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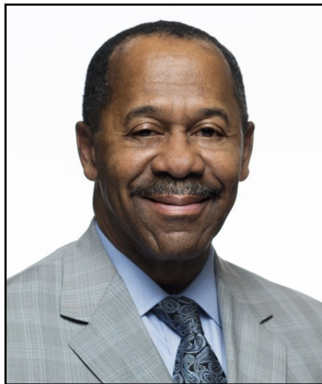
Half-Truths, False Implications and Trivial Omissions: The Supreme Court's Latest Attempt to Clarify the False Claims Act



Anthony Joseph

Tommy Buck

Any government contractor knows that if it charges the government for a service it did not actually perform, it could be in a world of trouble. But what if the service was performed, but was not performed in complete accordance with all applicable government regulations? In that situation, can the contractor be liable for fraud? For example, what if the contractor performed the service but used unqualified personnel to do so? Or what if the contractor fails to follow a requirement buried deep in the boilerplate language of the contract, but never *expressly* lies to the government when it submits its claim for payment? Can it be said that it has nevertheless submitted a *false* claim?

On June 24, in *Universal Health Services, Inc. v. United States ex rel. Escobar*, the U.S. Supreme Court began to address some of these issues under the False Claims Act. ("FCA"). *Escobar* involved claims for Medicaid payments made by a Massachusetts mental health facility that allegedly failed to disclose violations of staff qualifications and licensing requirements when it submitted payment for specific mental health services rendered. As permitted by the FCA, a private citizen with knowledge of the allegedly false claims sued the mental health facility on behalf of the United States. In doing so, the plaintiffs relied upon the "implied false certification theory" of FCA liability, which treats payment requests as implied certifications of compliance with relevant legal and contractual requirements.

Justice Clarence Thomas, writing for a unanimous Court, discussed whether implied false certification theory can be a basis for asserting FCA liability, as well as what is required for a misrepresentation to be "material" and actionable under the FCA.

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This is How We Roll – Tax Deferred Equity Roll Overs in M&A

Hardwick Walthall

As is often the case these days, a purchaser acquiring a target company will insist that some or all of the owners of a target company accept equity of the acquiring company as part of the consideration for the sale of the target company. Many times, the roll over sellers include the management team members of the target company who will continue to manage the target company business following the acquisition. As a result, a purchaser in this situation will frequently consider an acquisition structure that seeks to accommodate the roll over sellers' tax objectives of deferring the tax on the roll over equity while also balancing the purchaser's business and tax objectives to operate the target company in the most profitable manner following the acquisition. From the standpoint of both the purchaser and roll over sellers, the structure of any roll over equity transaction should be considered very carefully. This article summarizes a few of the key considerations that will impact a roll over transaction and the structures that are frequently used to address those considerations.

An equity roll over of part of the purchase price often provides a purchaser with several important benefits. From a business perspective, roll over equity allows the purchaser to bridge the valuation and financing gaps of a transaction by reducing the amount of cash consideration required for the deal. It can also align the roll over management team members' interests with the purchaser's business interests by providing the roll over management team with a continued stake in the performance of the business following the transaction closing much like an earn-out. Aside from the advantages listed above, a purchaser is generally also interested in obtaining a step up in the tax basis of the target company's assets based on the taxable purchase price in the deal. The step up in basis allows for future tax-write offs from the depreciable and amortizable assets of the target business such as equipment and goodwill. Depending on the transaction structure, certain issues can impact the ability to obtain or utilize such step up in basis. For example, depending on the period of existence of the target company's business and the amount of equity roll over involved, special "anti-churning" rules may apply that will impact the asset step up tax benefit. If the anti-churning rules are applicable to the transaction, careful planning is required in designing a structure that will avoid the impact of those rules.

On the roll over seller side, the major concern typically is that the equity roll over transaction be structured in a way that the roll over seller receives the equity on a tax deferred basis. The ability to do a tax deferred equity roll over will depend on a number of factors including the business entity type of the target company (e.g., LLC, S corporation, C corporation, etc.), the business type entity of the acquiring company issuing the equity to the roll over seller, and the amount of roll over equity in the deal. The tax laws governing the taxation of contributions of property to a corporation or partnership (as the case may be) in return for equity must be carefully considered in order to ensure the roll over equity is not taxed at the time it is issued.

