IN THE SUPREME COURT OF ALABAMA

EXXON MOBIL CORP.,	)	
	)	
Appellant,	)	
	)	
vs.	)	**SUPREME COURT**
	)	**NO. 1031167**
ALABAMA DEPARTMENT OF CONSERVATION AND NATURAL RESOURCES, et al.,	)	
	)	
Appellees.	)	
_____	)	

MOTION FOR LEAVE TO FILE BRIEF and BRIEF OF *AMICUS CURIAE* TAXPAYERS AGAINST FRAUD EDUCATION FUND

ON APPEAL FROM THE 15th JUDICIAL CIRCUIT (MONTGOMERY COUNTY) CV 99-2368

Joseph E.B. White
Taxpayers Against Fraud Education Fund
1220 19th Street, N.W.
Washington, D.C. 20036
(202) 296-4826
(202) 296-4838 (fax)

Erik S. Jaffe*
(*pro hac vice* motion pending)
ERIK S. JAFFE P.C.
5101 34th Street, N.W.
Washington, D.C. 20008
(202) 237-8165
(202) 237-8166 (fax)

* Counsel of Record

Counsel for *Amicus Curiae*

MOTION FOR LEAVE TO FILE BRIEF

Taxpayers Against Fraud Education Fund ("TAF") moves for leave to file a brief as *amicus curiae* in support of the appellees, Alabama Department of Conservation and Natural Resources ("DCNR"), *et al.* The proposed brief is bound together with, and follows, this motion.

Amicus TAF is a nonprofit public interest organization located in Washington, D.C. TAF is dedicated to educating the legal community, the public, legislators, and others about the various state and federal remedies for combating fraud against the government, with the goal of preserving effective anti-fraud measures that ultimately serve to protect taxpayers. The organization publishes educational materials and participates in litigation as a *qui tam* relator under state and federal False Claims Acts, and has filed numerous briefs as *amicus curiae* in the state and federal Supreme Courts and in the federal Courts of Appeal.

Based upon TAF's interest and experience, it intends to address in its brief the limited issue of whether the existence of an audit process vitiates the DCNR's ability

to place reasonable reliance upon false and fraudulent statements made to it by Exxon.

An *amicus* brief on the issue of audits and reliance is desirable because that issue has ramifications far beyond the particular facts of this case and would pose an especial threat to Alabama taxpayers and other taxpayers were such a rule to gain traction in the law generally. Under such a proposed rule, taxpayers would be forced to bear the cost either of fraud that remained undiscovered in the audit process and/or the cost of expanding audits to an absurd level of thoroughness in order to minimize (though never eliminate) the occurrence of undetected frauds.

Due to TAF's extensive and broad-ranging experience in litigating issues relating to fraud in government contracting, *amicus* is in a position to offer insight and perspective into the role of audit processes in government contracts, the utility (or lack thereof) of such processes in discovering intentional fraud, and the devastating consequences that would arise from Exxon's suggested rule that the presence of audit processes eliminates any

reasonable reliance on false or fraudulent statements made by those who would deal with the government. While the parties themselves may touch upon this topic in general, the breadth of issues they must address will necessarily preclude a thorough discussion of this important question of law. But given the potential ramifications of such a rule on a plethora of future cases, it would serve the Court well not to dive into such hazardous waters without a more detailed consideration of the consequences. *Amicus* aims to provide such additional assistance as it can to the Court on this issue and thus add value above and beyond that provided by the party briefs alone.

For the foregoing reasons, this Court should grant TAF's motion for leave to file a brief as *amicus curiae*.

Respectfully Submitted,

_____

Erik S. Jaffe*
(*pro hac vice* motion pending)
ERIK S. JAFFE P.C.
5101 34th Street, N.W.
Washington, D.C. 20008
(202) 237-8165
(202) 237-8166 (fax)

* Counsel of record

Joseph E.B. White
Taxpayers Against Fraud
Education Fund
1220 19th Street, N.W.
Washington, D.C. 20036
(202) 296-4826
(202) 296-4838 (fax)

Counsel for *Amicus Curiae*

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

Cases

Statutes

Other Authorities

STATEMENT OF THE CASE

This brief will narrowly address issues relating to the reasonable reliance by the Department of Conservation and Natural Resources ("DCNR") on Exxon's false statements and omissions notwithstanding their intention to subsequently audit Exxon's payments. The relevant facts and holdings of the district court are set forth in its description of the clear and convincing evidence that it found in support of the jury's verdict on DCNR's fraud claim. Post-Judgment Order ("PJO"), March 29, 2004, at 20-38.

