By Jay A. Brozost
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I Tell Them, I Tell Them Not:

Deciding When and How to Disclose False Claims Act Lawsuits to Shareholders

Your publicly traded company has been responding to subpoenas from the local United States Attorney's Office for two years. So far, your attempts to find out more about the case have been rebuffed. Finally, yesterday, an assistant US attorney sent you a letter. It says that a sealed *qui tam* action has been filed against your company and attaches the complaint and court order forbidding you from saying anything to anyone about even the existence of this case. You have a choice. You can disclose a lawsuit that may expose your company to millions of dollars in damages at the risk of going to prison, or you can hold on to the information and quite possibly face SEC-related liability. Neither option is attractive for in-house counsel.

A Quick History on *Qui Tam*

This catch-22 exists because of the tension between regulation of public companies and the seal afforded *qui tam* actions. *Qui tam* suits are filed under a statutory seal, so you may be unaware of a pending *qui tam* action until you receive a letter like this from the US Attorney's Office:

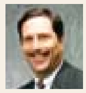
> *As you know,* qui tam *actions are filed under seal; accordingly, a court order was required in order for us to make this disclosure to you. The United States obtained a partial lifting of the seal from the Court that permits the United States at its exclusive option to share the relator's allegations and complaint with you. The court order granting the partial lifting of the seal in this case does not permit your company to make any further disclosure of the complaint to anyone. Therefore, with the exception of discussing these matters with the United States, you may not disclose further the complaint, other filings, or even the existence of this action without being in violation of the court order.*

On one hand, even when the seal is partially lifted, you cannot publicly acknowledge the existence of the case. Violating that seal can result in fines or criminal penalties against your company and its directors, officers, and employees, according to the United States Code.

On the other hand, a host of laws and regulations require that public companies disclose all information, which may materially affect the price of their stock. For example, rules like SEC Rule 12b-20 mandate disclosure of enough information to render a company's disclosure "not misleading." Knowing failure to disclose a material fact under circumstances where such failure is likely to mislead investors can create 10b-5 liability. See *Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261 (10th Cir. 2001).[1]

This dilemma is 20 years old, yet little has been written on it. In the new era of increased shareholder litigation, any organization subject to the False Claims Act must consider its options. And given the government's increased reliance on contractors, increasing numbers of large companies are subject to the Act.

A review of several Fortune 500 company filings indicates that all who received subpoenas in connection with a *qui tam* investigation disclosed receipt of the subpoenas relatively quickly. However, to the extent companies choose to disclose the existence of a *qui tam* suit—and many do not do so until the complaint is either completely unsealed or a settlement with the government has been reached—they do so in only the most general of terms.



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Are the following examples from actual SEC filings likely to pass muster as not misleading if challenged before a court of law?

> *Qui tam actions are sealed by the court at the time of filing. The only parties privy to the information in the complaint are the relator, the US government, and the court. Therefore, it is possible that* qui tam *actions have been filed against us and that we are not aware of such actions or have been ordered by the court not to discuss them until the seal is lifted. Thus, it is possible that we are subject to liability exposure under the False Claims Act based on* qui tam *actions other than those discussed here.*

Such disclosure provides no notice to the average investor that the company knows of a pending case.

Some companies choose another approach: violate the seal and disclose specifics about the case. These specifics include the names of the litigants, the subject matter of the suit, the company's efforts in defending itself and even the amount of potential exposure. This kind of disclosure is clearly "not misleading" but such a detailed disclosure before the complaint is served and the seal lifted almost certainly violates the terms of the seal. Perhaps these companies already have analyzed the tension at play and concluded that the wrath of the markets would be worse than that of the court.

While there is currently no tried and true solution, we offer a better alternative: moving the court for a partial lifting of the seal in order to inform shareholders of the nature of the suit. This is the only option that mitigates the risk of both a contempt citation and shareholder liability. We discuss this option, along with other options below.

Step One: Do I Have to Tell Them at All?

