UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA *ex rel.* KOLCHINSKY, Plaintiff, - v. - MOODY'S CORP. *et al.*, Defendants.	12 Civ. 1399 (WHP) Closed Case

STATEMENT OF INTEREST OF THE UNITED STATES IN CONNECTION WITH RELATOR'S RULE 59(e) MOTION TO ALTER JUDGMENT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases Page:

Statutes

PRELIMINARY STATEMENT

In accordance with the Court's scheduling order dated April 20, 2017, the United States of America (the "Government") respectfully submits this Statement of Interest (the "Statement" or "SOI") pursuant to 28 U.S.C. § 517.[1] This Statement addresses two issues raised in *qui tam* relator Kolchinsky's ("Relator") Rule 59(e) brief (the "Rel. 59(e) Br.") seeking to alter or amend the judgment that was entered in this case on March 3, 2017 pursuant to the Opinion and Order that the Court issued on March 2, 2017 [Dkt. 79] (the "3/2/17 Decision").

First, Relator asks the Court to reconsider its application of the materiality standard articulated by the Supreme Court in *United Health Svcs., Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016) ("*Escobar I*"). *See* Rel. 59(e) Br. at 9-14. Specifically, Relator contends that, under *Escobar I*, the fact that a government agency does not stop paying a defendant after public allegations of fraud surfaces against that defendant does not establish – at least at the pleadings stage – that the alleged fraud is immaterial as a matter of law. *See id.* In the Government's view, an agency's continued payment of claims to a potential FCA defendant who faces public allegations of fraud is insufficient – by itself – to establish that the alleged fraud is immaterial.

Escobar I makes clear that the relevance of an agency's response depends on whether the agency had "*actual knowledge*" of fraud, *see Escobar I*, 136 S. Ct. at 2003 (emphasis added); and "mere awareness of allegations … is different from knowledge of actual [misconduct]," *U.S. ex re. Escobar v. Universal Health Svcs.*, 842 F.3d 105, 112 (1st Cir. 2016) ("*Escobar II*").

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[1] The Government's interest here is two-fold. First, although it declined to intervene in this *qui tam* case, the Government is the real party in interest under the False Claims Act, 31 U.S.C. § 3729 *et seq.* (the "FCA"). *See United States ex rel. Eisenstein v. City of New York*, 556 U.S. 928, 934 (2009). Second, because the FCA is the "primary litigative tool for the recovery of losses sustained as the result of fraud against the government," *Avco Corp. v. U.S. Dep't of Justice*, 884 F.2d 621, 622 (D.C. Cir. 1989), the Government has a significant interest in how decisions by the courts, even in declined actions such as this one, may shape future enforcement of the FCA.

Thus, where a defendant is subject to public accusations of fraud but disputes such accusations, it would be premature to impute "actual knowledge" to a contracting agency and to construe the agency's lack of response as definitive proof of the lack of materiality. *See infra* Pt. I.B. *Escobar I* also mandates a holistic materiality analysis that does not rest upon a single factor as determinative. *See* 136 S. Ct. at 2001. Therefore, factors beyond whether a contracting agency stops paying a defendant — such as whether the agency pursues remedies other than terminating payments or whether the fraud "[goes] to the very essence of the bargain" between the agency and the defendant — also can be relevant to whether a party sufficiently pleads the materiality of the alleged fraud. *See infra* Pt. I.C.

Second, Relator also asks the Court to reconsider its decision to analyze his claims mainly under the "implied false certification" rubric. According to him, the Court should have considered whether his claims survive dismissal under a "fraudulent inducement" theory. It is well established that "fraudulent inducement" is a viable theory under the FCA. *See infra* Pt. II. Specifically, "FCA liability attaches to each claim submitted to the Government under a contract so long as the original contract was obtained through false statements or fraudulent conduct." *U.S. ex rel. Miller v. Weston Educational, Inc.*, 840 F.3d 494, 499 (8th Cir. 2016).[2] Accordingly, if Relator sufficiently pleads fraudulent inducement– an issue on which the Government takes no position – then he states a valid basis for finding that Moody's made false claims.

