Storming the Castle: *Qui Tam* After Sprint's $330M Settlement

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In this installment of Eyes on E-commerce, the authors examine efforts of private parties and states to use state false claims acts to bring lawsuits alleging the under-collection of state taxes — warning that *Wayfair* could exacerbate the situation.

Back in November 2016, we wrote "Barbarians at the Gates: Private State Tax Enforcement."[1] "Barbarians" was our polite term for private lawyers looking to cash in on alleged deficiencies in state and local tax collection by filing bounty hunter lawsuits against companies, including internet sellers, seeking to recover millions in penalties and attorney fees.

On the one hand, these attorneys were looking to file class action lawsuits claiming that businesses were over-collecting tax, pursuing what amounted to refund claims magnified many thousands of times; on the other, they were using state false claims statutes to file litigation in the name of states for the alleged under-collection of taxes. From the point of view of a commercial seller, it's a classic damned-if-you-do, damned-if-you-don't situation. If you err on the side of tax collection in what may be a gray area, you could be sued for what you collected, with the distinct possibility that you might not be able to recover your losses through a tax refund claim with the state. This is in part because class action claims often have statutes of limitations that go back further than the often-short period for seeking a refund — and in some cases only consumers can file such claims. If you erroneously make the judgment call that tax collection and remittance are not required, you could be hit for three times the amount of the taxes you theoretically should have collected, plus penalties and interest in a false claims case.

A little more than two years later, things aren't looking much better and, in some states, such as New York, things appear to be considerably worse.

State False Claims Acts: A Primer

A quick recap before we dive into recent developments. The federal False Claims Act was enacted during the Civil War as a protection against unscrupulous suppliers to the Union army.[2] At its core, it allows a private party (called a relator) to blow the whistle on corruption by filing a so-called *qui tam*[3] suit in the name of the government against alleged fraudsters, and to collect a percentage of the civil penalties, treble

[1] David W. Bertoni and David Swetnam-Burland, "Barbarians at the Gates: Private State Tax Enforcement," *State Tax Notes*, Nov. 21, 2016, p. 585.

damages, and attorney fees.[4] The federal act specifically excludes lawsuits based on alleged violations of the Internal Revenue Code, thus excluding federal income tax matters from the scope of the law.[5]

Twenty–nine states and the District of Columbia — more about that later — followed the federal government's lead and enacted their own false claims statutes modeled on the federal law.[6] Many also followed the federal government's lead in excluding tax matters from the scope of their statutes. Some, however, left the door open (for example, Illinois) by not excluding all tax claims from their scope;[7] still others expressly authorized the litigation of tax disputes in false claims cases (for example, New York).[8]

The False Claims Act on Steroids

At the time of the amendments to the New York false claims statute, then-Attorney General Eric Schneiderman referred to New York's approach — the express expansion of the statute to include alleged tax fraud — as creating a "false claims act on steroids."[9] He was not wrong. On December 21, 2018, then-Acting Attorney General Barbara Underwood and then-Acting Tax Commissioner Nonie Manion announced a $330 million settlement with Sprint, bringing an end to false claims litigation over unpaid sales taxes that began in 2011.[10] The press release announced that the settlement "not only is the largest-ever recovery by the New York attorney general resulting from an action filed under the New York False Claims Act, but it is the largest-ever recovery by a single state in an action brought under a state false claims act."[11]

Although unusual in some respects, the case is unlikely to remain an outlier. The incentive structure created by this result could not be clearer. The whistleblower, who was permitted to remain anonymous throughout the proceedings, pocketed $62.7 million of the recovery. With the significant financial incentives for both the state and private parties, the likelihood that these actions will proliferate is evident. Indeed, putting regulatory enforcement into the hands of private litigators has led to an explosion of lawsuits in a wide variety of contexts — from telemarketing to privacy — seeking vast sums.

Of course, the devil is in the details, and the *Sprint* facts, as reported, do not appear to be representative of business as usual in the complex world of state and local tax compliance. According to the New York attorney general's account, Sprint lobbied hard on the subject of some changes in the tax laws that would affect the taxation of its calling plans. Sprint's in-house tax lawyers knew of those lobbying efforts, and so knew what changes went into effect when they were enacted. Even so, Sprint continued a practice of collecting and remitting sales tax that did not comply with the amended statute.[12]

Under the set of facts outlined by the attorney general, Sprint may have been more than usually at risk of an adverse court judgment that the company had defrauded New York because it allegedly made false statements to hide or disguise its known collection and remittance obligations — the key elements of a false claims act case. Regardless, the company settled a case in

[2] 31 U.S.C. sections 3729-33; *see also United States ex rel. Mathews v. Bank of Farmington*, 166 F.3d 853, 857-58 (7th Cir. 1999) (describing the history of the federal statute).

