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FCA claims after *Escobar*

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The U.S. Supreme Court's seminal 2016 decision in *Universal Health Services, Inc. v. Escobar* continues to reverberate through the False Claims Act landscape. The opinion resolved the question of whether there can be liability for implied false certification claims under the FCA: There can, in some circumstances. But lower courts continue to grapple with what proof is required to establish such claims. Escobar armed both plaintiff's lawyers and defense counsel with ample arguments to apply the decision to their own advantage.

The 9th U.S. Circuit Court of Appeals' recent decision in *U.S. ex rel. Rose v. Stephens Institute*, 2018 DJDAR 8518 (Aug. 24, 2018), as amended 2018 DJDAR 11100 (Nov. 26, 2018), undertook to resolve some of these questions with respect to the FCA elements of falsity and materiality. But like *Escobar*, *Stephens Institute* ultimately has something for both plaintiffs and defendants. Significantly for defendants, the panel held that *Escobar*'s two-part limiting test for falsity is mandatory to establish falsity under an implied false certification theory. But *Stephens Institute* and other recent cases also reflect the ongoing reluctance by the 9th Circuit to abandon its more lenient prior case law, especially with respect to proof of materiality. So long as the 9th Circuit refrains from implementing *Escobar*'s more rigorous tests for falsity and materiality, defendants will continue to be exposed to implied false certification claims that threaten to transform the FCA into "an all-purpose antifraud statute" or "a vehicle for punishing garden-variety breaches of contract or regulatory violations."

Implied False Certification and the FCA

Implied false certification claims continue to be controversial because they have the potential to greatly expand the liability of businesses that make claims for payment on the government. Under the FCA, a defendant may be held liable if it knowingly presents or causes to be presented to the government materially "false or fraudulent claim[s] for payment." The FCA's remedies include treble damages; civil penalties (between $10,907 and $21,916 for each false claim); and attorney fees exposure. The government itself may bring a civil action under the FCA by intervening in the lawsuit. But the FCA also authorizes private parties, known as relators, to file and pursue qui tam suits, even when the government itself declines to intervene. If the suit is successful, the relator can receive up to 30 percent of the recovery.

The FCA was enacted during the Civil War in response to contractors delivering defective goods to the Union Army, such as decrepit horses, faulty rifles and rancid rations. Consistent with its origin, the archetypal FCA case involves a claim that is untrue on its face, such as a government contractor billing the government for goods it never provided. But because the FCA is intended to reach all types of fraud, liability is not limited to these "factually false claims."

In recent years, relators have increasingly pursued FCA cases under an implied false certification theory of liability. This allows a plaintiff to establish liability for knowingly submitting a false or fraudulent claim for payment even though there is nothing factually untrue in the claim, so long as the defendant knows it is not in compliance with a statutory, regulatory or contractual requirement. These claims are problematic because the modern contractual and regulatory environment is far more expansive than that in place during the Civil War. The statutory and regulatory schemes implicated by today's government contracts are increasingly complex. Within the health care industry, for example, the implied false certification theory could greatly increase the potential liability of health care providers, exposing them to civil liability for even minor deviations from byzantine regulations.

In view of the number and complexity of the requirements to which government contractors must adhere, implied false certification claims raise the specter that contractors will not actually have "fair notice" of the various regulatory and contractual requirements. This is troubling because the nature of modern government contracting requires that many contractors send out numerous invoices for relatively small dollar amounts. Each invoice can be the basis of a penalty of over $21,000. When these penalties are added to statutorily trebled damages and fee exposure, an FCA defendant could find itself facing claims for an enormous amount of damages. And because relators receive a significant percentage of the overall recovery, the statute overincentivizes relators to bring FCA claims — even meritless claims, which can still lead to significant settlements.

Prior to *Escobar*, circuit courts were split as to whether the implied false certification theory was valid. Most circuit courts approved it under certain circumstances but did not necessarily agree on what those circumstances were. The 7th Circuit rejected the implied certification theory altogether.

***Escobar* Balances Need to Protect Government Fisc with the Rights of Contractors**

The Supreme Court granted certiorari in *Escobar* to resolve the disagreement over the validity of the implied false certification theory. In *Escobar*, the court held that there can be liability for implied false certifications under the FCA "at least in certain circumstances." But the court specifically endorsed the theory only in the limited case where (1) there was a specific representation about the goods or services provided in the claim for payment, and (2) the failure to disclose noncompliance with material statutory, regulatory or contractual requirements made those representations misleading half-truths.