As is evident from the issues identified above, there are different business and tax objectives of a purchaser and a roll over equity seller in an acquisition. A number of alternate transaction structures are often considered in order to accomplish as many of those objectives as possible. One common structure involves dropping down the assets of the target business into a new LLC on a tax deferred basis. This can be done in exchange for the target company's receipt of all of the equity in the new LLC. The purchaser will then purchase the equity from the new LLC (now holding the business assets) while the roll over sellers will continue to hold their interest in the business through their ownership of the target company. For tax purposes, this transaction is treated an asset purchase where purchaser has purchased an undivided interest in each of the assets in the new LLC and then contributed those assets to the new LLC in exchange for its LLC interest. If transferring certain assets to a new entity is a problem, another structure called an "inversion" can achieve the same tax

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The Feds Are Looking Into Noncompete Agreements—You Should Too

Warren Lightfoot

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Although many employers know of their value, noncompete agreements and other restrictive covenants face increasing scrutiny and criticism in the eyes of lawmakers and the public. Because of this increasingly uncharitable environment—and recent and expected changes in state and federal laws applicable to noncompete agreements, confidentiality agreements, and other restrictive covenants—employers should review both the content of their existing agreements and their policies concerning how and from whom such agreements are obtained.

A May 2016 report from the White House estimated that noncompete agreements impact nearly a fifth of U.S. workers, or approximately thirty million individuals. The White House Report further estimated that approximately fifteen percent of workers without a college degree and approximately fourteen percent of individuals earning less than $40,000 are subject to noncompete agreements, including individuals working as fast-food employees, warehouse workers, and camp counselors. The White House concluded that noncompete agreements pose various dangers to the economy, including reduced job mobility, decreased worker bargaining power, artificially constricted labor pools from which to hire, restrictions on a former employee's ability to launch new companies, and reduced opportunities for consumer choice in various markets, among other possible harms. Because of this conclusion, the White House, together with Treasury and the Department of Labor, communicated a plan to convene a group of experts in labor law, economics, government, and business to facilitate a discussion on noncompete agreements and their consequences, with a goal of identifying the key issues presented by their implementation and enforcement, to examine various state practices regarding such agreements, and to put forward a statement of best practices and a call to action for state reforms.

Massachusetts's House of Representatives recently unanimously passed a bill reflecting the possible results of the criticisms highlighted in the White House Report. Under the bill that will now face consideration by the Massachusetts Senate, the maximum stated post-employment duration of a noncompete agreement would be limited to twelve months, and the agreement must contain a "garden leave clause" under which the former employer would have to pay fifty percent of the former employee's salary during the post-employment restricted time. Additionally, the bill would render noncompete agreements unenforceable against FLSA nonexempt employees, undergraduate or graduate student interns, employees that have been terminated without cause or laid off, and employees eighteen years old or younger.

In contrast to the Massachusetts bill, Alabama recently enacted a revised Restrictive Covenant statute in which the Alabama legislature reiterated the enforceability of restrictive covenants under the proper circumstances, subject to some new legislative guidance concerning the presumptively reasonable post-employment durations of various particular covenants. Alabama's new law went into effect on January 1, 2016. Because of these recent changes, it seems unlikely that the Alabama

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New Tax Credit Available To Small Businesses

Chris Smith

Certain Alabama small businesses are now eligible for a new $1,500 income-tax credit for each new employee they hire. The Alabama Small Business and Agribusiness Jobs Act (the "Alabama Jobs Act") was signed into law on April 26, 2016 and became effective on July 25, 2016. The primary impact of the Alabama Jobs Act is to create a one-time $1,500 income-tax credit for Alabama small business employers for each qualified new employee they hire. To qualify as an "Alabama small business employer," the company must (a) be formed, or qualified to do business, in Alabama (b) have its headquarters or principal place of business in Alabama and (c) employ 75 or fewer employees during the relevant tax year, not counting any new employees for which the credit is being claimed. A "qualified new employee" is an employee who, for a qualifying period of at least twelve consecutive months: (a) was employed on a full-time basis, (b) was an Alabama resident, (c) received wages from the Alabama small business employer of at least $40,000, and (d) was not a full-time employee of the Alabama small business employer at any time during the twelve month period immediately prior to the twelve month qualifying period.

The credit is calculated based on "net employee growth," which is the total number of full-time Alabama employees on the last date of each tax year for which an employer is claiming a credit, minus the total number of full-time Alabama employees on July 24, 2016. The credit may only be claimed for each qualified new employee one time. For each qualified new employee hired that represents net employee growth, the Alabama small business employer may claim the $1,500 credit.

The Full Employment Act of 2011 provides a tax credit for job creation that is somewhat similar to the credit under the Alabama Jobs Act. However, an employer may only claim a credit under one of these acts, not both.

