Escobar and the Implied Certification Theory: Initial Cases Raise the Bar on Materiality in False Claims Act Litigation

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On June 16, 2016, the U.S. Supreme Court in *Universal Health Services, Inc. v. United States ex rel. Escobar*[1] (*Escobar*) unanimously upheld the implied certification theory of False Claims Act (FCA) liability and strengthened the FCA's materiality requirement. In the months since the *Escobar* decision, lower courts have begun to assess the scope and impact of the Court's opinion on prior circuit court authorities. Here, we examine several important questions about *Escobar* and how the Department of Justice (DOJ) and private litigants have sought to shape its application on False Claims Act jurisprudence.

Top-Line Summary

- Since *Escobar*, the courts have been more willing to grant motions to dismiss for failing to plead the element of materiality with particularity. Similarly, to survive on summary judgment, plaintiffs must provide evidence that the alleged misrepresentations likely or actually influenced the government's decision-making process, not just that they could have done so.
- *Escobar* changes the focus of the "government knowledge defense" from scienter to materiality. Continued payment of allegedly false claims by the government will afford a defense previously rejected by DOJ and employed by the courts largely in the context of scienter considerations.
- The DOJ has filed statements of interest in numerous *qui tam* cases implicating *Escobar*. Although the government's articulation of materiality was expressly rejected in *Escobar*, in DOJ's view, *Escobar* has changed little.
- The definition of materiality remains vague and will likely spawn a new series of circuit splits as the courts struggle to apply *Escobar*'s reasoning.

Why the Supreme Court Holdings in *Escobar* Matter

Escobar changed the landscape for evaluating the viability of claims made in FCA cases. Specifically addressing facts involving a catastrophic injury to a patient, the Court dispensed with the largely accepted dichotomy of determining "falsity" under the FCA by distinguishing between "conditions of participation" and "conditions of payment" in a government health benefits program. The Court also rejected the sweeping expansion of falsity adopted by the U.S. Court of Appeals for the 1st Circuit that found nearly any alleged regulatory violation would suffice to state a claim under the FCA. Instead, the Court focused on the requirement that the alleged falsity be "material" to the government's decision to pay the claim.

How materiality is to be determined is now the nettlesome issue facing the parties and the courts in FCA cases. Thus far, it seems to have fallen into the category occupied by former Justice Potter Stewart's famous definition of pornography — hard to define, but we know it when we see it.

The *Escobar* Decision

In *Escobar*, the plaintiffs alleged that a health care provider submitted reimbursement claims for counseling and other mental health services but failed to disclose material

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

violations of regulations governing the treating professionals' qualifications and licensing requirements. The district court dismissed the action, holding that the relator had failed to state a claim because the alleged regulatory violations were not an express condition of payment. The 1st Circuit reversed, holding that every submission of a claim implicitly represents compliance with relevant regulations and that any undisclosed violation of a precondition of payment renders a claim false within the meaning of the FCA. In this case, the express language of the regulations established that compliance was a material condition of payment.

The Supreme Court addressed two issues. First, the Court held that implied certification theory can be a basis for liability where at least two conditions are met: (i) the claim for payment makes specific representations about the goods or services provided, and (ii) the party's failure to disclose noncompliance with material statutory, regulatory or contractual requirements makes those representations misleading half-truths. Specifically, the Court noted that the claims at issue represented that specific types of counseling were performed by providers with specific job titles. The Court found that these representations were misleading because the claims did not disclose that the health care provider had not met the basic staffing and licensing requirements for mental health facilities under state regulations.

Second, in expressly rejecting the 1st Circuit's and government's view of materiality, the Court explained that the FCA's materiality standard looks to whether knowledge of the noncompliance would have actually affected the government's payment decision, not just whether it could have done so. The Court found 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."[2] Importantly, the Court rejected the petitioner's assertion that materiality was too fact intensive for courts to address at the motion to dismiss stage.

How Have the Lower Federal Courts Addressed *Escobar*?

