

A Decade of Lessons From Litigating State Tax False Claims Act Cases

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In the last decade, we have witnessed a large upswing of False Claims Act (FCA) cases filed in the state tax arena. New York, particularly in the last few years with Attorney General Eric Schneiderman at the helm, has sharpened its tools and upped its enforcement efforts.¹ In Illinois, hundreds of state tax FCA cases have been filed by a single plaintiff

¹The New York False Claims Act was amended in 2010 to allow private citizens acting on behalf of the state to bring a tax claim alleging fraud against taxpayers who met a specific financial threshold. N.Y. State Fin. Law sections 189(1), (4), and 190(2). The amendments provide for treble damages, rewards of up to 30 percent of liability, and a 10-year statute of limitations, which is years beyond the statute of limitations governing state tax audits. N.Y. State Fin. Law sections 189(1)(h), 190(6)(b), and 192(1). The New York attorney general's office issued a press release regarding the first tax case it settled, announcing that it had negotiated a settlement that included a \$5.5 million tax payment, the entry of a guilty plea, and the possibility of a three-year prison term. Press Release, N.Y. State Office of the Attorney General, "A.G. Schneiderman Announces Arrest, Conviction and \$5.5 Million Settlement in Tax Fraud Case Against Prominent Tailor," Mar. 5, 2012. More recently, another widely publicized New York FCA case in which the attorney general has intervened survived a motion to dismiss. *People of the State of N.Y. v. Sprint Nextel Corp.*, 970 N.Y.S.2d 164 (N.Y. Sup. Ct., N.Y. County June 27, 2013). (However, allegations of violations of New York FCA section 189(c) were dismissed, and two causes of action were dismissed for some periods.)

law firm, triggering a State House Revenue and Finance Committee hearing on the abuse of the Illinois FCA and proposed legislation that would put significant limitations on the filing of claims.² Across the country, unclaimed property laws also have seen their fair share of FCA litigation.³

Currently, 29 states; the District of Columbia; New York City; Chicago; and Allegheny County, Pa., have FCA statutes.⁴ Of those jurisdictions, eight (Delaware, Florida, Nevada, New Hampshire, New York, Washington, Wisconsin, and Chicago) permit state tax FCA claims involving any type of tax.⁵ Three others (Illinois, Indiana, and Rhode Island) bar only income tax FCA actions; any other type of

²July 26, 2012, Public Hearing of Illinois House Revenue and Finance Committee, which included testimony from the director of the Illinois Department of Revenue, the Office of the Illinois Attorney General, taxpayer groups, practitioners, and defendants named in FCA litigation; and HB 0074, 98th Gen. Assem. (Ill. 2013). The Illinois cases have been the subject of several Illinois appellate court rulings. *See, e.g., State ex rel. Beeler, Schad & Diamond P.C. v. Target Corp.*, 367 Ill. App. 3d 860 (1st Dist. 2007) (affirming dismissal of litigation based on relator's failure to demonstrate it was an original source); *State ex rel. Beeler, Schad & Diamond P.C. v. Burlington Coat Factory Warehouse Corp.*, 369 Ill. App. 3d 507 (1st Dist. 2006) (affirming dismissal of litigation on state's motion to dismiss); *State ex rel. Beeler, Schad & Diamond P.C. v. Ritz Camera Centers Inc.*, 377 Ill. App. 3d 990 (1st Dist. 2007) (interlocutory ruling affirming trial court's denial of motion to dismiss raising defenses common to all defendants).

³*See, e.g., Grayson v. AT&T Corp.*, 980 A. 2d 1137 (D.C. 2009) (consumer protection claims not dismissed); *State of Cal. ex rel. Grayson v. Pac. Bell Tel. Co.*, 142 Cal. App. 4th 741 (Cal. Ct. App. 2006); *State of Del. ex rel. Higgins v. Source Gas LLC*, C.A. No. N11C-07-193 MMJ CCLD (Del. Super. Ct. 2012); *Total Asset Recovery Servs. v. MetLife Inc.*, No. 20111001225 (Ill. Cir. Ct. Jan. 21, 2011) (dismissed by stipulation or agreement).

⁴Taxpayers Against Fraud Education Fund, States With False Claims Acts.