Remember, violation of the seal constitutes civil and/or criminal contempt and carries the risk of fines for the organization, as well as fines and/or imprisonment for directors, officers, and employees. As discussed in *G. & C. Merriam Co. v. Webster Dictionary Co., Inc.*, civil contempt proceedings are remedial—they are intended to force compliance with a court order or compensate an injured party for losses sustained as a result of the violation. Thus, companies found to be in civil contempt for violating a seal order could be required to pay compensatory fines. Criminal proceedings, on the other hand, are intended to be punitive. A finding of criminal contempt could expose a corporation and its officers, directors, and agents to criminal penalties including fines and imprisonment. In *G. & C. Merriam Co.*, the First Circuit considered whether the district court's assessment of a $50,000 fine against related publishing companies and their president was appropriate. The First Circuit held that the fine could not be sustained based on the purposes of civil contempt proceedings. The $50,000 penalty would neither force compliance with the injunction nor compensate the plaintiffs for actual loss. See also*, United States v. United Mine Workers*, 330 US 258, 302 (1947).

The sealed nature of a *qui tam* complaint creates tension for public companies, because such companies generally have to divulge all "material" information. Getting your hands around the term "material" is difficult in light of the myriad laws and regulations requiring public companies to provide disclosure, including, among others, Rule 10b-5 and Rule 12b-20 where all reports must include all information necessary to make them "not misleading." Violation of these rules can result in civil and criminal penalties, as well as the suspension or delisting of your stock.[2]

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Generally, liability for a material omission attaches only in cases where a duty to disclose is triggered. As the First Circuit has explained in the 1990 *Backman v. Polaroid Corp.*, case, "[T]here is no affirmative duty to disclose material information just because it is material to an investor; other events must trigger a duty to disclose before there can be liability for the withholding of material facts." For example, "[t]he express language of 10b-5 proscribes omissions that render affirmative statements misleading; thus, incomplete disclosures, or 'half-truths' implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements," according to the *Schlifke v. Seafirst Corp.* case in 1989. An independent duty to disclose may also be triggered by a fiduciary-type relationship.

Where a duty to disclose has been triggered, liability for omissions attaches only with respect to "material" omissions. Given the number of rules and their serious consequences, some organizations take a conservative approach and rely on the broadest definition of "material." As noted by the Tenth Circuit in *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119 (10 th Cir. 1997), an omission under Section 10b is only "material" if a "reasonable investor would consider it important in determining whether to buy or sell stock," and if it would have "significantly altered the total mix of information available" to current and potential investors. This does not mean the information would *change* the investor's decisions to buy or sell, only that the investor would have deemed it important.

The Supreme Court has thus read "materiality" to be a business concept and, like other business decisions, it boils down to a cost/benefit analysis. Two factors are involved: the chance the case will succeed and the amount of potential damages involved. The average stockholder would likely consider information "material" if it pertains either to strong claims with moderate damages or weak claims with potentially exorbitant damages.

A Strong Case or a Weak One?

Determining the strength of a *qui tam* action can be difficult. Prior to being served with the complaint, a company has no way to know that it is even subject to a *qui tam* action, and is left to decipher the subject matter from a broad subpoena and the government's one-sided discovery—which can take years. As the Second Circuit noted in *United States v. Baylor Univ. Med. Ctr.*, examples abound to show that the government could extend a *qui tam* investigation up to five, six, or even eight years.

Even after being provided a copy of the relator's complaint, a company is only aware of the whistleblower's allegations against it, not the evidence upon which the allegations are based. An internal investigation can lead to a guess at potential evidence, but there is still no way to determine the government's focus or how strong it perceives its case to be. Further, if and when the government chooses to intervene, it often does so by filing an entirely new complaint with new allegations and causes of action.

The one objective criterion under which to assess the strength of a claim is whether the government intervenes in the relator's action. The government presumably intervenes in claims that have the greatest chance of success, so claims in which the government declines to intervene can be discounted to some degree. (That being said, this objective test is not foolproof. As was the case in *Rockwell Int'l Corp. v. United States ex rel. Stone*, the government may intervene after reconsidering its initial declination to do so.) But until the government decides one way or the other, the only way a corporation can assess the strength of a potential *qui tam* suit is by reviewing the allegations in its copy of the relator's complaint. Because that complaint is likely to evolve as the government builds its case, it is often unreliable as a basis to gauge potential exposure.

