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Implied Certification

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Sidestepping the Escobar Two-Step: *United States ex rel. Rose v. Stephens Institute* Rejects Two-Pronged Test

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New Supreme Court False Claims Act (FCA) precedent is a rare addition to the FCA practitioner's toolbox. This summer's opinion in *Universal Health Servs, Inc. v. United States ex rel. Escobar*[1] on implied certification may be the shiniest new FCA tool in years, but it remains to be seen how useful it will prove to be. *Escobar* conceivably may produce a consensus on detailed standards on the key materiality question that may lead to more consistent and predictable outcomes in implied certification cases. But, if the recent U.S. District Court for the Northern District of California case of *United States ex rel. Rose v. Stephens Institute*[2] is any guide, it seems more likely that Justice Clarence Thomas' broad pronouncements on how to apply materiality in implied certification cases will breed uncertainty and conflicting results in factually similar cases for years to come.

Will *Escobar*'s usefulness be limited by its facts, or does it provide practical guidance regarding how to apply the implied certification theory to all cases? *Rose* concerned a motion for reconsideration that alleged *Escobar* had changed the law that controlled the earlier denial of the FCA defendant's motion for summary

[1] *Universal Health Servs, Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (U.S. 2016).

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[2] *United States ex rel. Scott Rose et al. v. Stephens Institute d/b/a Academy of Art University* (N.D. Cal., No. 09-cv-05966, *order denying motion for reconsideration*, 9/20/2016).

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judgment. *Rose* thus presents one of the first decisions that squarely analyzed *Escobar*. Most notably, *Rose* refused to adopt *Escobar*'s two-pronged test.

1. Escobar's Two-Pronged Test: The Law of the Land?

The Supreme Court granted certiorari in *Escobar* to determine ''the validity and scope of the implied false certification theory of liability.''[3] Justice Thomas described the theory as follows:

> According to this theory, when a defendant submits a claim, it impliedly certifies compliance with all conditions of payment. But if that claim fails to disclose the defendant's violation of a material statutory, regulatory or contractual requirement, so the theory goes, the defendant has made a misrepresentation that renders the claim ''false or fraudulent'' under § 3729(a)(1)(A). This case requires us to consider this theory of liability *and to clarify some of the circumstances in which the False Claims Act imposes liability*. (Emphasis added.).[4]

The Court set forth one of its supposed ''clarifications'' as a two-pronged test:

> Accordingly, we hold that the implied certification theory can be the basis for liability, *at least* where two conditions are satisfied: *first*, the claim does not merely request payment, but also makes specific representations about the goods or services provided; and *second*, the defendant's failure to disclose noncompliance with material statutory, regulatory or contractual requirements makes those representations misleading half-truths. (Emphasis added).[5]

Stated simply, *Escobar*'s implied certification ruling is that False Claims Act liability may attach to claims that, while true on their face, fail to disclose the claimant's failure to comply with a relevant statute or regulation, or with the contract, where such an omission makes the claim misleading, or a ''half-truth.''

The *Escobar* two-step is easy: To determine whether to apply the implied certification theory to an FCA case, a court answers two questions: (1) Does the request for payment include specific representations (and not a mere request for payment)? (2) Does the noncompliance make the specific representations misleading?

This is simple and straightforward. Perhaps that is why virtually every court that has followed *Escobar* has applied it.[6] Not surprisingly, the courts usually begin with a line such as this: ''Implied false certification, as recently established by the Supreme Court, occurs where . . . .''[7] Likewise, courts use the following introduction: ''To establish implied false certification, a plaintiff must show that [followed by the two pronged test].''[8] Sometimes the implied certification theory is introduced as sanctioned by the Supreme Court in this way: ''It is implied where 'at least two conditions are satisfied . . . .' ''[9]

All was right with the world until Judge Phyllis J. Hamilton issued the *Rose* decision challenging all these assumptions and not applying the *Escobar* two-step. But before we get to the *Rose* opinion, let's look more closely at the *Escobar* two-step.

a. The First Prong Is Always Met. We view the first prong of Justice Thomas' two-part test to be a near, if not an absolute, nullity in that it will be satisfied in all cases. That is, it is hard to imagine a case in which the invoice or other form of claim does not make ''specific representations'' as to the basis for the payment request. How else would a government official know to pay the request for payment? The official has to know what he/she is paying money for.

As set forth by the Court,[10] the facts alleged in *Escobar* were seemingly straightforward. The relator alleged that unlicensed employees of a mental health facility were making diagnoses and prescribing drugs under Medicaid reimbursement codes that corresponded to services that, by law, properly could be done only by licensed professionals.