⁵Del. Code Ann. tit. 6, sections 1201-1211; Fla. Stat. sections 68.081-68.09; N.H. Rev. Stat. Ann. sections 167:61-b to 167:61-e; Nev. Rev. Stat. sections 357.010-357.250; N.Y. State Fin. Law sections 187-194; Wash. Rev. Code sections 74.66.020, 74.09.201-74.09.214; Wis. Stat. sections 20.931, 71.83(2)(b)4; Chi. Mun. Code sections 1-22-010 to -060.

state or local tax is fair game.⁶ The remaining jurisdictions either bar all tax-related claims⁷ or are limited to Medicaid-related claims.⁸

FCA laws, also referred to as *qui tam* or whistleblower laws, allow third-party, private citizens (whistleblowers or relators) acting on behalf of a government to sue persons who knowingly make or use a false statement material to an obligation to pay money to the government. In the tax arena, claims frequently are brought as “reverse” false claims, alleging a knowing concealment or avoidance of a tax obligation.⁹ “Knowingly” is broadly defined by the FCA laws as actual knowledge, deliberate ignorance of the truth or falsity of information, or acting in reckless disregard of the truth or falsity of information.¹⁰

The penalties associated with an FCA violation are severe, and the potential reward to a whistleblower is significant. Persons found to have violated a state FCA may be found liable for up to three times the amount of unpaid tax, interest, and penalties, plus per-occurrence civil penalties (up to \$11,000 per false claim in Illinois).¹¹ Up to 30 percent of the proceeds of any judgment or settlement may be awarded to the whistleblower, together with its litigation costs, expenses, and reasonable attorney fees.¹²

The groundswell of litigation appears to be rising. Although Tennessee amended its statute to bar the

use of FCA cases in the tax arena,¹³ proposed legislation to amend the Illinois statute to limit tax-related claims has stalled in committee. Recently, the Multistate Tax Commission Income and Franchise Tax Uniformity Subcommittee formed a working subcommittee to begin drafting a model provision for state false claims acts.¹⁴

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With no universal shutdown of state tax FCA actions on the horizon, we offer the following practical recommendations to the taxpayer community for defending against third party FCA claims, based on our years of battling in the FCA trenches. A subsequent article will offer practical tips for guarding against FCA claims brought by insiders, including employees.

Oppose the Enactment of State FCAs

Be a strong voice against the enactment of FCA litigation in the tax arena. Emphasize the powerful enforcement mechanisms that already are present and available for use by state tax departments against tax cheats. Explain the risks created when private citizens, with no tax experience, are armed with legislation that gives them the power to drive tax policy by filing whistleblower claims. Do not accept any assurance that a state statute is a copy of the federal FCA, which “has a tax prohibition.” Smart whistleblowers recognize that there is ample opportunity to bring tax-related state FCA litigation under such statutes, as they only prohibit income-tax related claims. See, for example, the Illinois FCA and related litigation referenced above, all of which involve sales and use tax-related claims under a state statute modeled on the federal FCA.¹⁵

If Sued, Expect Skepticism for Your Point of View

Generally speaking, the general public, judges included, believe whistleblower lawsuits serve a

⁶740 Ill. Comp. Stat. 175/3(c); Ind. Code section 5-11-5.5-2(a); R.I. Gen. Laws section 9-1.1-3(d).

⁷Allegheny County, Pa. (Allegheny County Code of Ordinances section 485-3(C)); California (Cal. Gov’t Code section 12651(f)); the District of Columbia (D.C. Code section 2-381.02(d)); Georgia (Ga. Code Ann. section 49-4-168.2(j)(4)); Hawaii (Haw. Rev. Stat. section 661-21(f)); Massachusetts (Mass. Gen. Laws ch. 12, section 5B(d)); New Mexico (N.M. Stat. Ann. section 44-9-3(E)); Minnesota (Minn. Stat. section 15C.03); Montana (Mont. Code Ann. section 17-8-403(4)); North Carolina (N.C. Gen. Stat. section 1-607(c)); New Jersey (N.J. Stat. Ann. section 2A:32C-2); New York City (N.Y.C. Admin. Code section 7-804(d)); Oklahoma (Okla. Stat. tit. 63, section 5053.1(E)); Tennessee (Tenn. Code Ann. section 4-18-103(f)); and Virginia (Va. Code Ann. section 8.01-216.3(D)).

⁸Colorado (Colo. Rev. Stat. sections 25.5-4-304 to -310); Connecticut (Conn. Gen. Stat. sections 17b-301a to -301p); Iowa (Iowa Code sections 685.1-685.7); Louisiana (La. Rev. Stat. Ann. section 437.1-440.3); Maryland (Md. Code Ann. Health-Gen. sections 2-601 to -611); Michigan (Mich. Comp. Laws sections 400.601-400.615); and Texas (Tex. Hum. Res. Code Ann. sections 32.039, 36.001-36.117; Tex. Gov’t Code Ann. section 501.101).