Having seen and heard all of the evidence at trial and received extensive briefing, the trial court concluded that Exxon "understood the plain language of the leases correctly and consistently with the understanding of DCNR," and yet made a decision to underreport and underpay that "was at once underhanded and chillingly rational, for it was predicated upon Exxon's calculation that defrauding the State was a no-lose proposition from which Exxon stood to realize huge profits." PJO at 20-21 (citations omitted). The ugly rationality of that scheme turned on

the same Catch-22 that Exxon would now have this Court enshrine into the law.

On the one hand, the "anticipated risk of detection was miniscule because Exxon knew it would depend upon the limited capabilities of what the Condray package tellingly termed the State's 'inexperienced regulatory staff and processes.' . . . [Exxon] knew that DCNR was grossly understaffed, that it was already overextended auditing Shell, and that the vagaries, complexities, and delays associated with the audit process likely would effectively frustrate any revelation of Exxon's underpayments for many years to come." PJO at 22 (citations omitted).

On the other hand, the "downside associated with any detection of its underpayment was non-existent from Exxon's perspective: it was certain that the very most it would have to pay the State would be what it already owed, the amount of its underpayment." PJO at 22. Essentially counting on the State's inability to recover punitive damages for fraud, Exxon deemed it "far more likely that the State would be willing to settle for a fraction of that; and, even if the State sued and won, Exxon knew that

its return on the monies it withheld would in any event substantially exceed the 12% simple interest penalty it might ultimately have to pay." PJO at 22 (citations omitted).

Indeed, throughout the early stages of the contract and even well into the litigation in this case, Exxon's fraudulent plan continued to be implemented effectively. Even after Exxon's (dishonest) construction of the lease was revealed, Exxon was able to hide the fraudulent intent behind that construction and continued to suppress from its royalty reports "its free use of plant fuel while maintaining internal accounting codes reflecting that very information, which Exxon knew the State wanted and expected to see in the reports. . . . After the State managed to extract Exxon's confession that it was taking *some* impermissible deductions, Exxon continued to suppress the specific nature and extent of those deductions even while the State wrenched that information from Exxon through force of law in this case." PJO 28-29 (citations omitted). Notwithstanding even an unexpectedly vigorous audit by the State, Exxon's scheme successfully continued

to evade full discovery, and "many of the specific, egregious deductions remained suppressed until the deposition of Bremmer in October 2000 pursuant to the first trial; and an even more egregious set of deductions remained suppressed until Exxon's disclosures in September 2003 on the eve of the second trial." *Id*.

Exxon's no-lose scheme threatened to derail not because of any lack of trust reflected by the expected routine audit procedures, but only because "the State, by mere happenstance, [made] the unprecedented decision to bring in an experienced and well-equipped group of external auditors to oversee its oil and gas leases." PJO at 22. What Exxon deemed a "negligible" risk – and what it would have this Court eliminate as a risk in its entirety – was the prospect of discovery of, and punitive damages for, its fraudulent scheme. That risk, however, became more than negligible when the State proved "sufficiently vigilant in pursuing and investigating Exxon's underpayment as to slowly and arduously wrest from Exxon – from 1996 through the present, the better part of a decade – the documents and evidence that lay bare not only the nature and extent

of Exxon's underpayments, but also expose the conscious, fraudulent design behind those underpayments." PJO 22-23 (citations omitted). The jury's verdict and the trial court's order thus turned that minimal risk into a substantive reality, thwarting Exxon's scheme and deterring future such schemes, subject only to this Court's rejection or confirmation of Exxon's initial fraud-inducing risk/reward assessment.

