id.* at *56, 58.

[9] *Id.* at *58 (quoting *United States v. Cohn*, 270 U.S. 339, 345-46 (1926)).

[10] *Id.* at *61, 62 (quoting *United States v. Neifert-White,* 390 U.S. 228, 231 (1968)) (emphasis and alteration in original).

[11] *Id.* at *63.

[12] *Id.* at *65.

[13] *Id.* at *65, 66 (emphasis original).

[14] *Id.* at *67-68 (citing *Hutchins v. Wilentz, Goldman & Spitzer*, 253 F.3d 176, 184 (3d Cir. 2001); *United States ex rel. Totten v. Bombardier Corp.*, 380 F.3d 488, 499 n.6 (D.C. Cir. 2004); *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 785 (4th Cir. 1999); and *United States ex rel Bustamante v. United Way/Crusade of Mercy, Inc.*, 2000 U.S. Dist. LEXIS 7326, at *13-14 (N.D. Ill. 2000)).

[15] *Id.* at *72.

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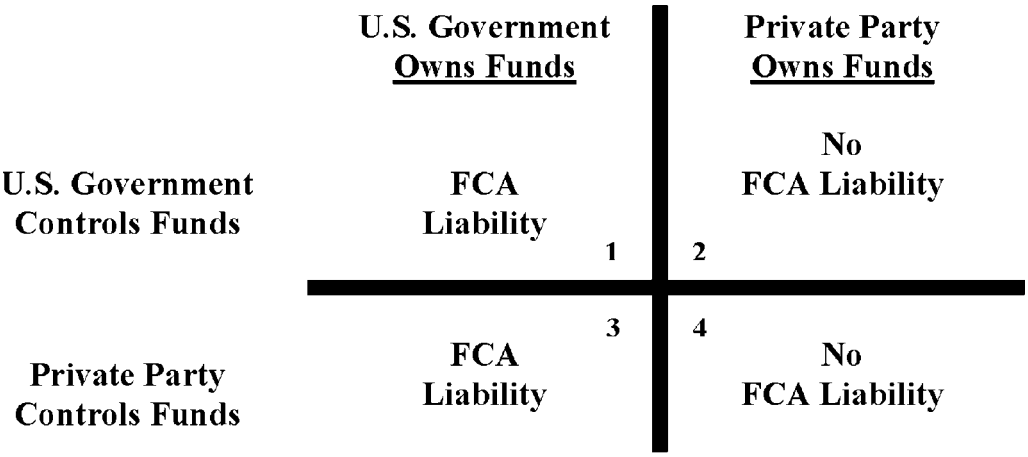
ment. It concluded that although Vested Funds were at one time property belonging to the government of Iraq, they became the property of the United States when they were confiscated pursuant to an Executive Order of the President of the United States since, at that time, ''the President was at liberty to direct the use of these funds for any purpose 'in the interest of and for the benefit of the United States.' ''[16] Similarly, Seized Funds became the property of the United States under the international laws and usages of war when they were physically seized by Coalition Forces because, at that time, the government ''had the discretion to direct their expenditure in the best interests of the United States, whether to fund the reconstruction of Iraq or to facilitate military operations in furtherance of the occupation.''[17] Accordingly, to the extent Custer Battles' bills sought payment of either Vested Funds or Seized Funds, those bills were ''claims'' within the meaning of the FCA.

DFI Funds, by contrast, never became U.S. government property. DFI Funds represented the proceeds of sales of Iraqi oil under a United Nations program, and were held in an account in the Federal Reserve Bank of New York. Although the CPA controlled the disbursement of DFI Funds for a time, that control alone was not enough to trigger FCA liability, however, since the CPA was ''merely a custodian, bailee, or administrator of a third-party's property.''[18] Accordingly, to the extent Custer Battles bills were paid from DFI Funds, they were not ''claims'' subject to the FCA.

Follow the Money

Thus, under the *Custer Battles* ruling, the touchstone for FCA liability is not who controls payment of the money at issue, but who owns the money that is being paid out. The decision may be illustrated as follows:



The first quadrant represents the classic case of a request made for funds owned and controlled by the U.S. government. The archetype first quadrant case is a prime contractor submitting bills to the government. There has always been FCA liability for first quadrant cases, and such cases were the impetus of the Act. The fourth quadrant, by contrast, represents a request for private party funds controlled by private parties. Since the fourth quadrant essentially covers all transactions with private money, it should be unsurprising that there has never been FCA liability for this type of case. The third quadrant involves a request for U.S. government funds controlled by a private-party. The archetype third quadrant case involves a sub-contractor submitting a bill to a prime contractor who is in turn paid by the government. The statutory definition of ''claim'' was added in the 1986 amendments in an attempt to bring third quadrant cases within the ambit of the FCA.[19]

It was the second quadrant concerning requests for payment from private party funds controlled by the U.S. government that was at issue in *Custer Battles*. The government and relators essentially argued that second quadrant cases were covered by the FCA. The clear holding of *Custer Battles* that there is no FCA liability for cases involving private party funds controlled by the U.S. government has several important implications.

Other CPA Contracts

The decision is obviously pertinent to other contracts with the CPA. The CPA entered into hundreds of contracts during its relatively brief existence, some of which may well be the subject of pending sealed FCA actions, or, to the extent the statutes of limitation have not run, future filed actions. If such cases fall into the second quadrant they should be dismissed under the rationale of *Custer Battles*. Accordingly, if any other FCA cases involving the CPA are unsealed, it will be extremely important to follow the money used to pay the contract to determine if U.S. government funds were utilized.