An Alabama small business employer who is eligible for the credit under the Alabama Jobs Act will also be eligible to receive an additional $1,000 credit if the qualified new employee is also a "recently deployed unemployed veteran," as defined in the "Heroes for Hire" Tax Credit Act of 2012.

To be clear, the credit provided by the Alabama Jobs Act is allowed only for employees hired after July 25, 2016. The credit is allowed only for tax years beginning on or after January 1, 2016. The credit is set to expire on January 1, 2019.

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The Feds Are Looking Into Non-Compete Agreements
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Legislature will revisit its recent substantive decisions in this area in the near future, despite the current national atmosphere surrounding such agreements.

Besides the recent and expected focus on the laws concerning noncompete agreements, other related (and often interconnected) agreements have also experienced a changing legal landscape. For example, trade secret and confidentiality agreements—which often are made part of noncompete and nonsolicitation agreements—should be reviewed and revised because of the recent enactment of the federal Defend Trade Secrets Act of 2016 (DTSA) that was signed by President Obama on May 11, 2016. In addition to state laws governing trade secrets, the DTSA creates several new avenues to protect a trade secret in the federal courts, but it also creates new obligations on employers and trade secret owners. For example, with regard to all contracts or agreements executed after May 11, 2016, including those with contractors and consultants, the DTSA requires that trade secret owners provide notice of its whistleblower exception "in any contract or agreement with an employee that governs the use of a trade secret or other confidential information." If employers or other trade secret owners fail to include this whistleblower exception notice, they will be barred from recovering some damages and fees that are otherwise available under the act.

The time is ripe for employers to review and consider revising all of their existing restrictive covenants, with an eye toward both recent changes and those to come. Those who fail to do so may find themselves behind the curve and left without the protections they expected.

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Tax Deferred Equity Roll Overs
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results. Under the inversion structure, the target owners create a new S corporation and contribute all of the target company stock to the new corporation. The target company then makes a "Q sub" election to be disregarded for tax purposes and then converts to an LLC. Once converted, the purchaser purchases the interest in the LLC with the same tax results described above. The availability of this structure will depend on whether the target company is an S corporation.

The best approach when structuring an equity roll over will depend upon a variety of factors. As is often the case, the circumstances are such that no available structure can accomplish all the parties' different tax and business objectives. With proper planning and comprehensive understanding of the issues, however, the parties can come to some compromise in designing a transaction structure that strikes the right balance and allows the deal to proceed.

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The Court held that the implied false certification theory can be a valid theory of FCA liability in some circumstances. At the very least, implied false certification can be a basis for liability when: (1) the claim does not merely request payment but also makes specific representations about the goods or services provided, and (2) the defendant's failure to disclose noncompliance with material requirements renders those representations "half-truths."

However, the Court went on to make clear that to be liable under the FCA, misrepresentations must be "material" to the government's decision to pay. The Court emphasized that this "materiality standard is demanding." Further, the FCA is "not a means of imposing treble damages and other penalties for insignificant regulatory or contractual violations." So, where noncompliance is minor or insubstantial, the noncompliance is not material.

In the past, some courts have determined whether compliance with a regulatory or contractual requirement is material based upon whether that requirement is labeled a "condition of payment." The Escobar Court rejected this test. Whether a provision is labeled a "condition of payment" may be relevant to whether it is material, but it is not dispositive. "Defendants can be liable for violating requirements even if they were not expressly designated as conditions of payment," and vice-versa. What matters is whether the defendant knowingly violated a requirement that the defendant knows is material to the government's decision to pay. Proof of materiality can include evidence that the defendant knows the government consistently refuses to pay claims based on noncompliance with a particular requirement. If the government pays a particular claim in full despite its actual knowledge that certain requirements were violated, that is "very strong evidence" that those requirements are not material.

Escobar has significant implications for healthcare providers, defense contractors, and others who do business with the federal government or participate in government payment programs. Under the Court's heightened "materiality" standard, not every regulatory misstep will be grounds for FCA liability. The Court seems to appreciate that among the myriad of regulatory and contractual requirements for government payees, some are "insignificant." However, it is equally clear that those receiving government funds for goods or services can be liable under the FCA when they make a claim for payment knowing they have violated material requirements relating to those goods or services. Whether any given requirement is significant enough to trigger FCA liability is a question to be addressed by lower courts in the coming years.

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From the Editor

Jim McLaughlin

Thank you for reading this issue of the Business Law Bulletin. Please follow us on LinkedIn to stay up-to-date on current firm news and relevant business alerts. As always, I welcome your feedback on articles, new topics, and other ways that we can serve you better.

Sincerely

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