What is Your Exposure?

Two types of exposure exist in a *qui tam* suit: monetary and legal. As explained in the sidebar, monetary exposure in *qui tam* suits accumulates rapidly as $5,000-$11,000 fines per line-item claim (recently raised 10 percent) are added to treble damages for the amounts improperly claimed. With settlements reaching eight digits, even a weak case may be "material" to the average shareholder.

Legal exposure is the risk of changes to the company's legal status, which threaten future earnings, or even the company's existence. Liability under the FCA can be a death knell for organizations that do business with the government. The Federal Acquisition Regulation requires that the US Government only do business with "responsible contractors." A judgment or award under the False Claims Act against a government contractor can be evidence of "serious or compelling" misconduct that can support a contractor's "suspension" or "debarment" from current or future contracts.

Legal exposure also applies to tax-exempt organizations, most notably hospitals and healthcare providers. For these entities, a *qui tam* suit alleging violations of the anti-kickback statute, 42 USC §1320a-7b, or the so-called Stark Law, represents an attack on the very existence of the organization. First, as with other government contractors, a violation of either statute constitutes a type of healthcare fraud and could exclude the hospital from participation in any federal healthcare program for no less than five years. Second, and more importantly, the IRS has found that a "substantial" violation of these statutes is grounds for the loss of tax-exempt status—a death sentence for any such organization, according to General Counsel Memorandum 39,862 dated Nov. 22, 1991.

Is Any Delay in Timing of Disclosure Permitted?

Courts have consistently held that the question of *whether* to disclose is judged by the perspective of the reasonable investor, but that the decision of *when* to disclose is granted the deference of the business judgment rule. Thus, once disclosure is determined to be required a court is not likely to scrutinize a delay in disclosing so long as that dis-

"What is a *qui tam* action?"

A *qui tam* action is a lawsuit brought by a whistleblower under the False Claims Act (FCA), 31 U.S.C. § 3729 *et seq.* The name derives from the Latin phrase "*qui tam pro domino rege quam pro se ipso in hoc parte sequitur*," which means "he who [sues] for the king as well as for himself." The whistleblower, known as a "relator" under the statute, sues a company on behalf of the federal government for defrauding (i.e., making false claims against) the federal government. As a reward, the relator gets 15-30 percent of any award plus attorney fees. While the Act itself dates back to the Civil War, the recent run of *qui tam* actions dates back to the 1986 amendments which raised relators' rewards to their current levels, provided for attorney's fees, and loosened restrictions on using publicly available information as a basis for suit.

False claims include almost any knowing misstatement to the federal government. What is more, *each* statement is considered a *separate* false claim subject to a $5,500-$11,000 fine and treble the damages caused, so exposure under the act can quickly stack up to millions of dollars.

The FCA affects every industry. As government has moved toward greater outsourcing, government contracts have sprung up for every function imaginable. Large contracts are routinely doled out in IT, administrative services, engineering, and so on—all subject to the FCA and, therefore, to *qui tam* actions.

The highest profile examples involve healthcare providers, such as HMOs. The company treats thousands of patients each day, with tens of line items per patient. It submits these claims for Medicare reimbursement. An error in pricing or coding these hundreds of thousands of line items, each constituting a "claim," can result in millions of dollars of exposure *per day.* The volume of patients and the number of reimbursable services per patient have long made healthcare providers the targets of some of the largest *qui tam* actions.

The second largest set of False Claims actions show up in the defense sector. For example, General Dynamics' subsidiary St. Marks Powder Co., which sells over $100 million in gunpowder to the US military every year, was sued for failing to test the gunpowder as required by contract. Afraid of the treble damages that might result from a *qui tam* suit, the company disclosed the fraud on its own hoping to take advantage of the False Claims Act's provision lowering the treble damages down to double for self-disclosure.

Still other examples include government auctions of all types. In July 2006, money manager and telecommunications tycoon Mario Gabelli settled a *qui tam* action for $130 million after it was disclosed that he created shadow corporations to permit large telecommunications companies to participate in FCC auctions open only to "small" or "very small" businesses.

