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Supreme Court's Escobar Decision Affirms Both Implied Certification and 'Demanding' Materiality Standard



By Tom Zeno, James Hafner and Rebecca Worthington

To the satisfaction of the government and many plaintiffs, the United States Supreme Court upheld the theory of implied certification liability under the False Claims Act in a June 16, 2016, decision in *Universal Health Services v. United States ex rel. Escobar*.

In the same decision, to the relief of many potential defendants, the Court made clear that the materiality inquiry is a ''demanding'' one; thus shielding contractors and providers from False Claims Act (FCA) liability for ''minor'' or ''insubstantial'' noncompliance.

The eagerly awaited decision did not fully resolve questions about FCA liability because the Court allowed the meaning of a materially false statement to develop on a case-by-case basis.

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While the full impact of the *Escobar* decision will not become apparent for some time, there is no question that the decision affects every contractor and provider of goods and services to the federal government, from defense industry contractors to life sciences companies to health care providers.

In addition, the ruling likely will affect providers of goods and services to state governments, whose courts often follow FCA case law for similar state statutes.

The decision's emphasis on the ''demanding'' standard of materiality affords some of the protection that providers sought from the costs of FCA litigation and seems to encourage judges to dismiss frivolous lawsuits prior to expensive discovery. Nonetheless, providers still must enforce vigorous compliance programs in order to prevent potentially ruinous liability.

Court Faced Conflicting Positions on Implied Certification Theory

Julio Escobar and Carmen Correa sued Universal Health Services when their teenage daughter died after being treated by staff at a mental health facility. The

 ISSN 1092-1079

parents asserted that Universal Health Services violated the FCA by allowing their daughter to be treated by ''unlicensed, unqualified, and unsupervised 'counselors.' ''

Although there was no express requirement that the health care staff be properly licensed and supervised, the parents claimed that a claim submitted for payment to Medicaid impliedly certified its compliance with the state law provisions governing licensure and/or supervision of employees. Joining the parents were a number of amici including the United States, state governments and the AARP.

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In its defense, Universal Health Services challenged the validity of the implied certification theory that holds a provider liable because it ''failed to abide by some regulatory, statutory or contractual term'' found somewhere else in government regulations. Instead, the FCA should be interpreted to hold a provider liable only when the provider makes an affirmative misstatement.

A number of amici, including hospital associations, warned of the ''breathtaking number of requirements and obligations'' imposed by government healthcare programs.

The implied certification theory also was challenged as unnecessary in light of the various ''regulatory mechanisms'' that already adequately ''police compliance with program requirements'' (including internal audits, external claims review, administrative sanctions, the availability of civil monetary penalties and revocation of a provider's Medicare billing privileges).

Analysis of the Court's Decision

A. Implied Certification Theory Accepted

The Supreme Court agreed that the implied certification theory can be the basis for liability under the FCA—''at least in some circumstances.''

In doing so, the Court confirmed that an omission can be considered false under the FCA when it is ''clearly misleading in context'' and regardless of whether ''the other party has expressly signaled the importance of the qualifying information.''

This unanimous decision resolved a split of opinion among lower courts, to the satisfaction of the federal government, state governments and supporters of potential *qui tam* relators, who are authorized by statute to sue on behalf of the government and receive up to 30 percent of the recovery.

The Court provided an example of such an omission as an applicant for a college teaching position whose resume ''lists prior jobs and then retirement, but fails to disclose that his 'retirement' was a prison stint for perpetrating a US$12 million bank fraud.''

B. Focus Changes to Materiality and Scienter

Although approving the implied certification theory, the Court replied to the concerns of providers when it required ''strict enforcement'' of the materiality and scienter requirements of the FCA.

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This approach shifts the focus from whether a misrepresentation was implicit or explicit to whether it was ''material'' to the government's payment decision. The Court's approach certainly reduces, and may eliminate, the debate about whether a regulation is a condition of payment.

