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FEATURE COMMENT: Frankenstein's Monster Is (Still) Alive: Supreme Court Recognizes Validity Of Implied Certification Theory

In a decision that will impact Government contractors, health care providers and all institutions that accept federal dollars, the U.S. Supreme Court this past week offered a qualified affirmation of the validity of the implied certification theory of False Claims Act liability, 31 USCA § 3729 et seq. *Universal Health Servs., Inc. v. U.S. et al. ex rel. Escobar et al.*, No. 15-7, 2016 WL 3317565 (U.S., June 16, 2016) (*Escobar*).

In a brief filed earlier this year in the *Escobar* case, petitioner United Health Services Inc. (UHS) called on the Court to reject the implied certification theory, which UHS characterized as "Frankenstein's monster." On June 16, the Court unanimously held that the implied false certification theory could, under certain circumstances, provide a basis for FCA liability if a defendant submits claims for payments and makes misleading representations or "half-truths" about compliance with underlying legal requirements and regulations. In other words, Frankenstein's monster is alive and here to stay, at least in part.

Not all of the *Escobar* decision reads like Mary Shelley's horror novel. In fact, the Court's application of a demanding materiality standard could make it more difficult for the Government and qui tam relators (colloquially referred to as "whistleblowers") to succeed under the implied certification theory.

Now that implied certification is established as a viable theory of FCA liability, future battles will focus on the applicable materiality element, especially whether defendants had knowledge that their violations would be material to the Government's decision to pay a claim. This FEATURE COMMENT provides background on the implied certification theory, summarizes the facts and holding of *Escobar*, and discusses the likely impact of the case on those subject to FCA liability.

Implied Certification Theory—Traditional FCA liability arises in cases involving claims that are factually false—for example, invoicing the Government for goods or services that were never delivered. Implied certification liability, however, involves a claim that is not on its face inaccurate, but rather, is legally false—for example, when a contractor fails to satisfy a legal requirement underlying a claim for payment and is construed to have implied compliance with that requirement in submitting the claim. Under this theory, FCA liability extends to situations in which the Government pays funds that it would not have paid if it had known of a failure to comply with a law, regulation or contractual provision underlying the claim for payment.

At the time of the Supreme Court's ruling in *Escobar*, eight of the 13 U.S. courts of appeals had accepted the implied certification theory in some form, but the approving circuits had articulated varying tests for its application. Some circuits recognized the theory, but held that liability would only attach if the violated underlying provision was an express condition of payment. Other circuits adopted a broader standard that held that FCA liability extended to circumstances in which a defendant failed to disclose violations of a statute, regulation or contractual provision material to the Government's decision to pay. This broad standard allowed for FCA liability based on a failure to comply with a technical (and arguably tangential) requirement. In contrast to the eight circuits endorsing some form of the implied certification theory, two other circuits had expressly declined to adopt it. The Supreme Court granted certiorari in *Escobar* to resolve the

conflict as to the validity and scope of the implied certification theory.

Background on *Escobar*—In a qui tam action, relators filed an FCA action after their daughter died of a seizure following treatment by unlicensed and unsupervised counselors at a mental health clinic. They alleged that the clinic, owned and operated by UHS, violated the FCA by presenting reimbursement claims to Medicaid without disclosing that it did not comply with Massachusetts' requirements regarding qualifications of mental health providers.

The district court dismissed the relators' complaint, observing that "not every regulatory violation gives rise to a potential FCA action." The district court found that the Massachusetts regulations at issue imposed only conditions of participation in the Government program, not preconditions to payment as required for FCA liability. On appeal, the First Circuit reversed, finding that the regulations at issue were in fact conditions of payment. *U.S. v. Universal Health Servs., Inc.*, 780 F.3d 504 (1st Cir.), cert. granted in part, 136 S. Ct. 582 (2015). In the First Circuit's view, each time UHS submitted a claim, it implicitly certified that it had complied with the relevant program requirements and thus was entitled to payment. Id. at 514, n. 14.

The Court's Holding—In the unanimous opinion authored by Justice Thomas, the Court held that the implied certification theory can be a basis for FCA liability if a defendant submits a claim for payment that "does not merely request payment, but also makes specific representations about the goods or services provided," *and* the "failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths." Such half-truths can be actionable as misrepresentations regardless of whether they are designated as conditions of payment.

The Court explained that, although the FCA does not define what makes a claim "false or fraudulent," the term fraudulent incorporates the common law meaning of fraud. The common law understanding of fraud, the Court pointed out, includes not only affirmative misrepresentations, but "half-truths" as well. Thus "[a] representation stating the truth so far as it goes but which the maker knows or believes to be materially misleading because of his failure to state additional or qualifying matter" is fraudulent for FCA purposes. Id. at 9. As an example of the type of half-truths that would be actionable misrepresentations, the Court used a classic contracts law hypothetical: A seller reveals there may be two new roads built near the property to be sold, but fails to mention a third projected road that would bisect the property. Id. at 10.