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[2] To the extent Relator suggest that the Court should revisit the denial of his request for a share of the January 2017 settlement between the Government and Moody's resolving claims under the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"), 12 U.S.C. § 1833a, *see* 3/2/17 Decision at 15-17, that request should be rejected. As explained in AUSA Pierre Armand's letter to the Court dated January 25, 2017 [Dkt. 78], Relator is not entitled to any share of that FIRREA settlement because his remaining FCA claims in this case relate solely to federal agencies' subscription of Moody's Ratings Delivery Service and have no nexus to the conduct resolved through the FIRREA settlement, which related to fraud or misrepresentations involving or affecting financial institutions.

POINT I

A MISREPRESENTATION IS NOT *PER SE* IMMATERIAL WHEN THE GOVERNMENT DOES NOT TERMINATE PAYMENT TO A DEFENDANT SUBJECT TO PUBLIC ALLEGATIONS OF FRAUD

A. *Escobar I* Requires a Holistic Assessment of Materiality under the FCA

In the past decade, both Congress and the Supreme Court have addressed the materiality inquiry under the FCA. First, Congress defined materiality in the 2009 amendments to FCA as "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property." *See* Pub. L. No. 111-213 § 4, *codified at* 31 U.S.C. § 3729(b)(4). Then, in *Escobar I*, the Supreme Court confirmed that the "natural tendency" test is the proper materiality standard under the FCA and further clarified "how that materiality requirement should be enforced." 136 S. Ct. at 2002-03. More specifically, *Escobar I* – citing both tort and contract treatises – explains that the "natural tendency" test can be satisfied in one of two ways: *first*, by showing that "a reasonable man would attach importance to [the misrepresented information] in determining his choice of action in the transaction"; or *second*, by demonstrating that "the defendant knew or had reason to know that the recipient of the representation attaches importance to the specific matter 'in determining his choice of action,' even though a reasonable person would not." *See id*.

Under *Escobar I*, assessing materiality under the FCA is not a mechanical process. *See id*. at 2003. Thus, while "the Government's decision to expressly identify [compliance with a regulatory] provision as a condition of payment is relevant," it is "not automatically dispositive" for purposes of materiality. *Id*. Instead, courts should follow a "holistic approach" to assess the tendency or capacity of the misrepresentation or omission to affect the Government's decision-making. *U.S. ex rel. Wood v. Allergan, Inc*., -- F. Supp. 3d. ----, 2017 WL 1233991, at *28 (S.D.N.Y. Mar. 31, 2017); *see generally Escobar I*, 136 S. Ct. at 2002–04; *Escobar II*, 842 F.3d at 109.

To guide courts in making this holistic assessment, the Supreme Court, in *Escobar I*, identified a number of factors relevant to materiality, which include, *inter alia*, (*i*) whether the defendant's misrepresentation or omission goes to the "very essence of the bargain," or is instead "minor or insubstantial;" (*ii*) the defendant's awareness that disclosure of its misrepresentation would cause "the Government [to] consistently refuses to pay claims;" and (*iii*) how the Government has reacted to the same or similar types of misconduct when it had "actual knowledge" of them. 136 S. Ct. at 2002-04. Importantly, the Supreme Court made clear that no one factor is dispositive, and a trial court must evaluate the totality of the factors to determine whether a particular misrepresentation or omission is material. *See id.* at 2001 (recognizing that the materiality analysis "cannot rest on a single fact or occurrence as always determinative") (internal quotation marks omitted); *see also Escobar II*, 842 F.3d at 110-12.

B. Under *Escobar I*, an Agency's Response Is Relevant to Materiality If the Agency Had "Actual Knowledge" of Fraud, Not Just Awareness of Allegations of Fraud

In identifying the factors relevant to materiality, the Supreme Court consistently linked the relevance of the Government's response to "its *actual knowledge* that certain requirements were violated." *Escobar I*, 136 S. Ct. at 2003-04 (emphasis added). This link is crucial because "mere awareness of allegations concerning [a defendant's misconduct] is different from knowledge of actual [misconduct]." *Escobar II*, 842 F.3d at 112; *see also FHFA v. HSBC N. Am. Holdings, Inc.*, 33 F. Supp. 3d 455, 481 ("Knowledge of conditions creating a risk of falsity, however, is not actual knowledge of falsity"); *Castro v. City of Los Angeles*, 797 F.3d 654, 673 (9th Cir.), *reh'g en banc granted*, 809 F.3d 536 (9th Cir. 2015) ("The law has long recognized a distinction between *constructive* knowledge, (*i.e.*, what a reasonable person should have known in a given situation) and *actual* knowledge (*i.e.*, what a particular person did in fact know in the same situation)") (emphasis in original).

