Legal Backgrounder

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A Year after *U.S. ex rel. Escobar*, Lower Courts Diverge on Key Question in Implied-False-Certification FCA Suits

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Just over a year ago, False Claims Act (FCA) watchers eagerly awaited the US Supreme Court's decision in *U.S. ex rel. Escobar v. Universal Health Services, Inc.*,[1] expecting that it would resolve once and for all whether implied false certification is a valid FCA theory. And while the Court did in fact resolve that question affirmatively, to the disappointment of the FCA defense bar and to any business that works with the federal government, the decision in some ways raised more questions than it settled.

While the decision confirmed that a contractor may impliedly certify compliance with material legal or contractual requirements when it bills the government, the Court also recognized that the doctrine, if unchecked, could impose virtually limitless liability on contractors for routine non-compliance with the literally millions of potentially applicable rules and regulations imposed by federal programs. Accordingly, the Court also imposed a "rigorous" materiality requirement, the contours of which remain very much undefined.

At a minimum, *Escobar* made clear that materiality requires close scrutiny of the government's actual or likely conduct in paying claims—both in the case at hand and in "the mine run of cases" involving allegations of similar conduct. That the government may have had the option to decline payment is insufficient in itself to allow a FCA action to go forward. Similarly, whether the government made compliance with a particular rule or regulation a condition of payment is relevant, but not determinative, of materiality. What appears to matter, in the Court's view, is how the government treats claims *in fact*.

Unfortunately but unsurprisingly, federal circuit courts have adopted conflicting views of just what materiality means in a post-*Escobar* world. Although several circuits have taken *Escobar*'s language to heart, finding materiality lacking where the government fails to act or intervene in the face of alleged noncompliance with statutory, regulatory, or contractual provisions, other circuits have resisted *Escobar*'s call for an increased focus on the government's actual conduct. This Legal Backgrounder analyzes the emerging circuit split and previews the future materiality battlegrounds.

Emerging Circuit Split on Materiality Post-*Escobar*

On the one hand, the US Courts of Appeals for the Third, Fifth, Seventh, and DC Circuits have embraced *Escobar*'s language and focused on the government's actual conduct in paying claims, finding materiality lacking where the government fails to act or intervene in the face of alleged noncompliance with statutory, regulatory, or contractual provisions. On the other hand, circuits including the First (on remand in *Escobar*)

[1] 136 S. Ct. 1989 (2016).

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and the Fourth have been more reluctant to deem actual conduct dispositive, arguably disregarding the Supreme Court's instructions. The Ninth Circuit, historically among the most reversed by the Supreme Court, has been internally inconsistent, issuing one decision which appears to hew closely to the materiality inquiry laid out in *Escobar* and another resisting it.

Key Decisions Dismissing Claims for Lack of Materiality

The first significant circuit court decision post-*Escobar* was *U.S. ex rel. Nelson v. Sanford-Brown, Ltd.*[2] This case involved allegations that a for-profit college failed to comply with several regulations connected to Title IV funding, and thus its claims for payment were impliedly false. The Seventh Circuit affirmed the grant of summary judgment to the college, reasoning that the relator presented no evidence that the government's decision to pay would likely or actually have been different had it known of the college's alleged noncompliance. In fact, "the subsidizing agency and other federal agencies in this case ha[d] already examined [the defendant] multiple times over and concluded that neither administrative penalties nor termination was warranted."

Several other circuits have followed suit, finding materiality lacking where the government was aware of the relator's allegations, conducted an investigation, and continued payment (or did not seek to recoup payments already made). For example, in *U.S. ex rel. McBride v. Halliburton Co.*,[3] the relator alleged that defendant Kellogg Brown & Root (KBR) failed to disclose that it had inflated headcounts representing the number of people who used recreation centers that KBR operated for the US military, thereby rendering KBR's claims for payment impliedly false. The DC Circuit affirmed the district court's grant of summary judgment to KBR, holding that the alleged headcount inflation was immaterial. The court focused on "what actually occurred," including that the Defense Contract Audit Agency had investigated the relator's allegations and chose not to disallow or challenge any of the amounts KBR had billed for recreation-center services. KBR also continued to receive an award fee for "exceptional performance" after the government learned of the relator's allegations. The court rejected the relator's reliance on an Administrative Contracting Officer's statement that he "might" have investigated further had he known false headcounts were being maintained, and that such an investigation "might" have resulted in charged costs being disallowed.[4]