STATEMENT OF THE ISSUES

This brief will address the first issue raised by Exxon on appeal: "Under *Hunt* and this Court's other precedents, was the evidence legally insufficient to support a fraud verdict, and therefore to allow any punitive damages?"

In particular, *amicus* will limit itself to addressing the subsidiary issue of whether the intent to perform and the actual performance of a back-end audit precludes the DCNR from reasonably relying on Exxon's fraudulent statements and omissions regarding its royalty calculations and payments?

SUMMARY OF ARGUMENT

The existence of routine audit procedures, such as are present in this case and in essentially all government contracts, are not a substitute for, and do not obviate, reliance on the fundamental duties and premises of integrity and honesty imposed by the law of fraud. Rather, audits are necessarily imperfect backstops that promote, but do not guarantee, such integrity and should be seen as a complement to, not a replacement for, reliance on the honesty of representations made in the course of commercial dealings. Routine back-end audits anchor a system that can most succinctly be described, in the words of President Reagan, as "trust, but verify." Indeed, combined with the prospect of punitive damages for fraud, they provide much of the justification for the "trust" component of that system in the first place, creating an incentive for honesty and hence a reasonable basis for reliance on representations made by parties to a government contract.

Such a system for promoting trust and integrity through routine audits and the deterrence of punitive damages would

be turned on its head by Exxon's exaggerated extension of this Court's decision in *Hunt Petroleum Corp.* v. *State*, 901 So.2d 1 (Ala. 2004). Exxon's proposition that the right or intent to audit renders it impossible to establish reliance, and hence fraud, would eliminate any possibility of trust and gut the integrity-producing deterrence value of audits and punitive damages for fraud. Indeed, Exxon's approach would (and did) affirmatively encourage fraud by creating a no-lose situation where the upside of undetected fraud is tremendous and the downside of detection through audit is little different than if the party had acted honestly from the outset. Precisely as happened in this case, parties would have the overwhelming incentive to engage in even further fraud aimed at frustrating the audit process, knowing full well that if they were successful they could keep their ill-gotten gains and if they failed they could simply point to the successful audit as evidence of no reliance, thus precluding any significant penalty beyond paying what was properly due in any event.

Because virtually all substantial contracts, with the State of Alabama and with all other governments, involve a right to audit, taxpayers would cease to be the beneficiaries of mutually favorable contracts and instead become the *guarantors* of the integrity of those with whom the government deals. Audits would cease to be simply prudent high-level reviews of transactions conducted with the perfectly reasonable assumption of integrity, and instead be converted into the sole assurance of honest dealings with the government, with the risk of contractor dishonesty resting almost entirely and inevitably on the government. Such an approach would guarantee that Alabama taxpayers paid the price in cases where audits failed to reveal a fraud against the government, and would waste tremendous resources as audits were forced to become the primary means of assuring honest performance and hence to become comprehensive forensic inquiries rather than spot-checks promoting an otherwise generally self-supporting system of commercial integrity.

Were Exxon's position accepted by this Court and others, both common-law and statutory checks on fraud would be severely undermined. Indeed, if applied in the context of the False Claims Act ("FCA") applicable to dealings with the federal government, Exxon's approach would effectively gut the civil elements of that act by making it impossible for the federal government to establish the common-law elements of fraud (incorporated into the FCA, *see United States* ex rel. *A+ Homecare, Inc.* v. *Medshares Mgmt. Group, Inc.*, 400 F.3d 428, 443 (6th Cir. 2005)) for even the most egregiously false claims. Such a consequence would be intolerable to governments and to taxpayers and hence, not surprisingly, Exxon cannot cite a single other authority that has even entertained its approach regarding the availability of audits vitiating reliance. Because the results of Exxon's approach would likewise be intolerable for Alabama and its taxpayers, this Court should reject Exxon's invitation to abolish the possibility of trust and reliance whenever an audit is involved.

ARGUMENT

NEITHER THE RIGHT NOR THE INTENT TO AUDIT DEFEATS RELIANCE.

