ADG Insights

Managing the ADG supply chain in the age of protectionism

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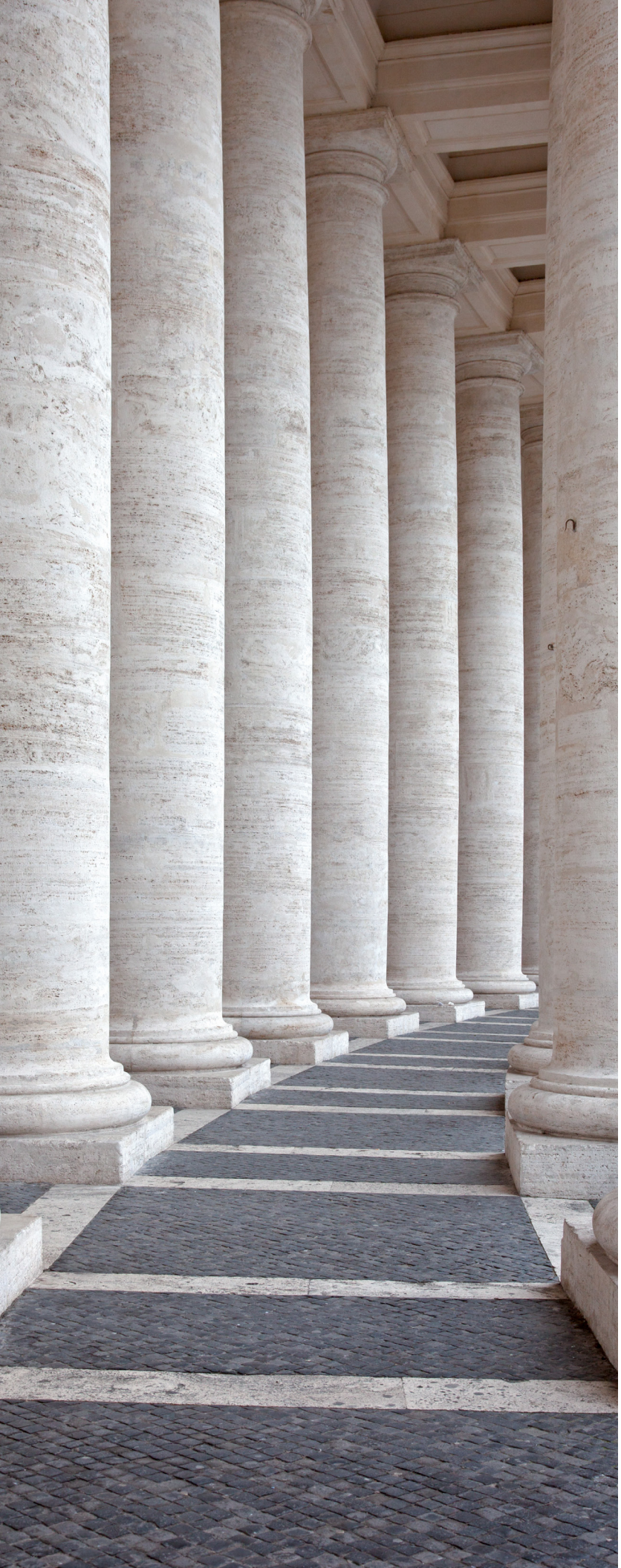
Hogan Lovells



Introduction

Manufacturers in the aerospace, defense, and government services (ADG) industry sector operate within a complex web of suppliers and subcontractors that provide raw materials, parts, and assembly services. Because of the extensive interconnectivity in this industry sector, disruptions in one part of an ADG supply chain can have a vast ripple effect. A significant uptick in global tariffs and the possibility of a "hard Brexit" pose significant supply-chain management challenges to ADG companies. In addition, ADG companies must monitor recent U.S. efforts: (1) to encourage government contractors to utilize materials manufactured in the United States; (2) to more aggressively enforce existing customs and duties laws; and (3) to utilize the False Claims Act (FCA) as a tool to enforce country-of-origin, customs, and duties laws.

Coping with increased tariffs

President Donald Trump has made a protectionist trade policy a centerpiece of his administration. Last year, the United States placed new tariffs on steel and aluminum products setting off retaliatory tariffs around the globe. This tariff or trade war has meant an increase of 10-25 percent on duties paid on imports of products such as aircraft and aircraft parts. Meanwhile, the United Kingdom has failed to reach a Brexit deal and the possibility of a "hard Brexit" is looming. The impact of these changes will be felt by ADG companies not just in higher costs they may be required to pay, but also through ripple effects of adjustments they may need to make to their supply chains to avoid tariffs. Sophisticated manufacturing plants utilized in the ADG industry cannot simply be picked up and moved to a new location. It may take years to change suppliers. And given the uncertainty about the longevity of any tariffs, strategic decisions about making such changes are extremely difficult.

