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How Escobar Reframes FCA's Materiality Standard

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On June 16, 2016, the U.S. Supreme Court resolved a circuit split by unanimously endorsing the implied false certification theory of liability under the federal False Claims Act , 31 U.S.C. §§ 3729-33, but specifying that material noncompliance with an applicable statute, regulation, or contract provision is required to support an FCA action — a "rigorous" and "demanding" fact-based analysis of whether a noncompliance had a natural tendency to influence, or be capable of influencing, the government's payment decision. Universal Health Services Inc. v. United States ex rel. Escobar, No. 15-7, 2016 U.S. LEXIS 3920 (June 16, 2016), available here.


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Because the materiality analysis "cannot rest on a single fact or occurrence as always determinative," the court held that whether a particular statutory, regulatory or contractual requirement is specifically labeled a condition of payment is not dispositive of its materiality. In other words, the court rejected a bright-line rule on materiality and adopted a fact-specific standard that will need to be litigated on a case-by-case basis. Thus, despite Escobar's endorsement of the implied false certification theory, it is far from the "victory" that the government and qui tam relators are trumpeting.

Implied False Certification Theory

The implied false certification theory is premised on the notion that a party, by the very act of submitting a claim to the government for payment, has impliedly certified compliance with the statutes, regulations and contract terms that govern the contractual relationship. Using this theory, the government and relators have claimed that any noncompliance is sufficient to trigger FCA liability, regardless of whether the defendant made an express false statement, whether the alleged noncompliance arose from a condition of payment, or how minor the noncompliance. Defendants, on the other hand, have variously argued that the implied false certification theory is invalid or that its operation should be limited to narrow circumstances, such as noncompliance with the government's expressly designated conditions of payment, as the defendant in Escobar argued.

Prior to Escobar, the lower courts were split on the theory's viability and scope. The Seventh Circuit had rejected the theory entirely, holding that only express false statements are actionable under the FCA. See United States v. Sanford-Brown Ltd., 788 F.3d 696 (7th Cir. 2015). The Supreme Court endorsed the theory but rejected other lower court formulations, such as the Second

Circuit's restriction of the theory to cases where the undisclosed noncompliance relates to an expressly designated condition of payment and the First and District of Columbia Circuits' holdings that the theory applies to undisclosed noncompliance with conditions of payment whether expressly designated or not. See, e.g., United States ex. rel. Escobar v. Universal Health Services., 780 F.3d 504 (1st Cir. 2015); United States v. Science Applications International Corp., 626 F.3d 1257 (D.C. Cir. 2010). (For a further discussion of the split reflected in the lower courts' various approaches, see this article by Post & Schell principals Matthew Newcomer and Barbara Rowland.)

The Court's Opinion

Relators in Escobar were the parents of a child treated by a mental health services provider, whose employees allegedly (a) did not have the licensing and qualifications required to meet the professional standard for the services billed to Medicaid, (b) had obtained National Provider Identification numbers for Medicaid billing based on false information about their licenses and qualifications, and (c) were not properly supervised. In their qui tam whistleblower lawsuit, in which the United States declined to intervene, relators alleged that the provider submitted reimbursement claims to Medicaid for counseling and other mental health services provided by specific types of professionals, but did not disclose "serious" violations of (and impliedly certified to compliance with) regulations governing the treating professionals' qualifications and licensing.

The district court dismissed the complaint for failure to state a claim because compliance with the (allegedly violated) regulations was not a condition of Medicaid payment — it was merely a condition of participation. The First Circuit reversed, holding that compliance with the overarching Medicaid regulatory provisions regarding supervision of the provider's employees was a "material precondition of payment."

In vacating and remanding to the First Circuit, the Supreme Court held that the implied false certification theory can provide a basis for FCA liability when two requirements are met: (1) the claim for payment makes specific representations about the goods or services provided; and (2) the "defendant's failure to disclose noncompliance with material statutory, regulatory or contractual requirements makes those representations misleading half-truths."

Regarding the reimbursement claims at issue in Escobar, the court held that "[t]hey fall squarely within the rule that half-truths — representations that state the truth only so far as it goes, while omitting critical qualifying information — can be actionable misrepresentations." The claims contained payment codes reflecting the services performed and the type of provider who performed them, but failed to disclose that the treating professionals did not meet the relevant state requirements for providing mental health services and were not properly trained, supervised or licensed. According to the court, the claims were materially misleading because anyone reviewing the claims "would probably — but wrongly — conclude that the clinic had complied with" the relevant legal requirements for providing treatment.

The court emphasized that only *material* noncompliance with a statutory, regulatory or contractual requirement can trigger FCA liability and the attendant possibility of treble damages. Although whether a particular requirement is or is not an express condition of payment factors into this materiality analysis, it is not dispositive of the question. Importantly, the court ruled that the materiality requirement applies to express false certification theories of liability too.
The court characterized the materiality requirement as "rigorous" and "demanding," and defined it by applying principles from both the FCA and the common law.