The distinction between an agency's awareness of public allegations of fraud and an agency's actual knowledge of fraud is particularly salient in cases when the defendant actively denies or disputes the allegations. In this case, news coverage shows that Moody's publicly denied allegations accusing it of assigning more favorable ratings in return for more business from securities issuers or underwriters. *See, e.g.*, Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping*, N. Y. TIMES, Dec. 6, 2008 (Moody's, through its spokesman, "denie[d] that it went easy on ratings to generate income" and claimed to "know[] of no instances in which a reconvened rating committee resulted in improper changes to ratings on Countrywide securities"). Further, when confronted with criticism of its ratings practices by Senator Levin and others in late 2011, Moody's responded that the "commercial and analytic aspects of our business operate separately" and that "*commercial considerations do not and never have influenced our ratings process*." John Detrixhe, *Big Spenders Rank Higher*, TREASURY & RISK BREAKING NEWS, Nov. 1, 2011 (emphasis added).

Under such circumstances, an agency with a relationship to the defendant cannot simply accept the truth of the public allegations while disregarding defendant's response. Accordingly, in the Government's view, it would be premature, at least at the pleadings stage, to impute agencies with "actual knowledge" of fraud based solely on the existence of public allegations of fraud, especially in cases where the pleadings and the public record present conflicting or disputed accounts of defendants' conduct. *See U.S. ex rel. Brown v. Pfizer, Inc.*, Civ. No. 05-6795, 2017 WL 1344365, at *11-12 (E.D. Pa. Apr. 12, 2017). Absent "actual knowledge" of fraud, the fact that an agency does not terminate payments to a contractor is not "strong evidence" – let alone dispositive proof – that the alleged fraud is immaterial as a matter of law. *See Escobar I*, 136 S. Ct. at 2003-04; *accord Escobar II*, 842 F.3d at 112; *United States v. Public Warehousing Co.*, 1:05-CV-2968-TWT, 2017 WL 1021745, at *6 (N.D. Ga. Mar. 16,

2017); *Pfizer*, 2017 WL 1344365, at *12.[3]

Moreover, a defendant's efforts to deny or dismiss genuine allegations of fraud can itself be evidence of materiality. As *Escobar I* recognized, a misrepresentation is material if "defendant knew or had reason to know that the recipient of the representation attaches importance to the specific matter 'in determining his choice of action,' even though a reasonable person would not." 136 S. Ct. at 2003. Thus, if a defendant that makes a misrepresentation and then tries to conceal the lie through false denials, one can infer that defendant believes its misrepresentation is significant to the recipient, and not just "minor or insubstantial." *See id.*[4]

C. Under the "Holistic Approach" Mandated by *Escobar I*, Materiality Can Be Shown Even If the Government Does Not Stop Payments to a Defendant

While *Escobar I* makes clear that the Government's reaction to actual knowledge of fraud is directly relevant to materiality, it also recognizes that this is just one among several types of relevant evidence. *See* 136 S. Ct. at 2003 (the types of evidence relevant to materiality under the FCA are "not necessarily limited to" those enumerated in the decision). Indeed, the Supreme Court reiterated that the materiality analysis "cannot rest on a single fact or occurrence as always determinative." *Id.* at 2001 (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 39 (2011)). Thus, under the "holistic approach" mandated by *Escobar I*, courts should

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[3] Under certain circumstances, public allegations of fraud – even if denied by a potential FCA defendant – may lead the Government to investigate the alleged misconduct. In such cases, the "appropriate time to impute knowledge is at the end of an investigation, not at the beginning," *i.e.*, when the investigation is first triggered by the public allegations. *See Public Warehousing Co.*, 2017 WL 1021745, at *6.