[3] "The term comes from the Latin expression, *qui tam pro domino rege quam pro se ipso in hac parte sequitur* ('Who brings the action for the King as well as for himself')." *Bank of Farmington*, 166 F.3d at 857.

[4] 31 U.S.C. section 3730.

[5] 31 U.S.C. section 3729(d).

[6] *See* Office of the Inspector General, U.S Department of Health and Human Services, "State False Claim Act Reviews" (identifying state false claims statutes).

[7] *See* 740 ILCS 175/3(c) (excluding only income tax matters from the scope of the state statute).

[8] *See* N.Y. Fin. Law section 189(4).

[9] William O. Reckler, Nathanael B. Yale, and Blake T. Denton, "False Claims Act 101: The Ever Expanding Application of State and Federal FCAs," *Business Law Today* (Dec. 2012).

[10] N.Y. Att'y. Gen. release, "A.G. Underwood and Acting Tax Commissioner Manion Announce Record $330 Million Settlement With Sprint in Groundbreaking False Claims Act Litigation Involving Unpaid Sales Tax" (Dec. 21, 2018).

[11] *Id*.

[12] At issue specifically in the *Sprint* case was the commerce clause sourcing rule for taxation of interstate telephone calls. The U.S. Supreme Court, in *Goldberg v. Sweet*, 488 U.S. 252, 256 n.6, 263 (1989), ruled that such calls could only be taxed if (1) they originated or terminated in the state; and (2) the call was charged to an in-state billing address. While this was easy to apply to landline calls, wireless calling created a host of difficulties as to which states could tax those calls and which could not. *See People ex rel. Schneiderman v. Sprint Nextel Corp.*, 26 N.Y.3d 98, 106 (2015). In response, Congress in 2000 established a uniform sourcing rule for the taxation of some interstate telephone calls — permitting taxation only by the state of the customer's address (or the primary company address in the case of services provided to businesses). New York adopted a sourcing approach consistent with Congress' rule, which Sprint was accused of violating.

which it was alleged to have understated its state and local tax liability by an already staggering $100 million for more than three times that amount, $330 million. Such is the potential for civil penalties and treble damages to warp the outcome when a tax dispute can be transmuted into a fraud claim under a state false claims statute. And because false statement claims can potentially be assembled from a jigsaw puzzle of documents, including emails and tax returns, even an innocent company acting in good faith can face arguments that it was intentionally misleading regulators or the public.

Copycats Are Coming

In announcing the settlement, Underwood proudly trumpeted that, of all the states to enact false claims act legislation, "only the New York False Claims Act broadly covers all types of tax fraud."[13] That claim may not be true for long. The District of Columbia is considering following New York's lead and expanding its false claims act expressly to include tax matters. Council member Mary Cheh (D) recently reintroduced for 2019 an amendment to the District's false claims act, which would do just that — with language tracking the New York statute.[14]

In comments submitted to the D.C. Council at a public hearing on a prior version of the bill, Alan C. Levine, chief counsel to the District's Office of Tax and Revenue, testified against the proposal, citing four chief concerns that should sound familiar.[15] First, an expanded false claims act would interfere with the chief financial officer's exclusive authority over financial matters. Second, the amendment would expose the District to the risk of parallel enforcement proceedings, one in court under the oversight of attorneys not versed in local tax matters — and the other in an audit by trained tax professionals. Third, the amendment would invite questionable lawsuits from bounty hunters, with Levine citing the examples of Illinois and New York specifically. Fourth, the amendment duplicates existing rewards offered for those who supply information to the tax office regarding violations.

The possibility of a big payday, such as New York obtained from Sprint, may make it more difficult for hard-pressed state and local governments to properly weigh the soundness of handing over tax policy to private parties and their private counsel. This copycat legislation bears watching.

Silver Linings

A few more promising developments are worth noting:

- A New Jersey appellate court affirmed the dismissal of a lawsuit in which a private relator asserted that "alternative minimum assessments" owed to the state were not taxes. The court concluded that the assessments were plainly taxes, and tax matters were excluded from the scope of the state false claims statute.[16]
- An Illinois appellate court held that while a retailer could be held liable for a false claims act violation for failing to collect and remit state use tax on internet and telephone sales, the relator — which was also the law firm bringing the case — could not recover attorney fees for its work because it was first and foremost a party to the litigation.[17]
- In a case brought by the same plaintiff's firm, an Illinois appellate court held that the relator had failed to state a claim on which relief could be granted because it had not identified any false statement allegedly made by the defendant wine sellers, a required element of the relator's claim.[18]

These opinions are useful reminders that the plaintiff still bears a heavy burden of proof in a false claims act case. Even if the wave of false claims litigation based on alleged failures to collect and remit state and local taxes continues, as we expect it will, the plaintiff — whether the relator, the state, or the two acting in concert —

[13] Release, *supra* note 10.

