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FEATURE COMMENT: Materiality Rules! *Escobar* Changes The Game

June 16th will mark the one-year anniversary of the U.S. Supreme Court's False Claims Act decision in *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*, 136 S. Ct. 1989 (2016). In the eleven months following the Court's landmark ruling on the implied-certification theory of liability, *Escobar* has been cited in nearly 100 court opinions. This Feature Comment will highlight some of the key cases and explore the developing trends.

The *Escobar* Decision—The implied-certification theory of FCA liability posits that when a contractor submits a claim for payment, the contractor impliedly certifies that it has complied with all underlying statutes, regulations and contract terms. Under this theory, the failure to disclose a violation of or noncompliance with any of those legal requirements makes the claim for payment false and could result in an FCA violation if the elements of materiality and scienter are met.

Because contractors have to comply with countless regulations and could conceivably face treble damages for noncompliance with trivial requirements, courts had been divided over the proper scope of the implied-certification theory. Some circuits held that the implied-certification theory could apply only if the underlying statute or regulation expressly states that the provider must comply in order to be paid; other circuits applied a less rigid test focused on materiality, while at least one other circuit questioned whether implied certification was even a valid theory of liability.

In light of this circuit split, the Supreme Court weighed in last June with *Escobar*. In its opinion, the Court recognized the viability of the implied-certification theory but rejected the prior circuit tests and narrowed its application to "material" misrepresentations, stating that the FCA's materiality requirement is both "rigorous" and "demanding" because the FCA is not "a vehicle for punishing garden-variety breaches of contract or regulatory violations." Id. at 2003; see generally Rhoad, McLaughlin, Crawford and Hill, Feature Comment, "Frankenstein's Monster Is (Still) Alive: Supreme Court Recognizes Validity Of Implied Certification Theory," 58 GC ¶ 219.

Notably, the Supreme Court declined to adopt the "express condition of payment" test that had been adopted by the Second, Third, Sixth, and Tenth Circuits. The Court reasoned that a provision's designation as a condition of payment could be relevant, but not dispositive, evidence of materiality. The Court also reasoned that a violation is not material under the FCA simply because the Government had the option to withhold reimbursement if the violation were known. Instead, the Court's standard focused on how violations would affect payment in the real world and laid out several specific factors that could contribute to a finding of materiality. Id. at 2002. Those factors include whether the Government regularly refuses to pay contractors who are out of compliance with a particular requirement, or whether a contractor subjectively knows that its violations would jeopardize reimbursement. On the other hand, if the Government pays a particular claim or regularly pays a particular type of claim despite actual knowledge of noncompliance, that is strong evidence that the requirements were not material. Because the *Escobar* materiality analysis is fact-specific, it is not surprising that many of the early battles in the lower courts have been fought over whether compliance with a particular requirement was material.

A Flexible but Heightened Standard—In *Escobar*, the Court shied away from a bright-line rule for determining materiality, noting that "ma-

teriality cannot rest on a single fact or occurrence as always determinative." Id. at 2001. In opting for a more holistic approach to materiality, the Court granted broad discretion to the lower courts. When deciding the *Escobar* case, the Supreme Court vacated and remanded three other cases for further consideration in light of the Court's holding. The flexible nature of the materiality standard is underscored by the fact that the three remanded cases that have applied the *Escobar* holding have all arrived at the same decisions on materiality that they had made prior to the Supreme Court's ruling. See *Universal Health Servs., Inc. v. U.S. ex rel. Escobar*, 842 F.3d 103 (1st Cir. 2016); *Weston Educ., Inc. v. U.S. ex rel. Miller,* 840 F.3d 494 (8th Cir. 2016); 58 GC ¶ 389; and *U.S. ex rel. Nelson v. Sanford-Brown, Ltd.*, 840 F.3d 445 (7th Cir. 2016); 58 GC ¶ 388; see also McLaughlin, Crawford, Brown, Kanu, Hill and Healy, Feature Comment, "The Top FCA Developments Of 2016 For Government Contractors," 59 GC ¶ 1.

