

False Claims Act: *Escobar's* Materiality Language Gets More Bite

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Government Contracts Issue Update

For more than a year, courts have grappled with the Supreme Court's unanimous *Escobar* opinion, which altered the False Claims Act (FCA) landscape by reframing the "rigorous" nature of the FCA's materiality standard. See *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016). Since *Escobar*, courts have embraced this heightened materiality standard and affirmed dismissal where it is not satisfied.

The Supreme Court's Landmark *Escobar* Ruling

The *Escobar* opinion impacted FCA litigation in two significant ways. First, the Court upheld the implied false certification theory under certain circumstances. Second, the Court clarified that materiality is a "demanding" standard. To be actionable under the FCA, "[a] misrepresentation about compliance with a statutory, regulatory, or contractual requirement[s] must be *material* to the Government's payment decision." However, "[a] misrepresentation cannot be deemed material merely because the Government designates compliance with a particular statutory, regulatory, or contractual requirement as a condition of payment." The Government's actual knowledge of a violation of requirements, coupled with its payment of a particular claim in full, or regular payment of a particular type of claim in full without indicating an objection, "is strong evidence that the requirements [violated] are not material." The Court further explained that materiality is a proper basis for dismissing an FCA case on either a motion to dismiss or a motion for summary judgment.

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Grappling with Post-*Escobar* Materiality

Since *Escobar*, courts have grappled with how to apply the announced standard. Defendants argue that *Escobar* raised the standard and imposed a greater burden on relators and the Government, focusing on the Court's discussion of the "rigorous" standard. Meanwhile, the Department of Justice has filed Statements of Interest in multiple cases arguing that *Escobar* did not change the materiality standard, focusing on the Court's discussion of statutory language and common law preceding its "demanding" standard discussion.

Several circuit court panels that have addressed the materiality standard in the wake of *Escobar* have embraced the heightened standard and focused on the impact of the government's knowing payment of claims notwithstanding some defect. They do not seem to have established a *per se* rule on government knowledge. In some cases, the plaintiff's attempt to demonstrate materiality failed where the Government investigated allegations or knowingly accepted the allegedly fraudulent information, but continued to authorize payment. *See, e.g., United States ex rel. Petratos v. Genentech Inc.*, 855 F.3d 481, 490-92 (3d Cir. 2017); *United States ex rel. McBride v. Halliburton Co.*, 848 F.3d 1027, 1033-34 (D.C. Cir. 2017); *United States ex rel. Kelly v. Serco, Inc.*, 846 F.3d 325, 334 (9th Cir. 2017). In *United States v. Sanford-Brown, Ltd.*, 840 F.3d 445, 447 (7th Cir. 2016), the Seventh Circuit panel concluded that where the Government had reviewed an allegedly fraudulent enterprise several times, but found no need to terminate the contract or apply administrative penalties, the alleged fraud could not have been material to the decision to make payment.

In a recent case, *United States ex rel. Harman v. Trinity Indus. Inc.*, No. 15-41172, 2017 WL 4325279 (5th Cir. Sep. 29, 2017), the Fifth Circuit overturned a \$663 million judgment against Trinity Industries, Inc. (Trinity), a guardrail manufacturer. The *Trinity* panel embraced *Escobar*'s heightened materiality standard. The relator has filed a petition for a rehearing en banc, arguing the panel ignored Supreme Court precedent and ignored and reweighed evidence.

In *Trinity*, The Federal Highway Administration (FHWA) reimbursed states for installing guardrail end terminal systems that meet the FHWA's standards. During the time period at issue, eligibility for federal reimbursement required FHWA acceptance of the installed product. The FHWA could require product testing, and required any changes to approved systems to obtain "approval unless an exercise of good engineering judgment finds they were not significant." The FHWA approved Trinity's guardrail end terminal system, ET-plus in 2000. In 2005, Trinity made changes to the system and the FHWA approved the modified version. However, Trinity omitted some of these changes from a crash test report submitted to the FHWA for approval. When Trinity sold an ET-Plus system (often to state departments of transportation) it often submitted a certificate stating that the system complied with the FHWA testing requirements with its invoices. The complaint alleged that the undisclosed changes to the ET-Plus system violated the FHWA testing requirements, so Trinity's certifications that ET-Plus systems complied with those requirements caused states to present the FHWA with false claims for reimbursement.

Although no single factor was outcome determinative, the *Trinity* panel held that there was compelling and unrebutted evidence the FHWA knew about these issues but continued routine payments; consequently, the relators could not establish that the changes were material to the Government's decision to pay the claims.

The appellate court distinguished this case from other post-*Escobar* appellate court opinions, emphasizing the seriousness and clarity of the Government's decision. First, the Fifth Circuit noted "*Escobar's* cautions have particular bite" when violations "involve potential for horrific loss of life and limb," such as the alleged violations regarding Trinity's guardrail system. Second, the *Trinity* court recognized that instead of inferring approval from continued payment as other circuit courts have post-*Escobar*, it could cite the Government's explicit approval. The FHWA issued a memorandum in 2014 expressing its continued approval of the ET-Plus system and identified "an unbroken chain of eligibility for Federal-aid reimbursement." At that time, the FHWA had actual knowledge of the alleged violations because its officials had seen the relator's thorough pre-filing presentation and had access to his *qui tam* complaint. The same day the FHWA released its memorandum, the Department of Justice responded to the relator's *Touhy* request, indicating no need for government employees' sworn testimony because the FHWA memorandum addressed all of the issues the parties raised. Accordingly, the Fifth Circuit held that the FHWA had actual knowledge of Trinity's alleged noncompliance with its 2005 changes, yet it continued to pay states' reimbursement claims for ET-Plus systems. Thus, the relator failed to satisfy his materiality burden and Trinity was entitled to judgment as a matter of law.

