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False Claims Act

The Supreme Court's decision in Universal Health Services v. Escobar ex rel. United States sought to clarify the standard for materiality under the False Claims Act, but lower courts have already begun to adopt different interpretations.

Materiality Under FCA: The Lower Courts Grapple With Escobar's Meaning



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In the six months since the Supreme Court's decision on implied certification and materiality in *Universal Health Services, Inc. v. United States ex rel. Escobar*, lower courts have begun to apply the Supreme Court's analysis to a variety of fact patterns and thus have begun to debate whether *Escobar* simply reaffirmed the prior understanding of materiality under the False Claims Act (FCA) or instead established a new, more rigorous test for materiality. 136 S. Ct. 1989 (June 16, 2016).

The defense bar, the Department of Justice (DOJ), and relators have all weighed in. This article provides an initial report on these contending readings of *Escobar*, the lower courts' efforts to apply the Supreme Court's guidance, and the follow-on questions about materiality that are headed back up to the courts of appeals and possibly to the Supreme Court.

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I. Escobar In *Escobar*, the parents of a girl who had died after being treated at a mental health clinic alleged that by submitting Medicaid reimbursement claims for these services, the clinic's parent company had impliedly (and falsely) certified that the girl's treatment had been performed by certain kinds of licensed professionals under certain kinds of supervision, as required by state Medicaid regulations. The district court dismissed, holding that the licensing and supervision regulations were not conditions of payment by Medicaid. The First Circuit reversed, concluding that the regulations did impose conditions of payment. *Id.* at 1996-99.

A unanimous Supreme Court vacated the First Circuit's decision and remanded for reconsideration in light of its refashioning of the tests for implied certification liability and materiality. The court reached three holdings.

First, it approved the viability of implied certification claims, but only in some cases. The court concluded that: ''at least in certain circumstances, the implied false certification theory can be a basis for liability. Spe-

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cifically, liability can attach when the defendant submits a claim for payment that makes specific representations about the goods or services provided, but knowingly fails to disclose the defendant's noncompliance with a statutory, regulatory, or contractual requirement. In these circumstances, liability may attach *if the omission renders those representations misleading*.'' *Id*. at 1995 (emphasis added). *See id*. at 1999 (emphasis added): ''We first hold that the implied false certification theory can, at least in some circumstances, provide a basis for liability. By punishing defendants who submit 'false or fraudulent claims,' the False Claims Act encompasses claims that make fraudulent misrepresentations, which include certain misleading omissions. When, as here, a defendant makes representations in submitting a claim but omits its violations of statutory, regulatory, or contractual requirements, those omissions can be a basis for liability *if they render the defendant's representations misleading with respect to the goods or services provided*.''

Second, the court held that ''liability for failing to disclose violations of legal requirements does not turn upon whether those requirements were expressly designated as conditions of payment,'' though it noted that such designation ''is relevant to . . . the materiality inquiry.'' *Id*. at 1996. ''What matters,'' the court explained, ''is not the label the Government attaches to a requirement, but *whether the defendant knowingly violated a requirement that the defendant knows is material to the Government's payment decision*.'' *Id*. (emphasis added), 1996, 2001. The court suggested that ''concerns about fair notice and open-ended liability'' that had led lower courts to limit FCA liability to violations of express conditions of payment could be ''addressed through strict enforcement of the Act's materiality and scienter requirements,'' which the court described as ''rigorous.'' *Id*. at 2002.

