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NY Settlement Highlights Growing Risk Of FCA Tax Claims

By **Meredith Auten, Kayla Kaplan, Cosimo Zavaglia and Ryan McCarthy**
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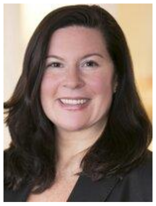
New York Attorney General Letitia James on March 2 announced a $105 million New York False Claims Act settlement against an individual hedge fund manager and his firm for alleged tax evasion based on allegations originally brought by a whistleblower, calling it the largest recovery against an individual in the state statute's 14-year history.



Meredith Auten

This recovery should remind both businesses and individuals that, while the federal False Claims Act specifically excludes tax claims from its purview, a watchful eye should be kept on the steadily growing trend of states permitting such claims under their false claims laws. In fact, Washington, D.C., amended its false claims law in January 2021 to mirror New York's allowance for tax claims.

Kayla Kaplan

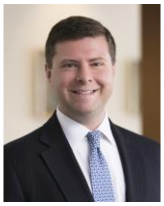
The issues in allowing tax claims to be pursued under a false claims statute, rather than state department of revenue or tax code enforcement mechanisms, are multifold.

First and foremost, such an allowance extends false claims statutes well beyond those businesses that appreciate and commonly undertake false claims risk by doing business with the government or receiving government funds, expanding exposure to a large population of companies and private citizens simply because they are taxpayers.

Cosimo Zavaglia

This risk is heightened by the fact that the New York False Claims Act and D.C. false claims law contain qui tam provisions allowing whistleblowers to bring and pursue such claims — and to be handsomely rewarded with a portion of any recovery — even if the state or district declines to intervene.

In addition, the complexity and oft-changing nature of tax codes provide fodder for whistleblower allegations that — while more likely to be subject to eventual defeat under false claims statutes' scienter provisions — create the prospect of an increase in filings and litigation avoidance settlements. The recent NYFCA settlement showcases all of these problems.



Ryan McCarthy

Sandell Settlement

In State of New York ex rel. Tooley LLC v. Sandell et al.,[1] the New York attorney general alleged that Thomas Sandell and his firm failed to pay tens of millions of dollars in state and city taxes on deferred fees for offshore hedge fund investment management services performed in New York City.

While these services were performed over a 10-year period ending in 2008, the income was not recognized until 2017 because of amendments to the Internal Revenue Code that changed deferred income allowances.

In the year prior to this recognition, Sandell left New York to live in London and his firm set up an office in Florida even though it allegedly continued to operate in New York City as its principal place of business. After allegedly conflicting consultations with two different accounting firms, Sandell and his firm did not pay New York state or city taxes on these fees for tax year 2017. Sandell did not admit or deny wrongdoing in settling these claims.

The NYFCA case against Sandell was brought by a limited liability company as a qui tam whistleblower in October 2018.

This whistleblower has not been identified beyond its corporate name, joining a growing trend of corporate whistleblowers in false claims law cases that typically may not have the type of inside information that may otherwise go undiscovered, as originally contemplated by the qui tam provisions.[2]

The Sandell relator is receiving $22.05 million, which represents 21% of the settlement, and can separately pursue attorney fees and costs against the defendants.

The Sandell settlement explicitly notes that the New York attorney general has an ongoing investigation into other entities involved in the alleged tax evasion conduct, and the agreement includes a cooperation clause.

State False Claims Statutes

As noted above, the federal False Claims Act[3] and several state statutes modeled after it explicitly exclude tax claims from their purview.[4] However, a growing number of state false claims statutes, including in New York and now the District of Columbia, expressly allow tax claims.

In New York, the expansion to the NYFCA was added through amendment in 2010, and is limited to defendants with taxable income or sales over $1 million in the tax year and claimed damages in excess of $350,000.[5]

The District of Columbia's amendment — signed in January and effective as of March 16 — includes these same limitations.[6] Similar amendments to allow tax claims were introduced in the state legislatures of California and Michigan.[7]

Meanwhile, the Illinois False Claims Act expressly allows for some tax claims, but excludes those related to income or property tax.[8] The Indiana and Rhode Island false claims statutes are similar in that they only exclude income tax claims.[9] Other state false claims statutes are silent about a tax claims exemption.

Implications

The significant monetary value of the Sandell settlement is likely to encourage more states to amend their false claims statutes to allow tax claims and more whistleblowers to come forward asserting these claims.