Relying on statements in this Court's earlier decision in *Hunt Petroleum Corp.* v. *State*, 901 So.2d 1 (Ala. 2004), Exxon would now have this Court rule that DCNR did not reasonably rely on Exxon's false statements and omissions because it intended to verify Exxon's payments through a back-end audit of the leases. Exxon Br. at 55 (intent to audit shows that "the State never simply 'trusted' Exxon to pay and report the correct amounts without verification").

That position is both an exaggeration of this Court's *Hunt* opinion and is dangerously wrong in any event. Such a view – that the intent to audit a party's performance of its duties precludes any reasonable reliance on that party's representations regarding such performance – would effectively declare open season for fraudulent schemes against the government or against any party that maintained such audit rights. Indeed, it would create a perverse and

overwhelming incentive for parties to attempt to defraud those who could audit because it would guarantee what Exxon had long counted on – a no-lose situation where, if the fraud was discovered, the only downside would be to pay what was owed at the outset. But if – through the "vagaries, complexities, and delays associated with the audit process," PJO at 22 – the fraud were not discovered it would be tremendously profitable.

Precisely because of the perverse incentives that would be created by the rule Exxon seeks, no court has adopted it. Indeed, were such a theory generally incorporated into the law of fraud, it would destroy any semblance of trust and fair-dealing between governments and those it deals with, it would ensure that every transaction became an adversarial relationship and a game of "gotcha" with only the government as potential loser, and it would relegate taxpayers in Alabama and throughout the country to the permanent status of prospective victims and patsies to be defrauded with impunity because, given the possibility of an audit, they would only have themselves to blame. That

takes the notion of *caveat emptor* to new and absurd heights that surely could not have been intended by this Court in *Hunt* and that, in any event, should not be the law in Alabama or anywhere else.

In *Hunt*, this Court reviewed a fraud verdict based on Hunt's filing royalty reports using net rather than gross proceeds for gas produced under the same leases at issue here. 901 So.2d at 3. In ruling against the State, this Court observed, *inter alia*, that the "fact that the State always planned to audit Hunt indicates that the State did not simply 'assume' that the royalty reports were correct." *Id*. at 7. Rather, this Court observed that the State "'was unwilling to accept the statement[s] of [Hunt] without verification.'" *Id*. This Court did not rest its decision on that observation, however, but instead went on to discuss whether the State had acted or failed to act to its detriment based on Hunt's misrepresentations, and ultimately grounded its decision in the absence of adequate evidence of such detrimental change in position. *Id*. at 7-9. This Court's discussion of whether the intent to audit

itself can negate reliance is thus quite reasonably viewed as *dicta*.[1]

Exxon would have this Court expand and enshrine its *dicta* in *Hunt* into a new rule that declares the intent to audit to be *per se* proof of a lack of any trust and hence

[1] *Amicus* will leave to others a discussion of the particulars of how the State acted or failed to act in reliance on Exxon's myriad false statements, and will limit itself to the legal issue of whether the intention to audit defeats reliance in and of itself. *Amicus* notes, however, that the mere failure of the State to terminate the lease with Exxon or to take other drastic and disruptive measures when it later found out, in bits and pieces, about Exxon's false statements, does not show that it did not rely on those statements at the time they were made. There is a considerable difference between the course of action available to a party to remedy a candid disagreement about a contract or about various facts *ex ante*, and the prudent course of action for that party much later when it finds out about fraudulent representations. Where a party knows that there is an actual dispute regarding an substantial underpayment, as opposed to merely a potential dispute that may or may not arise in audit, it has other options. At a minimum it can begin negotiations and bring a contract suit earlier where the disagreement is transparent. But where the disagreement is concealed, and then further muddied through continuing misrepresentations that distort the scope of the disagreement and its consequences, resolution even through litigation is delayed and the State remains deprived of its rightful funds for a longer period of time even assuming an eventually successful lawsuit. Indeed, such a series of events seems to have occurred here, with Exxon letting out just enough of a mix of revelations and new falsehoods to keep the State negotiating, almost to the point of having the statute of limitations run.

the absence of reliance. That approach is neither required by *Hunt* nor sensible on its own merits.