Third, the court, in its view, ''clarif[ied] how [the FCA's] rigorous materiality requirement should be enforced.'' *Id*. at 1996. But the clarification was perhaps less than crystalline. The court began by acknowledging that the FCA expressly defines ''material'' as ''having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property,'' a definition it characterized as having ''common-law antecedents.'' *Id*. at 2002. Looking to definitions of materiality drawn from contract and tort law, the court explained 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.' '' *Id*. (quoting 26 R. Lord, Williston on Contracts § 69:12, p. 549 (4th ed. 2003)) (emphasis added). Which: likely or actual? In tort law, the court observed, a representation is material ''in only two circumstances'': (i) when a reasonable person would attach importance to it, *i.e.*, it would ''*likely induce*'' the person to act or refrain from acting; or (ii) when the party receiving the representation would attach importance to it in that sense, even if a reasonable person would not. *Id*. at 2002-03 (emphasis added). But it then cited treatises suggesting that many courts define materiality for purposes of the first of those standards as limited to representations that, ''had [they] not been made, the party complaining of fraud *would not* have taken the action alleged to have been induced by the misrepresentation.''*Id*. at 2003 n.5 (citing Williston on Contracts § 69:12, p. 549-50) (emphasis added). And it described two prior examples of material misrepresentations with parentheticals supporting the ''would not'' approach: ''*See United States ex rel. Marcus v. Hess*, 317 U. S. 537, 543 (1943) (contractors' misrepresentation that they satisfied a noncollusive bidding requirement for federal program contracts violating the False Claims Act because ''[t]he government's money would never have been placed in the joint fund for payment to respondents had its agents known the bids were collusive''); *see also Junius Constr*., 257 N. Y., at 400, 178 N. E., at 674 (an undisclosed fact was material because ''[n]o one can say with reason that the plaintiff would have signed this contract if informed of the likelihood'' of the undisclosed fact).''*Id*. at 2003.

Emphasizing that the FCA's materiality requirement is ''demanding,'' the court explained: ''A misrepresentation cannot be deemed material merely because the Government designates compliance with a particular statutory, regulatory, or contractual requirement as a condition of payment. Nor is it sufficient for a finding of materiality that the Government would have the option to decline to pay if it knew of the defendant's noncompliance. Materiality, in addition, cannot be found where noncompliance is minor or insubstantial.'' *Id*. at 2003. The court further explained that: ''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. Conversely, if 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 are not material. Or, 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.'' *Id*. at 2003-04.

Responding to the concern that its tests for materiality would make it difficult for defendants to prevail on a motion to dismiss or summary judgment, the court emphasized: ''We reject Universal Health's assertion that materiality is too fact intensive for courts to dismiss False Claims Act cases on a motion to dismiss or at summary judgment. The standard for materiality that we have outlined is a familiar and rigorous one. And False Claims Act plaintiffs must also plead their claims with plausibility and particularity under Federal Rules of Civil Procedure 8 and 9(b) by, for instance, pleading facts to support allegations of materiality.'' *Id*. at 2004 n.6.

II. The Debate Over Materiality Many lower courts have addressed *Escobar*'s analysis of materiality. Several, including two courts of appeals, have adopted the multifactor approach to materiality advocated by the government. But some have dismissed claims or granted summary judgment to defendants in light of *Escobar* based on the plaintiff's failure adequately to allege or prove that the representations at issue sufficiently influenced the government's decision to pay. At least some have recognized *Escobar*'s holding that plaintiffs must allege not only that the alleged false statement was material but also that the defendant *knew* the alleged false statement was material, but that does not seem to have proven dispositive in many cases so far.

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A. The Government's Position The Justice Department and various U.S. Attorneys' offices have filed briefs, notices of supplemental authority and statements of interest laying out the government's take on *Escobar*'s materiality analysis in dozens of cases.