One thing the circuit courts seem to agree on, however, is that the Supreme Court's decision in *Escobar* has heightened the materiality test for FCA liability beyond the "natural tendency to influence" test codified in the statute at 31 USCA § 3729(b)(4). As the high Court ruled, "[t]he materiality standard is demanding." 136 S. Ct. at 1994. The courts of appeals in response to this and other reasoning in *Escobar* have been willing to go far beyond just looking at a "natural tendency" analysis in making determinations on materiality. In fact, the Third Circuit in *U.S. ex rel. Petratos et al. v. Genentech Inc*., stated, "we now join the many other federal courts that have recognized the heightened materiality standard after *Universal Health Services*." 2017 WL 1541919 at *7 (3d Cir. May 1, 2017). As seen below in the multiple appellate opinions issued in the wake of *Escobar*, this is welcome news for contractors.

DOJ Stakes Out Its Position—In addition to the briefs filings in intervened cases, the Department of Justice has routinely filed statements of interest in non-intervened cases to articulate its view of the *Escobar* standard. In many of the statements of interest, DOJ has taken the position that *Escobar* did not impose a heightened materiality standard. Yet on this point, as observed above, DOJ has gained little traction. See *Genentech Inc*., 2017 WL 1541919 at *7. Even so, in its filings, DOJ has regularly asked courts to focus the materiality analysis on four factors:

- whether the requirement at issue is called out as a condition of payment;
- whether the violation went to the essence of the Government program or contract;
- how the Government treats violations of the requirement;
- whether the violation was minor or insubstantial.

DOJ has had some early success in getting district courts to apply this multifactor analysis. Most notably, in *Rose v. Stephens Institute*, the relator alleged that the defendant fraudulently obtained funds from the Department of Education by falsely alleging compliance with Title IV's incentive compensation ban (ICB). 2016 WL 6393513 (N.D. Cal. Sept. 20, 2016). On a motion for reconsideration of the court's order denying summary judgment, the defendant pointed to the Government's failure to take action against it notwithstanding its awareness of the allegations in that litigation. In denying the defendant's motion for reconsideration, the court applied the multifactor analysis and found that the Government's decision not to take action against the defendant was "not terribly relevant to materiality." Id. at *6. That inaction, 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. The district court has since certified three questions for interlocutory appeal to the Ninth Circuit, including the question of whether compliance with the ICB is material. In January, the Ninth Circuit granted the petition for appeal, setting the stage for another circuit-level interpretation of *Escobar*'s materiality standard.

Payment to Noncompliant Contractors—Undoubtedly, there will continue to be divergent rulings because reasonable minds can differ on materiality. Yet a clear trend is emerging in cases where the Government continues to pay despite having notice of the defendant's alleged or actual conduct. Recently, several circuits have relied on *Escobar* in ruling for defendants on materiality grounds, usually at the summary judgment stage. These courts may very well have been following Jerry Maguire's immortal words of "show me the money" because these courts focused on the Government's payment of claims in cases where the Government knew that the contractor was allegedly out of compliance with a requirement. As the Supreme Court reasoned, payment in the face of noncompliance may not be dispositive, but it is "very

strong" evidence that a requirement was not material. 136 S. Ct. at 1995.

In *U.S. ex rel. Kelly v. Serco, Inc.*, 846 F.3d 325 (9th Cir. 2017), the relator asserted that Serco violated material contractual requirements because Serco's monthly cost reports allegedly did not comply with certain guidelines set forth in American National Standards Institute Standard 748. In affirming the grant of summary judgment, the Ninth Circuit noted that the Government accepted Serco's cost reports despite knowing that such cost reports did not follow ANSI–748, and so compliance with this guideline could not have been material.

Relatedly, an agency's inaction in response to allegations of misconduct can be relevant to the materiality analysis if there is evidence that the Government investigated the relator's allegations and decided not to deny claims or seek repayment from the contractor. In *U.S. ex rel. McBride v. Halliburton,* 848 F.3d 1027 (D.C. Cir. 2017); 59 GC ¶ 56, the relator alleged that defendant Kellogg Brown and Root (KBR) inflated headcount data that purported to track the number of troops who frequented KBR's recreation centers. The district court granted summary judgment in favor of the defendant after finding that the relator had failed to present evidence that the alleged headcount practices were material to the Government's decision to pay.