New York Times News Service

In 2016, the U.S. Supreme Court resolved the question of whether there can be liability for implied false certification claims under the False Claims Act, but lower courts are still grappling with what proof is required to establish such claims.

The Supreme Court made clear that the FCA "is not a means of imposing treble damages and other penalties for insignificant regulatory or contractual violations." Recognizing the risks that an expansive implied false certification theory would pose, the court set additional boundaries. The court instructed lower courts to apply a "rigorous" and "demanding" materiality standard to prevent plaintiffs from using the theory to turn the FCA into a vehicle for punishing garden-variety violations. The court further clarified that whether a provision is labeled a condition of payment is relevant to, but not dispositive of, the materiality inquiry and that a court must instead look to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation. Under this inquiry, the court explained that proof of materiality can include evidence that the defendant knows that the government consistently refuses to pay claims based on noncompliance with the particular statutory, regulatory or contractual requirements. Conversely, "if the Government pays a particular claim in full despite its actual knowledge that certain requirements were violated" or "regularly pays a particular claim in full despite its actual knowledge that certain requirements were violated and has signaled no change in position," that is "very strong evidence that those requirements are not material."

In short, the Supreme Court sought to ensure that defendants are provided with "fair notice" and safeguarded from the potential "open-ended liability" of implied false certification claims through both (1) the two-part test for falsity and (2) a rigorous and demanding materiality standard, based on the effect on the likely or actual behavior of the recipient of the alleged misrepresentation.

The 9th Circuit Largely Reverts to Pre-*Escobar* Standards

In *Stephens Institute*, a three-judge panel of the 9th Circuit addressed the circuit's requirements for establishing falsity and materiality after *Escobar*. The opinion was a mixed bag for both defendants and plaintiffs — defendants gained a limited win on falsity, but the 9th Circuit walked back some of *Escobar*'s important materiality protections.

The relators alleged that defendant Stephens Institute violated the FCA by adjusting the salary of its admissions representatives based on the number of students they enrolled. Stephens Institute had agreed to follow various statutory, regulatory and contractual requirements, including an incentive compensation ban, in exchange for federal financial aid funding. On interlocutory appeal, the 9th Circuit considered whether, after *Escobar*, the university's failure to disclose its noncompliance with the ban was sufficient to render its claims false under an implied false certification theory.

Since *Escobar*, one of the central questions has been whether the two conditions identified by the Supreme Court — a specific representation about goods or services and a failure to disclose noncompliance with statutory, regulatory or contractual requirements that makes the representations misleading — must both be satisfied to establish falsity in an implied false certification case. The Stephens Institute panel answered that question "yes" and held *Escobar*'s two-part test as mandatory in the 9th Circuit. In doing so, the panel overruled *Ebeid v. Lungwitz*, which allowed a relator to establish falsity in an implied certification claim merely by pointing to noncompliance with a law, rule or regulation that is necessarily implicated in a defendant's claim for payment.

But the Stephens Institute court explained that were it to decide the issue anew, it would not find the test mandatory because the Supreme Court never stated that these two conditions were the only way to establish an implied false certification claim. However, the panel acknowledged that it was hamstrung by prior 9th Circuit decisions that found the two *Escobar* conditions do have to be satisfied. The Stephens Institute court therefore held the two-part test mandatory "unless and until our court, en banc, interprets *Escobar* differently." (The court later declined to take the case en banc.)

The court's holding that the two-part test for falsity is mandatory is, on balance, a win for government contractors concerned about limiting the scope of potential implied false certification claims. But the panel's application of the two-part test left an opening for plaintiffs. With minimal analysis, the Stephens Institute court found that the relators satisfied the two-part test because the university specifically represented that the students and program were eligible to receive federal financial aid funds and failed to disclose its noncompliance with the incentive compensation ban, making those representations misleading half-truths. But the panel failed to explain how a representation that programs and students were eligible for federal funding rendered the failure to disclose noncompliance with the incentive compensation ban misleading. The panel also failed to explain how a representation that the students and programs were eligible for federal funds was "a specific representation about the goods or services provided." Here, in exchange for the federal financial aid funds, the service that the university provided was educating students; there were no specific representations about that service. In short, while the *Stephens Institute* panel paid lip service to a mandatory two-part test, the panel appeared to continue to rely on Ebeid.