In *Escobar*, the Court traced the payment codes to state regulations that dictated minimum qualifications and licensing requirements for the service. But even absent such a link, every payment request submitted to the government must be pursuant to a contract of some sort. And, typically, the solicitation itself, or something very close to it, becomes the contract. All payment requests will at least be traceable to the underlying solici-

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[3] *Escobar*, 136 S. Ct. at 1998-99. The Court noted that the Seventh Circuit had held that only express falsehoods could make a claim ''false'' under the FCA (*United States v. Sanford-Brown, Ltd.*, 788 F. 3d 696, 711–712 (7th Cir. 2015)), while others had limited implied certification to situations where the defendant had failed to disclose violations of expressly designated conditions of payment (*Mikes v. Straus*, 274 F. 3d 687, 700 (2d Cir. 2011)) or had found liability for violations of other conditions stated in or underlying the contract (*United States v. Science Applications Int'l Corp.*, 626 F. 3d 1257, 1269 (D.C. Cir. 2010)).

[4] *Escobar*, 136 S. Ct. at 1995.

[5] *Id.* at 2001.

[6] *U.S. ex rel. Creighton v. Beauty Basics Inc.* (N.D. Ala., No. 2:13-cv-01989, *order denying motion to amend complaint*, 6/28/2016); *United States ex. rel. Dresser v. Qualium Corp.* (N.D. Cal., No. 12-cv-01745, *motion to dismiss amended complaints*, 7/18/2016); *United States v. Center for Employment Training* (2016 WL 4210052, E.D. Cal., Aug. 9, 2016); *United States of America et al v. Marder, D.O. et al* (S.D. Fla., 2016); *United States v. Fulton County, Georgia* (2016 WL 4158392, N.D. Ga., Aug. 5, 2016); *United States of America et al. v. Northern Adult Daily Health Care Center et al.* (E.D.N.Y., No. 13-cv-04933, *order regarding motion to dismiss*, 9/7/2016); *State of New Jersey v. Haig's Service Corporation*, D.N.J., No. 12-cv-04797, *opinion*, 8/24/2016). The Ninth Circuit Court of Appeals summarized *Escobar* as ''holding 'half-truths — representations that state the truth only so far as it goes while omitting critical qualifying information — can be actionable misrepresentations' under the False Claims Act.'' (*USA, et al. v. United Healthcare Insurance Co., et al.*, 9th Cir., No. 13-56746, *opinion vacated and remanded*, 8/10/2016.

[7] *United States ex. rel. Dresser v. Qualium Corp.* (N.D. Cal., No. 12-cv-01745, *motion to dismiss amended complaints*, 7/18/2016).

[8] *United States v. Center for Employment Training* (2016 WL 4210052, E.D. Cal., Aug. 9, 2016).

[9] *United States v. Fulton County, Georgia* (2016 WL 4158392, N.D. Ga., Aug. 5, 2016).

[10] As an author pointed out in an earlier BNA article, the facts of *Escobar* are much more complicated than the Supreme Court lets on. *See* Brian D. Miller, Fraud Without a Word, 105 FCR 19 (May 17, 2016) (accurately predicting the outcome of the *Escobar* case). For example, the Massachusetts Health regulations contemplate even ''unlicensed counsellors'' providing services under supervision from a qualified professional staff member, such as a psychiatrist, psychologist, social worker or psychiatric nurse. 130 Mass. Code Regs. § 429.424.

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tation, contract or grant, which in turn will identify the goods or services purchased, and very likely the specifications and terms and conditions, as well. If, as in *Escobar*, numbers/codes without words are ''specific representations,'' then it is inconceivable that anything would be a ''mere request for payment'' under the first prong of the test. So, the first prong will always be met.

In *Rose*, the relator alleged that the defendant, the Academy of Art University (AAU), over a period of years violated the Department of Education's incentive compensation ban (ICB), which prohibits educational institutions that receive federal student loan funds from using commissioned salespeople to recruit students. To be an ''eligible institution'' entitled to receive the loan proceeds, the school had certified its compliance with the ICB in a Department of Education program participation agreement that covered the time period in question.

One of AAU's defenses raised in its reconsideration motion was that the loan forms it submitted to the Education Department on behalf of students represented only that the student-borrower was ''eligible'' and that she was enrolled in an ''eligible program.'' Noting that the form did not represent that AAU was an ''eligible institution'' to receive the funds, AAU argued that the allegations failed the first prong of *Escobar* because the form was a ''mere'' request for payment and did not make a ''specific representation'' of compliance with the alleged underlying regulatory violation.

