

After *Escobar*, When Will Government Knowledge + Payment = ‘Not Material’?**False Claims Act****Litigation**

The Supreme Court’s recent ruling in *Escobar* on False Claims Act liability is best known for having confirmed the “implied certification” route to liability. Attempting to impose some boundaries on that doctrine, however, the decision also recognized that “a misrepresentation about compliance with a statutory, regulatory, or contractual requirement must be material to the Government’s payment decision in order to be actionable under the False Claims Act.” Author Mark Colley of Arnold & Porter Kaye Scholer LLP assesses the many lower court opinions that have interpreted the materiality caveat in specific cases.

By MARK D. COLLEY

Mark D. Colley is a partner in Arnold & Porter Kaye Scholer’s Government Contracts practice, based in Washington, DC. His experience includes substantial False Claims Act investigation and defense matters, which have involved Federal defense and civilian agencies, pricing under GSA schedule contracts, alleged royalty underpayment for resources extracted from Federal lands, and cases alleging false Medicare and Medicaid billings. Mr. Colley also regularly prosecutes and defends cases before all Federal bid protest tribunals encompassing a wide variety of procurements, including classified acquisitions, major weapons systems, sophisticated technology, professional services, and innovative products. He is the former chair of the firm’s government contracts and national security practices, and past chair of the ABA Section of Public Contract Law.

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Universal Health Services, Inc. v. United States ex rel. Escobar 136 S. Ct. 1989 (2016) is best known for having confirmed the “implied certification” route to False Claims Act liability. Attempting to impose some boundaries on that doctrine, however, the decision also recognized that “a misrepresentation about compliance with a statutory, regulatory, or contractual requirement must be material to the Government’s payment decision in order to be actionable under the False Claims Act.” *Id.* at 2002.

The Court wrote at length endeavoring to clarify this materiality requirement. One passage in the decision presents what could be, for many firms, a sort of “get out of jail free” card in terms of defending against alleged False Claims Act violations. Specifically, the Court observed that

[p]roof of materiality can include, but is not necessarily limited to, evidence that the defendant knows that the Government consistently refuses to pay claims in the mine run of cases based on noncompliance with the particular statutory, regulatory, or contractual requirement. Conversely, if the Government pays a particular claim in full despite its actual knowledge that certain requirements were violated, that is very strong evidence that those requirements are not material. Or, if the Government regularly pays a particular type of claim in full despite actual knowledge that certain requirements were violated, and has signaled no change in position, that is strong evidence that the requirements are not material.

Id. at 2003-04. The Government and *qui tam* relators nevertheless have insisted that there may be many reasons for continued payments under a contract, even when failure to comply with some requirement is known, other than the requirement being immaterial to the payment decision.

Lower courts have been grappling with how to apply this government knowledge test to assess whether an alleged deviation from requirements has implicated a consideration “material” to payment. Areas of uncertainty remain, but some bright lines appear to be emerging with regard to the type and substance of information that the Government must know, and who in the Government must know it, in order to treat this standard as having been met when payments continue despite that knowledge.

Although some courts may be less demanding, it seems apparent that, absent extraordinary circumstances, failure to comply with a statutory, regulatory or contractual requirement will be found not material if payments continue even after there is detailed disclosure of the non-compliance to the entity within the Government responsible for deciding whether to pay the claims.

Explicit Disclosures and Investigations Courts so far have not hesitated to find that the materiality requirement is not met where the procuring agency has received specific factual details about, or has specifically investigated, the allegedly unsatisfied requirement, which was the premise for allegedly implied false claims, and yet continued to make payments. The following three decision demonstrate the point.