The *Stephens Institute* panel divided on the issue of materiality, but the majority's opinion provided a more clear-cut win for plaintiffs. The majority again showed an unwillingness to abandon its pre-*Escobar* approach. The panel recounted the Supreme Court's holding that materiality looks to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation and discussed the various factors *Escobar* noted were relevant. But ultimately, the panel concluded that *Escobar* merely "creat[ed] a 'gloss' on the analysis of materiality" that did not overrule prior circuit law in *U.S. ex rel. Hendow v. University of Phoenix*. And, analyzing the case under *Hendow*, the *Stephens Institute* court found that the failure to comply with the incentive compensation ban at issue *was* material because the Department of Education's payment was conditioned on compliance with the incentive compensation ban and supported by the government's prior enforcement actions and because the forbidden incentive payments were substantial in size.

A sharply worded dissent picked apart the majority opinion. Proclaiming that *Hendow* remains good law ignores the clear contradiction between the two cases: Under *Hendow*, condition of payment was both necessary and sufficient on its own to establish materiality, while *Escobar* explicitly held that whether a requirement is a condition of payment is not dispositive. And the majority's continued adherence to *Hendow* directly leads to an incorrect materiality finding in favor of the plaintiffs. As the dissent put it, the majority failed to "properly apply the demanding and rigorous *Escobar* standard to the evidence in this case." There was no evidence in the record regarding how the government would respond to the specific violations of the incentive compensation ban. The relators relied exclusively on aggregate data regarding the government's general enforcement of the incentive compensation ban. But this data showed only that the government sometimes imposed minor fines for violations. It did not show that the government sought repayment of all of the funds it paid. Moreover, the data did not show the government would find these alleged misrepresentations material because it failed to show whether Stephens Institute's conduct was more or less egregious than the schools that had been fined. This lack of context also undermined the majority's reliance on the size of the incentive payments. In short, the only relevant evidence was the fact that compliance with the incentive compensation ban is a condition of payment. Under the more rigorous and demanding *Escobar* inquiry into the actual or likely behavior of the government, materiality should have been found wanting.

While the *Stephens Institute* majority's opinion on materiality is not consistent with *Escobar*, it underlines the 9th Circuit's continued resistance to modifying its more lenient materiality standard in the post-*Escobar* landscape. That resistance is also reflected in the earlier three-judge panel decision in *U.S. ex rel. Campie v. Gilead Sciences, Inc*. In *Gilead*, the relators alleged that a pharmaceutical company made false statements to obtain FDA approval for drugs. The government paid for these drugs through federal programs such as Medicaid and Medicare. The defendant argued that the alleged noncompliance was not material because the government was aware of the alleged regulatory violations for years, never retracted the FDA approval, and granted supplemental regulatory approval. The 9th Circuit rejected defendant's arguments and reinstated the FCA case, indicating that there are many reasons the FDA would not withdraw approval for a drug even after it learned of the noncompliance and finding that relators had alleged more than the mere possibility that the government would be entitled to refuse payment if it were aware of the violations. The *Gilead* decision on materiality is equally as problematic as the *Stephens Institute* case. Like the majority in *Stephens Institute*, the *Gilead* panel rejected the *Escobar* standard of actual or likely behavior of the government in favor of a more lenient standard emphasizing the old condition of payment standard.

Future FCA Cases

The *Gilead* decision was appealed to the Supreme Court, but the petition for certiorari was recently denied. Defendants in 9th Circuit implied false certification FCA cases can still rely on the mandatory two-part test for falsity set forth in *Escobar* to provide some limitations on implied false certification claims. But absent a change in approach, and based on its recent interpretations of the materiality standard, defendants in the 9th Circuit should not expect to reap the protections of the rigorous and demanding materiality requirement described in *Escobar*.

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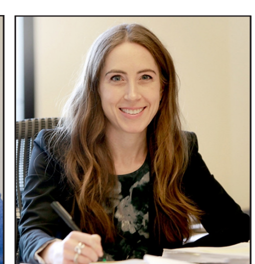
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