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FEATURE COMMENT: Lessons Learned On The Second Anniversary Of *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*

On June 16, 2016, the U.S. Supreme Court issued one of the most important False Claims Act (FCA) decisions in recent history, *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*, 136 S. Ct. 1989 (2016); see Rhoad, McLaughlin, Crawford and Hill, Feature Comment, "Frankenstein's Monster Is (Still) Alive: Supreme Court Recognizes Validity Of Implied Certification Theory," 58 GC ¶ 219. The decision changed FCA investigations and litigation in two significant ways.

First, *Escobar* confirmed the existence of the implied certification theory as a basis of liability. Under the implied certification theory, liability may be found when a person (entity or individual) submits a claim for payment to the Federal Government without meeting all of the statutory, regulatory or contractual compliance standards associated with that claim. Under the implied certification theory, a person seeking the payment of Government funds impliedly certifies compliance with all attendant laws, regulations and rules. The implied certification theory expands the scope of potential FCA liability exposure exponentially relative to what would otherwise be explicit certifications in connection with claims for payment with Government funds.

Second, *Escobar* requires that alleged implied certification violations be tested under a "rigorous" materiality standard that the Court set forth in its decision. Under *Escobar*, a violation of a statutory, regulatory or contractual obligation must be material to the Government's decision to pay.

Over the last two years, the materiality inquiry has become a bulwark against transforming run-of-the-mill breach of contract claims into FCA actions.

When *Escobar* was decided, it was unclear what was meant for an alleged violation to be material. Compare 31 USCA § 3729(a)(1)(A) (no materiality requirement to establish liability for one who "knowingly presents, or causes to be presented, a false or fraudulent claim"), with 31 USCA § 3729(a)(1)(B) (liability for one who "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim"). In 2009, Congress passed the Fraud Enforcement and Recovery Act (FERA), which defined materiality for purposes of false statement liability as "having a natural tendency to influence, or be[ing] capable of influencing, the payment or receipt of money or property." 31 USCA § 3729(b)(4) (defining "material" as "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property"). But the language in *Escobar* suggests that it imposed a materiality standard for implied certification cases that is far more rigorous and demanding than the FERA standard.

As the second anniversary of the *Escobar* decision approaches, lower courts have confirmed that *Escobar* did in fact impose a materiality standard far more rigorous and demanding than the standard set forth in FERA. A violation is material under *Escobar* when the Government decision-maker responsible for paying claims would have refused to pay a claim had it known of the claimant's alleged statutory, regulatory and/or contractual violation. This view is confirmed by the *Escobar* decision itself, which defined the concept of materiality using what are generally considered to be five principles:

1. Government Knowledge/Government Treatment of Violations (A Subjective Test). This principle is perhaps the most important: whether the Government knew of a claim's falsity, but nevertheless paid the claim, which would tend to negate a finding of materiality. *Escobar*, 136 S. Ct. at 2003. Con-

versely, "evidence that the defendant knows that the government consistently refuses to pay claims in the mine run of cases based on noncompliance" supports a finding of materiality. Id.

2. Option Not Relevant. This is the converse of the Government knowledge principle—it does not matter what the Government could have done, it matters only what the Government would have done. "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." Id. at 2003.
3. Importance (An Objective Test). A violation is material when the violation is important to the Government decision-maker. To quote from the decision, importance asks whether a "reasonable man [acting on the Government's behalf] would attach importance to [the representation] in determining his choice of action in the transaction." Id. It follows that a reasonable person would not attach importance to a violation that is "minor or insubstantial." Id.
4. Labels Used. Before *Escobar*, some jurisdictions recognized implied certification cases only when the statute, regulation or contract at issue identified compliance as an express condition of payment. Importantly, *Escobar* rejected the so-called "condition of payment" requirement. In doing so, however, the Court noted that such labels may be helpful in determining materiality. Thus, this principle asks whether the Government has "expressly identif[ied] a provision as a condition of payment," although such identification is "relevant but not automatically dispositive." Id. at 2002.
5. Essence of the Bargain. In certain cases, an alleged violation is so severe that it goes to the very heart of what the Government was purchasing. Thus, this principle, which derives from the common law, examines materiality by asking whether the regulatory, statutory or contractual violation goes to the "essence of the bargain." Id. at 2003 n.5.

In the last two years, a series of decisions applied these principles to cases involving Government contractors. These decisions have made FCA litigation more predictable. These decisions will also continue to provide defendants with increased incentives to litigate, rather than settle, FCA cases.

Government Knowledge of Violations Weighs Heavily Against Materiality—Perhaps the most interesting cases that have arisen in the wake of *Escobar* have been those dealing with Government knowledge. The idea behind Government knowledge is that a violation of a statutory, regulatory or contractual requirement does not matter (i.e., is not material) if the Government agent responsible for paying claims knows of the violations and nonetheless pays the claim.

In *U.S. ex rel. Harman v. Trinity Indus., Inc.*, 872 F.3d 645 (5th Cir. 2017), the court reversed a $663 million jury verdict after finding no materiality in the alleged false certifications at issue. On the issue of Government knowledge, the court held that what was important was not what was disclosed to the Government, but instead what the Government actually knew. The court noted that the Government was made aware of the relator's allegations and continued to pay claims because the Government was not persuaded by the allegations. Id. at 667.