⁹See, e.g., 740 Ill. Comp. Stat. sections 175/3(a)(1), 175/4(b)(1); N.Y. State Fin. Law sections 189(1), 190(2).

¹⁰See, e.g., 740 Ill. Comp. Stat. section 175/3(b)(1); N.Y. State Fin. Law section 188(3).

¹¹See, e.g., 740 Ill. Comp. Stat. sections 175/3(a)(1), (2); N.Y. State Fin. Law sections 189(1), (3).

¹²See, e.g., 740 Ill. Comp. Stat. section 175/4(d); N.Y. State Fin. Law section 190(6).

¹³Tennessee amended its FCA to provide that it does not apply to any state-administered taxes (Tenn. Code Ann. section 4-18-103(f)), following FCA litigation filed by the same law firm responsible for filing the Illinois litigation (*State of Tenn. ex rel. Beeler, Schad & Diamond P.C. v. Target Corp.*, No. 02-3763-III (Tenn. Chancery Ct. Dec. 1, 2003)).

¹⁴See Multistate Tax Commission, Memorandum to MTC Uniformity Committee, Sales and Use Tax Subcommittee (July 12, 2013).

¹⁵The Indiana and Rhode Island statutes are similarly worded.

useful purpose because they ferret out fraud against the government. Rightly or wrongly, many people view fraud on the government as a rampant problem. In the tax arena, these views are exacerbated by the fact that everyone hates a tax cheat. These ingrained beliefs can present a significant hurdle that must be overcome in order to prevail in the defense of FCA litigation.

Be Prepared to Present Your Case Simplistically

Because FCA litigation typically arises outside the context of a traditional state tax proceeding, lawsuits often are assigned to courts, and state attorneys, with little or no tax background. In fact, the state taxing authority may not even be named as a party to the litigation.

Individuals without a background in taxation frequently take frivolous claims more seriously than would a more experienced jurist. As a result, it is critical for you to explain your tax position clearly and succinctly. It's difficult for a judge to agree to dismiss a case as meritless if he does not understand the defect in the whistleblower's tax claim.

If your jurist also lacks experience with FCA litigation, analogize your arguments to other legal concepts that the jurist frequently addresses in other types of litigation. For example, in a motion to dismiss, argue that FCA litigation is like fraud litigation, in that a relator's claims must be pleaded with specificity.

Recognize That the State Has Competing Interests in the Litigation

In all likelihood, the state did not initiate the FCA litigation. The state's attorneys may even agree with you, at least privately, that the whistleblower's claim lacks merit. Despite this fact, the state may not have the resources to take an active role in the matter. It may simply decline to intervene, which frees the whistleblower to proceed with the litigation on its own. This is cheaper for the state, but it does not relieve the litigation expense for the taxpayer defendant.

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Even more importantly, recognize that a state's interest in helping taxpayer defendants named in unworthy cases is compromised by the fact that the state will benefit if the cases are settled rather than dismissed. At least 70 percent of the dollars paid in

any settlement go to the state's coffers. In some states, a portion of the funds collected in FCA litigation go straight to the budget of the state attorney general, rather than to the general revenue funds into which tax payments typically are deposited. As a result, you may find it far easier to persuade a state official to support a nominal settlement of an unworthy FCA case than to publicly support your claim that the lawsuit is meritless.

Also, be aware that states must analyze their actions in the broader context of all state FCA litigation, not just tax cases. A state attorney may be unwilling to publicly express a view that a case lacks merit for fear that it may compromise the state's ability to use the FCA in other, more worthy disputes.

Be Wary of the Power of the State

The state is the "real party in interest," with strong rights of control over the litigation, even when it does not intervene,¹⁶ including the right to control discovery and a preferential dismissal standard.¹⁷ In addition, the state's approval is essential to the settlement of any FCA matter. Cultivate a strong working relationship with the state attorneys assigned to your FCA case, even if the state doesn't intervene, so you can call on the state's lawyers for assistance when needed.

Use Joint Defense Groups When Appropriate

If multiple lawsuits have been filed against a number of defendants on the same issue, consider forming a joint defense group to share ideas and work together on common issues. Be prepared, however, to stand out from the pack in order to emphasize the more favorable aspects of your case.

