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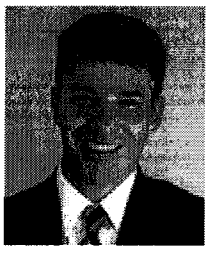
False Claims Act

When Does a Breach of Contract Violate the False Claims Act?

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With the government and private plaintiffs creatively using the False Claims Act [1] to police every aspect of government contracting, courts have struggled to draw the line between ordinary breaches of contract and true fraud. But as the Fourth Circuit explained, sometimes a breach of contract is only that:

[1] 31 U.S.C. §3729 *et seq.* (2000).

> An FCA relator cannot base a fraud claim on nothing more than his own interpretation of an imprecise contractual provision. To hold otherwise would render meaningless the fundamental distinction between actions for fraud and breach of contract. [2]

[2] *United States ex rel. Wilson v. Kellogg Brown & Root, Inc.*, 525 F.3d 370, 378 (4th Cir. 2008).

What separates an ordinary breach of contract from true fraud is precisely the question the Fifth Circuit considered in *United States ex rel. Steury v. Cardinal Health*. [3] In *Steury*, the Fifth Circuit held that, while a company that breaches a contract with the government may be liable for fraud under FCA, only breaches of those contractual provisions that are a precondition of the government's decision to pay a contractor's claim are actionable under the Act.

[3] *United States ex rel. Steury v. Cardinal Health, Inc.*, — F.3d —, 2010 WL 4276073 (5th Cir. Nov. 1, 2010).

The Fifth Circuit's decision should help contractors, courts, and potential *qui tam* whistleblowers distinguish between ordinary breaches of contract, which are not actionable under the FCA, and true fraud, which is. *Steury* makes clear, consistent with prior cases, that merely breaching a minor

contractual provision or some obscure federal regulation incorporated into a federal contract, which is not a condition of payment, is not actionable under the FCA as a false certification.

Medical Equipment Sparks a Lawsuit

4

[4] All factual allegations are taken from the Fifth Circuit's decision and Steury's amended complaint, which is available on the court's public docket.

In 2007, Leslie Steury filed a *qui tam* complaint on behalf of the United States, seventeen states, and the District of Columbia, alleging that Cardinal Health (Cardinal) sold defective medical equipment to unsuspecting hospitals, including hospitals operated by the Veterans Administration. Steury alleged that Cardinal's conduct violated the False Claims Act and similar state false claims laws that prohibit recipients of government funding from making false claims for payment. [5]

[5] 31 U.S.C. §3729(a)(1).

According to her complaint, Steury worked for Cardinal for five years, beginning in 1996, where she helped market medical products to local hospitals. [6] During this time, she marketed an infusion pump to Veterans Administration hospitals. The pump was intended to regulate the rate at which intravenous fluids flowed into patients. However, Steury alleged that it had a dangerous defect: air bubbles would accumulate in the device and would be injected into a patient's intravenous lines. She feared that this air seepage could kill the patient—especially infants. While the device was created with a sensor that was designed to detect air bubbles passing through a patient's intravenous lines, Steury alleged that the sensor failed to do so.

[6] 2010 WL 4276073 at *1.

Steury claimed to have learned about this life-threatening defect in 2000 when a pediatric anesthesiologist at Children's Hospital of Akron reported that Cardinal's pump had injected air bubbles into his patient's intravenous lines. The anesthesiologist investigated the problem himself and allegedly learned of a similar incident occurring at the Children's Hospital of Philadelphia. Several months later, Steury was allegedly pulled aside by a nurse at the same Akron hospital and told that an infant had died after air bubbles had entered her intravenous lines via Cardinal's pump. [7] Although this nurse and several other hospital staff were concerned about the pump, voicing fears about its safety at a meeting with Cardinal, Steury's manager allegedly refused to believe that the pump had caused any deaths and instructed Steury to continue marketing the device to other hospitals, despite the fact that Cardinal had temporarily suspended shipments of the pump to review its safety. Steury's employment was terminated several months later. [8]

[7] First Amended Complaint ¶ 14.

[8] *Id.* ¶ 19.

Six years later, Steury filed a complaint against Cardinal under the *qui tam* provisions of the FCA, in which she alleged, among other things, that Cardinal was obligated by its government contract "to provide safe, reliable, and quality-tested products" to the government, but failed to do so. [9] According to Steury, Cardinal was impliedly "certifying compliance with the terms of its contract with the Government." Its certifications to the government were necessarily false, she reasoned, because its pumps were defective and were not, in violation of the contract, "safe, reliable, and quality assured."

[9] *Id.* ¶ 59.

After the Department of Justice declined to intervene in her *qui tam* action, Cardinal moved to dismiss Steury's complaint. The district court granted the motion and dismissed the complaint with prejudice. Steury appealed the dismissal to the Fifth Circuit to decide a specific question: Had she stated a valid claim for relief under the False Claims Act by alleging that Cardinal had willingly sold the government defective medical equipment? [10] The crux of her appellate argument was that Cardinal had impliedly certified to the government that the pumps complied with the terms on its contract. The Fifth Circuit

was called to decide if (and when) a breach of a contractual provision was actionable under the FCA as a false certification.

[10] 2010 WL 4276073 at *3.

Not All Breaches Of Contract Are Created Equal

The Fifth Circuit concluded that Steury had not stated a valid claim for relief under the FCA. Summarizing her complaint, the Fifth Circuit noted that Steury was alleging that Cardinal had impliedly, and falsely, certified compliance with the warranty of merchantability in its contract with the government. This allegedly false certification was implicit, rather than explicit, because Steury alleged that each claim for payment carried with it an implied certification that Cardinal's products were manufactured in accordance with its contractual requirements.

