

CLIENT ALERT

Second Circuit Reinforces the Relator's Burden to Plead Materiality

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In *U.S. ex rel. Foreman v. AECOM*, the U.S. Court of Appeals for the Second Circuit confirmed that the materiality factors set forth by the Supreme Court in *Universal Health Services, Inc. v. U.S. ex rel. Escobar* apply to all types of False Claims Act claims and reinforced the relator's heavy burden even at the pleading stage. This precedential opinion provides several key takeaways for defendants facing FCA liability where the significance of the allegations to the government's payment decision is in doubt.

Foreman involved a contract to provide maintenance and management support services for the Army, including tactical vehicle and equipment maintenance, facilities management and maintenance, supply and inventory management, and transportation services. The alleged violations stemmed from the contractor submitting timesheets with improper labor hours, failing to properly log and track government property, and hitting a consistently low man-hour utilization ("MHU") rate—the ratio of time personnel would spend actively engaged in maintenance projects. After the government declined to intervene, the district court dismissed the relator's claims for failure to plausibly allege materiality.

On appeal, the Second Circuit largely affirmed the district court, while reversing only as to the allegations of labor overcharging due to the lower court's improper reliance on a document not incorporated into the complaint. The Court's discussion with respect to the other allegations provides important guidance as to the materiality analysis and the burdens that apply at the pleading stage.

As a threshold matter, the Court first rejected the relator's argument that the *Escobar* materiality analysis applies to implied certification claims only, not other types of false claims, such as fraudulent inducement, factual falsity, and express false certification claims. To the contrary, the Court held that "nothing" in *Escobar* suggested that its materiality requirement was limited to the implied certification theory of liability – an important ruling given this not uncommon attempt by relators to circumvent the Supreme Court's expression of the rigorous and demanding materiality standard.

Next, as it did in its 2020 opinion in *U.S. v. Strock*, the Court applied *Escobar's* holistic materiality analysis, including the factors of (1) whether the government expressly designates compliance with a particular statutory, regulatory, or contractual requirement as a condition of payment; (2) the government's response to noncompliance with the relevant contractual, statutory, or regulatory provision; and (3) whether the defendants' alleged noncompliance was "minor or insubstantial."

Express Condition of Payment

Under *Escobar*, the first factor relevant to materiality is whether the government expressly identified the provision at issue as a condition of payment. In *Foreman*, the relator argued the contract incorporated, and required compliance with, numerous Performance Work Statements ("PWS") and Federal Acquisition Regulations ("FAR") that the defendant, AECOM, violated. AECOM countered that none of those provisions specifically identified the requirements that AECOM allegedly violated as an express condition of payment, cutting against materiality. AECOM also noted that, under the relator's logic, "every single PWS, and thousands of FAR provisions, would *each* constitute an express condition of payment." The Court agreed, finding that the

first factor weighed neutrally in the materiality analysis “at most,” and emphasizing that the “generic and routine” contractual provisions referencing the importance of these requirements “do not put a contractor on notice of the importance of a given requirement to the government’s payment decision.”

Government Response to Non-Compliance

The Court then considered the government’s response to the alleged noncompliance in both the “mine run of cases” and in the particular case. The relator had alleged facts involving another overbilling case against a different defendant in which the government initiated an enforcement action and ultimately received a settlement. The Court noted that at the pleading stage, when drawing inferences in a plaintiff’s favor, the facts underlying the other case must be accepted as similar to the instant case. But, citing *Strock*, it explained that allegations of post hoc prosecutions or other enforcement actions do not carry the same probative weight as allegations of nonpayment, and thus, the probative value of the other enforcement action alleged in the complaint was neutral at best.

The Court further explained that continued payment by the government after learning of the alleged fraud substantially increases the burden on the relator in establishing materiality, citing *U.S. ex rel. Harman v. Trinity Industries, Inc. et al.*, 872 F.3d 645 (5th Cir. 2017). Here, allegations in the complaint and a pair of DCMA corrective action reports demonstrated that the government had actual knowledge of AECOM’s alleged MHU rate violations, with AECOM even holding discussions with the Army about how to address the DCMA’s concerns. The Second Circuit agreed with the district court that repeated renewal and extension of the contract undermined materiality in light of the government’s knowledge and investigation.

The Court also distinguished two cases where circuit courts reached a different conclusion: *U.S. ex rel. Prose v. Molina Healthcare of Illinois, Inc.*, 10 F.4th 765 (7th Cir. 2021) and *U.S. ex rel. Cimino v. International Business Machines Corp.*, F.4th 412 4 (D.C. Cir. 2021). In those cases, the Second Circuit explained, the filing of the relator’s complaint was “the *only* evidence of the government’s alleged knowledge of the contractual violations at issue.” (Emphasis added.) In contrast, the Court found, it was not just “bald assertions” by the defendant, but “documentary evidence demonstrating that the government had actual knowledge” of the contractual failures “yet nevertheless not only continued to extend and pay claims . . . but also never demanded repayment, disallowed any charged costs, or penalized AECOM.”

Lastly, the Court observed that there “may be circumstances” where continued payment will not be “particularly probative” of a lack of materiality. It qualified, however, that “the plaintiff must plausibly plead facts to support such possible alternative explanations in the complaint (and at a later stage of litigation, must support these allegations with evidence).” The relator had failed to do so in the instant case, the Second Circuit held.

Substantiality of Non-Compliance

The Second Circuit then considered whether the defendants’ alleged noncompliance was substantial, because only material falsehoods are deemed to go “to the very essence of the bargain” under *Escobar*. Expanding upon its holding in *Strock*, the Court reasoned that the standard for determining substantiality is whether the defendants’ noncompliance deprived the government of its intended benefits under the contract, because substantiality requires a showing that there are sufficiently widespread deficiencies in the contractor’s performance that go to the heart of the bargain, such that any regulatory, statutory, or contractual violations would likely affect the government’s payment decision.

With respect to the labor billing and property tracking allegations, the Second Circuit concluded that the substantiality factor “weighs modestly in favor of a finding of materiality.” The Court reasoned that these violations, which led to approximately \$140 million in overpayments and liability, might have affected the government’s payment decision. Even so, the Court upheld dismissal of the property tracking allegations. With respect to the low MHU rate, the Court found that the substantiality factor weighed against materiality because there was nothing to suggest that the contractor’s noncompliance with the agreed-upon MHU rate resulted in significant financial costs to the government, even though the MHU rate designated in the contract (between 85-90%) was identified as a critical metric. While the Court noted it was “likely that AECOM’s MHU rate violation led to some inefficiencies and government waste,” it was not clear that this violation deprived the Army of its intended benefits under the contract.

Conclusion

In conclusion, the Court upheld the dismissal of the MHU rate and property tracking violation claims for lack of materiality, but overturned the dismissal of the labor billing violation claims because the district court improperly considered the DCAA Report—not incorporated into the complaint—for this holding. The Court’s affirmance of the dismissal of the property tracking allegation was in spite of its finding that the substantiality factor weighed “modestly” in favor of materiality.

Key Takeaways

This opinion is a key development in the case law analyzing materiality in the wake of *Escobar*. It clarifies that the rigorous materiality standard espoused by the Supreme Court applies to all types of FCA theories and reinforces that it is the relator who holds the burden to plead factual allegations, not just conclusory statements, to support an inference of materiality. This pleading burden extends to cases in which the relator seeks to explain why the government continued paying even after becoming aware of the violation a relator claims is material to payment. Finally, *Foreman* provides that materiality is not sufficiently pleaded where the factors in *Escobar* are only “marginally probative” in favor of an inference of materiality.

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