First, the government argues that *Escobar* reaffirmed rather than changing the definition of ''materiality'' codified in the FCA. In the government's view, ''the Supreme Court did not purport to impose a heightened test for materiality beyond the 'natural tendency' test codified in the False Claims Act, entrenched in the common law.'' Br. for the U.S. as Amicus Curiae Supporting Appellant at 14, *United States ex rel. Escobar v. Universal Health Servs.*, No. 14-1423 (1st Cir. Aug. 22, 2016); *see also* Br. for the U.S. as Amicus Curiae Supporting Appellant at 11-12, *United States ex rel. Miller v. Weston Educational d/b/a Heritage College*, No. 14-1760 (8th Cir. Sept. 14, 2016). *Escobar*, according to the government, simply ''reaffirmed that the 'term ''material'' means having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property.' '' Statement of Interest at 2-3, *United States ex rel. Zayas v. AstraZeneca Biopharm., Inc*, No. 14-cv-1718 (FB) (E.D.N.Y. Aug. 8, 2016) (ECF No. 103) (quoting *Escobar*, 136 S. Ct. at 2002); Statement of Interest at 23, *United States ex rel. Herman v. Coloplast Corp.*, No. 11-cv-12131-PWZ (D. Mass. Aug. 19, 2016) (ECF No. 180); Statement of Interest at 6-7, *Stephens Institute*, No. C-09-5966 PJH (N.D. Cal. July 25, 2016) (ECF No. 202). Thus, the government contends, *Escobar* does not require that the government or a relator ''must demonstrate that the government would *in fact* refuse payment'' if it knew of the misrepresentation at issue. U.S. *Escobar* Brief at 12; Supp'l Br. for the U.S. at 11, *U.S. ex rel. Badr v. Triple Canopy*, Nos. 13-2190(L), 13-2191 (4th Cir. Aug. 19, 2016) (ECF No. 78); *see also Coloplast* Statement of Interest at 3.

Second, the Justice Department contends that determining materiality requires considering multiple factors, not merely whether the government paid or would have paid if it had known of the violation at the time a claim for payment was submitted. *See* U.S. *Escobar* Brief at 12-15; U.S. *Miller* Brief at 11-17; U.S. Supp'l *Badr* Brief at 9-14; *AstraZeneca* Statement of Interest at 3. The government has identified at least four factors that it considers bearing on the materiality analysis: (1) ''the label or textual context of the requirement that was violated''; (2) ''whether the violation went to the essence of the government program or contract''; (3) ''how the government treats violations of the requirement''; and (4) ''whether the violation was 'minor or insubstantial.'' *See AstraZeneca* Statement of Interest at 3; *Coloplast* Statement of Interest at 4-9 (setting out and applying the same four factors); *Stephens Institute* Statement of Interest at 7 (describing factors 2-4); U.S. *Escobar* Brief at 17-26 (applying all four factors); U.S. *Miller* Brief at 19-26 (applying all four factors); U.S. Supp'l *Badr* Brief at 9-14 (describing factors 2-4).

Third, the government repeatedly has argued that ''even in the case where the Government has actual knowledge of the defendant's conduct, its inaction may not undermine a materiality finding because other important considerations, such as public health or safety, may dictate that the Government continue to accept and pay for the items or services even with actual knowledge of the violations of a law, regulation, or contract.'' *AstraZeneca* Statement of Interest at 5; *see also* U.S. *Escobar* Brief at 24-26 (''[E]ven where the government has actual knowledge of the defendant's wrongful conduct and continues to pay claims, such action does not necessarily undermine a materiality finding because there are many good reasons, including important public health and safety considerations, why the government might continue to pay claims in such circumstances.''); U.S. *Miller* Brief at 24-27 (same).

B. Defendants' Arguments Defendants, by contrast, have focused on the court's description of the materiality standard as ''demanding'' and ''rigorous'' and on the court's admonitions that minor instances of noncompliance and ones simply giving the government an option not to pay do not suffice to show materiality. They have contended that *Escobar* requires a showing that the government actually would not have paid the submitted claims had it known of the alleged misrepresentations, drawing on the court's many statements noted above supporting that view, including that ''if 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.'' *See, e.g.*, Ltr. Br. at 2, *AstraZeneca*, 1:14-cv-01718-FB (E.D.N.Y. June 24, 2016) (ECF No. 101) (arguing *Escobar* held that to demonstrate materiality, ''it is not enough that the government could refuse payment upon learning of the violation — Relator must allege facts showing that the Government *would* refuse payment''); Not. of Supp'l Authority, *United States ex rel. Brown v. Celgene Corp*, No. 10-cv-03165 (C.D. Cal. Oct. 12, 2016) (ECF No. 364); *Escobar*, 136 S. Ct. at 2003-04.