While this article focuses on the federal government, it is useful to note that many state governments have enacted False Claims Acts having scopes and penalties similar to their federal counterpart.

closure could rationally be described as prompt. Acceptable reasons for delay include:

- Corporate officials are in the process of verifying the information. In the 1978 case of *Elkind v. Ligget & Myers, Inc.,* a federal district court upheld a corporation's delay in reporting a drop in earnings until it determined that the drop represented a trend.
- Disclosure would jeopardize a pending business deal such as in *Texas Gulf Sulfur*, where the Second Circuit held that TGS was justified in waiting to disclose the discovery of mineral deposits until after it had purchased adjoining properties.
- Disclosure would expose the company to undue and avoidable risk of loss as in *Segal v. Coburn Corp. of America*. In that case, a federal district court held that the plaintiff's complaint was inadequate where it alleged harm to stockholders due to Coburn Corp., of America's nondisclosure of its decision to gradually withdraw from the installment paper business. According to the district court, the plaintiff had it backwards. Disclosure of Coburn's plan to gradually withdraw could have impaired stock value and ultimately forced liquidation of the business. Nondisclosure may have minimized stockholders' loss.

Step Two: What Are My Options?

In-house counsel who receive a copy of the complaint from the prosecutor prior to service has traditionally exercised one of two options:

- Refuse to disclose, or
- Disclose general information.

As shown above, neither is ideal. In lieu of these, we prefer two approaches that don't revolve around disclosure *per se*: (a) judicial relief—filing a motion with the court to partially unseal the case and obtaining permission to disclose, and (b) legislative/administrative relief—amending the laws and regulations to take notice of and resolve this dilemma.

Option One: Don't Disclose

This option complies strictly with the judicial seal, but subjects the company to the greatest risk of reprisal from the SEC or exchanges if the *qui tam* suit turns out to be material. The risk presented is untested, as we have been unable to locate a reported case where shareholders successfully argued that the failure to disclose a sealed, but nevertheless material, *qui tam* case was misleading. In the mine run of cases, nondisclosure will not constitute violations of § 10(b) and Rule 10b-5 because many, if not most, *qui tam* suits turn out to be immaterial. Even so, assessing materiality *ex ante* is difficult. Corporate decision makers are left with little more than favorable odds as a basis for making disclosure determinations.

Option Two: Disclose in General Terms

This is the current, preferred form of disclosure. Indeed, companies include the general statement that they "might" be subject to *qui tam* suits in every filing. This creates a "cry wolf" problem. If you always disclose, regardless of whether a case actually exists, the language reveals nothing to your shareholders. Thus, if you decide to include the potential for *qui tam* suits in the "risks" section of your filings, recognize that to comply with your disclosure responsibilities, you likely need to make an additional disclosure of the specific case, even if that disclosure reads something like this passage, again adapted from an actual SEC filing:

> *A* qui tam *lawsuit against [Company Name] has been filed in the United States Federal District Court. The action is under seal and the federal government is conducting an investigation of the matters alleged in this complaint. We have received subpoenas for documents related to that investigation.*

This appears to be a reasonable early disclosure. Since the company can only confirm the existence of the case, that is all it can disclose and that disclosure is "not misleading" information. That said, if the company has obtained the complaint, regardless of whether that complaint remains under seal, it is privy to material information not contained within such a disclosure. To the extent that information gives the company a greater understanding of the strength of the claims, failure to disclose that information may be interpreted as "misleading."

Option Three: Move to Partially Unseal the Case

This entire exercise has been about disclosing as much information as is prudent to disclose without incurring the wrath of the court for violating the seal order. The most direct solution for in-house counsel is to move for a partial lifting of the seal order for the purpose of disclosing the matter to shareholders. Thus, the Court, not the company, would decide what information could be disseminated and the company could face regulators with a clear basis for its disclosure decisions.

To date, we are unfamiliar with any attempted motions for partial removal of the seal. While the government has successfully filed motions to unseal documents for use in talks with defendants, the case law does not indicate that defendants have been successful at doing the same. The Courts seek to protect relators and the government for as long as they need to complete their investigations. For example, in the *United States v. Baylor Univ. Med. Ctr* case, the court noted that Courts routinely grant the government multiple extensions to the 60-day investigation period. It is uncertain whether the court will see the market and public interest in disclosure as sufficient to upset that rule.