The following strategies may help your company navigate these difficulties:

- Know who your primary suppliers are and who your lower-tier suppliers are so you can anticipate possible disruptions and strive to avoid dependence on a single source for any given component in your supply chain.
- Scrutinize product specification to see if any reasonable changes to those specifications could enable additional suppliers to meet your requirements and result in lower tariffs.
- Employ innovative technologies such as the industrial internet of things, and distributed ledger technology to gain greater transparency into your supply chain and facilitate enhanced analytics that better enable your company to respond to unanticipated tariffs.
- Run hypothetical scenarios that illustrate the impact of making changes to your suppliers in the short term and long term as new information becomes available.

Trade-related FCA claims

President Trump issued a recent executive order that urges federal agencies to "maximize, consistent with law, the use of goods, products and materials produced in the United States, in Federal procurements and through the terms and conditions of Federal financial assistance awards."[1] Although this executive order neither modifies existing laws or regulations nor requires contractors working under existing contracts to change their procurement or supply-chain plans, it does suggest that agencies will soon incorporate new terms into grant and loan awards and purchase contracts that will require the use of certain domestic materials. This follows a 2017 executive order that called for U.S. Customs and Border Protection (CBP) to increase its efforts to fight customs law violations, especially those involving evasion of antidumping and countervailing duties.[2] The Trump administration's desire to encourage government contractors to use domestic materials and to strengthen enforcement of customs laws and import duties is also consistent with an emerging trend in FCA litigation.

Increasingly, relators and the U.S. Department of Justice (DOJ) are employing the FCA to enforce country-of-origin requirements of the Buy America Act (BAA) and the Trade Agreements Act of 1979 (TAA), as well as the Tariff Act of 1930 and other customs laws, and duties imposed upon importation of certain goods. Incentivized by the FCA's qui tam provisions, relators may bring FCA actions seeking treble damages and penalties on behalf of the United States for alleged noncompliance with these statutes and rules. When such a case is filed, DOJ has the right to intervene and pursue the claim itself. Pursuit of such actions aligns with the Trump administration's trade policy. In the last five years, DOJ has recovered more than US$100 million in FCA settlements involving the evasion or underpayment of import duties for a wide variety of merchandise.

Because ADG companies often rely on a global supply chain, they should understand this emerging FCA risk and the key defenses available in such an action.

Lack of specificity and inadequate materiality and scienter allegations may thwart FCA claims

Trade-related FCA claims are commonly styled as "reverse false claims" actions and allege importers avoided paying duties by knowingly making false statements to the government about tariff classification, valuation, country-of-origin, eligibility for trade preference program treatment, or the applicability of antidumping or countervailing duties. Alternatively, relators or the government may bring an FCA action alleging that a government contractor impliedly certified compliance with country-of-origin requirements of the BAA or TAA when seeking payment under the contract, when in fact the contractor did not comply with those requirements. Such "implied false certification" cases have become commonplace in FCA litigation.

In either case, an FCA complaint must be pled with the specificity required to satisfy the Rule 9(b) pleading standard. In addition, the U.S. Supreme Court has recently affirmed that the FCA's materiality and scienter requirements are rigorous and should be strictly enforced.[3] These hurdles have proved significant in several recent cases.

In *United States ex rel. Berkowitz v. Automation Aids Inc.*,[4] the U.S. Court of Appeals for the Seventh Circuit affirmed the dismissal of a qui tam action brought by Berkowitz, who alleged his competitors were selling products to the

government that did not comply with the TAA while impliedly certifying the products were compliant. The relator compiled reports showing the defendants sold thousands of noncompliant products over a three-year period but did not tie those products to specific claims for federal reimbursement and certifications of TAA compliance. The court found the lack of specific allegations about the fraud at the individualized transactional level for each defendant fatal and granted a motion to dismiss. In doing so the court observed that the "fact that the defendants may have sold noncompliant products during a certain time period in violation of the TAA does not equate to the defendants making a knowingly false statement in order to receive money from the government."[5]

The court also found the relator failed to adequately plead scienter by alleging either that the defendants had actual knowledge their certifications of TAA compliance were false or that they acted with reckless disregard of the truth or falsity of those certifications. Finally, the court expressed skepticism about whether the relator could satisfy the materiality requirement noting the government paid "millions of dollars" for products it knew were allegedly noncompliant suggesting that this payment indicated the alleged false certifications were not material to the government's decision to pay.