Similarly, in *U.S. ex rel. McBride v. Halliburton Co.*, 848 F.3d 1027 (D.C. Cir. 2017); 59 GC ¶ 56, the court found no materiality after a Defense Contract Audit Agency investigation found no wrongdoing by the contractor. "In fact," the court noted, "KBR continued to receive an award fee for exceptional performance under Task Order 59 even after the Government learned of the allegations. This is 'very strong evidence' that the requirements allegedly violated by the maintenance of inflated headcounts are not material." Id. at 1034 (quoting *Escobar*, 136 S. Ct. 1989, 2003 (2016)).

In sum, when the Government agency responsible for paying claims has actual knowledge of the alleged violations and pays claims anyway, it is nearly impossible for a court to find such violations material. For this reason, the Government knowledge inquiry is often the most critical question when examining materiality.

It Is Not Enough That The Government *Could* Refuse Payment—The Question Is Whether The Government *Would* Refuse Payment—Another feature of *Escobar* is its explanation that it is not enough that the Government could refuse payment. Rather, what matters is whether the Government would have refused payment had it known of the alleged violations.

For instance, in *U.S. ex rel. Kelly v. Serco, Inc.*, 846 F.3d 325 (9th Cir. 2017), the court held that "[e]vidence

that the government 'would be entitled to refuse payment were it aware of the violation' is insufficient by itself to support a finding that the violation is material to the government's payment decision."

Similarly, in *U.S. ex rel. McBride v. Halliburton Co.*, 848 F.3d 1027 (D.C. Cir. 2017), the court explained "McBride persists, claiming as 'dispositive' an Administrative Contracting Officer's (ACO) statement in a declaration that he 'might' have investigated further had he known false headcounts were being maintained, and that such an investigation 'might' have resulted in some charged costs being disallowed. The ACO's speculative statement could be true of the maintenance of any kind of false data; it tells us nothing special about headcounts."

Lastly, in *U.S. v. DynCorp Int'l, LLC*, 253 F. Supp. 3d 89 (D. D.C. 2017), "[t]he fact that 'the Government would have the option to decline to pay' is relevant but not sufficient to find materiality. Therefore, the [Federal Acquisition Regulation's] provision for contracting officers to refuse to pay unreasonable costs is one indication that unreasonableness may be material to some claims, but it does not automatically render unreasonableness material in every instance."

This line of reasoning is particularly important in cases where deposition testimony of Government officials or other record evidence shows that the Government would not have acted differently regardless of whether the defendant actually violated a statutory, regulatory or contractual requirement. Following *Escobar*, such evidence has taken on a new level of importance and will continue to do so in future litigation.

Whether a Reasonable Person Would Consider the Violated Requirement "Important" Goes to Materiality—In a case where the Government does not know of an alleged violation, how can materiality be determined? *Escobar* answered in objective terms, explaining that materiality can be determined by asking whether a "reasonable man [acting on the Government's behalf] would attach importance to [the representation] in determining his choice of action in the transaction." *Escobar*, 136 S. Ct. at 2003.

Under the reasonable person standard for evaluating whether a violation is minor or insubstantial, a defendant cannot, as a defense, claim "the agency did not know of the violation and therefore the violation did not matter." It does not matter that the agency did not actually know of the alleged violation. It matters only whether knowledge of a violation would have affected the agency's payment decision if it had known. So, for example, in *U.S. v. Savannah River Nuclear Solutions, LLC*, 2016 WL 7104823 (D. S.C. Dec. 6, 2016), "[t]he fact that the common law's test of materiality in the tort context would not require the plaintiff to be aware of the representation supports the court's conclusion that the [Department of Energy's] not being aware of [Flour Federal Services Inc.'s]certifications is not dispositive of materiality." Id. at *23. The court also observed that "common sense suggests that the alleged unallowability of the challenged costs would influence the DOE's decision to pay them, and Defendants' alleged conduct in covering up the costs suggests that they would be material to the DOE." Id. at *24.

This element of *Escobar*'s decision is important because there will always be cases in which the Government does not know whether a violation occurred. In those cases, this objective test of whether a "reasonable man [acting on the Government's behalf] would attach importance to" the representation becomes critical in determining whether the alleged violation was material. *Escobar*, 136 S. Ct. at 2003.

Labels Matter: Pre-*Escobar* Dichotomy of "Conditions of Payment" Versus "Conditions of Participation" Remain Relevant, But Not Dispositive, Following *Escobar*—Before *Escobar*, some courts held that implied certification cases could survive a motion to dismiss only if the statute, regulation or contractual provision that was allegedly violated was a "condition of payment," as opposed to a "condition of participation" in a Government program. Because liability under the FCA attaches only to the submission of claims for payment, the theory went that only violations of provisions integral to the payment of those claims could result in liability under an implied certification theory.

