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CIVIL FALSE CLAIMS ACT: Supreme Court Rejects DOJ's Expansive Theory for FCA Falsity and Requires Rigorous Materiality, Scienter Standards in All False Certification Cases

The Supreme Court yesterday issued a watershed False Claims Act ("FCA") decision, *Universal Health Services, Inc. v. United States ex rel. Escobar*, No. 15-7, 2016 WL 3317565 (U.S. June 16, 2016). In a unanimous decision authored by Justice Thomas, the Court wasted little time on its ruling that the implied false certification theory of liability may be applied to FCA cases, a result that was neither surprising nor groundbreaking. The most important aspect of the Court's opinion is its focus on devising critical limits on the scope of this theory in all false certification cases (express or implied) and its unequivocal rejection of the DOJ's and relators' arguments that the "falsity" element of the FCA is easily proven.

- First, the Court made clear that the FCA imposes a "rigorous" materiality standard that derives from the common law understanding that fraud cannot exist "without proof of materiality." *Id.* at *11. Materiality requires a misrepresentation that "went to the very essence of the bargain," not a "minor" or "insubstantial" violation. *Id.* at *11 n.5, 12.
- Second, the Court emphasized that materiality requires much more than mere designation by the government that compliance is a "condition of payment," or *post hoc* assertions that the government would not have paid had it known of the misrepresentation. The Court completely rejected the government and relator arguments that merely labeling a statute or regulation as a "condition of payment" made it so. *Id.* at *4, *9.
- Third, the Court recognized what the DOJ and relators have always denied: that the government's payment of a claim can be compelling evidence that violations of statutory or regulatory requirements were not "material." *Id.* at *12.
- Fourth, proof that the defendant knew that the violation was material to the government's payment decision—at the time of claim submission—is required. *Id.* at *4, *10.
- Finally, the Court made clear that the materiality question can be addressed at the outset of litigation, through a motion to dismiss, or on summary judgment. The Court emphasized this point in particular, noting that "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 *12 n.6.

The Court justified imposing “rigorous” materiality and scienter standards as a check on the false certification theory by pointing to its prior rulings that the FCA is “essentially punitive,” and that it “is not ‘an all-purpose antifraud statute.’” *Id.* at *5, *12 (quoting *Vermont Agency of Natural Resources v. United States ex rel. Stevens*, 529 U.S. 765, 784 (2000); *Allison Engine Co. v. United States ex rel. Sanders*, 553 U.S. 662, 672 (2008)).

Background of the *Escobar* Case

The relators in *Escobar* are parents of a teenage girl who suffered a fatal reaction to medication after receiving treatment at the Arbor Counseling Services, a mental health facility owned by Universal Health Services in Lawrence, Massachusetts. Prior to bringing their *qui tam* suit, the relators initiated a state administrative action against the facility and its caregivers, which resulted in one individual’s agreement to pay a \$1,000 fine and the clinical director’s agreement to a two-year supervised probationary period. In their *qui tam* suit, the relators alleged that the facility submitted false claims for payment to Medicaid. There was no claim that the Medicaid claims were factually false, that the claims described services other than those provided, or that the facility billed incorrectly for the services. Neither Massachusetts nor the federal government intervened in the relators’ suit.

The district court dismissed the *qui tam* suit for failing to allege that a condition of payment was violated. The First Circuit reversed, concluding that the claims were “legally false” under the implied false certification theory because of the defendants’ misrepresentation of compliance with regulatory staffing and supervision requirements that the court deemed to be conditions of payment. Both the federal government and Massachusetts supported the relators in amicus briefs to the Supreme Court.

