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FEATURE COMMENT: When 'Molehills' Become 'Mountains'—The Implications Of *U.S. ex rel. Longhi v. Lithium Power Techs. Inc.* For SBIR Grantees And Beyond

In *U.S. ex rel. Longhi v. Lithium Power Techs. Inc.*, 513 F.Supp.2d 866 (S.D. Tex. 2007), 2008 WL 62207 (S.D. Tex. Jan. 3, 2008), the U.S. District Court for the Southern District of Texas ruled that a small business that made false statements to obtain Small Business Innovation Research (SBIR) grants violated the False Claims Act and must pay the Government treble damages on all amounts received under the grants, plus the maximum civil fine per grant. Identifying what it considered a "novel issue of law," the Court addressed for the first time the "proper way to calculate damages for a fraudulently induced research grant." The defendant urged the Court to adopt the "benefit of the bargain" theory, arguing that the Government received what it paid for, i.e., high-quality research, and therefore was not damaged. The Court, however, determined that the grant work was "valueless" to the Government.

This Feature Comment analyzes the liability and damages decisions in *Longhi* and discusses the impact on SBIR grantees, as well as other recipients of research and development (R&D) funding.

Background—The SBIR program has three phases. Phase I is considered the "start-up" phase and involves small amounts of funding and relatively brief performance periods. The focus generally is on the technical merit and commercialization prospects for a particular concept or technology. Only Phase I award recipients are eligible for Phase II support, which is more significant and for an extended period of time. During Phase II, the SBIR awardee performs R&D work and continues to assess commercial potential. Phase III is the actual commercialization of the technology. Although referred to as Phase III, no SBIR funding is provided; rather, the Government may award contracts to purchase the technology.

Defendant Lithium Power Technologies (LPT) was founded in 1998. At issue in the case are four SBIR grants that LPT received between 1998 and 2004 from the Army Space and Missile Defense Command (ASMDC), the Ballistic Missile Defense Organization (BMDO), and the Air Force. The ASMDC grant was a Phase I effort to develop thin, rechargeable batteries, and the BMDO grant was the follow-on Phase II award for continued development. LPT also applied for and received both Phase I and Phase II grants from the Air Force to study the feasibility of microelectricalmechanical system batteries using solid electrolytes for microsatellites. The value of the four awards totaled $1.66 million.

The relator, Alfred Longhi, came into contact with LPT in 1997 when he began recruiting investors for LPT and later invested in the business himself. In March 2000, Longhi became LPT's vice president of sales and marketing. During his time as an LPT employee, Longhi learned of what he viewed as fraudulent conduct related to the SBIR program. In November 2002, Longhi sold his stock back to the company, resigned his position and filed a qui tam action against LPT. After a lengthy investigation, the U.S. elected to intervene in those claims "pertaining to duplicative research and work, and the fraudulent billing related to that duplicative research and work." Ultimately, the U.S. Attorney's Office elected not to pursue criminal charges against LPT or any of its employees.

Legal Analysis—The first issue facing the Court was whether LPT was liable under the FCA for making false statements in its proposals for the four SBIR grants in question. On cross-motions for partial summary judgment, the Court ruled

that LPT violated the FCA by making in its SBIR proposals several "knowingly false" statements and misrepresentations that were "crucial and material" to the Government's decision to select LPT's proposals. LPT:

- misrepresented its corporate status and history in the ASMDC Phase I proposal by claiming that it had been in business since 1992, although it did not incorporate as a business until five months after proposal submission;
- made false statements about its available facilities in the ASMDC Phase I grant proposal;
- misrepresented "cooperative arrangements" that it claimed to have with the University of Houston and Polyhedron Laboratories in all four SBIR proposals; and
- misrepresented the amount of related work it had performed in the Air Force SBIR proposals by not disclosing the funding received for the ASMDC Phase I and BMDO Phase II grants.

Noting that the falsity of a claim is determined at the time of submission, the Court found that a number of these statements were not true when LPT submitted the proposals. Moreover, the Court determined that LPT made these statements either with actual knowledge of their falsity or with a "reckless disregard for their truth." The Court also accepted the Government's argument that a false statement made in a Phase I proposal "tainted" the Phase II proposal because, under SBIR terms and conditions, a Phase I grant is a precondition to the receipt of a Phase II grant.