- *United States ex rel. McBride v. Halliburton Co.*, 848 F.3d 1027 (D.C. Cir. 2017). False claims were premised upon allegedly misrepresented headcounts of personnel using contractor-run facilities. Agency witnesses testified, however, that the headcount data had no bearing on costs billed. The contractor continued to receive award fees for exceptional performance despite the relator’s allegations. In addition, the DCAA audited the contractor’s claims in light of the relator’s allegations, yet did not disallow any of the contractor’s charged costs. The court affirmed summary judgment because the allegedly misrepresented headcounts were not material to the Government’s decision to pay the contractor. (Note, however, that the court in *McBride* did not state that completing the audit without adverse findings was essential to holding the allegedly violated requirement immaterial.)

- *Abbott v. BP Exploration & Production Inc.*, 2017 WL 992506 (5th Cir., Mar. 14, 2017). The relator’s claims that the defendant was not complying with Department of Interior (“DOI”) regulations governing an oil production facility in the Gulf of Mexico sparked Congressional hearings and a DOI investigation. The investigation found that the defendants did not violate the regulations and should be allowed to continue operating the oil drilling site. *Id.* The court stated that “when the DOI decided to allow [the project] to continue drilling after a substantial investigation into Plaintiffs’ allegations, that decision represents ‘strong evidence’ that the requirements in those regulations are not material.” *Id.* at *3. Unfortunately, the court did not give any guidance on what qualifies as a “substantial investigation,” nor whether an exonerating investigation is essential.

- *United States ex rel. Kelly v. Serco Inc.*, 846 F. 3d 325 (9th Cir. 2017). The defendant subcontractor disclosed to the Government’s project manager that it would not be able to comply with the project’s required cost reporting methodology, and received express permission from the project manager and Department of Homeland Security to report its costs using a different methodology. The court found that this approval, coupled with the government’s acceptance of the cost reports on a monthly basis, and subsequent periodic payments for work under the relevant Delivery Orders, was strong evidence that “no reasonable jury could return a verdict for [relator] on his implied false certification claim”. *Id.* at 335.

General Knowledge or Awareness When the Government’s knowledge about a claimant’s failure to comply with a requirement is less specific, courts have disagreed over what it takes to show that a failure to comply was not material, and so not a viable basis for False Claims Act liability. Courts have tended to examine the type and extent of information that the Government has received (specificity, facts or allegations) and who within the Government received it (contracting agency personnel responsible for claim payment decisions vs. Department of Justice).

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At one extreme is the outcome in *United States ex rel. Kolchinsky v. Moody's Corp.*, 2017 WL 825478, *6 (S.D.N.Y. March 2, 2017), where a qui tam relator alleged false claims to pay for credit reporting services. The court found that media and Congressional reports, published prior to the time period encompassed by the allegedly false claims, were sufficient to put the Government on notice “of the very facts relied upon to support the fraud alleged here.” The public reports discussed the defendant’s practice of inflating the credit rankings it provided, which included those sold to executive government agencies that continued to pay for the credit-ratings products each year during the relevant time period. *Id.* Interestingly, the court went so far as to state that “*Kolchinsky* provides no allegation giving rise to an inference that any listed agency could have been unaware of the alleged fraud during the proscribed time period.” *Id.*

Similarly, in *D’Agostino v. ev3, Inc.*, 845 F.3d 1 (1st Cir. 2016), the court looked at actions by the Centers for Medicare and Medicaid Services (“CMS”) after it was aware of the relator’s allegations that defendants had fraudulently induced FDA medical device approvals. The court observed “[t]he fact that CMS has not denied reimbursement for [the medical device] in the wake of “[relator’s] allegations casts serious doubt on the materiality of the fraudulent representations” alleged. *Id.* at 7. In light of the *Escobar* standard, the court found this behavior contrary to the “demanding” materiality standard for False Claims Act liability. *Id.*