The Court stated that the representations made by UHS fell squarely in the category of misleading half-truths. Id. By submitting claims using payment codes corresponding to specific mental health services, UHS implicitly represented that it had provided those services. Further, the Court found that UHS implicitly misrepresented staff qualifications in registering for and using National Provider Identification numbers corresponding to specific job titles. The Court stated that anyone would assume that a psychiatrist or social worker providing mental health counseling services at a Massachusetts mental health clinic possesses the minimum prescribed qualifications and specialized training required to provide those services. Id. at 11. Thus, representing that psychiatrists and social workers were providing specific services as part of the state Medicaid program, without disclosing that these practitioners violated licensing requirements, was a misrepresentation.

The Court's Ruling on Materiality—After explaining the circumstances under which a claim may be false or fraudulent by implication, the Court turned to the second critical question of determining whether a violation is "material." The Court rejected the First Circuit's expansive view that *any* violation is material if the contractor knows that the Government would merely be entitled to refuse payment were it aware of the violation. Id. at 17. The Court vacated the First Circuit's judgment and remanded the case for reconsideration under what it termed a more "rigorous" test for determining whether the defendant's allegedly false claims were material to payment.

First, the Court considered the majority rule limitation to express conditions of payment to be both over- and under-inclusive. It reasoned that a contractor may know that a requirement is material even though payment is not expressly conditioned on compliance with the provision. Id. For example, a contractor would know that the ability to shoot was material to the purchase of guns whether or not the Government specified that payment was conditioned on the guns' actual ability to shoot. By the same token, however, if the Government expressly conditioned payment on compliance with every applicable legal and regulatory requirement, this would not

automatically make each of the thousands of pages of regulations material. Nor would it benefit defendants to create a rule that would incentivize the Government to expressly deem all regulations conditions of payment. Id.

Turning to its interpretation of the materiality standard, the Court emphasized that it is not enough for the Government to make post hoc assertions that a defendant's failure to comply with legal requirements influenced the Government's decision to pay. Rather, the misrepresentation has to go to the essence of the contractual bargain. Importantly, the Court rejected the express condition of payment standard adopted by the majority of circuits that have recognized the validity of the implied certification theory. Ultimately, the Court found that a provision's designation as a condition of payment is not dispositive of materiality, although it may be relevant evidence.

The decision makes clear that the question of whether a violation of a law, regulation or contractual provision is material to the Government's decision to pay will be analyzed according to common law tort and contract principles. The FCA defines "material" as "having a natural tendency to influence, or be capable of influencing, the payment or receipt of money or property." § 3729(b)(4). The Court declined to rule whether that statutory definition expressly governs the materiality standard required for implied certification claims, reasoning instead that under "any understanding of the concept, materiality look[s] to the effect on the *likely or actual* behavior of the recipient of the alleged misrepresentation." *Escobar*, slip op. at 14 (citing 26 R. Lord, Williston on Contracts § 69:12, p. 549 (4th ed. 2003) (emphasis added)).

Looking itself to common law tort and contract principles, the Court stated that a representation is material if a reasonable person would attach importance to it in deciding on the transaction, or if the defendant knew or had reason to know that the recipient of the representation would attach importance to it, even if a reasonable person would not. *Escobar*, slip op. at 15 (citing Restatement (Second) of Torts § 538, at 80). Thus, materiality may be determined objectively (a reasonable person test) or subjectively (e.g., the defendant's actual knowledge regarding the importance of the provision to the Government). Nevertheless, the Court emphasized in no uncertain terms that the materiality standard was "demanding," and that "minor or insubstantial" violations would not give rise to FCA liability. Id. In other words, the question is not whether the Government *could* refuse payment based on the violation at issue, but something more—whether the Government was objectively likely to do so, or the defendant knew that the Government would refuse payment if it knew of the violation.

Ultimately, the Court set forth a standard that permits, if not requires, a fact-intensive inquiry into materiality. For example, a plaintiff might rely on evidence "that the defendant knows the Government consistently refuses to pay claims … based on noncompliance with the particular statutory, regulatory, or contractual requirement." Id. If, on the other hand, the Government paid the claim in full despite actual knowledge of the noncompliance, this would be "very strong evidence that those requirements are not material." Id.

Implications for Contractors—In reaching its decision, the Court departed from the express condition of payment standard that has been applied by the majority of the circuits, but the Court also rejected the broad materiality standard that the First Circuit applied in *Escobar*. Rather than adopt a bright-line test, the Court gave a rule-of-reason-type analysis. The Court's middle-ground approach will likely be a mixed bag for the Government, qui tam relators and FCA defendants alike.