Overview of the Implied False Certification Theory

The Supreme Court agreed to review both the validity and scope of the implied false certification theory—issues that have divided the circuit courts for more than twenty years. See John T. Boese, *Civil False Claims and Qui Tam Actions*, §§ 2.03[G], 2.04 (Wolters Kluwer Law & Business) (4th ed. & Supp. 2016-2). See also FraudMail Alert [No. 15-12-09](#); FraudMail Alert [No. 15-06-15](#); FraudMail Alert [No. 13-04-04](#); FraudMail Alert [No. 11-08-31](#); FraudMail Alert [No. 10-11-03](#). Under this theory, relators and the government have argued that FCA liability, with its extraordinary consequences of treble damages and per claim penalties, attaches to the slightest statutory, regulatory, or contractual noncompliance, without the need for any false statement in the claim for payment, or even any awareness of a regulatory violation by the claimant. One need only look at recent court of appeals decisions to demonstrate how abusive such a theory can be. See, e.g., *United States ex rel. Bishop v. Wells Fargo & Co.*, No. 15-2449, 2016 WL 2587426 (2d Cir. May 5, 2016); *United States ex rel. Thomas v. Black & Veatch Special Projects Corp.*, No. 15-3155, 2016 WL 1612857 (10th Cir. Apr. 22, 2016); *United States ex rel. Wall v. Circle C Constr., LLC*, 813 F.3d 616 (6th Cir. 2016). See also FraudMail Alert [No. 16-02-10](#). (The reader should note that the authors of this Alert advised the defendant in the *Thomas* case and represent the defendant in the *Bishop* case on other matters).

The Petitioner (a defendant below) argued against the theory’s validity by looking to the common law meaning of the key statutory terms “false” and “fraudulent,” which are not defined in the FCA, and contending that, under common law “fraud” and the FCA, absent active concealment, there is no duty to disclose noncompliance with regulatory requirements that are not referenced in the claim for payment.

Thus, Petitioner argued that, absent a legal obligation to disclose them, the regulatory staffing and supervision violations are not a basis for FCA liability. Alternatively, Petitioner contended that a defendant should face FCA liability only if it fails to disclose a violation of a statutory, regulatory, or contract provision that the government expressly designated a condition of payment. The Court rejected both of these positions.

The Supreme Court's Materiality and Scierter Standards

As already noted, the Court validated the implied false certification theory, holding that a claim may be fraudulent by omission under the common law fraud rule that half-truths can be actionable as misrepresentations. The Court also rejected Petitioner's second argument—that liability should turn on whether the requirements allegedly violated expressly were designated as conditions of payment. *Escobar*, 2016 WL 3317565, at *4, *9. While that type of evidence may be relevant, the Court specified that it is not dispositive. The Court reasoned that an express designation requirement would create arbitrariness, and ruled that neither the government nor defendants could rely solely on such designations or lack thereof. In rejecting the express designation rule, the Court rejected the Second Circuit's test in *Mikes v. Straus*, 274 F.3d 687 (2d Cir. 2001) in favor of the D.C. Circuit's formulation of the implied false certification theory in *United States v. Science Applications Int'l Corp.*, 626 F.3d 1257 (D.C. Cir. 2010) ("SAIC"). However, the Court added significant rigor and specifics to the materiality and scierter standards that went beyond the more limited definitions of those standards in SAIC. Indeed, the Court addressed FCA defendants' concerns about fair notice and open-ended liability by requiring strict—the government and relators will probably contend "overly strict"—enforcement of the FCA's materiality and scierter requirements. *Escobar* at *10 (citing SAIC).

While the Court's materiality standard is not new, *id.* at *8, the Court's inclusion of two examples of omissions that went to the heart of the transaction firmly establishes that the regulatory violation must substantially undermine the claim for payment for the specific goods or services provided. These examples reflect the high level of materiality required—i.e., the case of a seller of property who mentions two new roads may be near the property, but fails to disclose that a third road might bisect the property, and the case of an applicant for a teaching position at a college who uses a resume disclosing a "retirement" from a previous job, without revealing that the "retirement" was occasioned by a prison sentence for bank fraud. Based on these examples, and on the use of payment codes and provider identification numbers corresponding to specific job titles without disclosing the "many violations of basic staff and licensing requirements" by the mental health facility in *Escobar*, the Court arrived at the following threshold for FCA liability under the implied certification theory:

at least . . . two conditions [must be] satisfied: first, the claim does not merely request payment, but also makes specific representations about the goods or services provided; and second, the defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths.