Defendants have also emphasized the court's suggestion that materiality should frequently be resolvable at the motion to dismiss or summary judgment stage. In addition, defendants have stressed that materiality alone is not sufficient. In *Escobar*, the court held that plaintiffs must show that ''the defendant knowingly violated a requirement *that the defendant knows is material* to the Government's payment decision'' *Escobar*, 136 S. Ct. at 1996 (emphasis added). Knowledge of materiality is therefore also required. The government appears to have accepted this point. *See, e.g.*, U.S. Supp'l *Badr* Brief at 9 (''The United States' complaint sufficiently pleads materiality and that Triple Canopy knew its violations were material.''). But it has rarely featured in decisions so far. *See United States v. Dynamic Visions, Inc.*, No. 11-695 (CKK) (D.D.C. Oct. 24, 2016) (ECF No. 114) (at summary judgment, separately addressing whether defendant knew violations were material and holding that defendant at least acted with reckless disregard as to the materiality of its violations in light of former administrator's acknowledgment in writing that failure to comply could lead to withholding of payment, defendant's employee manual's instruction that employees bill in compliance with relevant regulations, and, in at least one instance, defendant's hurried attempt to comply when it realized it was not doing so).

C. Lower Court Decisions The Supreme Court sent three cases back for reconsideration by courts of appeals in light of *Escobar*. In the two that have seen decisions on remand, both courts embraced the government's reading of *Escobar* and reaffirmed earlier decisions in favor of relators. But the Ninth Circuit, in an even more recent decision, has drawn on the court's emphasis on the rigorousness of the materiality stan-

dard to affirm a grant of summary judgment in favor of a defendant.

In *Escobar* itself, the First Circuit, parroting the government's brief, held that ''[t]he language that the Supreme Court used . . . makes clear that courts are to conduct a holistic approach to determining materiality in connection with a payment decision, with no one factor being necessarily dispositive.'' *United States ex rel. Escobar v. Universal Health Servs.*, 842 F.3d 103, 109 (1st Cir. 2016); *see also* U.S. *Escobar* Brief at 12 (''the Court made clear that materiality is determined through a holistic assessment of the tendency or capacity of the undisclosed violation to affect the government decision maker''). Quoting an earlier post-*Escobar* First Circuit decision, the court held that the ''fundamental inquiry'' is ''whether a piece of information is sufficiently important to influence the behavior of the recipient.'' *Escobar*, 842 F.3d at 110 (quoting *United States ex rel. Winkelman. v. CVS Caremark Corp.*, 827 F.3d 201, 211 (1st Cir. 2016)); *see also United States ex rel. Worthy v. Eastern Maine Healthcare Sys.*, No. 2:14-cv-00184 (D. Me. Jan. 18, 2017) (applying this approach in denying motion to dismiss).

The court then looked to several considerations in finding the alleged misrepresentations about licensing and supervision requirements material. First, in the court's view, they were conditions of payment. Second, as the Supreme Court itself had suggested, the requirements were ''so central to the provision of mental health counseling that the Medicaid program *would not have* paid these claims had it known of these violations.'' *Id*. at 111 (quoting *Escobar*, 136 S. Ct. at 2004) (emphasis added). Eliding the difference between the Supreme Court's two formulations on this point, the First Circuit called them a ''textbook example of representations that would '*likely* . . . induce a reasonable person to manifest his assent.' '' *Id*. (quoting *Escobar*, 136 S. Ct. at 2003) (emphasis added).

Third, the court of appeals discounted Universal Health's argument that the government's having continued to pay the Medicaid claims at issue despite knowledge of the violations showed the alleged violations were immaterial, finding instead that the defendants' allegations were insufficient to suggest that the Massachusetts Medicaid agency had actual knowledge of the alleged violations at the time it paid. Despite allegations concerning repeated investigations of the conduct at issue, the court suggested that allegations of government payment ''up to the time of this litigation'' were insufficient to suggest the government knew of the violations because ''mere awareness of allegations concerning noncompliance with regulations is different from knowledge of actual noncompliance'' when it paid. *Id*. at 112. Moreover, the court noted, the investigations all occurred after the payments at issue and were not conducted by the Medicaid department. *Id*.; *see also United States ex rel. Williams v. City of Brockton*, No. 12-cv-12193-IT (D. Mass. Dec. 23, 2016) (denying motion to dismiss, applying ''holistic'' approach to materiality adopted in *Escobar* on remand). The court therefore concluded that it ''need not decide whether actual knowledge of the violations would in fact be sufficiently strong evidence that the violations were not material to the government's payment decision so as to support a motion to dismiss in this case.'' *Escobar*, 842 F.3d at 112.