As the Court noted, the focus on materiality avoids the problem of having the government simply designate ''compliance with the entire U.S. Code and Code of Federal Regulations'' as an express condition of payment—a result that would do little to protect providers from penalties for violations of innumerable minor regulations.

In focusing on materiality, the Court explicitly rejected the government's position that knowing use of a stapler not made in the U.S. could become a material misrepresentation just because the government could refuse to pay on account of that regulatory breach.

Although not an FCA case, a recent Tenth Circuit case expressed a similar concern about the thicket of the regulatory environment when discussing the volume of health care laws and regulations as well as their often stunningly complex content. The decision criticized CMS for being ''confused about its own law.''

Relying on a variety of sources, the Supreme Court held that ''under any understanding of the concept, materiality looks to the effect on the likely or actual behavior'' of the party receiving services. In other words, a reasonable person must believe that the service was deficient in a way that would be important to the government's decision whether to pay.

For a misrepresentation to be material, it must have ''a natural tendency to influence, or be capable of influencing'' the government's payment decision. A plaintiff cannot prove materiality merely by showing that the government ''would have the option to decline to pay if it knew of the defendant's noncompliance.''

On the other hand, if the government chooses to ''pay 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.''

The Court also emphasized that, in addition to proving materiality, a plaintiff seeking to recover on an FCA claim must also allege that the provider ''knowingly'' submitted a false or fraudulent claim (the ''scienter'' requirement).

In a reference to the Civil War activity that led to creation of the statute, the Court said a provider of firearms could face liability under the implied certification theory of the FCA for guns that do not fire if (1) it has

   ISSN 1092-1079

actual knowledge that the government ''routinely rescinds contracts if the guns do not shoot'' or (2) a ''reasonable person would realize the imperative of a functioning firearm.''

C. Materiality and Falsity Scienter Are ''Demanding'' and ''Rigorous.''

The Court went out of its way to make clear that the materiality and scienter standards are high ones by repeatedly describing the burden of each as ''demanding'' or ''rigorous.''

The Court emphasized that the FCA is not ''an all-purpose antifraud statute'' or a means for punishing ''garden-variety breaches of contract and regulatory violations.''

While a provider is not permitted to deliberately ignore (or recklessly disregard) the truth of the information it submits, this standard does provide some protection from treble damages and other penalties that can be imposed for violations of the FCA.

D. Preventing Frivolous Litigation

Sometimes a footnote indicates how the Court expects its decision to be applied, and the Court appears to have added such a footnote in *Escobar* in order to address a concern expressed by Universal Health Services.

In its brief, the company complained that despite the materiality and scienter requirements, providers may still face uphill battles when challenging FCA suits because these ''elements are often ill suited for resolution on a motion to dismiss.''

In its sixth footnote the Court specifically ''rejected'' those concerns by reiterating that the standard for materiality is ''familiar and rigorous'' and that false claims must be pleaded with ''plausibility and particularity.''

This footnote seems to refer to prior decisions of the Court which have been widely understood as encouraging lower courts to prevent excessive litigation by dismissing faulty lawsuits before expensive discovery is required. It is nearly certain that defendants will invoke the footnote when asking lower courts to dismiss FCA complaints at the pleading stage.

Conclusion

At first glance, providers may view the Court's decision to uphold the implied certification theory only as a troubling expansion of FCA liability.

However, upon closer examination, the Court's emphasis on the ''demanding'' materiality and ''rigorous'' scienter requirements should prevent the FCA from becoming—in the words of the Court—an ''all-purpose antifraud statute.''

On this front, several test cases—remanded for reconsideration in light of *Escobar*—should be closely followed by the provider community, as they are likely to be important early decisions on the new materiality and scienter requirements.

In any event, while the provider community can take some solace from these two requirements, the best protection against the risk of expensive and burdensome FCA lawsuits remains implementation of an effective compliance program that prevents litigation about misrepresentations from happening in the first place.