In rejecting this argument, Judge Hamilton implicitly recognized that the ''specific representation'' prong of the two-part test has no teeth. First, she rejected AAU's contention that *Escobar* even erected a two-part test that includes a ''specific representation'' requirement. Calling it an ''alleged'' test, Judge Hamilton reasoned that when the Court stated that ''the implied certification theory can be the basis for liability, at least where two conditions are satisfied,'' it was indicating that the two-part formulation identifies some, but not necessarily all, of the circumstances in which liability under the theory may attach. Even without a direct link from the request to the alleged violation (the loan form to the AAU-Education Department program participation agreement that contained the ICB provision), implied certification liability may attach.

Second, Judge Hamilton determined in the alternative that even if *Escobar* created a two-part test, the requirement for a ''specific representation'' was met because under the prevailing regulations, ''eligible programs'' may only be offered by ''eligible institutions.'' In much the same way that the Supreme Court in *Escobar* connected the dots between the codes on the payment requests and the associated Medicaid qualifications and licensing requirements that allegedly had been violated, the court in *Rose* found the link between the loan form submitted by AAU and the school's promise, found in the program participation agreement, to abide the ICB regulation.[11]

Judge Hamilton's decision suggests that the answer to the first prong does not matter. In all cases, the analysis proceeds to weigh the demonstrated or demonstrable importance of the alleged hidden violation to the government's decision whether to pay the claim had it known of the violation. In other words, are the omissions important enough to make the representations in claim for payment misleading or half-truths?

b. The Second Prong Is Really a Materiality Requirement: The Noncompliance Must Be Important Enough to Make the Representation Misleading. As to its second prong, as a seeming antidote to the observation that the FCA's civil penalties are ''essentially punitive in nature,''[12] *Escobar* stated the materiality standard must be ''demanding'' and ''rigorous,'' lest every statutory, regulatory or contractual violation trigger FCA liability.[13] The second prong appears to be a materiality standard of sorts read back into the determination of whether to apply the implied certification theory. The noncompliance must make the representations ''misleading half-truths.'' Insignificant noncompliance would not make the representation misleading or a half-truth.

Whether this is the objective test's reasonable and prudent person or whether it is just a common-sense approach to whether the representations are misleading does not really matter.[14] The point is that the noncompliance is significant enough (material) to belie the representation that these goods or services were what the government wanted and paid for.[15] Bolstering the demanding and rigorous materiality standard, Justice Thomas added that materiality could be determined in a motion to dismiss or for summary judgment. Materiality is not so fact-specific that it had to wait for trial.[16] Justice Thomas provided a number of helpful factors but stopped short of citing any dispositive factors. He stated that it would be ''very strong evidence'' of immateriality when the government pays a particular claim despite its actual knowledge that certain requirements were violated, or where the government *regularly* pays *those types* of claims despite knowing of the noncompliance and has not indicated a change in position.[17]

Despite Justice Thomas' indication that the materiality inquiry provides an early check on runaway implied certification liability, the *Rose* opinion adopted a relaxed standard for materiality. Judge Hamilton refused to find the Education Department's consistent payment of claims submitted by institutions the department knew violated the ICB to be dispositive. In fact, she construed the government's punishments of institutions that violated the ICB while still paying claims to be evi-

[11] No doubt both Universal Health Services and AAU will continue to argue that these dots should not be connected, but they will now have to do so in the context of the implied certification theory.

[12] *Escobar*, 136 S. Ct. at 1996.

[13] *Id.* at 2003 (''The materiality standard is demanding. The False Claims Act is not 'an all-purpose antifraud statute,' or a vehicle for punishing garden-variety breaches of contract or regulatory violations.'') (Citation omitted).

[14] Some might be tempted to say that Justice Thomas adopts an objective test from the following comment: ''*Anyone* informed that a social worker at a Massachusetts mental health clinic provided a teenage patient with individual counseling services *would probably* — but wrongly — *conclude that* the clinic *had complied with* core Massachusetts Medicaid requirements . . . .'' *Escobar*, 136 S. Ct. at 2000-01 (emphasis added).

[15] The Supreme Court warned: ''We emphasize, however, that the False Claims Act is not a means of imposing treble damages and other penalties for insignificant regulatory or contractual violations.'' 136 S. Ct. at 2004.

[16] *Id.* at 2004, n.6.