In *United States ex rel. Miller v. Weston Educational d/b/a Heritage College*, 840 F.3d 494 (8th Cir. 2016), a case concerning Title IV student aid funds, the Eighth Circuit largely reinstated its earlier opinion reversing a grant of summary judgment for the defendant. The earlier decision is at 784 F.3d 1198 (8th Cir. 2015). Although *Miller* involved alleged fraudulent inducement, the parties and the court agreed that *Escobar*'s materiality discussion should guide the analysis. According to the Eighth Circuit, under *Escobar*, ''[a] false statement or record is 'material' for FCA purposes if either (1) a reasonable person would likely attach importance to it or (2) the defendant knew or should have known that the government would attach importance to it.'' *Weston Educational*, 840 F.3d at 503.

Construing the evidence most favorably to the relators, the court concluded that the defendant's promise ''influenced the government's decision.'' *Id*. at 504. It reached that conclusion based on several considerations. First, in its view, both the participation agreement and the relevant regulation indicated that the government conditioned participation in the program on compliance. Second, ''the significance of the requirement,'' judged by whether ''a reasonable person would attach importance to a promise to do what is necessary to ensure funds go where they are supposed to go,'' supported materiality. *Id*. Third, that the Department of Education ''sometimes terminates otherwise eligible institutions for falsifying student attendance and grade records'' shows the materiality of the recordkeeping requirements at issue. *Id*. at 505.

At least two district courts have also rejected defendants' summary judgment motions resting on post-*Escobar* materiality arguments. Both courts reacted skeptically to claims that the government knew of the alleged misconduct at the time the relevant agency paid the claims, despite considerable evidence put in by the defendants to support show such knowledge.

In *Rose v. Stephens Institute*, the district court denied defendants' summary judgment motion of relator's claims that the defendant fraudulently obtained funds from the Department of Education by falsely alleging compliance with Title IV's incentive compensation ban (ICB). No. 09-cv-05966 (N.D. Cal. Sept. 20, 2016). In support of its argument that the ICB was not material to the department's payment decision, the defendant pointed to the government's failure to take action against it notwithstanding its awareness of the allegations in that litigation. The court was not convinced. Applying the multifactor analysis preferred by the government, the court concluded that the department's decision not to take action against the defendant was ''not terribly relevant to materiality.'' *Id*. at *6. That decision, the court reasoned, ''could well have been based on difficulties of proof or resource constraints, or the fact that the truth of the allegations has yet to be proven.'' *Id*. Furthermore, the court noted that the department, in the past, had taken a variety of corrective actions that, though falling short of revocation of payments, nonetheless suggested that the department ''cared about the ICB'' and sufficed to make materiality a genuine issue. *Id. United States ex rel. Brown v. Celgene Corp.*, concerned alleged promotion of off-label marketing of two drugs that were paid for by Medicare and Medicaid. No. 10-cv-03165 (C.D. Cal. Dec. 28, 2016). Despite ''five lines of evidence'' that Celgene presented to demonstrate the government's awareness of the defendants'

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practice, the court held the evidence was insufficient to ''establish non-materiality as a matter of law.'' *Id*. at *13.

In *United States ex rel. Kelly v. Serco, Inc.*, No. 14-56769 (9th Cir. Jan. 12, 2017), however, the Ninth Circuit affirmed a grant of summary judgment in favor of the defendant, finding that under *Escobar*'s ''rigorous'' test for materiality, the relator had failed to raise a genuine dispute about the materiality of the alleged false statements at issue. The relator claimed the defendant failed to make cost reports under a Defense Department contract using the form and methods required by governing regulations. The district court granted summary judgment on the basis that the regulations were not express conditions of payment. The Ninth Circuit recognized that *Escobar* had done away with that test for materiality, but affirmed nonetheless.