First, this Court's *Hunt* opinion discussed only a fraud in connection with the decision to calculate royalties based on net rather than gross proceeds, and contained no discussion of any further misrepresentations or omissions designed to conceal that initial fraud or to undermine the application of a gross-proceeds calculation once the dispute over the interpretation of the lease came to light. Whether or not an audit would be expected to reveal contract interpretation issues, nothing in *Hunt* suggested that where a party's false statements are designed and expected to thwart an audit (and in fact thwarted the audit and even trial discovery procedures) a party is precluded from relying on false statements when it had no realistic prospect of discovering the truth.

Here, of course, there is a more far-reaching and varied set of misrepresentations at issue, many of which seemed designed to thwart the audit process and some of which successfully thwarted even the court-backed discovery process until the eve of the second trial. Statement of

the Case, *supra*, at 3-4; PJO at 24 ("Exxon made a *fraudulent* decision to *misrepresent* and continually *suppress* the fact that it was underpaying the royalties it owed, with the hope and expectation that its breach would pass undetected and thus unredressed by the State. To Exxon's way of thinking, . . . [the State] would likely be unable to identify the full extent of Exxon's underpayment, if it indeed identified it *at all*.") (emphasis in original).

Second, even if the intent to audit demonstrates an unwillingness naively to assume *perfect* accuracy in the royalty reports, there is still a great expanse of reasonable reliance that exists between such a naïve assumption and a less naïve, yet perfectly reasonable, trust that the reports will not be intentionally deceiving and designed to thwart subsequent verification. *See* RESTATEMENT (SECOND) TORTS § 547(2) (1977) ("The fact that the recipient of a fraudulent misrepresentation is relying upon his own investigation does not relieve the maker from liability if he by false statements or otherwise intentionally prevents the investigation from being

effective.”); *see also Myers* v. *Moody*, 67 So.2d 891, 892-93 (Ala. 1953) (“The mere circumstance that Myers made an investigation of the machinery and equipment does not necessarily show that he relied on his own judgment rather than upon the representation claimed to have been made by” defendant.); *Cf*. *United States* v. *Yeager*, 331 F.3d 1216, 1222 (11th Cir. 2003) (“the common law definition of fraud does not require [the victim] to undertake rigorous investigation to pierce the façade presented by the defendant.”) (*citing* RESTATEMENT(SECOND) OF TORTS §§ 540, 541 (1977)).

Third, Exxon’s exaggerated interpretation of *Hunt* is problematic for the further reason that it imputes to audits the power of producing perfect knowledge and discovering any fraud, no matter how hardy or pernicious. That, of course, is not at all what audits are designed or reasonably expected to do. As recounted by the Supreme Judicial Court of Massachusetts:

> “There are certain limitations inherent in the auditing process. For example, the American Institute of Certified Public Accountants (AICPA) *Codification of Statements on Auditing Standards* provides in part that:

> ‘Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is the auditor trained to do so. Also, *audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional* and is concealed through collusion between client personnel and third parties or among management or employees or the client.’ (Footnotes omitted.)”

Wareham Educ. Ass’n v. *Labor Relations Comm’n*, 713 N.E.2d 363, 366 (Mass. 1999) (emphasis added) (quoting *Matter of Wareham Educ. Ass'n, Bridgewater Educ. Ass'n, Fairhaven Educ. Ass'n,* 24 M.L.C. 23, 26-27 (1997)), *cert. denied*, 528 U.S. 1062 (1999).

Rather than substitutes for reliance, audits provide a backstop, not a certainty of discovering the truth, and provide some measure of deterrence that actually makes it *more* reasonable to rely on the contracting party’s statements, on the assumption that they would be risk-averse regarding the potential of being caught in a lie. *Cf*. *Yeager*, 331 F.3d at 1222 (fraud victim’s “efforts to monitor [performance of contract] served as a predicate for

reasonable reliance on the misrepresentations"; "On-site audits and requests for corrected and complete information by [the victim company] were deflected by active deception"). The entire premise behind routine audit procedures is, as President Ragan said in a slightly different context: "Trust, but verify." In fact, the availability of some verification is precisely what makes it both reasonable and possible to trust in (*i.e.*, rely upon) another party's statements in the first place.