[14] *See* False Claims Amendment Act of 2019 (Council of D.C.).

[15] *See* Testimony of Alan C. Levine, chief counsel, D.C. Office of Tax and Revenue, False Claims Act Amendment of 2017, Bill 22–166.

[16] *State ex rel. Campagna v. Post Integrations Inc.*, 451 N.J. Super. 276 (App. Div. 2017).

[17] *People ex rel. Schad, Diamond & Shedden P.C. v. My Pillow Inc.*, 2017 Ill. App. 152668.

[18] *State ex rel. Stephen B. Diamond P.C. v. Winetasting Network*, 2017 Ill. App. 152829–U.

still must prove not only (1) a failure to collect and remit tax, but that the party failing to collect the tax (2) knew it should have collected it, and (3) made false statements to the state to hide or disguise that known obligation. An honest mistake is still not a false claims act violation, although this may be cold comfort for the company waging an expensive battle to dismiss a *qui tam* case, particularly if the court permits burdensome and intrusive discovery.

The Shape of Risks to Come

With the U.S. Supreme Court's decision in *South Dakota v. Wayfair*,[19] the risks of *qui tam* actions in the state tax arena have increased in two respects: enforcement of the new *Wayfair* standard for tax periods after the case was decided, and efforts to apply the *Wayfair* standard retroactively.

Aggressive Enforcement After *Wayfair*

Companies struggling to comply with the new and sudden obligation to collect sales and use taxes across the country, or perhaps even unaware of that obligation (or its scope), could become prime targets not only for audits, but for false claims lawsuits. These businesses may find themselves embroiled in costly litigation, including discovery into their tax planning communications and internal deliberations, as private lawyers seek to establish that these companies knowingly ignored their legal obligations or that innocent representations were deceptive.

Because *Wayfair* upheld a remarkably low standard for tax collection, validating a statute that required even modestly sized firms to register for and collect South Dakota's sales tax, many companies could be caught in this trap. Indeed, in place of the long-standing physical presence requirement, the Court upheld South Dakota's arbitrary thresholds of $100,000 in annual sales or a mere 200 transactions a year, standards that capture small and medium-sized sellers that never before had to wrestle with tax collection for 46 states and thousands of localities. In response to *Wayfair*, a long list of other states moved quickly to impose identical or similar minimal standards.[20] The *qui tam* enforcers cannot be far behind. The few jurisdictions that have not yet adopted similar low thresholds, including the District of Columbia (whose emergency enforcement standards are not yet permanent), are poised to do so.[21]

Private attorneys policing the state tax landscape create the very real possibility that they will parachute into favorable jurisdictions with claims of treble damages, forcing companies to face the prospect of paying three times as much as they would pay in an ordinary, state-run tax audit. And they will face this prospect while sitting across the table from private attorneys who have no incentive to take into account the unique circumstances of each seller or to credit more nuanced arguments about the undue burdens associated with a particular state's tax system.[22]

[19] *Wayfair*, 138 S. Ct. 2080, 2104, 201 L. Ed. 2d 403 (2018).

[20] *See, e.g.*, Ind. Code section 6-2.5-2-1(c) ($100,000 or 200 transactions) Minn. Stat. 297A.66, subdiv. 3(d) ($100,000 in sales or 100 transactions); N.Y. Tax Law section 1101(b)(8)(i)(E), 1101(b)(8)(iv) ($300,000 and more than 100 transactions).

[21] *See* Bill 22-914 (amending chapter 20, title 47). Moreover, while*Wayfair* did not expressly address the collection of local taxes, the elimination of the commerce clause's physical presence requirement opens the door to audits — and consequently the potential for *qui tam* actions — in any instance in which an internet seller has an obligation to collect tax at the state level, but has failed (or been unable) to extend its tax collection systems to the countless local jurisdictions that impose transactional taxes. Indeed, the *Sprint* case in New York involved both state and local taxes on flat-rate wireless contracts.

Some commentators believe that the complexity and burdensome nature of local sales taxes might lead "a creative court [to] devise an undue burdens-based remedy that targets the municipal components of [sales and use tax] systems," but it may be the case that state trial courts hearing *qui tam* actions are less interested in novel theories than in enforcing *Wayfair*'s standard across the board. Walter Hellerstein, *State Taxation* (3d Ed. 2018), para. 19.02. "Constitutional Restrictions on States' Power to Impose, and Require Vendor Collection of, Sales and Use Taxes on Interstate Transactions," 1999 WL 1399033, 18.

