

Courts Are Taking Materiality Seriously Post-Escobar

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In the three months since the U.S. Supreme Court issued its decision in *Universal Health Services v. United States ex rel. Escobar*, lower court decisions suggest a trend of strict interpretation of the high court's materiality requirement for False Claims Act allegations. Pleadings generally must allege facts demonstrating materiality to avoid dismissal. As a result, contractors have more tools to avoid liability by arguing that the materiality or scienter requirements have not been met. Thus, although the Escobar decision opened contractors to liability in jurisdictions that previously did not recognize implied certification theory — such as the Seventh Circuit — the high materiality bar may afford them additional protections.

The Escobar Decision

On June 16, 2016, the Supreme Court handed down its decision in *Escobar*. This important case decided the fate of future False Claims Act allegations that were based on an implied certification theory. Implied certification is the notion that — instead of an actual, express misrepresentation — there is an implicit misrepresentation in the claim for payment as a result of a contractual or regulatory noncompliance. In other words, if the contractor failed to disclose a failure to comply with a contract term or regulation, it would be considered just as liable for fraud as if it had expressly certified compliance as part of its claim for payment. Prior to the *Escobar* decision, jurisdictions were split with some, such as the First Circuit, applying the implied certification theory liberally while others, such as the Seventh Circuit, refused to give the theory credence.

In its decision, the Supreme Court unanimously decided that implied certification theory is valid, but narrowed its application to “material” misrepresentations. Thus, the court required that plaintiffs demonstrate that the defendant (1) made a “specific representation” about the goods or services provided, and (2) failed to disclose noncompliance with a material statutory, regulatory, or contractual requirement. Moreover, the Supreme Court described the materiality requirement as “rigorous” and “demanding” because a material misrepresentation is outcome determinative. The court explained that nonmaterial noncompliances that an informed agency would likely resolve through the contracting process while continuing to pay the contractor's claim are not what the FCA was designed to punish. In fact, it is not enough that the misrepresentation is technically a condition of payment, or that it would give the government a right to withhold payment. Rather, it must be so serious that the government would withhold payment and/or terminate the contract.



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Thus, although the validation of the implied certification theory appeared at first to be a boon to a plaintiffs bar looking to hold contractors accountable not only for fraud but for any contractual or regulatory noncompliance, the Supreme Court's language on materiality, and subsequent decisions implementing it, may serve to temper some of that enthusiasm.

Ongoing Debate Over the Application of Escobar

Although contractors are likely disappointed by the legitimization of the implied certification theory, its application appears to afford significant protections. The materiality requirement is significant and requires a plaintiff to supply more proof and specifics. Predictably, plaintiffs and defendants have been filing disparate arguments in False Claims Act cases since Escobar in an attempt to persuade lower courts to their interpretations of the ambiguities that remained in how materiality would be applied.

The debate centers on three questions: (1) what is material; (2) is the Supreme Court test necessary or merely sufficient for an implied certification argument; and (3) how strictly should lower courts enforce the materiality and scienter requirements? Now, a calendar quarter removed from the Escobar decision, we can see some trends emerging in False Claims Act decisions that may give contractors a ray of hope. Courts are finding that: (1) materiality is established when the misrepresentation is outcome determinative; (2) it is necessary to satisfy the Supreme Court test for a successful implied certification claim; (3) and they should generally apply the materiality and scienter requirements strictly.

Recent Decisions Establish a High Bar for Materiality

Many judges are interpreting Escobar to require more in a pleading, especially with regard to materiality. Because Escobar requires materiality for an implied certification False Claims Act case, it is no longer enough for relators to plead "mere noncompliance." Instead, judges are requiring plaintiffs to show that the government would not have paid the claim had they known of the noncompliance. In other words, the misrepresentation must be outcome determinative. Therefore, if the government has paid earlier claims despite knowing of the noncompliance at issue, a contractor may be protected from False Claims Act liability.

The recent cases post-Escobar have taken various tracks. First, in a couple cases courts have granted a defendant's motion to dismiss for failure to establish materiality. In *United States ex rel. Dresser v. Qualium Corp.*, 2016 WL 3880763 (N.D. Calif. July 18, 2016), the court partially granted a motion to dismiss, with leave to amend, because the Government's complaint merely alleged "that the government would not have paid Defendants' claims had they known of Defendants' fraudulent conduct." As the Court noted, however, the mere allegation was insufficient because the government "does not explain why" the government would not have paid the claims, i.e., why the noncompliance was material. The defendants' certifications in their Medicare enrollment forms stated that they would "abide by Medicare laws, regulations, and program instructions, and that they understood that payment of a claim was conditioned on the claim being compliant with Medicare laws, regulations, and program instructions." The court held, citing Escobar, that payment being conditioned on compliance with regulations could be evidence that a misrepresentation was material but did not in and of itself establish materiality.