On the one hand, FCA defendants sometimes benefited from the application of the bright-line express condition of payment standard that was adopted by a number of circuits. This standard arose from the application of the FCA to the Medicare context, in which the Centers for Medicare and Medicaid Services' regulations delineate between conditions of payment and conditions of participation. In contrast, the Federal Acquisition Regulation does not make such a distinction, and so depending on where a case had been filed, FCA defendants were often able to argue that violated regulations were merely conditions of participation in a Government program, as opposed to conditions of payment. Going forward, the condition of payment/condition of participation distinction will be relevant, but not dispositive.

On the other hand, FCA defendants will nevertheless surely welcome the Court's rejection of the broad materiality standard adopted by the First Circuit (i.e., any legal noncompliance is material so long as the defendant knows that the Government would be *entitled* to refuse payment were it aware of the violation). An exchange during oral argument illustrates

the potential implications of such a broad standard. Chief Justice Roberts posed the following hypothetical to the deputy solicitor general: The Government contracts for services and adds a requirement that contractors purchase U.S.-made staplers. The contractor submits a claim for payment for those services, but fails to disclose its use of foreign staplers. Is this violation actionable under the FCA?

The deputy solicitor general responded that such a violation could be considered material, potentially exposing the contractor to the FCA's penalties and treble damages provisions. The Court explicitly rejected this interpretation of the statute in the opinion, referencing the deputy solicitor general's position and stating that the "False Claims Act does not adopt such an extraordinarily expansive view of liability." (At the same time, the Court's opinion does not go so far as to equate materiality with a breach of contract significant enough to permit repudiation of the entire contract, a hypothetical posed by Justice Breyer during oral argument.)

To be sure, the *Escobar* opinion serves up plenty of passages about the rigor of the materiality standard for the defense bar to quote in dispositive motions in false certification cases based on "minor" or "insubstantial" violations. The burden will be on the relator or the Government to demonstrate that the Government would not have paid the allegedly false claim had it known that the contractor did not comply with the requirement at issue. Pleading facts sufficient to meet that burden could prove difficult, because contracting officers often pay invoices even if they are aware that the contractor may not have complied with every applicable regulation.

Moreover, the Court underscored that the allegations of materiality need to meet both plausibility and particularity pleading standards of Federal Rules of Civil Procedure 8(a)(2) and 9(b). It also remains to be seen how narrowly lower courts will construe the requirement that "specific representations" be made in the claim beyond just requesting payment that would trigger an implied certification theory of falsity, a factor that may provide a hurdle for relators bringing an action without knowledge of the claims for payment themselves.

But the opinion also has plenty for the plaintiff's bar to herald. Foremost is that the Court validated the implied certification theory, expressly ruling that a claim may be false or fraudulent even if it does not expressly contain an inaccurate representation. Further, the Court appeared to find the *Escobar* case itself an example of the significance of the implied certification theory in its analysis of the "half-truths" made by UHS in requesting payment for the mental health services rendered. It is safe to say that the Court's decision will not cause any significant decrease in actions relying on implied certification. If anything, the result will likely be the opposite.

Ultimately, the impact of the Court's ruling for both plaintiffs and defendants will likely turn on the lower courts' application of the materiality standard set forth in *Escobar*. The Court recognized that the materiality analysis can be fact intensive, and that materiality may be determined either objectively or subjectively—i.e., the focus will be on what the defendant knew or should have known about how the Government would have responded if it had known about the alleged noncompliance. This seems to give lower courts a good deal of leeway in determining whether materiality in an implied certification case has been adequately pleaded or proven. While only time will tell, the Court's standard may ultimately increase a defendant's ability to win on summary judgment; but its fact-intensive nature may make it more difficult for contractors to prevail at the motion to dismiss stage, assuming well-pleaded allegations.

Conclusion—For practitioners who hoped that *Escobar* would offer a final word in the unsettled area of implied certification, the decision may leave something to be desired. For as many answers that it offers, it seems to raise just as many questions for the lower courts to determine case-by-case going forward.

In the days since the decision came down, both the whistleblower and defense bars have hailed the decision as a win for their respective camps. But the true impact of the decision—and whether it will expand or restrict FCA liability—will not be understood until the new standard is interpreted and applied by the lower courts. In the meantime, FCA defendants will want to reexamine their compliance programs, and they should revisit the representations and certifications that they make to the Government to ensure they are not presenting claims containing half-truths because, as the saying goes, the implied certification theory is here to stay.

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This Feature Comment was written for The Government Contractor by* Robert T. Rhoad, Brian Tully McLaughlin, Jason M. Crawford *and* Sarah A. Hill *of the Washington, D.C. office of

Crowell & Moring LLP. Mr. Rhoad is a partner and co-chairs the firm's False Claims Act and Health Care Litigation practices, and is a member of the firm's Government Contracts and Health Care practice groups. Mr. McLaughlin is a partner in the Government Contracts Group and is a member of the False Claims Act team. Mr. Crawford and Ms. Hill are associates and members of the firm's Government Contracts practice group and False Claims Act team.