Were the audit procedure converted into a comprehensive obligation to check every datum and every claim, with the risk of falsehoods shifted to the victim rather than the perpetrator, then indeed there would be no basis for trust at all, and audits would not be designed to verify, but rather to do the initial heavy lifting royalty calculations in the first place given that nothing the other party said would be believable. That, of course, is not what audits are, is not what they were intended or expected to be regarding the gas leases, but is surely what they would become under Exxon's attempted expansion of *Hunt*.

This case is a perfect example of how routine audit procedures are neither expected to nor capable of revealing an active and multi-faceted fraud. As the trial court explained, Exxon based its entire scheme on the judgment that the State's audit process would be conducted with "'inexperienced regulatory staff and processes,'" that DCNR would be "grossly understaffed" and "overextended," and that the "vagaries, complexities, and delays associated with the audit process" would frustrate detection of its fraud. PJO at 22. And even after DCNR unexpectedly brought in outside auditors, Exxon continued successfully to hide much significant information regarding the scope of its fraud until the eve of the second trial – after the audit *and* court assisted discovery. *Id*. at 28-29.[2] That even full-blown discovery backed by the force of

[2] Exxon would convert audits by the state into a component of its own performance obligations under the contract, rather than what they are – a subsequent administrative measure to resolve ordinary performance and calculation issues, not a remedy (much less the *sole* remedy) for fraud by Exxon. By Exxon's reasoning, the availability of optional arbitration proceedings, or even a lawsuit would obviate reliance on any fraud, because the counterparty obviously does not simply "trust" that performance will be complete and accurate. Yet the fact that a party sues for

the courts could not readily unearth all of Exxon's fraud demonstrates how unrealistic it is to assume that audits can or do take the place of reliance on a party's basic honesty and integrity.

Fourth, the extremity of Exxon's position regarding audits can be seen from its inability to cite any other court that has adopted such a position as its measure of the lack of reasonable reliance. Virtually all substantial government contracts have some audit procedures, whether at the state or federal level. *See, e.g.*, *Kennard* v. *Comstock Resources, Inc.*, 363 F.3d 1039, 1040, 1048 (10th Cir. 2004) (False Claims Act case involving Indian tribe oil and gas leases, the royalties on which are collected, audited, and

---

a subsequently discovered fraud, and asserts a continuing legal right to receive the proper performance due, has never negated reliance on fraudulent acts and omissions regarding performance. Reliance must be measured prior to the use of remedial measures; otherwise fraud would never be actionable so long as the victim preserved its legal remedies to receive what was properly due. Were that the case no party could possibly fully rely until after the statute of limitations had run, and then there could never be an action for fraud or punitive damages, only an action for restitution. Subsequent remedial measures, whether in the form of an audit, arbitration, or a lawsuit, are only a complement to honest performance, not a substitute therefor, and cannot negate either the right to rely or the fact of reliance on the initial performance.

disbursed by the federal government; service within Department of Interior "is required to collect payments and to have 'a comprehensive ... accounting and auditing system ... to accurately determine oil and gas royalties.'") (citation omitted), *cert. denied*, -- U.S. --, 2005 WL 1499772 (2005); *Seldowitz* v. *Office of Inspector General, U.S. Dept. of State*, 95 Fed. Appx. 465, 465-66, 2004 WL 193130 (4th Cir. 2004) (unpub.) (discussing potential civil FCA claim based on false statements in travel vouchers discovered by State Department audit procedures); *UMC Electronics Co.* v. *United States*, 249 F.3d 1337, 1338 (Fed. Cir. 2001) (FCA claim against military contractor arising in part from an audit by the Defense Contract Audit Agency). Yet no court to *amicus*'s knowledge, and none cited by Exxon, has ever held that the presence of such routine procedures evinced such a lack of trust that there could be no reliance on statements made by the parties subject to audit. Indeed, were such an approach applied broadly, it would severely hamper the ability to police and deter fraud in public contracts.