The most immediate impact of *Escobar* may be observed in the pleading and motion stages of FCA cases. Several cases exemplify this trend.

Motions to Dismiss

Based on *Escobar*, courts now must be more willing to consider motions to dismiss complaints based on a failure to plead materiality with particularity. Conventionally, materiality was often considered too fact-bound for dismissal motions, but courts post-*Escobar* are willing to address the issue at the pleading stage.[3] The following selection illustrates this effect:

- In *United States ex rel. Lee v. Northern Adult Daily Health Care Center*, relators alleged the defendants violated Medicare regulations by billing for substandard or worthless claims.[4] The court found that under the new *Escobar* standard, the relators failed to sufficiently allege how violation of these regulations were material to the government's decision to pay.[5] Accordingly, "[b]ecause Relators have not alleged that noncompliance with [federal] regulations listed in the Amended Complaint would have influenced the government's decision to reimburse Northern Adult, Relators have not stated a claim under an implied false certification theory of liability."[6]
- Similarly, the court in *Knudsen v. Sprint Communications Company* noted that *Escobar* explicitly rejected a theory "that any statutory, regulatory, or contractual violation is material just because it can result in the government's decision not to pay a claim."[7]
- Courts also have recognized that *Escobar* may have obviated long-standing precedent. For example, in *Rose v. Stephens Institute*, the court found that *Escobar* did not affect U.S. Court of Appeals for the 9th Circuit materiality precedent set forth in *United States ex rel. Hendow v. University of Phoenix*.[8] Nevertheless, the court certified three related questions of law for interlocutory appeal to determine the impact of *Escobar* on long-standing 9th Circuit precedents.[9] In certifying these questions, the *Rose* court noted splits in the courts on (i) whether *Escobar* created a "rigid" two-part test for implied certification liability, and (ii) whether noncompliance with regulations under Title IV of the Higher Education Act of 1965 is material

[2] *Id.* at 2003–04.

[3] *See, e.g.*, *United States ex rel. Voss v. Monaco Enters., Inc.*, No. 2:12-CV-0046-LRS, 2016 WL 3647872, at *6 (E.D. Wash. July 1, 2016); *United States ex rel. Creighton v. Beauty Basics Inc.*, No. 2:13-cv-1989-WEH, 2016 WL 3519365, at *3 (N.D. Ala. June 28, 2016); *United States ex rel. Williams v. City of Brockton*, No. 12-CV-12193-IT, 2016 WL 4179863, at *5-6 (D. Mass. Aug. 5, 2016).

[4] No. 13-CV-4933 (MKB), 2016 WL 4703653, at *12 (E.D.N.Y. Sept. 7, 2016).

[5] *Id.*

[6] *Id.*

[7] No. C13-4475 CRB, 2016 WL 4548924 at *13 (N.D. Cal. Sept. 1, 2016) (dismissing relator's claims with prejudice).

[8] No. 09-CV-05966-PJH, 2016 WL 5076214, at *5 (N.D. Cal. Sept. 20, 2016) (citing *United States ex rel. Hendow v. Univ. of Phoenix*, 461 F.3d 1166 (9th Cir. 2006)).

[9] Order Granting in Part Motion to Certify Order for Interlocutory Appeal at 4-6, *United States ex rel. Rose v. Stephens Institute d/b/a Academy of Art University*, No. 4:09-cv-05966-PJH (N.D. Cal. July 25, 2016), ECF No. 219.

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under *Escobar* (discussed further below).[10] Given the 9th Circuit's previous reliance on implied certification holdings expressly rejected by *Escobar*, that circuit's controlling law is likely to see change.