[17] *Id.* at 2003-04.

dence of the condition's materiality.[18] She wrote: ''Here, the government's corrective reforms, fines, and settlement agreements show that it considered the ICB to be an important part of the Title IV bargain . . . .''[19]

Such a broad view of materiality belies the Court's statements about materiality being a demanding and rigorous standard.

2. The Rose Opinion Rejects Escobar's Two-Pronged Test

To be sure, in sidestepping the two-part test, the *Rose* opinion is an outlier. Whatever the wording of or qualifications imposed on the test, the two-pronged test is still a pronouncement of the highest court of our land addressing the application of the implied certification theory. So, it is not surprising that most courts have accepted and applied all statements of *Escobar* without question.[20] These cases may suggest that the only time the implied certification theory can be applied is if the two-pronged test is satisfied.[21]

Judge Hamilton's nuanced view of *Escobar* is that it did not establish a ''rigid 'two-part test' for falsity'' that applies to ''every single implied certification claim.''[22] She quoted *Escobar* again:

> The Court explicitly prefaced its holding by making clear that ''[w]e need not resolve whether all claims for payment implicitly represent that the billing party is legally entitled to payment.''[23]

This statement is supported by the careful language of the Supreme Court in framing the issue:

> We first hold that, *at least in certain circumstances*, the implied false certification theory can be a basis for liability. Specifically, liability can attach when the defendant submits a claim for payment that makes specific representations about the goods or services provided, but knowingly fails to disclose the defendant's noncompliance with a statutory, regulatory or contractual requirement. In these circumstances, liability may attach if the omission renders those representations misleading.[24]

Judge Hamilton explained:

> The Supreme Court's use of ''at least'' [in the two-pronged test[25]] indicated that it need not decide whether the implied false certification theory was viable in all cases, because the *particular* claim before it contained ''specific representations'' that were ''misleading half-truths.'' The language in *Escobar* does not purport to set out, as an absolute requirement, that implied false certification liability can attach *only* when these two conditions are met.[26]

Judge Hamilton concluded: ''In sum, *Escobar* did not establish a rigid two-part test for falsity that must be met in *every single* implied certification case.''[27]

In conclusion, *Rose* may be a bold opinion, but it carefully examined *Escobar* and reached well-reasoned conclusions. By rejecting the two-pronged test as mandatory, the court identified the significant ''white space'' left by *Escobar* to be filled in on a case-to-case basis. The cynic would say the principle after *Escobar* is that, as before, the implied certification theory applies when a judge says it does.

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[18] *United States ex rel. Scott Rose et al. v. Stephens Institute d/b/a Academy of Art University* (N.D. Cal., No. 09-cv-05966, *order denying motion for reconsideration*, 9/20/2016).

[19] *Id.*

[20] To interpret *Escobar* to apply only to its facts — as Judge Hamilton does — makes the Supreme Court's attempt at resolving the conflict and providing guidance to lower courts less meaningful. It makes *Escobar* idiosyncratic and of little benefit to lower courts as to when to apply the implied certification theory. To eliminate the two-pronged test leaves almost no guidance as to when to apply the implied certification theory. In applying the implied certification theory, the Court emphasizes the materiality and scienter requirements as limits. *Escobar*, 136 S. Ct. at 2002 (‘‘ . . . concerns about fair notice and open-ended liability 'can be effectively addressed through *strict enforcement of the Act's materiality* and scienter requirements.' Those requirements *are rigorous*.'') (Citation omitted) (emphasis added).

[21] *See, e.g., U.S. ex rel. Creighton v. Beauty Basics Inc.* (N.D. Ala., No. 2:13-cv-01989, *order denying motion to amend complaint*, 6/28/2016). Other examples are listed in footnote 6.

[22] *United States ex rel. Scott Rose et al. v. Stephens Institute d/b/a Academy of Art University* (N.D. Cal., No. 09-cv-05966, *order denying motion for reconsideration*, 9/20/2016).

[23] *Id.* (quoting *Escobar*, 136 S. Ct. at 2000).

[24] *Escobar*, 136 S. Ct. at 1995 (emphasis added).

[25] ''Accordingly, we hold that the implied certification theory can be the basis for liability, *at least* where two conditions are satisfied . . . .'' *Escobar*, 136 S. Ct. at 2001.

[26] *United States ex rel. Scott Rose et al. v. Stephens Institute d/b/a Academy of Art University* (N.D. Cal., No. 09-cv-05966, *order denying motion for reconsideration*, 9/20/2016) (citations omitted) (emphasis in original).

[27] *Id.* (emphasis added). The judge hedged her bets by adding that the two-pronged test was met anyway. *Id.*

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