Call the Whistleblower's Bluff on Unworthy Cases

If the case filed by the whistleblower is meritless and, from your perspective, worthy of a fight, aggressively defend your position. Seek to have the case dismissed. Issue discovery requests requiring the whistleblower to disclose evidence supporting the required elements of its claim, including that the whistleblower is an original source, that there was

¹⁶See, e.g., *Scachitti v. UBS Fin. Servs.*, 215 Ill. 2d 484, 510-11 (2005) (holding that in an Illinois FCA case, the state, acting through the Illinois attorney general, "retains authority to control the litigation at every stage of the proceedings" consistent with its role as the chief legal officer of the state).

¹⁷*Id.*; see also *U.S. ex rel. Sequoia Orange Co. v. Baird-Neece Packing Corp.*, 151 F.3d 1139 (9th Cir. 1998); *Swift v. United States*, 318 F.3d 250 (D.C. Cir. 2003); and *Burlington Coat Factory*, 369 Ill. App. 3d at 516-17 (all discussing the favorable standard afforded to a government that moves to dismiss a lawsuit filed under the FCA).

no prior public disclosure of the tax issue, and any evidence of deliberate misconduct. Consider filing a counterclaim seeking your attorney fees and expenses on the ground that the whistleblower's claim is frivolous. Many whistleblowers file these suits hoping for a quick settlement. If you make it apparent that you intend to aggressively defend your litigation, the whistleblower may back away, focusing instead on less bothersome opponents.

If You Settle, Be Prepared to Pay the Whistleblower's Expenses

FCA lawsuits can be expensive to defend, even when the underlying tax claims are without merit. When the amount at issue is small or the defense to the underlying tax claim is weak, it may be cheaper for a taxpayer defendant named in FCA litigation to negotiate a settlement.

Most FCAs provide that a whistleblower that prevails in the litigation is entitled to its reasonable attorney fees, costs, and expenses. Courts have ruled that a whistleblower is deemed to have prevailed when it enters into a court-approved settlement.¹⁸ In the event you decide to settle, be prepared to compensate the whistleblower for its reasonable attorney fees, costs, and expenses, without regard to the merits of the underlying claim. Fees and expenses also can be awarded to the state.

Use State Audits for Protection

Take steps now to keep yourself from being named in this type of litigation. Disclose your "no tax" positions to state auditors and get their approval, in writing if you can (or preserved in an internal memo if you cannot). Evidence of a state's favorable review of an issue on audit is extraordinarily helpful in defeating a whistleblower's subsequent claim of a deliberate, knowing failure to collect and remit a particular tax.

Recognize the Inherent Limitation of Relying on Secondary Sources

Secondary sources can provide a good overview of a state's tax structure. Do not assume, however, that

¹⁸See, e.g., *United States ex rel. Saidiani v. Nextcare Inc.*, No. 3:11CV141 (W.D.N.C. Feb. 4, 2013); *United States ex rel. Miller v. Bill Harbert Int'l Const. Inc.*, 786 F. Supp. 2d 110, 116 (D.D.C. 2011); *United States ex rel. LeFan v. Gen. Elec. Co.*, No. 4:00-CV-222 (W.D. Ky. Jan. 15, 2008); *United States ex rel. Educ. Career Dev. Inc. v. Cent. Fla. Reg'l Workforce Dev. Bd. Inc.*, No. 6:04-CV-93-ORL-19DABC (M.D. Fla. June 1, 2007).

sources are always up to date and 100 percent accurate, or that your reliance on information contained in a source can absolve you from any whistleblower claim. Secondary sources do miss new developments, as well as the nuances that may be created by case law.

Make sure that someone in your organization is responsible for following new state tax developments. If your organization prepares a regular survey of state tax obligations, keep the document up to date. Conduct your reviews as frequently as the title (for example, "annual survey") of the document suggests.

Consider the Risk of FCA Litigation in Your Tax Planning

When deciding whether to take a particular tax position, consider not just the possible penalties and interest associated with an adverse audit determination, but also the risk of FCA or class action litigation. Risky tax positions can be fodder for litigation.

Lobby for the Amendment of Bad Laws

Speak up in favor of the amendment of existing state FCAs to exclude tax claims, or other modifications designed to limit a whistleblower's right to file tax-related claims. The proposed amendment to the Illinois FCA statute was introduced after the House Revenue and Finance Committee held a public hearing on FCA abuse in the tax arena at which taxpayers testified about the expense and disruption caused by the litigation.¹⁹

While most would agree that there are contexts in which whistleblower claims are useful in ferreting out government fraud and abuse, the use of claims in the state tax arena is problematic at best, especially as many laws are currently enacted. If you have the misfortune of being named in one of these suits, rely on the above principles to guide you through the litigation. ☆

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¹⁹HB 0074, 98th Gen. Assem. (Ill. 2013).