To demonstrate that LPT's false statements were material under the FCA, the Government provided declarations from the scientists who evaluated the ASMDC Phase I and Air Force proposals. The scientists asserted that the false statements made by LPT were "crucial and material" to their decision to fund LPT's SBIR proposals. In response, the defendant argued that the Government "has made a mountain out of a group of small molehills" in arguing that the allegedly false statements were material. The Court, however, found that LPT "embellished a whole series of molehills so it could present a mountain of experience, facilities, and novelty to attract the reviewers." Therefore, the Court found that LPT fraudulently induced the Government to award the SBIR projects.

In its damages decision, the Court first recognized that no other circuit had addressed the proper way to calculate damages for a "fraudulently induced research grant." In arguing that the Government was not damaged, the defendant urged the Court to adopt a "benefit of the bargain" theory or the closely related "no harm, no foul" approach because the Government got what it paid for—the research proposed in the SBIR proposals. Thus, according to LPT, the Government was not damaged.

The Court found that the Government did not receive the benefit of its bargain for two primary reasons. First, the Court noted, in most cases in which courts apply the benefit of the bargain approach, the contract at issue is a procurement contract with a tangible end product such as a "bridge" or "widget." In contrast, the SBIR projects, according to the Court, produced no tangible end product. Second, the Court described the congressional intent underlying the SBIR program as providing assistance "to small-business concerns to enable them to undertake and to obtain the benefits of research and development in order to maintain and strengthen the competitive free enterprise system and the national economy." 15 USCA § 638(a). According to the reviewing scientists, they would not have selected LPT for award if its proposals had been truthful. Thus, by submitting false proposals, LPT prevented the Government from receiving the "intangible" benefit that it had anticipated, e.g., helping deserving small businesses develop innovative new products.

Although the Court rejected LPT's position that the Government received the benefit of the bargain, it nonetheless examined the "value" of the work LPT performed. On this issue, the Court concluded that "since the legislative history of the SBIR demonstrates that the value of the program lies not in innovation, but in innovation by eligible small businesses, it is clear that any alleged end-product of the Four Contracts is valueless from the government's standpoint."

Because the Government received nothing of value, the Court found that the proper amount of actual damages was three times the $1.66 million value of the grants—or $4.97 million. However, the Court rejected the Government's request for civil penalties on each of the 54 invoices submitted under the four projects, determining that the fine should attach only once to each project. Specifically, the Court noted that in its earlier decision it made no finding on the falseness of the individual invoices. Rather, the Court found that the false statements were the four projects themselves and that falseness was imputed to the

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invoices. Because the defendant's fraud was "systematic and knowing," the Court assessed the maximum penalty per grant, for a total of $43,000.

Implications and Conclusions—*Longhi's* impact on SBIR recipients and the broader R&D community is potentially far-reaching. As the Court noted in its damages decision, "today's SBIR is big business." For instance, in fiscal year 2007, the Department of Defense and the National Institutes of Health awarded over $1.7 billion in SBIR grants. As SBIR dollars grow, the Phase I SBIR grant process becomes increasingly competitive. In 2001, nearly 30 percent of all Phase I applications at NIH received funding, but in 2006, only 19 percent of NIH SBIR applicants were successful. With greater competition and the growing importance of early stage R&D funds, the pressure to produce a competitive proposal is intensifying.

The *Longhi* decision is a wake-up call to small businesses aggressively "marketing" themselves to SBIR funding agencies. First, the liability decision's discussion of LPT's proposals shows that what an applicant might consider "shading" or "puffery" if pushed too far, can become a knowingly false statement. Applicants should be certain that the assertions made in their SBIR proposals are true and accurate at the time of proposal submission, not when they receive SBIR funding. This is particularly relevant as the decision holds that a "tainted" Phase I proposal can spill over into a Phase II proposal, thereby potentially broadening FCA liability.

Second, the Court's analysis on what constitutes a material false statement logically can extend to other aspects of an SBIR proposal. Applicants often struggle with SBIR eligibility rules, especially if they have received venture capital funding. For example, determining whether a company meets the Small Business Administration's ownership and control test set forth at 13 CFR 121.702 can be difficult. Under the *Longhi* Court's analysis, if an applicant is found to have incorrectly represented its status to meet that test, it could be found to have violated the FCA.