For example, the federal False Claims Act ("FCA"), 31 U.S.C. §§ 3729, *et seq*., which uses the terms "false or fraudulent" to modify "claims" subject to the Act, has been held "to incorporate the well-settled meaning of common-law fraud." *A+ Homecare*, 400 F.3d at 443. Courts thus have construed the FCA to contain a materiality requirement that also includes a reliance component. *See, e.g.*, *Costner* v. *URS Consultants, Inc.*, 153 F.3d 667, 677 (8th Cir. 1998) (observing that "a 'claim' under the FCA is a 'demand for money' that induces the government to disburse funds or 'otherwise suffer immediate financial detriment'") (citation omitted); *id*. ("only those actions by the claimant which have the purpose and effect of causing the United States to pay out money it is not obligated to pay . . . are properly considered 'claims' within the meaning of the FCA"); *A+ Homecare*, 400 F.3d at 443-44 (The "FCA requires that the false statement be used "to get a false or fraudulent claim paid.' 31 U.S.C. § 3729(a)(2)."; "[T]he common-law definitions of the terms 'false' and 'fraudulent' are consistent with including materiality as an element of the FCA."); *Mikes* v. *Straus*,

274 F.3d 687, 697 (2d Cir. 2001) (“it would be anomalous to find liability when the alleged noncompliance would not have influenced the government’s decision to pay”); *United States* ex rel. *Watson* v. *Connecticut General Life Ins. Co.*, 2003 WL 303142, at *10 (E.D. Pa. 2003) (“Liability under the FCA for a false or fraudulent certification of compliance . . . exists only if certification of such compliance influenced the government’s payment decision.”), *aff’d*, 87 Fed. Appx. 257, 2004 WL 234970 (3rd Cir. 2004).

Under Exxon’s theory, however, virtually no fraud against the federal government would be actionable or eligible for the FCA’s treble damages remedy because federal audit procedures would negate any reliance on such fraud and hence make it impossible to recover damages for a fraudulent claim (as opposed to some parallel contractual remedy).

Such an approach is not part of the common-law of fraud and it is not part of the FCA. In *A+ Homecare*, for example, the Medicare reimbursement claims at issue were, just as here, subject to audit and all payment requests are

subject to verification by fiscal intermediaries for Medicare. 400 F.3d at 447. In fact, the auditor in *A+ Homecare* actually rejected the fraudulent expenses claimed by the Medicare provider and the defendants sought to avoid liability by claiming that they expected the audit to determine the correct amount of their Medicare payment and that the government could seek reimbursement of any overpayments. *Id*. at 447, 455-56. The Sixth Circuit correctly rejected those arguments, noting that "the responsibility is on [defendants] to calculate [the proper claim for payment], not on [the auditor] to determine it for them. A party cannot file a knowingly false claim on the assumption that the fiscal intermediary will correctly calculate the value in the review process." *Id*. at 447. The absurd result of such an approach – the same as suggested by Exxon here – would be to "shift the burden of cost calculation from the provider to the fiscal intermediary and encourage the filing of false claims, which is directly at odds with the stated goal of the FCA." *Id*.

Furthermore, the Sixth Circuit correctly and squarely rejected the claim, such as Exxon makes here, that the government did not rely on the fraud to its detriment where the auditor had in fact discovered the fraud and could simply have submitted a demand for reimbursement. Instead, the court recognized that the audit procedures exist "as an administrative mechanism to make 'necessary adjustments due to previously made overpayments or underpayments' not as a remedial mechanism for fraud." 400 F.3d at 456 (citation omitted). Whereas the defendants in that case had asked the court to conclude that "the remedy for fraudulent claims made on Medicare cost reports would be limited to the disallowance of those claims by the [auditor] and the simple repayment of those claims," the court instead found that a viable action for fraud provided a necessary supplement to simple audit and reimbursement:

> The damages provision in the FCA reflects Congress's view "that some liability beyond the amount of the fraud is usually necessary to compensate the Government completely for the costs, delays and inconveniences occasioned by fraudulent claims." *Id.* at 130, 123 S.Ct. 1239 (quotation omitted). Moreover, the treble damages provision ensures not only full compensation, but also the fundamental integrity of all those who

> seek to do business with the Government. *See Midwest Specialities,* 142 F.3d at 302 (noting the purpose of the FCA is to effect "the maxim that [m]en must turn square corners when they deal with the Government").