The U.S. District Court for the District of Columbia has previously held in *United States v. Comstor Corp.*[6] that the existence of a Federal Acquisition Regulation requiring TAA compliance does not establish that compliance with TAA was material to the government's decision to pay. The *Comstor* court also held that the relator's claim failed to adequately plead materiality or scienter.

A third recent trade-related FCA action was dismissed when the court found the United States, which had intervened in the case, had not adequately alleged scienter. In *United States ex rel. Krawitt v. Infosys Technologies Limited Inc.,* the complaint alleged that Apple Inc., which had subcontracted with a company in India to provide live training sessions to its employees in California, conspired with the Indian company to violate U.S. immigration laws by securing B-1 visas for the Indian trainers instead of more expensive and selective HB-1 visas. The court granted Apple's motion to dismiss, finding the foreign nationals provided services permitted by their B-1 visa status. The court further explained that even if the trainers conducted business that was not allowed under their B-1 visas, the fact that the scope of allowable business activities under a B-1 visa is not well-defined rendered the relator's scienter allegations insufficient. The defendants "cannot be charged with knowledge or willful blindness to the correct uses of the B-1 visa because there is simply no exhaustive list or case law of all permissible activities under a B-1 visa."[7]

Any FCA claim relating to customs, duties, or country-of-origin requirements should be scrutinized to ensure it meets the pleading standards discussed in these recent cases.

Consider the impact of the government action bar

Although the facts of the Krawitt decision relate to regulations enforced by CBP, nothing in that opinion suggests that CBP was involved in identifying, investigating, or prosecuting the alleged violations. If it had been, the government action bar may have provided another basis for dismissal.

The FCA's "government action bar" prohibits qui tam actions from proceeding if they are "based upon allegations or transactions which are the subject of a civil suit or an administrative civil monetary penalty proceeding in which the Government is already a party."[8] In *Schagrin v. LDR Industries LLC*,[9] a federal court recently considered what form of CBP proceedings trigger the government action bar and concluded that a CBP penalty proceeding can be initiated only by issuance of a pre-penalty notice pursuant to 19 U.S.C. § 1592. Thus, an FCA claim based on allegations or transactions investigated by the CBP in a penalty proceeding that was initiated by a pre-penalty notice issued pursuant to 19 U.S.C. § 1592 is likely barred by the government action bar.

Looking ahead

The Trump administration's trade policy and enforcement priorities inject additional risk into ADG supply chains. In the coming months and years, ADG companies must prepare to navigate a growing number of tariffs, new agency policies, rules that may emerge as a result of President Trump's January 31, 2019 executive order, and increased FCA risk relating to customs, trade, and country-of-origin requirements. Recent FCA decisions demonstrate that some relators have difficulty pleading such cases with the required level of specificity and to meet the FCA's rigorous scienter and materiality standards. However, ADG companies should continue to monitor case law developments in this area. Of particular note, agency-level policies that result from Trump's January 31, 2019 executive order could tighten the nexus between noncompliance and the government's decision to pay, making it easier for FCA plaintiffs to surmount the materiality hurdle.

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Endnotes

1. Executive Order 13858, "Strengthening Buy-American Preferences for Infrastructure Projects," 84 Fed. Reg. 2039 (Jan. 31, 2019).
2. Executive Order 13785, "Establishing Enhanced Collection and Enforcement of Antidumping and Countervailing Duties and Violations of Trade and Customs Laws," 82 Fed. Reg. 16719 (March 31, 2017).
3. *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989, 2002 (2016).
4. 896 F.3d 834 (7th Cir. 2018).
5. Id. at 841-42.
6. *United States ex rel. Folliard v. Comstror Corp.*, 308 F. Supp. 3d 56 (D.D.C. 2018).
7. *United States ex rel. Krawitt v. Infosys Techs. Ltd., Inc.*, 342 F. Supp. 3d 958, 967 (N.D. Cal. 2018).
8. 31 U.S.C. Section 3730(e)(3).
9. *United States ex rel. Schagrin v. LDR Indus., LLC,* No. 14 C 9125, 2018 WL 6064699, at *4 (N.D. Ill. Nov. 20, 2018).

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