[22] For example, in addition to upholding South Dakota's low sales/transactions thresholds, the Supreme Court explained that the statute "appeared designed" to minimize the risks of imposing an "undue burden" on interstate commerce, because the law reflected some favorable elements, including the state's participation in the Streamlined Sales and Use Tax Agreement, a multistate tax simplification project in which some, but not all states, participate. 138 S.Ct. at 2099-100 ("South Dakota is one of more than 20 States that have adopted the [SSUTA]. This system standardizes taxes to reduce administrative and compliance costs: It requires a single, state level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the State. Sellers who choose to use such software are immune from audit liability. See App. 26–27."). The low-risk, high-return proposition of *qui tam* actions increases the likelihood of lawsuits being filed to test whether a state's failure to participate in the SSUTA or to adopt other elements of the South Dakota law bars tax collection and remittance obligations under *Wayfair.*

The Specter of Retroactivity

With*Wayfair* also comes the risk of retroactive application of the new lower commerce clause standard, something that private attorneys may be eager to pursue. Indeed, while numerous states have indicated that they will not seek to apply the *Wayfair* test to periods before the date it was decided, June 21, 2018, not all have done so. Some, like Massachusetts, have taken the position that the *Wayfair* standard must "apply to past as well as future tax periods."[23] The revenue commissioner rested his position on the Supreme Court's decision in *Harper v. Virginia Department of Taxation*,[24] which he argues requires the constitutional decision in *Wayfair* to apply to "all tax periods at issue, not just those since *Wayfair* was decided."[25]

Massachusetts is not alone. Florida has also sought to apply *Wayfair* retroactively. The pending case of *Global Hookah Distributors v. Florida Department of Business and Professional Regulation*[26] concerns the imposition of the state's tobacco excise tax. The statute imposing the tax states that it can be imposed to the extent permitted "under the Commerce Clause to the United States Constitution."[27] In its response to the plaintiff's motion for final summary judgment, the state expressly stated that "*Wayfair* controls the outcome of this matter, and there is no reason that case should not be applied retrospectively as well as prospectively."[28]

Another large state — and one with a false claims act that covers state taxes — has also yet to disavow retroactive enforcement of *Wayfair*. Some representatives of the New York State Department of Taxation and Finance are reported to have indicated informally their view that the *Wayfair* test can be applied retroactively.[29]

Frankly, we fear that more states may seek to apply *Wayfair* retroactively to pending cases that include tax periods before the date *Wayfair* was decided. We expect that the private bar would be even more aggressive in seeking to apply *Wayfair* retroactively and, with the threat of treble damages dangling over the head of large and small private businesses, we might see settlements being struck long before any court passes on the constitutionality of such retroactive taxation.

How strong a case is there for retroactivity? The risk is real. In his dissenting opinion in *Wayfair*, Chief Justice John G. Roberts Jr. noted that the issue whether the *Wayfair* rule could be applied retroactively was a "troubling question" that was glossed over in the majority's opinion.[30] This issue was previously identified by the majority in *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 n.10 (1992), which declined to overrule the physical presence requirement: "An overruling of [*National*]*Bellas Hess* [*v. Department of Revenue*, 386 U.S. 753 (1967)] might raise thorny questions concerning the retroactive application of those taxes and might trigger substantial unanticipated liability for mail-order houses. The precise allocation of such burdens is better resolved by Congress rather than this Court."

Those seeking to apply *Wayfair* retroactively could point to Supreme Court precedent explaining the general principle that "when the Court has applied a rule of law to the litigants in one case it must do so with respect to all others not barred by procedural requirements or *res judicata*."[31] Indeed, the Court has previously recognized that the rule of "retrospective operation" has "governed 'judicial decisions . . . for near a thousand years.'"[32] In this regard, it should be noted that seven states previously

[23]Massachusetts Commissioner of Revenue's Opposition to Crutchfield's Motion to Compel, *Crutchfield Corp. v. Harding*, Case No. CL1700145-00 (Albemarle County Cir. Ct., Sept. 28, 2018).

[24]509 U.S. 86 (1993).

[25]*See also* "Remote vendors frequently asked questions," Massachusetts Department of Revenue (explaining that its economic presence regulation applies retroactively to Oct. 1, 2017).

[26]Case No. 2017-CA-1623 (Fla. Cir. Ct., 2d Judicial District).