Similarly, in *Abbott v. BP Exploration & Production, Inc.*,[5] the relators alleged BP falsely certified that the design of its semi-submersible floating oil-production facility in the Gulf of Mexico complied with certain safety regulations. Specifically, relators alleged that BP design documents were missing a stamp showing that the designs had been approved by an engineer. In addition to filing a FCA suit, the relator also filed a written submission with the Department of Justice, after which multiple government agencies conducted thorough investigations and unanimously concluded that the relator's allegations were unfounded and there were no grounds for suspending the BP facility's operations. The Fifth Circuit affirmed the district court's grant of summary judgment on materiality grounds, holding that the government's decision to allow the oil-production facility to continue operating after an investigation into the relator's allegations is "strong evidence" that the regulation's alleged stamping requirement is not material.[6]

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[2] 840 F.3d 445 (7th Cir. 2016).

[3] 848 F.3d 1027 (D.C. Cir. 2017).

[4] Disclosure: Author Craig Margolis and Vinson & Elkins LLP represented KBR in the *McBride* case.

[5] 851 F.3d 384 (5th Cir. 2017).

[6] At least two other circuit courts have found materiality lacking post-*Escobar*. *See U.S. ex rel. Kelley v. Serco, Inc.*, 846 F.3d 325 (9th Cir. 2017) (materiality lacking because government accepted progress reports despite their noncompliance with certain governing standards and continued to pay defendant for work performed after learning of relator's allegations); *U.S. ex rel. Petratos v. Genentech Inc.*, 855 F.3d 481 (3d Cir. 2017) (relator failed adequately to plead materiality where he failed to allege that government would not have reimbursed Medicare claims had it known about allegedly withheld information).

Key Decisions Holding that Materiality Was Adequately Alleged

Most notable among the cases on the other side of the split is the First Circuit's decision on remand in *Escobar* itself. That court once again held that the relators' complaint was sufficient to survive a motion to dismiss.[7] Relators alleged that the defendant violated the FCA by submitting claims for reimbursement without disclosing that the service providers for whom it was seeking payment either lacked certain qualifications or were not properly supervised under applicable state regulations. Reading the Supreme Court's decision as instructing the use of a "holistic approach" to materiality, the First Circuit had "little difficulty" finding that the relators adequately pleaded materiality.

The court cited three distinct reasons in support of its holding: (1) the relators alleged that compliance with the regulations was a condition of payment, which, while not dispositive, is evidence of materiality; (2) licensing and supervision requirements were "central" to the regulatory program, as the "core" of the program was "the expectation that mental health services are to be performed by licensed professionals, not charlatans"; and (3) there was no basis in the complaint to conclude that the government paid Universal Health's claims while having actual knowledge of the alleged violations.

The First Circuit's third rationale warrants particular scrutiny. The First Circuit distinguished between "mere awareness of *allegations* concerning noncompliance" and "knowledge of *actual* noncompliance," despite the absence of any such distinction in the Supreme Court's opinion. Further, although the complaint's allegations made clear that state regulators had conducted a full investigation and chose not to recoup any payments, the First Circuit reasoned that the relevant "government knowledge" was that of "the entity paying" the claim, not knowledge by "various [other] state regulators." Finally, and as has become central to the government's post-*Escobar* arguments nationwide, the First Circuit appeared to require evidence of government knowledge and payment *at the time the specific claims were made*, discounting subsequent investigations by state regulators.

The Fourth Circuit's decision in *U.S. ex rel. Badr v. Triple Canopy, Inc.*[8] is another outcome unfavorable to FCA defendants. In this intervened *qui tam* action, the government alleged that Triple Canopy submitted false claims for payment for guards who failed to meet the marksmanship skill level the contract required. The Fourth Circuit held that the complaint adequately pleaded materiality, reasoning that "[c]ommon sense" compels the conclusion that "[g]uns that do not shoot" (an example given by the Supreme Court in the *Escobar* decision) "are as material to the Government's decision to pay as guards that cannot shoot straight." The court also pointed to the government's decision not to renew its contract with Triple Canopy and its "immediate" intervention in the case as evidence of materiality. Notably absent from the decision, however, is any discussion of the government's conduct in the "mine run of cases" when a contractor bills for services without explicitly referencing compliance with underlying terms. It is important to note that although the result in *Triple Canopy* is unfavorable, its import likely will be limited, as the court relied heavily on Triple Canopy's alleged concealment to find materiality—which should be fairly unique to that case. Further, the decision provides defendants with ammunition to argue that the government's decision not to intervene (which happens in the overwhelming majority of *qui tam* FCA cases) could be evidence of immateriality.