Summary Judgment

On remand from the Supreme Court, the U.S. Court of Appeals for the 7th Circuit recently held in *United States v. Sanford-Brown Ltd.* that the government's mere ability to decline payment was not enough to survive summary judgment on the materiality element.[11] The court concluded that the relator "offered no evidence that the government's decision to pay [defendant] SBC would likely or actually have been different had it known of SBC's alleged noncompliance with Title IV [of the Higher Education Act of 1965] regulations."[12]

In contrast, in a "fraudulent inducement" case relating to payments of federal financial assistance under Title IV, the U.S. Court of Appeals for the 8th Circuit cited *Escobar*'s demanding materiality standard in reversing summary judgment granted to the defendants.[13] Instead of focusing on government decisions to pay, however, the court found that "[m]ateriality depends on whether [the defendant's] promise to maintain accurate grade and attendance records influenced the government's decision to enter into its relationship with [defendant]."[14]

How Does *Escobar* Affect the Government Knowledge Defense to FCA Liability?

Possibly the most significant impact of *Escobar* on FCA jurisprudence is renewed focus on the government's knowledge, particularly in the context of the materiality element. Although some courts have viewed government knowledge as rebutting the falsity element of an FCA action,[15] more recent pre-*Escobar* court decisions have held that the government's knowledge of the underlying facts related to a supposedly false claim distinguishes "between the submission of a false claim and the *knowing* submission of a false claim — that is, between the presence and absence of scienter."[16] The courts have applied the "government knowledge defense" — or "government knowledge inference," as some courts have called it, sparingly, and at the summary judgement stage, not the motion to dismiss stage.[17] That may change.

Escobar appears to have refocused the consideration of the government's knowledge from the falsity or scienter elements to materiality: "[I]f 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."[18] This language seems to expressly repudiate the notion expressed in recent DOJ statements of interest, discussed further below, that the government's decision to pay is inscrutable and no grounds for defense.[19]

After *Escobar*, courts must consider government knowledge at the early stages of litigation, at least as it may pertain to materiality. As the *Knudsen* court noted, in the post-*Escobar* landscape, "it appears that government knowledge of noncompliance also bears on whether such violations were actually material to the government's decision to pay a claim."[20]

What Has Been the DOJ's Response?

The impact of *Escobar* also can be seen in recent filings by the DOJ arguing that *Escobar* has not significantly changed the FCA landscape. For example, DOJ has emphasized that the test for materiality remains the "natural tendency" test: "This test makes clear that the Court was not endorsing a requirement that an FCA plaintiff show that a claim would not have been paid but for the misrepresentation. An outcome dependent materiality standard that is stricter than the natural tendency standard or the common law objective and subjective standards is not supported by *Escobar*."[21] DOJ filings also have asserted that prior circuit law accepting the implied certification theory of falsity are unchanged and remain good law.[22]

Apparently recognizing that *Escobar* could be read to obviate the "conditions of payment" grounds for pleading falsity and the

[10] *Id.* at 4.

[11] No. 14-2506, 2016 WL 6205746, at *1 (7th Cir. Oct. 24, 2016).

[12] *Id.*

[13] *United States ex rel. Miller v. Weston Educ., Inc.*, No. 14-1760, 2016 WL 6091099, at *5 (8th Cir. Oct. 19, 2016).

[14] *Id.*

[15] *See, e.g., United States ex rel. Durcholz v. FKW Inc.*, 189 F.3d 542, 544–45 (7th Cir. 1999).

[16] *United States ex rel. Burlbaw v. Orenduff*, 548 F.3d 931, 951–52 (10th Cir. 2008) (emphasis in original).

[17] *See United States v. Bollinger Shipyards, Inc.*, 775 F.3d 255, 263–64 (5th Cir. 2014).

[18] *Escobar*, 136 S. Ct. at 2003–04.

[19] *See., e.g.*, DOJ Statement of Interest at 15, *United States ex rel. Brown v. Celgene Corp.*, No. 2:10-cv-03165-GHK-SS (C.D. Cal. Aug. 29, 2016), ECF No. 328 ("Thus, the fact that the government may continue to pay even after discovering wrongdoing does not establish a lack of materiality."); DOJ Statement of Interest at 4, *United States ex rel. Mateski v. Raytheon Co.*, No. 2:06-cv-03614-ODW-KS (C.D. Cal. Aug. 15, 2016), ECF No. 163. ("Moreover, the Government's decision not to pursue a particular violation is not necessarily evidence that the violation is not material, as the Government may have legitimate reasons to overlook even a material violation.")