Also noteworthy, the panel seemed to endorse the net trebling approach for calculating damages, although it did not identify the method by name. Under the pro-defense "net trebling" methodology, the value to the Government of the defendant's performance is first subtracted from the single damages figure before calculating treble damages. Contrastingly, the pro-government "gross trebling" methodology trebles the Government's alleged damages *first*, and then makes a reduction for any value received. Here, the appellate court explained the appropriate measure of calculation for damages is "the difference between what was promised and what was received."

Nonetheless, courts still critically apply the materiality standard based on the unique facts of each case:

- *United States ex rel. Escobar v. Universal Health Servs., Inc.*, 842 F.3d 103 (1st Cir. 2016): The First Circuit panel in *Escobar*, on remand, concluded that the relator met the materiality threshold. The relators alleged that a health care provider violated the FCA because it submitted Medicaid claims for reimbursement but failed to disclose employees lacked proper supervision or licenses and impliedly certified that its services complied with applicable requirements regarding employee qualifications. The Court held that the provider's misrepresentations were material because regulatory compliance was a condition of payment and the "very essence of the bargain," and there was no evidence that the Government had actual knowledge of the violations when it paid the reimbursement claims.
- *United States ex rel. Campie v. Gilead Sciences, Inc.*, 862 F.3d 890 (9th Cir. 2017): The Court reversed a Rule 12(b)(6) dismissal where the defendant contended that the Federal Drug Administration (FDA) continued to pay for HIV drugs despite knowledge that they did not meet manufacturing requirements. The case alleged: (1) Gilead manufactured drugs in an unapproved Chinese facility but charged the Government for them; (2) by selling these "knock-offs" to the Government and causing others to seek reimbursement for them, Gilead implicitly certified that the drugs were approved for distribution; and (3) Gilead lied to the FDA to secure approval of the Chinese manufacturing facilities, making them eligible for government payments. The court held the relators sufficiently plead materiality because: (1)

it was unclear whether Gilead obtained the FDA approval by fraud; (2) there are many reasons the FDA may decide not to withdraw a drug approval; and (3) continued government approval here lacked the significance it has in other cases because Gilead ultimately replaced the noncompliant drugs with compliant drugs, the Government approved the compliant drugs, and the parties disputed the Government's actual knowledge.

- *United States v. Luce*, No. 16-4093, 2017 WL 4768864 (7th Cir. Oct. 23, 2017): The Seventh Circuit panel applied *Escobar's* “demanding” standard and held materiality was satisfied despite evidence of the Government's actual knowledge when approving payments. This case involved the owner and president of a company that was a Federal Housing Act (FHA) loan correspondent, who received FHA insurance for originating approved loans. The United States alleged the individual violated the FCA because he signed and submitted the company's annual certifications, lying about being subject to a current criminal proceeding. Although the Government had actual knowledge of the fraud and approved FHA insurance on new loans, the court explained this “acquiescence” was not prolonged because the Government subsequently initiated debarment proceedings resulting in debarment. The court cited additional evidence supporting materiality, including that (1) the certification at issue was a threshold eligibility requirement and thus linked to every loan issued; and (2) the failure to submit the Yearly Verification Form would have resulted in termination of FHA approval.

Important Takeaways for a Contractor's Strong Defense

This “demanding” materiality standard is important for contractors legally and practically. Importantly, the same facts that may defeat the materiality element may also defeat the scienter element. As the *Escobar* Court noted (in dicta) the scienter requirement for an FCA claim is “rigorous,” too. The “government knowledge defense” can rebut the scienter element “under some circumstances . . . on the ground that the claimant did not act knowingly, because the claimant knew that the Government knew of the falsity of the statement and was willing to pay anyway.” *United States ex rel. Colquitt v. Abbott Laboratories*, 858 F.3d 365, 379 (5th Cir. 2017) (internal quotation marks and citations omitted). This overlap in facts makes it imperative for defendants to approach discovery aggressively. It also further demonstrates the importance, during contract performance, of documenting with the Government any resolution of disagreements surrounding compliance or differences in interpretation of requirements.

Conclusion

More than a year after *Escobar*, litigants and courts continue to grapple with FCA materiality. Several appellate courts have embraced *Escobar's* heightened materiality standard, making it more challenging for FCA plaintiffs to satisfy their burden. Under this rigorous standard, the Government's actual knowledge and continued payment are key to defending against materiality because the Government's approval can be inferred from continued payment. Express approval, although present in the extreme *Trinity* case, is not required. This emphasizes the need for documentation during performance and aggressively pursuing discovery from the Government.