[4] In his brief, Relator incorrectly characterizes the Government's FIRREA settlement with Moody's as evidence of materiality for his remaining FCA claims. *See* Rel. 59(e) Br. at 5. This is incorrect because Relator conflates different representations made to different recipients. The FIRREA settlement concerned Moody's representations to or affecting federally insured financial institutions, and did not involve a federal victim or false claims to the Government. *See* Dkt. 78 at 1. By contrast, the surviving *qui tam* claims in this case involved Moody's alleged misrepresentations to federal agencies that subscribed to Moody's Ratings Delivery Service.

examine all the factors relevant to materiality instead of focusing just on the governmental response. *See Allergan*, 2017 WL 1233991, at *28.

Not restricting the materiality assessment solely to whether the Government stops paying a defendant's claims is appropriate because terminating payments typically is just one among several remedies available to the Government, and courts accord the Government broad discretion "to choose among a variety of remedies, both statutory and administrative, to combat fraud." *U.S. ex rel. Onnen v. Sioux Falls Indep. Sch. Dist.*, 688 F.3d 410, 414-15 (8th Cir. 2012); *see also U.S. ex rel. Worthy v. Eastern Maine Healthcare Sys.*, 2017 WL 211609, at *27 (D. Me. Jan. 18, 2017) (relator's allegations about an earlier government investigation into similar misconduct is sufficient to plead materiality under *Escobar I*). Further, as courts have long recognized, there may be sound policy reasons — such as to avoid excessive costs associated with terminating contractual payments — for "a government entity [to] choose to continue funding [a] contract despite earlier wrongdoing by the contractor." *U.S. ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 917 (4th Cir. 2003). Finally, whether or how quickly an agency responds to a particular instance of misconduct may reflect more on the agency's resources and resourcefulness than on the significance of the misconduct. *See United States v. Rogan*, 517 F.3d 449, 452 (7th Cir. 2008) ("laws against fraud protect the gullible and the careless – perhaps *especially* the gullible and the careless – and could not serve that function if proof of materiality depended on establishing that the recipient of the [false] statement would have protected [its] own interests") (emphasis in original). Accordingly, even if the Government is aware of a defendant's misconduct, the fact it does not stop paying the defendant's claims is not proof *per se* that the misconduct is immaterial under the FCA.

Under the "holistic approach," another factor highly relevant to materiality is whether an alleged misrepresentation goes to "the very essence of the bargain" between the defendant and

the Government. *See Escobar I*, 136 S. Ct. at 2003 n.5 (quoting *Junius Constr. Co. v. Cohen*, 257 N.Y. 393, 400 (1931)). As numerous courts have recognized, applying this factor involves a commonsensical assessment of the "centrality," *vel non*, of the representation to the "contractual relationship." *Escobar II*, 842 F.3d at 110 (under *Escobar I*, the "centrality of the licensing and supervision requirements" to providers' relationships with Medicaid is "strong evidence" of materiality of those requirements); *see also U.S. ex. rel. Williams v. City of Brockton*, 2016 WL 7429176, at *7 (D. Mass. Dec. 23, 2016) (compliance with civil rights laws is material to federal funding decisions under *Escobar I* because it "goes to the very essence of the bargain" between local police department and the Department of Justice); *United States v. Quicken Loans, Inc.*, --- F. Supp. 3d ----, 2017 WL 930039, *18-19 (E.D. Mich. Mar. 9, 2017) (requirement for mortgage lenders to certify compliance with FHA requirements is material under *Escobar I* because "the certification requirement goes to the essence of the bargain" between lender and HUD). In the Government's view, where contractors make representations about key features of their products or services, *e.g.*, their guns are reliable or their analysis is unbiased, while knowing this is not so – *i.e.*, if "the guns do not [actually] shoot," *Escobar I*, 136 S. Ct. at 2001, or if the analysis is in fact biased – then courts can reasonably find the misrepresentations material because it goes to the "very essence of the bargain" between seller and buyer. *Id*. at 2003 n.5; *accord Quicken Loans*, 2017 WL9300039, *18-19.[5]

[5] This is not to suggest that *qui tam* relators are relieved from having to satisfy their burden to plead materiality. Instead, as the Supreme Court recognized in *Escobar I*, Rules 8 and 9(b) require "pleading facts to support allegations of materiality" in FCA cases. *See* 136 S. Ct. at 2004 n.6.