The Fifth Circuit disagreed. The court began its analysis by describing, but not adopting, a legal theory of liability under the FCA known as an "implied-certification" claim. Under this theory, a company that has a contract with the government may be held liable under the False Claims Act based on the notion that the act of submitting a claim for reimbursement itself implies compliance with those rules and contractual provisions that are a precondition of payment. After noting that this theory had not yet been recognized in the Fifth Circuit, the court declined to do so. It instead found that, even if Steury could bring an implied false certification claim, she had not properly alleged one.

According to Steury, Cardinal's claims were rendered false because Cardinal was billing the government for pumps that were not in compliance with its contract—*i.e.*, the warranty of merchantability. But the claims were not expressly false, as Cardinal did not certify contract compliance, so Steury alleged that they were false because they contained an implied certification of compliance with the contract. The Fifth Circuit rejected Steury's approach to liability, however, to preserve the "crucial distinction ... between ordinary breaches of contract" and actual fraud that would be punishable under the FCA. [11] "Not every breach of a federal contract is an FCA problem," the court wrote. It is only where a contractor's compliance with "federal statutes, regulations, or contractual provisions" is a precondition of payment that the FCA may be implicated. [12] Ordinary breaches of statutes, regulations or contractual provisions that are not a precondition of payment do not render a contractor's claims false. [13]

[11] 2010 WL 4276073 at *4 (citing *United States v. Southland Mgmt. Corp.*, 326 F.3d 669, 680 (5th Cir. 2003).

[12] 2010 WL 4276073 at *4.

[13] *Id.*

By adopting the prerequisite-to-payment standard, the Fifth Circuit joined the Second Circuit in holding that "unless the Government conditions payment on a certification of compliance, a contractor's mere request for payment does not fairly imply such certification." [14] Notably, the court did not limit its holding to implied certifications, writing that:

[14] 2010 WL 4276073 at *4 (citing *Mikes v. Strauss*, 274 F.3d 687, 699 (2d Cir. 2001).

> even if a contractor falsely certifies compliance (implicitly or explicitly) with some statute, regulation, or contract provision, the underlying claim for payment is not "false" within the meaning of the FCA if the contractor is not required to certify compliance in order to receive payment... . In short, a false certification of compliance, without more, does not give rise to a false claim for payment unless payment is conditioned on compliance. [15]

[15] 2010 WL 4276073 at *4 (citation omitted).

Because Steury did not allege that Cardinal's compliance with the warranty of merchantability was a condition of payment, she failed to state a claim. [16]

[16] *Id.*

Steury's Practical Importance

The *Steury* decision is important to any entity or individual that works with and/or receives funds from the federal government because it provides much needed guidance as to the type of contractual provisions, statutes and regulations that will, if breached, be punishable under the FCA. The government and private *qui tam* relators have argued in the past that almost *any* breach of *any* contractual or regulatory provision may be a basis for FCA liability, even minor regulations incorporated into a contract. For instance, whistleblowers have tried to turn improperly-fitting safety goggles and respirators, at best a violation of an OSHA regulation, into fraud cases under the False Claims. [17] Although such suits have been blocked by courts, there remained uncertainty as to the types of contractual breaches that might lead to FCA liability.

[17] *See, e.g., United States ex rel. Shurick v. Boeing Company*, 2009 WL 1385928, at *2 (11th Cir. May 19, 2009).

Steury should help resolve this uncertainty. By creating a bright-line rule that is easy for companies and courts to follow, the Fifth Circuit clarified that only those statutes, regulations and contractual provisions that are a condition payment may be actionable under the FCA. If they are not a precondition of payment, by contrast, they do not give rise to FCA liability. This is true regardless of whether the government would not have paid the claim if it knew about the contractual breach, and regardless of whether the contractor's certification was express. The government, after all, has other remedies for a garden variety breach of contract.

Notably in *Steury*, the Fifth Circuit drew a distinction between the FCA elements of *materiality* and *falsity*. Although a false certification might be *material* to the government's decision to pay a claim, a claim was still not rendered *false* by a contractor's mere non-compliance with a statute, regulation or contractual provision. Thus, liability cannot be imposed, even if the government could prove that the provision breached was material to its payment decision—and that it would not have paid the claim if it knew about the breach—unless it can also prove that the provision was a known precondition of payment.

A Good Steury, But How Will It End?

Steury gives contractors a clearer understanding of what contractual provisions must be followed to avoid an FCA compliant. Contractors can use this information to tailor their training and compliance programs to ensure that explicit conditions of payment are followed, or corrected quickly if not. *Steury* should have the added benefit of cautioning whistleblowers against initiating FCA cases based upon their own interpretations of imprecise contractual provisions or some vague or obscure federal regulation. This should lessen the number of breach of contract cases that are masquerading as fraud cases. Regardless, this decision arms courts with a bright-line rule that will make dismissing them much easier. [18]

[18] Only a few weeks after the Fifth Circuit joined the Second Circuit and adopted the prerequisite-to-payment standard, the D.C. Circuit, in *United States v. Science Applications International Corporation*, held that "to establish the existence of a false or fraudulent claim on the basis of implied certification of a contractual condition, the FCA plaintiff ... must show that the contractor withheld information about its noncompliance with material contractual requirements." *United States v. Science Applications International Corporation*, No. 09-5385, — F.3d —, 2010 WL 4909467, at *8 (D.C. Cir. Dec. 3, 2010). The critical factor under the D.C. Circuit's reasoning is the element of materiality, not whether the particular contractual provision in question was a precondition of payment.

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