Id. Notwithstanding the existence of an audit that actually discovered the fraud, and the availability of an ordinary reimbursement mechanism, the court upheld both the award of compensatory damages for fraud in the full amount of the false claim submitted and the award of treble damages based on that amount. *Id*. at 433.

Exxon's suggested approach has been squarely rejected in state court as well. In *Reis* v. *Peabody Coal Co.*, 997 S.W.2d 49 (Mo. Ct. App. 1999), the court considered a case very much like this one, but involving royalties on coal leases. There too, the defendant argued that "plaintiffs had no right to rely because of their contractual audit rights." *Id*. at 66. The court, however, held that even assuming a broad reading of the audit clause, that did "not require a holding that the jury could not find reliance." *Id*. at 67. The court concluded that "we do not find that the audit clause precludes a finding of reliance

but rather presented an issue for the jury." *Id*. Whatever degree of doubt – or, more likely, ordinary prudence – was suggested by the presence of an audit clause, that simply was not sufficient to defeat reliance. Neither trust nor reliance need be absolute; merely reasonable.

Applied generally, Exxon's approach would gut the FCA, gut the common-law of fraud, and afford a license to attempt to defraud the government; precisely the opposite of both the common law's and the FCA's purposes. Were such an approach widely adopted, taxpayers would become the perpetual victims of fraud, with their only protection being the fanciful power of audits to discover all attempted frauds and with little punishment or deterrence even then. Because such an approach would be absurd, it has quite correctly never been endorsed by the courts.

For the same reasons that Exxon's bold position has never been adopted elsewhere, it should not be adopted by this Court. The innocent taxpayers of Alabama, no less than other state and federal taxpayers, should not be forced to bear the full risk of fraud by companies such as

Exxon (or alternatively to abandon audit procedures entirely and adopt a childlike faith that everything will work out by itself). Rather, Alabama and its taxpayers should be allowed to "trust, but verify," rely on the basic integrity of statements made by parties contracting with the government, and if and when a party nonetheless violates that trust they should be allowed to bring a claim for fraud and punitive damages. The risk of fraud should be placed squarely on the shoulders of the wrongdoer, with the deterrence that comes from the combination of audits and punitive damages serving to remove the incentive for fraud at the outset.

CONCLUSION

For the above-stated reasons, this Court should affirm the judgment of the circuit court.

Respectfully Submitted,

_____

Erik S. Jaffe*
(*pro hac vice* motion pending)
Erik S. Jaffe P.C.
5101 34th Street, N.W.
Washington, D.C. 20008
(202) 237-8165
(202) 237-8166 (fax)

* Counsel of Record

Joseph E.B. White
Taxpayers Against Fraud
Education Fund
1220 19th Street, N.W.
Washington, D.C. 20036
(202) 296-4826
(202) 296-4838 (fax)

Counsel for *Amicus Curiae*

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of the foregoing upon the parties listed below by placing a copy thereof in the United States Mail, postage prepaid, and properly addressed to them on this 30th day of June, 2005.

_____
Erik S. Jaffe

David R. Boyd
W. Joseph McCorkle, Jr.
Balch & Bingham LLP
P.O. Box 78
Montgomery, Alabama 36101-0078

Samuel H. Franklin
M. Christian King
Lightfoot, Franklin & White L.L.C.
400 20th Street N
Birmingham, Alabama 35203
(334) 581-0700
(334) 581-0799 (FAX)

Ernest Terry
McGinnis, Lochridge & Kilgore, L.L.P.
3200 One Houston Center
1221 McKinney Street
Houston, TX 77010-2009
713-615-8500
713-615-8585 (FAX)

Charles J. Cooper
Deputy Attorney General
COOPER & KIRK, PLLC
1500 K Street, N.W., Suite 200
Washington, D.C. 20005
(202) 220-9600