Most recently, in *U.S. ex rel. Campie v. Gilead Sciences, Inc.*[9] relators alleged that a manufacturer of anti-HIV drugs had included an active ingredient in certain drugs from an unapproved source, contrary to statements made to the Food and Drug Administration (FDA) when Gilead Sciences sought approval for the drugs. The FCA allegation was that all claims submitted to federal healthcare benefit programs were false because claims

[7] *U.S. ex rel. Escobar v. Universal Health Services, Inc.*, 842 F.3d 103 (1st Cir. 2016).
[8] Nos. 13-2190, 2191, 2017 WL 2115196 (4th Cir. May 16, 2017).
[9] No. 15-16380, 2017 WL 2884047 (9th Cir. July 7, 2017).

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could only be paid for FDA-approved drugs and the drugs at issue here appear to have lost their FDA approval due to the inappropriate sourcing, even though FDA had issued warning letters relating to the conduct at issue and had not pulled the drug from the market. The court held that materiality was sufficiently pled because the relators alleged more than "the mere possibility that the government would be entitled to refuse payment if it were aware of the violations," holding for trial the question whether there would be evidence that the government actually continued to pay with knowledge of the allegations at issue. The defendant has sought and was granted an extension to file a petition for rehearing, signaling the possibility that it might seek *en banc* review of the decision.

Future Materiality Battlegrounds

Although several common arguments appear throughout the government's post-*Escobar* briefing, there are two points that courts are likely to face for some time.

First, the government regularly argues that *Escobar* requires actual knowledge of fraud, not just an awareness of fraud allegations.[10] Although the government argues this approach is faithful to the Supreme Court's language in *Escobar*, the Court made no such distinction. Moreover, in addition to the *Sanford-Brown*, *McBride*, and *Abbott* decisions discussed above, several district court decisions have expressly held that continued payment despite knowledge of fraud *allegations* can defeat materiality. For example, in *U.S. ex rel. Kolchinsky v. Moody's Corp.*,[11] the district court held that congressional investigations and news reports about the relator's allegations put federal agencies on notice of those allegations. Because the government paid the defendant's claims after those public investigations and reports, the court concluded that the relator's complaint failed *Escobar*'s materiality test. Similarly, in *City of Chicago v. Purdue Pharmaceuticals, LP*,[12] the court applied *Escobar* to dismiss claims under Chicago's municipal False Claims Act because the city's continued payment of claims after learning about the allegations of wrongful conduct showed that the conduct was not material.

Second, as these authors have experienced, the government also has argued that materiality must be assessed based on the knowledge of government officials at the time the claims were submitted and that subsequent investigations and decisions not to recoup payments should carry little weight. The argument finds no support in the text of the Supreme Court's decision. Nowhere did the Court suggest that the materiality inquiry is limited to the time period during which the claims initially were submitted. Nor would such a distinction be consistent with *Escobar*'s reasoning; the government's decision to continue payment (or not claw back payments already made) reflects the government's view of the importance of the alleged violations every bit as much as the government's decisions at the time the claims were submitted. As the DC Circuit explained in *McBride*, *Escobar* affords courts "the benefit of hindsight," and so they "should not ignore what actually occurred."[13]

In addition to these issues, FCA practitioners should anticipate heated discovery disputes regarding the proper scope of materiality discovery. While most post-*Escobar* decisions have involved the merits, *Escobar* also has significant discovery implications, as it should afford FCA defendants the ability to discover how the government actually has handled the disputed issue in that case as well as other cases. Courts likely will continue to grapple with this and other issues as they adapt to the post-*Escobar* landscape, and we look forward to the virtually inevitable further Supreme Court review of the metes and bounds of implied false-certification liability.

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[10] *See, e.g.*, Statement of Interest of US in Connection With Relator's Rule 59(e) Motion to Alter Judgment 4-6, No. 12-cv-1399, *United States ex rel. Kolchinsky v. Moody's Corp.* (S.D.N.Y. May 8, 2017) [Dkt. 90].
[11] 12-1399, 2017 WL 825478 (S.D.N.Y. Mar. 2, 2017).
[12] 14-4361, 2016 WL 5477522 (N.D. Ill. Sept. 29, 2016).
[13] 848 F.3d at 1034.

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