Foreign Military Sales

The decision also has important implications for contracts entered into under the Foreign Military Sales (''FMS'') program. The FMS program is statutorily authorized by the Arms Export Control Act (''AECA'').[20] Under the FMS program, the United States frequently enters into agreements with eligible foreign governments and international organizations for the sale of defense articles and services, and then, in turn, enters into contracts with private contractors for the procure-

[16] *Id.* at *73, 76 (quoting 50 U.S.C. § 1702).
[17] *Id.* at *84.
[18] *Id.* at *88.

[19] That attempt may or may not have been fully successful. *See id.* at *64 n.61.
[20] 22 U.S.C. § 2751 *et seq.*

ment of defense articles on behalf of those foreign governments and international organizations.[21] The Department of Defense has created a special U.S. Treasury Account to handle these transactions commonly known as the FMS Trust Fund.[22] Foreign governments deposit money into the FMS Trust Fund, and those funds are then paid directly or indirectly to contractors pursuant to their contracts with the U.S. government.

This arrangement begs the question of whether requests for payment made by contractors under FMS contracts with the government are first quadrant cases requesting U.S. government funds (with the attendant FCA liability) or second quadrant cases requesting foreign government funds (without FCA liability). The available authority is in conflict. On the one hand, the Comptroller General of the United States, who serves as the head of the Government Accountability Office, has repeatedly stated that ''[a]mounts deposited into the FMS Trust Fund are, in reality, foreign customers' funds that are administered by the United States Government only in a fiduciary capacity,'' and that the U.S. government acts only as ''an agent for a foreign government . . . using the foreign government's funds that have been deposited in the FMS Trust Fund Account in the Treasury.''[23] On the other hand, two district court cases decided prior to *Custer Battles* appear to have held that funds in the FMS Trust Fund ''are funds of the United States.''[24] Those decisions were based, in part, on a finding of fact made by the Tax Court that ''funds in the FMS Trust Fund 'vest[]' in the United States Government upon deposit therein.' ''[25]

The *Custer Battles* decision noted that ''possession, by itself, is not sufficient to trigger FCA liability- indeed, neither is possession and administration for the benefit of a third party.''[26] Rather, it is ''possession plus the freedom to *use* or *waste* property for the government's own benefit [that] is sufficient to establish ownership.''[27] Employing that test, the earlier FMS cases finding FCA liability would seem to be wrongly decided since, under the terms of the AECA, the monies within the FMS Trust Fund may be utilized only to pay for FMS goods or services or for refunds to the depositing country.[28] Viewed through this lens, monies in the FMS Trust Fund appear similar to DFI funds which ''could not be used or wasted to further the interests of the United States.''[29]

On the other hand, the prior FMS decisions appear to have been based at least in part on the notion that monies in the FMS Trust Fund ''vest'' in the government upon receipt, and the *Custer Battles* decision holds that ''[t]he plain meaning of the term 'vest' is to transfer ownership or title.''[30] Viewed through this lens, funds in the FMS Trust appear similar to Vested Funds over which title was transferred to the U.S. government at the time of seizure.

No doubt additional decisions will be forthcoming in this area.

The Next Frontier

Another important question suggested, but unanswered, by the *Custer Battles* decision involves the award of treble the damages ''which the Government sustains''[31] where the U.S. government has suffered no real economic injury. As the *Custer Battles* decision noted, ''[w]ere FCA liability to attach to a false claim presented to the United States for Iraqi funds merely in the government's possession, it is Iraq that would sustain the damages, not the United States.'' Further, the court said, ''even if the government could be said to have 'sustained' the damage in some loose sense if it once possessed the funds but does no longer, to whom should the treble damages be paid?'' According to the statute, recovery would be paid to the government and to relators, but not to Iraq, the court said.[32]

The court's concern highlights the seeming inequity of allowing the government and relators to recover treble damages in situations where the U.S. government has suffered no economic harm. In such a circumstance it is not only the relator but the government as well that would earn a bounty for bringing a FCA action. Indeed, as the court noted, the contractor might also face additional liability in an action by the foreign government itself.[33] Future cases will almost certainly have to grapple with this question as well as it arises on the continually moving frontier of FCA jurisprudence.

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[21] *Procurements Involving Foreign Military Sales*, B-165731, 58 Comp. Gen. 81, 81-82 (Nov. 16, 1978); 22 U.S.C. § 2762(a).

[22] 58 Comp. Gen. at 83.

[23] 58 Comp. Gen. at 87 n.1; *Optic-Electronic Corp.*, B-235885, 89-2 Comp. Gen. Proc. Dec. ¶ 326 at 2 (Oct. 6, 1989). *See also Goddard Indus., Inc.*, B-275643, 97-1 Comp. Gen. Proc. Dec. ¶ 104 at 1 (Mar. 11, 1997) (The AECA ''authorizes the Department of Defense, acting as an agent for a foreign country and using funds of that country that have been deposited in the FMS Trust Account, to enter into contracts for purposes of resale to foreign countries.'').

[24] *United States ex rel. Hayes v. CMC Elecs., Inc.*, 297 F. Supp. 2d 734, 739 n. 6 (D.N.J. 2003) (citing *United States ex rel. Campbell v. Lockheed Martin Corp.*, 282 F. Supp. 2d 1324, 1340 (M.D. Fla. 2003)). The author represented the defendants in the *Campbell* case.

[25] *Campbell*, 282 F. Supp. 2d at 1340 (citing *Soboleski v. Comm'r*, 88 T.C. 1024 (1987).

[26] 2005 U.S. Dist. LEXIS 13743, at *82 n.76.

[27] *Id.* (emphasis in original).

[28] 22 U.S.C. § 2777(a).

[29] 2005 U.S. Dist. LEXIS 13743, at *86.

[30] *Id.* at 73-74.

[31] 31 U.S.C. § 3729(a).

[32] 2005 U.S. Dist. LEXIS 13743, at *66 n.62.

[33] *Id.*

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