The court of appeals explained: ''In *Escobar*, a unanimous Supreme Court clarified how rigorously the FCA's materiality requirement must be enforced:

''The materiality standard is demanding. The False Claims Act is not 'an all-purpose antifraud statute' or a vehicle for punishing garden-variety breaches of contract or regulatory violations. A misrepresentation cannot be deemed material merely because the Government designates compliance with a particular statutory, regulatory, or contractual requirement as a condition of payment. Nor is it sufficient for a finding of materiality that the Government would have the option to decline to pay if it knew of the defendant's noncompliance. Materiality, in addition, cannot be found where noncompliance is minor or insubstantial.'' *Id*. at *6 (quoting *Escobar*, 136 S. Ct. at 2003).

The Ninth Circuit emphasized that under *Escobar*, ''the possibility that the government would be entitled to refuse payment if it were aware of [the defendant's] alleged violations is insufficient by itself to support a finding of materiality.'' *Id*. The court noted that the government was aware of the defendant's deviation from what the relator asserted was a required method of tracking costs and had nonetheless continued to pay the defendant's invoices. ''Given the demanding standard required for materiality under the FCA, the government's acceptance of [defendant's] reports despite their non-compliance with ANSI-748, and the government's payment of [defendant's] public vouchers for its work under Delivery Orders 49 and 54,'' the court concluded, ''no reasonable jury could return a verdict for Kelly on his implied false certification claim.'' *Id*. at 7.

In *D'Agostino v. ev3, Inc.*, the First Circuit — though emphasizing the lower court's finding that the relator had not met its burden as to the causation element specific to their fraudulent inducement theory of liability — held that the relator's description of the materiality standard as requiring a showing only that the misrepresentations ''could have'' influenced the government's decision ''may well misconstrue the FCA's materiality standard,'' and highlighted that the absence of any denials of reimbursement ''casts serious doubt on the materiality of the fraudulent representations'' that the relator alleged. 845 F.3d 1 (1st Cir. 2016).

A number of other courts have dismissed claims (or rejected implied certification theories) on materiality grounds, noting, for example, the insufficiency of allegations that the representations at issue were conditions of payment. *See United States ex rel. Dresser v. Qualium Corp.*, No. 5:12-cv-01745-BLF (N.D. Cal. July 18, 2016); *United States ex rel. Southeastern Carpenters Reg'l Council v. Fulton Cnty,*, No. 1:14-cv-4071-WSD (N.D. Ga. Aug. 5, 2016); *United States ex rel. Scharf v. Camelot Counseling*, No. 13-cv-3791 (S.D.N.Y. Sept. 28, 2016). Others have looked to the government's continued payment of claims in the face of knowledge of the alleged noncompliance at issue. In *City of Chicago v. Purdue Pharma L.P.*, the district court invoked *Escobar*'s materiality standard in dismissing the city of Chicago's claims under the municipality's False Statement Act and False Claims Act. MCC § § 1-21-010 and 1-22-020. Noting that the city's own complaint alleged that it had continued to pay claims even after learning of the defendant's allegedly unlawful business practices, the court concluded the complaint did not sufficiently allege materiality. No. 14-cv-4361 (N.D. Ill. Sept. 29, 2016). The dismissed complaint, however, was filed before *Escobar*, and the court granted the city an opportunity to amend, taking *Escobar* into account. *Id*. In *United States v. Sanford-Brown, Ltd.*, the Seventh Circuit affirmed dismissal of FCA claims where the relator had ''offered no evidence that the government's decision to pay [the defendant] would likely or actually have been different had it known of [the] alleged noncompliance.'' 840 F.3d 445, 447 (7th Cir. 2016). The court emphasized that the government had already examined the defendant's conduct ''and concluded that neither administrative penalties nor termination was warranted.'' *Id*.