Likewise, the *Longhi* Court's analysis could be applied to other federally funded research programs. For example, the widely used Public Health Service 398 grant application requires applicants to complete numerous certifications and assurances. Similarly, there are eligibility criteria such as citizenship requirements, research experience and degree requirements for other federal grant programs. And there are certifications and assurances that apply to traditional R&D contracts. In light of *Longhi*, one can imagine the Government asserting that a false certification on any of those types of requirements induced the award and that, as a result, the full amount of the funding is the appropriate damages in an FCA suit.

Third, the damages model applied by the *Longhi* Court yields essentially the maximum available FCA damages (putting aside the penalties) inasmuch as LPT received no "credit" for any work it performed. Thus, decisions such as *Longhi* create an incentive for a potential relator to file qui tam actions against participants in the SBIR program. Defending against an FCA case is burdensome for even the largest companies; for a small business, it likely will be even more so. In short, SBIR awardees should be aware that being a small business does not mean that they are immune to FCA suits, especially qui tam actions filed by former or disgruntled employees.

Although some aspects of the *Longhi* decision are potentially far-reaching, there are reasons why the case should be afforded only narrow application. Perhaps most significant is that the *Longhi* decision involved the fraudulent inducement of an award intended to benefit only eligible small businesses. Most research programs do not have the strict eligibility criteria that govern the SBIR program and, therefore, are not as susceptible to a fraudulent inducement argument.

It also is important to bear in mind that the allegedly false statements in *Longhi* were made during the application process. If an FCA complaint were based, for example, on allegedly fraudulent postaward accounting activity instead of on misstatements made during the application process, the Government or a qui tam relator likely would not be able to argue successfully that the *Longhi* damages model should be applied.

In addition, among the false statements the *Longhi* Court identified was LPT's failure to identify its Army support in the SBIR proposal submitted to the Air Force. Applicants for grant support generally must disclose to funding agencies what is referred to as "other support," although the presence of related or overlapping work does not mean that a second project will be denied funding. NIH, for example, makes clear that it will work with an applicant to resolve financial, budgetary or scientific overlap between projects. It therefore seems likely that the testimony of the scientific reviewers in the *Longhi* decision

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was integral to the Court's conclusion. Absent such unequivocal and unchallenged testimony, the Government could not establish the direct causality between a false statement and a funding decision on which the *Longhi* Court relied.

More generally, the *Longhi* Court's conclusion that the research LPT provided was valueless is in some respects difficult to square with the purposes underlying federal R&D support. The Court acknowledged a distinction between the procurement of goods or services and the award of funds for research purposes, but arguably discounted that difference in assessing the appropriate measure of damages. For example, although R&D work is not necessarily expected to produce "bridges" or "widgets," the Court remarked that the absence of a "bridge" or "widget" at the end of a project supported its finding that LPT's work produced no tangible benefit to the Government.

Federal Acquisition Regulation 35.002 provides that the "primary purpose of contracted R&D programs is to advance scientific and technical knowledge and apply that knowledge to the extent necessary." Similarly, NIH's description of its SBIR program is to "us[e] small businesses to stimulate technological innovation, strengthen[] the role of small business in meeting Federal R/R&D needs, [and] increase[] private sector commercialization of innovations developed through Federal SBIR R&D." To discount the value of work performed under a SBIR award or any other R&D project because it does not generate something tangible seems inconsistent with the purpose of R&D.

The Court also noted that any value to the Government was lessened or eliminated because LPT would own any battery technology developed and could market it to non-Government customers. That finding overlooks Congress' intent, through the Bayh-Dole Act, to create a regulatory regime under which small businesses are encouraged to take title to patentable inventions developed with federal support. Moreover, the Government receives a permanent royalty-free license for any such invention and is free to provide that license to other contractors to produce the technology for Government purposes. So although LPT may "own" the technology, the Government can derive benefit out of the license if it so chooses.

Overall, the *Longhi* decision could be significant for SBIR applicants. It also has potentially broad effect on other R&D programs and institutions performing basic research. However, the *Longhi* damages model is not easily applied to many FCA cases involving basic research or R&D work.

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