The FCA defines "material" as "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property." 31 U.S.C. § 3729(b)(4). The court stated that this definition contains no language limiting materiality to expressly designated conditions of payment, thereby rejecting the defendant's urged limitations on the theory's application. Similarly, the FCA's scienter requirement, found in 31 U.S.C. § 3729(b)(1)(A), does not restrict materiality to designated conditions of payment. The court explained that a "defendant can have 'actual knowledge' that a condition is material without the Government expressly calling it a condition of payment," for example when the defendant knows that the government "routinely rescinds contracts" not in compliance with the condition. Moreover, a defendant can act with deliberate ignorance or reckless disregard regarding the materiality requirement if "a reasonable person would realize the imperative" of complying with the condition, even if the government failed to expressly designate it as a condition of payment.

Addressing the contours of the materiality requirement, the court began by noting that the materiality requirement "descends from common-law antecedents," as "the common law could not have conceived of 'fraud' without proof of materiality." The court declined, however, to address whether the materiality requirement was governed by the FCA or the common law, holding that "[u]nder any understanding of the concept, materiality look[s] to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation" (alteration in original). This is consistent with the definition of materiality in the FCA, discussed above, as well as principles of contract and tort law. The court explained that the materiality standard ensures that the FCA is not used as "a vehicle for punishing garden-variety breaches of contract or regulatory violations."

The need for a case-by-case determination of materiality was made clear by the court's discussion of what is, is not or might be material:

- The government's express designation of a requirement as a condition of payment is certainly relevant to the materiality inquiry, but it is not dispositive.
- The fact that the government has the option to refuse to pay a claim if it knew of the noncompliance is not sufficient to find materiality.
- Minor or insubstantial noncompliance will not be sufficient to find materiality.
- The FCA "is not a means of imposing treble damages and other penalties on insignificant regulatory or contractual violations."

In addition, the court essentially reintroduces the concept of government knowledge of a false claim as a defense to an FCA case. As the court explains:

- "… [I]f the government pays a particular claim in full despite its actual knowledge that certain requirements were violated, that is very strong evidence that those requirements were not material."
- And, "if the government regularly pays a particular type of claim in full despite actual knowledge that certain requirements were violated and has signaled no change in position, that is strong evidence that the requirements are not material."

- Conversely, of course, "proof of materiality can include, but is not necessarily limited to, evidence that the defendant knows that the government consistently refuses to pay claims in the mine run of cases based on noncompliance with the particular statutory, regulatory or contractual requirement."

The court's broad outline of what constitutes materiality will be considered in the near future in the cases vacated and remanded by the Supreme Court in light of Escobar. In addition to Escobar itself, of particular interest are the Fourth Circuit's United States ex rel. Badr v. Triple Canopy Inc., Nos. 13-2190 and 13-2191 (addressing allegations that defense contractor submitted false claims for payment due to noncompliance with regulations regarding minimum proficiency standards for firearm use by contractor-provided guards at U.S. airbase in Iraq); the Eighth Circuit's United States ex rel. Miller v. Weston Educational Inc., No. 14-1760 (involving allegations that for-profit college manipulated and failed to properly maintain student records to secure continued receipt of federal student aid funds), and the Seventh Circuit's United States ex rel. Nelson v. Sanford-Brown Ltd., et al., No. 14-2506 (addressing allegations that educational institution improperly received Department of Education funds due to noncompliance with conditions in program participation agreement with the department).

Conclusion and Practice Tips

Although Escobar is a win for the government and the relators' bar on the question of the implied false certification theory's validity, the net impact of the court's decision may well be to narrow the theory's availability, given the court's newly defined "rigorous" materiality standard. The government and relators will now be required to establish that the compliance defect, if known, would have actually affected the government's reimbursement decision — a higher standard than whether the government would be entitled to refuse payment under the contract had the defect been known.

To show that it would not have paid a claim, the government may need to develop evidence of its past payment practices and, to dispute the government's contention, defendants may seek discovery of the government's past payment practices. Anyone who has represented either the government or a contractor/provider in a government program knows that the discovery disputes on past payment practices will be heated and, at least until further case law develops, can consume the limited resources of the courts and the parties. We can also expect that competitors — nonparties in the FCA case — will get drawn into these FCA discovery disputes as their claims — those paid and those rejected — are critically examined by the litigants.

In anticipation of the issues that will arise out of the "materiality" disputes in implied false certification cases, we offer the following suggestions to government contractors and providers:

1. Disclosure of compliance issues to the government will be evidence of immateriality should the government continue to pay your claims; therefore, seek counsel as to the risks and the potential value of disclosure as it regards FCA liability.

2. Memorialize all communications with government personnel regarding compliance issues. Based on those communications, consider amending contracts, sending the agency involved a letter/email reflecting an understanding of the government's requirements, and/or write a memo to the file memorializing verbal communications.

3. Consult with counsel about these communications — who should author and sign them; who in the government should they be sent to; when to send them; how often to send them; how to respond to the government if it responds — because these communications will be evidence of the government's knowledge of a compliance issue and your good faith reliance on its knowledge.

4. Nonparties should be prepared to fight to protect their confidential commercial information, such as pricing terms and claims for payment, if they find themselves drawn into a "past payment practices" discovery dispute.

Escobar seemingly raises as many questions as it answers. Beginning with the remanded circuit court cases, we will see years of litigation over the parameters of the FCA's "materiality" element as defendants push back at relators and the government.

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