Further, it is possible for the government to argue that the company does not have standing to move the court for relief prior to formal service of the complaint. At this point in the litigation, the company has only been served with subpoenas and a courtesy copy of the complaint. Until the complaint is served, the company is not formally a party to the case and lacks standing for a motion to dismiss. See 4A Wright & Miller, Federal Practice and Procedure § 1083 (Rules of Construction for Fed. R. Civ. P. 4, quoting *United States v. American Optical Co.*, 97 F. Supp. 66, 69 (N.D.Ill.1951) for the proposition that "one is not bound by a judgment *in personam* in litigation in which he is not designated as a party or to which he has not been made a party by service of process.")

Option Four: Fix the Laws, Regulations, and Rules

At bottom, the disclosure dilemma related to *qui tam* suits cannot be a judicial versus legislative one. Because it is the law (the False Claims Act) which provides that *qui tam* complaints be filed under seal and it is the law (the Securities and Exchange Acts of 1933 and 1934 and attendant regulations) that requires disclosure of these claims provided they are material, it follows that the best solution would be legislative. If Congress or the SEC recognized the dilemma they have created, they could alter the rules to resolve it. A solution in either statute would work.

Congress or the SEC could amend the law and regulations to recognize that *qui tam* suits are filed under seal and exempt them from disclosure; alternatively, Congress or the SEC could specify what disclosures are necessary and when—although the varying circumstances from case to case would make this more detailed approach cumbersome. Congress could also amend the False Claims Act to make explicit when and how courts should lift seals on *qui tam* suits to permit disclosure.

ACC Extras on…False Claims Act Lawsuits

ACC Docket

Now, Never, or Somewhere In Between?: The Nuts And Bolts of Setting Reserves (2004). It's a thorny set of questions that, in an era of hyper-scrutiny on SEC filings, carry more weight than ever: How do you decide when a litigation matter must be disclosed on financial statements and to shareholders, and for how much? *www.acc.com/resource/v4889*

ACC might have more material on this subject in our Virtual Library[SM]. To create your personalized search, visit *www.acc.com*, click on the "Research" pull down menu button, then select Virtual Library. Type in your keywords and search to see the other resources we have available.

Choosing the Impossible

For years, corporations have faced the impossible task of choosing between their duty to their shareholders and restrictions of the judicial seal. Over time, the government's foot-dragging in *qui tam* actions has prompted some to choose market over courtroom and ignore the judicial seal, revealing as much about the case as they dare. Corporations cannot continue to labor in this state of legal limbo, particularly when so much money is at stake. The results—general, meaningless disclosures—help no one. It is time to request action of both sides; courts should grant motions to partially unseal *qui tam* suits permitting limited disclosure. Similarly, Congress and the SEC should work to clarify in the statutes and regulations a corporation's responsibility in these circumstances.

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Notes

1. This article does not address the related dilemma presented by individuals who know of the *qui tam* complaint and trade company stock while the complaint remains under seal. As the Supreme Court explained in *United States v. O'Hagan*, 521 US 642 (1997), liability for insider trading may be established under § 10(b) of the Securities Exchange Act and SEC Rule 10b-5 based on one of two theories. Under the "traditional" or "classical" theory, § 10(b) and Rule 10b-5 are violated "when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." *Id.* at 651-52. Under the "misappropriation" theory, § 10(b) and Rule 10b-5 are violated when a person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652. Whereas the "classical" theory targets a corporate *insider's* breach of duty to shareholders, the "misappropriation" theory targets a corporate *outsider's* breach of duty to the source of nonpublic information. *See id.* at 652-53. As to the first theory, the Ninth Circuit has held that corporate insiders could be held liable for insider trading based, in part, on their knowledge of a pending FAA investigation which the corporation had not disclosed to investors. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003). The risk of insider trading is obviously reduced when a company chooses to disclose or seeks an order unsealing the complaint for purposes of disclosure to shareholders.
2. For a detailed analysis of the above laws and regulations see Chapter 9: The Disclosure Dilemma, in Health Care Fraud and Abuse: Practical Perspectives (Cumulative Supp. 2005).