And, as in Sandell, those whistleblowers are increasingly likely to be corporate entities, including competitors, who may have knowledge of particular tax implications for the industry and can access any tax information that may be public but are not true whistleblowers in that they do not possess inside information.

False claims cases have seen a general increase in this type of corporate competitor whistleblower.

The public disclosure bar, which bars false claims actions by whistleblowers based on publicly available information where they are not the original source, is a defense to consider in all qui tam suits but especially those by corporate whistleblowers. This defense, however, also has nuances that vary by state.[10]

Another defense that may particularly arise when tax claims are at issue is a provision present in some state false claims laws, mirroring the federal False Claims Act,[11] for the government to pursue the false claim through any alternate remedy, which may be a typical tax audit.

Under such a provision, the whistleblower may have similar rights to participate, but only if the remedy was actually an alternative to intervention in the qui tam case.

Companies and individuals should be aware of the breadth of the state false claims statutes — and any pending amendments — in the states in which they do business.

To the extent companies and individuals are doing business in any of these states, take the time to more closely understand your historical tax filing positions, the state's false claims law statutes of limitations, and any tax information that may be made public.

Taxpayers and practitioners alike also must understand that, unlike a tax audit by a state department of revenue, in a false claims act case the relator or government must meet a higher burden of proof to substantiate a violation and access treble damages, and must also prove the reckless or intentional state of mind of the taxpayer.

Compliance with all laws and a robust compliance program remain critical to protecting companies and individuals from enforcement actions.

Meredith Auten is a partner, Kayla Stachniak Kaplan is an associate and Cosimo Zavaglia is a partner at Morgan Lewis & Bockius LLP.

Morgan Lewis partner Ryan McCarthy contributed to this article.

[1] Index No. 101494/2018 (N.Y. Sup. Ct. N.Y. Cty.).

[2] For example, in 2019, a federal district court granted the U.S. Department of Justice's motion to dismiss qui tam suits brought by limited liability company relators under both the federal and various state false claims statutes, asserting that the companies were created only for purposes of pursuing such lawsuits and that their allegations lacked merit. That decision is currently pending appeal in the Fifth Circuit. While the Department of Justice has denied that its dismissal decision was based on reflexive animus toward corporate relators, it did note the real concerns that such "relators had used 'cloned complaints' to make essentially the same sweeping allegations against numerous defendants in courts throughout the nation," which goes "to the critical question of whether the relators were bringing valuable new information about fraud to the government's attention or simply attempting to capitalize on publicly available information and extract settlements through meritless qui tam suits." Brief for Appellee United States of America at 44, United States ex rel. Health Choice Alliance, L.L.C. v. Eli Lilly & Co., No. 19-40906 (5th Cir. Mar. 5, 2020).

[3] See 31 U.S.C. § 3729(d) ("This section does not apply to claims, records, or statements made under the Internal Revenue Code of 1986.").

[4] See, e.g., Cal. Gov't Code § 12651(f) (2018); Iowa Code § 685.2(5) (2011); Md. Code Ann., Gen. Provisions § 8-102(a) (2015); Mass. Gen. Laws Ann. ch. 12, § 5B(d) (2012); Minn. Stat. § 15C.03 (2019); N.C. Gen. Stat. § 1-607(c) (2018); Vt. Stat. Ann. tit. 32, § 631(d) (2015); 2004 Va. Acts ch. 589.

[5] N.Y. State Fin. Law § 189(4)(a).

[6] D.C. Law L23-0180 (amending D.C. Code § 2-381.02(d)).

[7] See AB-2570, 2019-2020 Leg. (Cal. 2020); AB-1270, 2019-2020 Leg. (Cal. 2019); S.B. 484, 100th Leg. (Mich. 2019); H.B. 4875, 100th Leg. (Mich. 2019).

[8] 740 Ill. Comp. Stat. § 175/3(a)(1).

[9] Ind. Code 5-11-5.5-2 (statute does not apply to "a claim, record, or statement concerning income tax"); R.I. Gen. Laws § 9-1.1-3(c) ("This section does not apply to claims, records, or statements made under the Rhode Island personal income tax law ….").

[10] Compare New York's public disclosure bar, N.Y. State Fin. Law §190(9-b), to the federal False Claims Act's bar, 31 U.S.C. § 3730(e)(4).

[11] 31 U.S.C. § 3730(c)(5).