The Third Circuit went even further in *United States ex rel. Petratos v. Genentech Inc.*, 2017 WL 1541919 (3rd Cir. May 1, 2017). The relator alleged that the drug company defendant had induced false claims to CMS for Medicare payments by failing to disclose data about adverse results that would have led to drug label changes and fewer prescriptions. The court found that there was no evidence of materiality because the relator had previously disclosed evidence of the supposed fraud to both the FDA and the Department of Justice, but after that disclosure the FDA continued to approve the use of the drug at issue for at-risk populations, added three more approved indications for the drug, did not initiate proceedings against the drug company, and did not require the company to change its labeling practices. *Id.* at *5. Importantly, the court went on to cite the fact that, in the six years since the relator made his allegations known, “the Department of Justice has taken no action against Genentech and declined to intervene in this suit.” *Id.* The court took note of this development even though the government did not expressly state any reason for its declination. In total, the court considered these facts, which relator did not contest, as an admission that “the expert agencies and government regulators have deemed these violations insubstantial (or at least would do so if made aware).” *Id.* at *6. This is a somewhat remarkable turn, as the Department of Justice has long maintained that no inference can be drawn from a decision not to intervene in a qui tam action because of the many reasons that can trigger that step, but defendants will no doubt be citing this precedent going forward.

Lack of Specific Knowledge by the Paying Entity Other courts have been more exacting about what constitutes Government “payment with knowledge,” finding that a general awareness of allegations is not sufficient to find that the Government had “actual knowledge” of the fraud when it continued to pay the claims. When deciding whether compliance with a particular requirement was material to claim payment, these courts have distinguished facts from allegations, and knowledge by contracting officials from knowledge by prosecutors, as well as focusing on the timing of the government’s knowledge relative to payment decisions.

The First Circuit adopted this approach when it took up *Escobar* on remand. In *Escobar*, False Claims Act liability was premised on claims for medical services administered by unqualified providers. Regardless of the possibility that several state regulators may have had notice about the defendants’ alleged noncompliance a year or two before the litigation commenced, the court concluded that “mere awareness of allegations concerning noncompliance with regulations is different from knowledge of actual noncompliance.” *United States ex rel. Escobar v. Universal Health Services, Inc.*, 842 F.3d 103, 112 (1st Cir. 2016) (“*Escobar III*”). Moreover, the court declined to dismiss because “there is no evidence in the complaint that MassHealth, the entity paying Medicaid claims, had actual knowledge of any of these allegations (much less their veracity) as it paid [the] claims.” *Id.* In addition, although the Department of Public Health issued reports a year after the litigation began, which confirmed the defendant’s misrepresentations about provider qualifications, those reports did not show timely and thus relevant government knowledge because the complaint only involved claims leading up to the litigation.

The details of disclosures to the Government were key in *United States v. Public Warehousing CO. K.S.C., et al.*, 2017 WL 1021745 (N.D. Ga. Mar. 16, 2017). That case involved a contract to supply subsistence items to U.S. military personnel in the Middle East, where False Claims Act liability was premised on a supplier’s allegedly inflated prices and failure to pass along discounts to the Government. The defendants argued lack of materiality because the Government continued to make payments although the supplier and discount arrangement were disclosed in the proposal for the contract, and after learning of the alleged fraud via the relator’s qui tam complaint. The court found these disclosures to be an insufficient basis to establish continued payments as evidence that the alleged violations were immaterial.

The misrepresentations at issue in *Public Warehousing CO. K.S.C.* included allegations that the supplier did not qualify as a supplier under the contract and that the defendant received prompt payment discounts when it did not actually pay the supplier promptly. *Id.* *6. The contractor’s proposal did not disclose these details to the Government and “unless the Government knew about the Defendants’ alleged *deception*, the Government could not have the knowledge necessary to undermine materiality.” *Id.* (emphasis in original). This conclusion indicates, not unreasonably, that before the Government’s continued payment will demonstrate that an alleged noncompliance is not material, the knowledge and alleged misconduct must align.

In addition, contrary to *D’Agostino* and *Kolchinsky*, the court in *Public Warehousing CO. K.S.C.* stated that knowledge regarding allegations of fraud in the relator’s complaints was insufficient because “mere suspicion of wrongdoing is not enough.” *Id.* The court declared that “the appropriate time to impute knowledge is at the end of an investigation, not at the beginning.” *Id.* Therefore, it was not relevant that the Department of Defense (DoD) continued to

pay the contractor while the United States Attorney's Office ("USAO") investigated the relator's claims. Rather, it was when the USAO's investigation was complete and the DOJ decided to intervene in the case that the court attributed actual knowledge to the government. *Id.* Because the DoD promptly ceased payment at that point, the court found that it did not continue to pay claims when it had actual knowledge of the misrepresentations.