Id. at *9. In other words, proof of a defendant's nondisclosure of noncompliance with specific, material representations is a necessary element of an FCA violation under the implied certification theory.

Moreover, the Court described the enforcement of the FCA's materiality and scierter requirements as "rigorous." *Id.* at *10. In clarifying how materiality should be enforced, the Court added teeth to that requirement by pointing to the common law fraud requirement of "proof" of materiality. *Id.* at *11. The

Court also emphasized that the material misrepresentation must go “to the very essence of the bargain,” *id.* at *11 n.5, and that materiality is not found where noncompliance is “minor or insubstantial,” *id.* at *12. Evidence that the defendant knows that the government “consistently” refuses to pay in cases of noncompliance can be proof of materiality. *Id.* Thus, where no record or pattern of payment has been established with respect to a particular requirement, or where the government’s payment has been inconsistent, it would be extremely difficult to prove materiality. Not surprisingly, misrepresenting compliance with a non-collusive bidding requirement for federal program contracts, such as in *Marcus v. Hess*, 317 U.S. 537 (1943), is clearly material. *Escobar* at *12. It is also noteworthy that the Court emphasized that the facts of materiality must be properly pled under Rules 8 and 9(b). *Id.* at 12 n.6.

Finally, and perhaps most importantly, the Court included a final example drawn from the oral argument in *Escobar*—the hypothetical in which the contractor provided health services but used non-American-made staplers in violation of an additional requirement that staplers must be purchased in the U.S. At oral argument, the Justices expressed overt skepticism at the Deputy Solicitor General’s insistence that violation of such an ancillary regulation could be “material” and result in a false claim. That skepticism proved prophetic, with the Court’s opinion yesterday firmly rejecting liability under that very scenario. *Id.* at *12. The mere possibility that a violation “could” lead the government not to pay a claim can no longer be argued as a basis for proving materiality.

Thus, while the Court declined to fashion a bright line rule for separating material from nonmaterial violations in false certification cases, the Court’s decision means that the government and relators will have a much tougher time proving that a violation is “material.” The Court’s characterization of the materiality and scienter standards as “rigorous” and “demanding,” its setting of parameters for these standards by way of clear examples, and its emphasis on the common law’s proof requirements give FCA defendants, the government, relators, and the courts more guidance than they had before. Most importantly, the application of rigorous standards and additional fact-dependent proof requirements should prevent the most egregious overreaching under the implied certification theory.

Conclusion

Application of the *Escobar* standards in the lower courts will not be easy, almost assuring the future need for the Supreme Court to revisit and clarify the tests it sets forth in *Escobar*. Because FCA liability can implicate millions of dollars (and referrals for exclusion or debarment), and—in false certification cases—is based on what the contractor did not say, clear boundaries would be very useful. While contractors may have hoped that the Court would provide clearer direction, enabling them to determine the difference between a breach of contract and an FCA violation, the Court’s emphasis on the limited nature of the FCA and its reaffirmation that the FCA is “essentially punitive in nature,” “not ‘an all-purpose antifraud statute,’” and not “a vehicle for punishing garden-variety breaches of contract or regulatory violations,” provides some comfort. *Id.* at *5, *12. Moreover, while the Court’s decision today validates the theory of implied false certification in certain cases, the Court rejected the government’s and the First Circuit’s expansive view of materiality:

that any statutory, regulatory, or contractual violation is material so long as the defendant knows that the Government would be entitled to refuse payment were it aware of the violation The False Claims Act does not adopt such an extraordinarily expansive view of liability.

Id. at *12. The *Escobar* decision requires courts to rigorously enforce this theory using demanding materiality and scienter standards, and requiring a close, factual inquiry into each element. Thus, false certification cases will continue to be resolved case-by-case, but under more demanding materiality and scienter standards.

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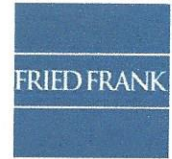
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