On appeal, the D.C. Circuit relied on *Escobar* when affirming summary judgment. The court held that the headcount data could not have been material because the Defense Contract Audit Agency had investigated the relator's allegations and had not disallowed any charged costs, and Army witnesses testified that headcount data had no bearing on costs billed to the Government. Id. at 1029. Additionally, KBR received an award fee for exceptional performance under its contract, even after the Government learned of relator's allegations. Moreover, the court rejected relator's reliance on an administrative contracting officer's declaration that he "might" have investigated further had he known false headcounts were being maintained. The D.C. Circuit found that this statement was too speculative in light of *Escobar*, by which the Supreme Court made clear that it was not enough for a plaintiff to show that the Government *could* refuse payment based on the violation at issue. Rather—under the *Escobar* materiality standard—a plaintiff must show that: (1) the Government was objectively likely to refuse payment if it knew of the violation or (2) the defendant subjectively knew that the Government was likely to refuse payment under the specific circumstances.

The First, Third, and Fifth Circuits have also rejected FCA claims on materiality grounds after considering the Government's response—or, in some cases, the lack thereof—to the relator's allegations. In *D'Agostino v. ev3 Inc*., 845 F.3d 1 (1st Cir. 2016), relator alleged that the defendant manufacturer misled the Food and Drug Administration to secure approval for a medical device. Citing the facts that, in the six years since relator's allegations surfaced, (1) the Centers for Medicare and Medicaid Services had never denied reimbursement, and (2) FDA had not withdrawn its approval of the device, the First Circuit found the alleged false statements were not material and affirmed dismissal with prejudice. Similarly, in *Genentech Inc*., the relator claimed to have disclosed "material, non-public evidence of Genentech's campaign of misinformation" to the FDA and DOJ in 2010 and 2011 regarding the cancer drug Avastin. 2017 WL 1541919 at *5. But in finding that the complaint failed to meet the materiality standard, the court noted: "[s]ince that time, the FDA has not merely continued its approval of Avastin for the at-risk populations that Petratos claims are adversely affected by the undisclosed data, but has *added* three more approved indications for the drug." Id. The court even suggested that DOJ's decision not to intervene was a factor that weighed against a finding of materiality. Id. ("And in those six years, the Department of Justice has taken no action against Genentech and declined to intervene in this suit.").

In *Abbott v. BP Exploration & Prod.*, 851 F.3d 384 (5th Cir. 2017), the relator alleged that British Petroleum (BP) was noncompliant with engineering regulations which resulted in the submission of false claims. The qui tam complaint prompted the Department of the Interior to investigate and ultimately conclude that defendant was in compliance and there was no basis to stop BP's drilling. In affirming summary judgment in favor of BP, the court reasoned that the Government's decision to allow BP to continue drilling was strong evidence that the engineering regulations were not material.

What Did the Agency Know and When Did It Know It—As these applications of *Escobar* demonstrate, the continued payment of claims by the Government or Government inaction in the face of

noncompliance affords contractors a strong materiality defense. But these cases also raise several unsettled questions. First, what sort of knowledge does an agency need to have—is it knowledge of *actual* noncompliance, or do *allegations* of noncompliance count as well? The Supreme Court's ruling certainly seemed to focus on the former, but several recent decisions seem to have expanded the analysis to the latter. The First Circuit itself provides a good example, as it has seemingly ruled in both directions. On remand in *Escobar*, the court stated that "mere awareness of allegations concerning noncompliance with regulations is different from knowledge of actual noncompliance." 842 F.3d at 103. But in *D'Agostino*, the First Circuit found a lack of materiality given the agency's failure to take any action after fraud was alleged by a relator in an FCA complaint. 845 F.3d at 8.

This, in turn, raises another question: is materiality measured only based on what the Government knew at the time it paid the claims, or can notice to the Government after payment or even after performance of a contract/program has ended be relevant? Again, here, the First Circuit's *Escobar* and *D'Agostino* opinions seem to conflict. On remand in *Escobar*, the First Circuit focused on what the Government knew at the time of payment: "we find no evidence that MassHealth had actual knowledge of the violations at the time it paid the claims at issue." 842 F.3d at 112. But in *D'Agostino*, as discussed above, the First Circuit affirmed summary judgment on materiality grounds based on agency inaction in the face of a relator's allegations after the fact. 845 F.3d at 8.

Far from cutting off this timing question at the time of payment, other circuits thus far have certainly focused on the agency response to allegations of fraud in analyzing materiality. *E.g., McBride*, 848 F.3d at 1029; *Genentech*, 2017 WL 1541919 at *5.