Moreover, the court also determined that, even if this were not the case, the initial allegations were made to the Attorney General, not to the Government agency in the contractual relationship with the defendant. "[J]ust because one agency within the vast bureaucracy of the federal government has knowledge of a contractor's wrongdoing does not mean that the Defendants have a 'government knowledge' defense." *Id.*

Perhaps most significant, the court in *Public Warehousing CO. K.S.C.* cast doubt on whether the Government's continued payment, even with knowledge of the alleged fraud, will always show that the violation was not material. Observing that the contract was "for the procurement of necessary supplies for American troops in an active theater of war," the Court recognized that contracts essential to an important government interest might continue even in the face of a material violation. *Id.* (quoting *U.S. ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 917 (4th Cir 2003) ("a government entity might choose to continue funding the contract despite earlier wrongdoing by the contractor").

Similarly, in *Rose v. Stephens*, the fact that the Department of Education ("DOE") did not attempt to take away the defendant's Title IV funds, despite being aware of the relator's allegations that the defendants did not comply with an incentive compensation ban, was found to be not "terribly relevant to materiality." 2016 WL 5076214, *6 (N.D. Cal. Sept 20, 2016). In justifying this ruling, the court stated that there may have been a number of reasons the DOE did not take action, including a possibility that it was waiting until the allegations were proven, so the court was unable to infer that DOE had actual knowledge of the violations. *Id.*

To similar effect was the decision in *United States v. Celgene Co.*, 2016 WL 7626222 (C.D. Cal. Dec. 28, 2016), where the defendant allegedly caused false claim submissions to the Centers for Medicare & Medicaid Services ("CMS") by promoting the use of prescription drugs for purposes not approved by the FDA (*i.e.* "off-label" uses). The defendants argued that failure to disclose that a claim related to an off-label use was not material because FDA has long been aware of these uses. Consistent with *Public Warehousing CO. K.S.C.*, the court found that knowledge by one agency would not be imputed to another: "[t]he fact that the FDA knew generally about off-label use does not mean CMS knew about and agreed to reimburse particular off-label claims." *Id.* *13. Moreover, the court looked for specific knowledge to establish lack of materiality as a matter of law. The court held open the prospect that lack of materiality might be shown at trial, but ruled against summary judgment just because CMS knew after the case began that some incoming claims did not meet requirements—"it does not follow that CMS had actual knowledge that particular claims were non-compliant and reimbursed them anyway." *Id.* (The FDA's knowledge deemed relevant by the Third Circuit in the *Petratos* case, despite the claim submissions to CMS, is not necessarily inconsistent. In *Petratos* the fraud alleged was misleading the FDA, which supposedly caused false claims. In *Celgene* the question was whether CMS had knowledge comparable to the FDA's regarding off-label uses.)

Perhaps the easiest, and likely very unusual situation, for finding that a requirement is not material to payment is where the government admits that it continued with payments even after being aware of the noncompliance. In *City of Chicago v. Purdue Pharma LP*, the City admitted in its complaint that it continued to reimburse defendant's opioid prescription claims that it otherwise would not have paid had it known about the defendant's misrepresentations. 2016 WL 5477522 (N.D. Ill. Sept. 29, 2016). While the court did not analyze what, or how much, information the City needed before it would find the City had actual knowledge of the fraud, it did state that, due to the City's admission it "has difficulty understanding how the City remained unaware that the claims were false after the lawsuit was filed." *Id.* Because the City had enough information to bring the suit and identify the claims which it otherwise would not have paid, yet continued to pay them, defendants were entitled to *Escobar's* Government knowledge defense.