[27]Fla. Stat. sections 210.276(4), 201.230(4).

[28]Defendant's Response to Plaintiff's Motion for Final Summary Judgment at 2, *Global Hookah Distributors Inc. v. Florida Department of Business & Professional Regulation*, Case No. 2017-CA-1623 (Leon County Cir. Ct., Aug. 9, 2018).

[29]Timothy Noonan and Craig K. Reilly, "NY Tax Minutes: *Wayfair*, Executive Budget, Goldman Offshore," Law360, Feb. 1, 2019.

[30]*Wayfair*, 138 S. Ct. 2080, 2104.

[31]*James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529, 544 (1991); *Harper*, 509 U.S. at 90.

[32]*Harper*, 509 U.S. at 94 (quoting *Kuhn v. Fairmont Coal Co.*, 215 U.S. 349, 372 (1910) (Holmes, J., dissenting)); *James B. Beam*, 501 U.S. at 547 (Blackmun, J., concurring) ("Unlike a legislature, we do not promulgate new rules to be applied prospectively only.").

adopted economic presence laws that create a potential basis for retroactive liability,[33] and 19 others have laws ostensibly permitting retroactive liability on overruling *Quill*.[34]

Those retroactivity arguments, however, could be countered in several ways. For one, the majority in *Wayfair* made clear that the non-retroactive nature of the South Dakota tax statute played an important role in its decision to uphold that law. Also, the Supreme Court pointed out that challenges to any attempt to retroactively apply *Wayfair* might be based not only on an undue burden analysis, but also under a theory that retroactive application of the case would violate the commerce clause for other reasons, including the risk of double taxation of interstate sales.

Conclusion

Wayfair upset the settled expectations of businesses practiced in applying *Quill*'s physical presence nexus standard. Nexus means something different now and in the future — and as just discussed, some jurisdictions seem inclined to believe that it should mean something different in the past as well. One can add to that uncertainty the apparent increase in interest among the plaintiffs' bar in using state false claims statutes to bring claims of "tax fraud," hoping to ring the bell for treble damages, civil penalties, and attorney fees, or at least extract lucrative settlements in light of the threat of those remedies. Businesses potentially exposed to tax liability in a new set of far-flung jurisdictions must take even greater care to both comply with shifting and uncertain obligations and document how diligently they are working to keep up-to-date. The specter of false claims act litigation amplifies the financial and reputational risks of error, even as the aftershocks of *Wayfair* still rumble unpredictably across the legal landscape.

[33] Alabama (Dept. of Revenue Rule 810-6-2-.90.03); Connecticut (*see* Connecticut Dept. of Revenue Services release, "Connecticut Pursues Sales Taxes Not Paid by On-line Retailers," (Mar. 28, 2017)); Indiana (Ind. Code 6-2.5-9-9(e)); Maine (36 Me. Rev. Stat. Ann. section 1951-B(3)); Massachusetts (830 Mass. Code Regs. 64H.1.7); Mississippi (Miss. Code Ann. section 35.4.03.09); and Ohio (Ohio Rev. Code section 5741.01(I)(2)(h) & (i); and Ohio Dept. of Taxation information release ST 2017-02 (Oct. 2017)).

[34] Arizona (*see* Ariz. DOR Transaction Privilege Tax Ruling 16-1); California (Calif. Rev. & Tax. Code section 6203); Colorado (Colo. Rev. Stat. 39-26-102(3)(b)(I)); Florida (Fla. Stat. 212.0596(2)(l)); Georgia (Ga. Code Ann. section 48-8-1); Idaho (Idaho Code section 63-3611(2)); Kansas (Kan. Stat. Ann. section 79-3207(h)(1)(f)); Minnesota (Minn. Stat. section 297A.66, subdiv. 3(a)); Nevada (Nev. Rev. Stat. section 372.724(1)(a), (b)); New Jersey (N.J. Stat. Ann. 54:32B-2(i)(1)(C)); New York (N.Y. Tax Law section 1101(b)(8)(E)); North Carolina (N.C. Stat. Ann. 105-164.8(b)(5)); North Dakota (N.D. Cent. Code section 57-40-2.01(7)); Oklahoma (Okla. Admin. Code 710:65-15-3(c)); Pennsylvania (72 Pa. Stat. Ann. 7201(b)(3)); Rhode Island (R.I. Gen. Laws sections 44-18-15(a)(6)(iv), -23(3)(iv), -24)); South Carolina (S.C. Code Ann. section 12-36- 1340(4)); Virginia (Va. Code Ann. section 58.1-612(F)); and Wisconsin (Wis. Admin. Code 11.97(1)).