POINT II

"FRAUDULENT INDUCEMENT" IS AN ANALYTICALLY DISTINCT AND VIABLE BASIS FOR LIABILITY UNDER THE FCA

In his Rule 59(e) motion, Relator contends that, instead of scrutinizing his claims concerning Moody's post-2009 ratings mainly under the "implied legal falsity" standard, the Court also should have analyzed those claims under the "fraudulent inducement" theory. *See* Rel. 59(e) Br. at 7-8. While the Government takes no position on whether the Relator has adequately pled a fraudulent inducement claim here, the Government submits that Relator is correct in contending that such a claim is distinct from a claim under the implied falsity/implied false certification theory.

The "fraudulent inducement" theory "stems from *United States ex rel. Marcus v. Hess*, 317 U.S. 537 (1943)," which "held that because the [government contracts that defendants had obtained] were induced by the defendants' frauds, [otherwise valid] claims for payments based on those contracts were also fraudulent." *United States v. Wells Fargo Bank, N.A.*, 972 F. Supp. 2d 593, 623 (S.D.N.Y. 2013). This theory applies to "a contract or extension of government benefit [that] was originally obtained through false statements of fraudulent conduct" and renders "subsequent claims [] false because of [the] original fraud." *U.S. ex rel. Hendow v. Univ. of Phx.*, 461 F.3d 1166, 1173 (9th Cir. 2006); *see also In re Baycol Prods. Litig.*, 732 F.3d 869, 876 (8th Cir. 2013) (recognizing the theory's validity); *U.S. ex rel. Laird v. Lockheed Martin Eng'g & Sci. Servs. Co.*, 491 F.3d 254, 259 (5th Cir. 2007) (same); *Harrison*, 176 F.3d at 787-88 (same); *cf. U.S. ex rel. Feldman v. Van Gorp*, 697 F.3d 78, 91 (2d Cir. 2012) (summarizing the contours of the fraudulent inducement theory of FCA liability).

The "fraudulent inducement" theory of FCA liability is analytically distinct from the "implied legal falsity" theory. Specifically, the focus of the fraudulent inducement theory is on conduct that takes place *before* the contractual relationship, and it asks whether the fraudulent

conduct caused the contracting agency to agree to something that it would not have agreed to otherwise. By contrast, under the implied legal falsity theory, the focus is on the representation associated with a particular claim. *See Hendow*, 461 F.3d at 1173 (recognizing that fraudulent inducement theory is "broader" than the implied legal falsity theory). Fraudulent inducement was not at issue in *Escobar I*, and post-*Escobar* decisions such as *Weston Educational* from the Eighth Circuit, *see* 840 F.3d at 499, *Pfizer* from the Eastern District of Pennsylvania, *see* 2017 WL 1344365, at *9-12, and *U.S. ex rel. Landis v. Tailwind Sports Corp.*, --- F. Supp. 3d ---- (D.D.C. Feb. 13, 2017) from the U.S. District Court for the District of Columbia, *see* 2017 WL 573470, at *9-10, make plain that fraudulent inducement remains a distinct and viable theory under the FCA.

As explained above, the "fraudulent inducement" theory applies when a contractor induces a government agency to agree to buy its product or advisory service by, for example, mischaracterizing the product as reliable or the advice as unbiased. In that case, "under a fraudulent inducement theory, subsequent claims for payment made under the contract," even if not themselves false, are nonetheless "actionable false claims" because "they derived from the original fraudulent misrepresentation." *Van Gorp*, 697 F.3d at 91 (internal quotation marks omitted); *accord Weston Educational*, 840 F.3d at 499 ("FCA liability attaches to each claim submitted to the Government under a contract so long as the original contract was obtained through false statements or fraudulent conduct") (internal quotation marks omitted).

CONCLUSION

For the reasons above, the Government respectfully submits that (*i*) the fact that a government agency has not stopped paying a defendant based on public allegations of fraud against that defendant is not dispositive of immateriality under *Escobar I*, and (*ii*) "fraudulent inducement" is an analytically distinct and valid theory of FCA liability.

Dated: New York, New York
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