Escobar eliminated this distinction, noting that the labels used are no longer dispositive of liability, but are still relevant. *U.S. ex rel. Brown v. Celgene Corp.*, 226 F. Supp. 3d 1032 (C.D. Cal. 2016), provides a good example of how this can play out in practice. There, the labels used were Medicare regulations that stated Medicare Part D may reimburse only "covered part D drugs," which must be "used for a medically accepted indication." Id. at 1049 (citing 42 CFR § 423.100). The court explained that although this language, which rendered a medically accepted indication "an explicit condition of payment under the program," was not "automatically dispositive," it was nevertheless "highly 'relevant.'" Id. (citing *Escobar*, 136 S. Ct. at 1996).

These holdings are significant because they demonstrate that what matters in the post-*Escobar* world is only whether the violation was material to the Government's decision to pay, not the labels used by a statute, regulation or contract. That a statute, regulation or contractual provision renders compliance a "condition of payment" is certainly relevant to whether the Government would pay a particular claim, but it may not be dispositive in light of evidence showing that the Government agency pays claims despite the "condition of payment" label and despite its knowledge that a violation likely occurred. This represents a significant movement away from per se rules about what labels are used to a common sense view that the only things that matter for purposes of the FCA are those things that actually mattered to the Government payor responsible for approving claims.

Violations of Regulations That Speak to the Essence of the Bargain Between the Government and Contractors Are Likely to Be Material—*Escobar* held that regulations that go to the "essence of the bargain" between a contractor and the Government are likely to be material to the Government's decision to pay. A good example of how this plays out took place in *U.S. ex rel. Badr v. Triple Canopy*, 857 F.3d 174 (4th Cir. 2017); see Rhoad, Turetzky and Bauman, Feature Comment, "Right On The Bullseye? Fourth Circuit Takes Its Shot At Applying *Escobar*'s Materiality Standard After SCOTUS Sends Iraqi Security Guard Case Back For Further Consideration," 59 GC ¶ 165. This was the case involving a contract for security services in Iraq in which the contracted security guards could not meet the contract's marksmanship requirement. The Fourth Circuit in that case noted that "nothing in [*Escobar*] undermines our earlier conclusion that Triple Canopy's falsity was material. In fact, far from undermining our conclusion, [*Escobar*] compels it." Id. at 178. The court cited to a hypothetical provided in the *Escobar* decision, which states as follows:

> If the Government failed to specify that guns it orders must actually shoot, but the defendant knows that the Government routinely rescinds contracts if the guns do not shoot, the defendant has "actual knowledge." Likewise, because a reasonable person would realize the imperative of a functioning firearm, a defendant's failure to appreciate the materiality of that condition would amount to "deliberate ignorance" or "reckless disregard" of the "truth or falsity of the information" even if the Government did not spell this out.

Id. at 179 (citing *Escobar*, 136 S. Ct. at 2001–02). "Guns that do not shoot," the Fourth Circuit explained, "are as material to the Government's decision to pay as guards that cannot shoot straight." Id.

Thus, requirements that go to the essence of the bargain between the parties—e.g., the ability of hired security personnel to shoot straight when hired to protect a military base in a warzone—are likely to be found material.

The Takeaway: Materiality is an Increasingly Difficult Hurdle for Relators to Overcome in Implied Certification Cases—Although *Escobar* raises the bar for *pleading* materiality, it is a bar that the Government and relators will be able to clear in many cases. To succeed at *summary judgment* and *trial*, however, the evidentiary hurdle is much, much higher. Consider the following:

- First, claims at issue will have been paid long before litigation is commenced, often years before. Thus, the material facts are set and the Government or a relator will have little meaningful ability to shape (or re-shape) them.
- Second, the nature of agency regulation, practice and decision-making is characteristically (although not invariably) more flexible than civil or criminal enforcement, and agency decision-makers often have greater discretion over how to address non-compliance. In fact, agency officials are generally expected and required to consider programmatic needs when deciding the appropriate response to non-conforming goods, services or regulatory paperwork. Proving that the administering agency has elected not to deny payment in favor of a more measured remedy may be a decisive defense.
- Third, among agency contractors, some agencies are notorious for giving vague, little or no guidance concerning what they expect from contractors in terms of regulatory compliance or how the agency will respond to non-compliance. Indeed, it is the dearth of agency guidance that has spawned an entire industry of compliance consultants. This reality of agency practice will likely make it difficult for the Government to show a contractor knew or should have known a particular non-compliance would be material to the agency's decision to pay.

- Fourth, defendants' employees will often be well-versed in the range of responses the regulatory agency makes to instances of non-compliance. If an agency routinely pays a particular deficient claim, a Government contractor would reasonably expect that deficiency was immaterial to the Government's decision to pay claims.

By validating the implied certification theory, *Escobar* has certainly opened the door to more FCA litigation. But its imposition of a rigorous materiality standard gives the Government contracting industry a solid platform from which to defend cases that are nothing more than mere regulatory violations. In this vein, *Escobar* rebalances FCA jurisprudence to prevent well-intentioned companies from being subjected to the FCA's Draconian penalties based on technical regulatory non-compliance or post hoc rationalizing.

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