[20] *Knudsen*, 2016 WL 4548924, at *13.

[21] DOJ Statement of Interest at 15, *United States ex rel. Brown v. Celgene Corp.*

[22] *See, e.g.*, DOJ Statement of Interest at 2-3, *United States ex rel. Mateski v. Raytheon Co.* (stating that the Supreme Court "left intact the Ninth Circuit's prior case law addressing this very question" of implied certification liability). But *see* Order Granting in Part Motion to Certify Order for Interlocutory Appeal, *United States ex rel. Rose v. Stephens Institute d/b/a Academy of Art University.*

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DOJ rejection of the government knowledge defense or inference, DOJ statements of interest filed in pending *qui tam* cases focus on those issues:

- In the U.S. District Court for the Northern District of California, DOJ argued that "[t]he Supreme Court in *Escobar*, therefore, makes clear that the materiality of a misrepresentation depends not just on the specific label attached to the violation but rather on the *capacity* of the violation to affect the government decision maker. Thus, materiality is a flexible standard that can be met in a variety of circumstances."[23] However, as DOJ notes in a U.S. District Court for the Western District of North Carolina case, "while designation as a condition of payment is not dispositive by itself, the Court continued to recognize that such a designation remains relevant to the materiality inquiry."[24]
- Before the U.S. Court of Appeals for the 4th Circuit, DOJ argued that "[b]y embracing the 'natural tendency' test codified in the False Claims Act and enshrined in the common law, *Escobar* makes clear that materiality is determined through a holistic assessment of the tendency or capacity of the undisclosed violation to affect the government decision maker. The Court did not impose a new requirement — contrary to both the FCA and the common law — that the United States (or a relator) must demonstrate that the government *would actually* refuse payment. ... This test makes clear that the Supreme Court was not establishing a new requirement that the United States show that a claim *would not* have been paid or even that it *would likely* not have been paid."[25]
- Appearing before the U.S. District Court for the Central District of California, DOJ argued that "the fact that the government may continue to pay even after discovering wrongdoing does not establish a lack of materiality. The government may wish to avoid further cost or simply wish to afford an accused party the opportunity to be heard in court."[26]

The viability of DOJ's arguments, given *Escobar*'s analysis of materiality in the light of the government's knowledge of any supposedly false claims, remains to be seen.

Where Will Things Go From Here?

- As some district court decisions already have shown, *Escobar*'s affirmance of the implied certification theory of liability comes with a price — a new hurdle for FCA plaintiffs and the government on the question of materiality, possibly at the motion to dismiss stage.
- The definition of materiality, however, remains unduly vague and will likely spawn a new series of circuit splits as the courts struggle to apply *Escobar*'s reasoning.
- Continued payment of claims by the government will afford a materiality defense long resisted by DOJ and previously employed by the courts largely in the context of scienter considerations.

[23] DOJ Statement of Interest at 7-8, *United States ex rel. Rose v. Stephens Institute d/b/a Academy of Art University*, No. 4:09-cv-05966-PJH (N.D. Cal. July 25, 2016), ECF No. 202 (emphasis in original).

[24] DOJ Statement of Interest at 6, *United States ex rel. Parker v. Community Care Partners Inc. d/b/a CarePartners Health Services*, No. 1:14-cv-00006-MOC (W.D.N.C. Aug. 31, 2016), ECF 34; *see also* DOJ Statement of Interest at 4, *United States ex rel. Mateski v. Raytheon Co.*

[25] Supplemental Brief for the *United States at 11, United States ex rel. Badr v. Triple Canopy, Inc.*, No. 13-2190(L) (4th Cir. Aug. 19, 2016), ECF No. 78 (emphasis in original).

[26] DOJ Statement of Interest at 15, *United States ex rel. Brown v. Celgene Corp.*

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