Similarly, in *United States ex rel. S.E. Carpenters Regional Council v. Fulton County, Ga.*, 2016 WL 4158392 (N.D. Ga. Aug. 5, 2016), the U.S. District Court for the Northern District of Georgia dismissed a suit because the complaint merely alleged that the defendant failed to comply with all provisions of the Davis-Bacon Act, which was required by its contract. The court found this alone to be insufficient. Citing Escobar, the court concluded that "statutory, regulatory, and contractual requirements are not

automatically material, even if they are labeled conditions of payment.” As a result, the complaint failed to allege all elements of a False Claims Act violation, and the case was dismissed, without leave to amend.

Likewise, in *United States ex rel. Williams v. City of Brockton*, 2016 WL 4179863 (D. Mass. Aug. 5, 2016), the Massachusetts district court found that allegations of false certification of compliance with Title VI nondiscrimination requirements did not establish materiality where there had been no formal finding of violations. Once again, citing *Escobar*, the court concluded that the government’s normal practice is not to suspend payments under a grant until there is a formal finding of discrimination, and therefore the complaint failed to plead that alleged false certification of Title VI compliance was material to the payment decision. On the other hand, with respect to the relators’ allegations of noncompliance with “non-supplanting requirements” that prohibit states from using the federal grants at issue to replace funding the state itself would otherwise have provided, the court denied the motion to dismiss. Notably, the court found that the relator had adequately pleaded that the government “with some frequency” has withheld payment to agencies violating nonsupplanting requirements. The government’s prior withholding of payments sufficed as an allegation of materiality.

In a more generous mien, a judge might give the plaintiff another chance to meet the materiality requirement. In such a case, *U.S. ex rel. Ben Ferris v. Afognak Native Corp.*, the U.S. District Court for the District of Alaska invited the relator to amend his complaint in light of the considerably more stringent pleading requirements for FCA actions set by *Escobar*, rather than dismissing the case.

Second, even where courts have decided matters on unrelated grounds, they have recognized the increased burden materiality places on the government or the relator. For example, in *Carlson v. Dyncorp*, the Fourth Circuit held that a retaliation case under the FCA was necessarily unsuccessful unless there was a reasonable connection to a properly alleged False Claims Act violation. The court noted that, even if the contractor’s accounting practices were not entirely consistent with the Federal Acquisition Regulation or Cost Accounting Standards, any such mere noncompliance is insufficient to successfully plead fraud following the decision in *Escobar*.

Similarly, in *Knudsen v. AT&T Corp.*, the court stated that materiality is not an “easy standard” despite the government’s attempts to argue that a mere statement of noncompliance should be sufficient. In the decision, however, the court also stated in dicta that materiality is likely too fact-intensive an inquiry for dismissal. Thus, despite demonstrating the disconnect between the government’s view on materiality as an “easy standard” and how the courts are actually viewing it, this case also presents some contractors’ worst fears about *Escobar* — that courts may require lengthy and expensive discovery before reaching a conclusion on the rigorous requirement.

Against the Trend

Finally, no legal trend would be complete without contrary views. In this case, that contrary position is exhibited by the decision in *United States ex rel. Handal v. Center for Employment Training*. On motions to dismiss, the U.S. District Court in the Eastern District of California found that compliance with the regulations defendants were alleged to have violated was either express conditions of payment of federal grants or was “part and parcel of the regulatory scheme defendants agreed to follow” and therefore was, ipso facto, material to payment. This decision appears to run counter to the trend of requiring allegations of more than mere regulatory noncompliance to meet the Supreme Court’s materiality standard and may not survive much further than the dismissal stage, let alone any potential appeal.

How Should Parties Proceed?

In summary, the overall approach of courts following the Escobar decision appears to require plaintiffs to clear a higher bar for pleading materiality to survive a motion to dismiss. The government or a relator must not only allege that a contractual or regulatory noncompliance occurred but it must allege that the government would not have paid claims had it known of the noncompliance. Moreover, a mere conclusory statement to meet this standard is not sufficient. Rather, as some decisions have described, plaintiffs will be required to allege that it has not made payments in similar circumstances or explain why the government would not pay in this circumstance.

Given the increasing emphasis on materiality, plaintiffs must do their homework before filing False Claims Act complaints based on a theory of implied certification, to ensure they meet the Supreme Court's rigorous standard. On the other side, defending contractors should look for opportunities to argue that the plaintiff has not sufficiently pled materiality in such cases. In addition, where a court determines that discovery is necessary to resolve the issue of materiality, such a question could be ripe for limited, bifurcated discovery that would focus on an agency's prior conduct. In this way, contractors may be able to keep the costs of discovery down while still allowing the court to make a final determination of whether the government would have withheld payment. And, in all events, both sides should continue to monitor the post-Escobar jurisprudence to see if this trend continues or if other trends in the decisions emerge.

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