Intertwined with these questions is one other takeaway that cannot be underscored enough: the focus on the agency determination in investigating allegations of fraud and the agency response to allegations of fraud. While it has always been vital to understand the agency's view when defending against an FCA action, the courts of appeals in recent decisions applying *Escobar* seem to have increased the impact the agency can play in determining the fate of allegations of fraudulent conduct. Indeed, if the agency has conducted an investigation and determined that there is no misconduct or even if the agency has simply not taken any action to investigate or otherwise hold up payments in light of allegations of fraud, courts are finding that a showing of materiality has been fatally undermined. Whether this trend continues will be of vital importance to defending oneself under the FCA.

***Escobar*'s Practical Effects**—It is no surprise that last June's decision has therefore had several practical effects on the way that FCA cases are litigated. In the past, many practitioners considered the statutory definition of materiality to be a low bar for plaintiffs to meet because a plaintiff merely had to show that a defendant's action had the "natural tendency to influence, or be capable of influencing, the payment or receipt of money." See § 3729(b)(4). But *Escobar*'s focus on a "rigorous" and "demanding" materiality standard means that parties must now focus on introducing evidence of materiality into the record in order to prevail on summary judgment or at trial. To show whether compliance with a particular requirement is material to payment, both relators and defendants need discovery about the agency's prior conduct in the face of noncompliance in order to understand if the agency regularly pays claims in full despite knowing that certain requirements were violated.

Both plaintiffs and defendants have an interest in getting discovery from the Government about the agency's awareness of a contractor's non-compliance, but getting agency documents or testimony from Government employees is no easy feat. When the Government is a party to a civil matter in federal court, the Federal Rules of Civil Procedure typically provide the best vehicle to obtain discovery from the Government. However, in the FCA context, the Government is a party to a qui tam action only if it intervenes. *U.S. ex rel. Eisenstein v. City of New York*, 129 S. Ct. 2230, 2234 (2009). When the Government does not intervene, parties must contend with the agency procedures that govern how and when a party can get access to Government documents and witnesses. These regulations are designed to protect Government personnel from being burdened with discovery matters and are typically referred to as "*Touhy*" regulations, a name derived from the Supreme Court's 1951 decision in *U.S. ex rel. Touhy v. Ragen,* 340 U.S. 462 (1951). One possible upshot of *Escobar* may be a rise in the number of *Touhy* requests to obtain documents or testimony from Government witnesses. Moreover, going forward, there may very well be a greater use of experts and former

Government officials to opine on whether compliance with a particular legal requirement is material to the decision of whether to pay a contractor.

Escobar has also made its mark on FCA motions practice. In a footnote, the *Escobar* decision noted that that the materiality analysis is not too fact intensive to decide on a motion to dismiss. 136 S. Ct. at 2004, n. 6. When the decision was issued, it was unclear whether courts would actually grant motions to dismiss on materiality grounds, but courts have shown a willingness to do just that. In *U.S. ex rel. Kolchinsky v. Moody's,* the relator alleged that Moody's issued inaccurate credit ratings in its electronic delivery service, and relator alleged that Government agencies subscribed to the service after May 2009 which resulted in the submission of false claims for payment. 162 F. Supp. 3d 186 (S.D.N.Y. March 2, 2017). In granting the motion to dismiss, the court reasoned that there were news articles regarding inaccuracies in Moody's credit ratings well before 2009. In fact, these stories prompted congressional investigations into the alleged fraud, and yet the Government continued to pay the company for credit ratings services each year. Accordingly, the court granted Moody's motion to dismiss because the relator's allegations failed to meet *Escobar*'s materiality test. Cases that are dismissed at the pleading stage on materiality grounds are welcome news for defendants because the high cost of discovery in FCA cases can put pressure on defendants to settle claims even when they have a strong defense on the merits.

Conclusion—The Supreme Court decided *Escobar* to address the circuit split that had developed regarding the scope of the implied-certification theory. The decision was meant to clarify the implied-certification theory of liability, but it has raised new questions that need to be settled, many of which will greatly impact the strength of contractor defenses to FCA allegations. We may be approaching *Escobar*'s one-year anniversary, but Government contractors will need to wait much longer to understand the decision's lasting impacts.

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