An Underused, Powerful Tool Can Fend Off False Claim Act Charges

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The Bottom Line

- The False Claims Act's knowledge of materiality requirement is an important and underused tool for defendants facing alleged FCA liability.
- The one recent circuit case limiting this requirement to implied false certification cases is unsound.
- Knowledge of materiality may be a particularly useful defense for companies under investigation for FCA liability based on alleged DEI or other civil rights related violations.

The Department of Justice's Civil Rights Fraud Initiative aims to pursue claims under the False Claims Act against entities that "promote divisive DEI policies." It announced its first resolution in April and reportedly continues to investigate other companies for using diversity, equity, and inclusiveness initiatives in hiring and promotion.

Targeted entities have a variety of traditional defenses, including that such claims fail to satisfy the FCA's materiality requirement or give rise to damages. But there is an additional, lesser-used defense available to fend off accusations: the government's obligation to prove the defendant's knowledge of materiality.

The US Supreme Court has confirmed that knowledge of materiality is a distinct element of scienter — in other words, that the government must demonstrate both the defendant's knowledge of falsity and knowledge of materiality in FCA cases. Although the US Court of Appeals for the Fifth Circuit has articulated a narrow view of when the government must prove knowledge of materiality in *US ex rel. Montcrief v. Peripheral Vascular Associates*, that decision is unsound.

When properly understood and applied, the FCA's knowledge of materiality requirement offers defendants a powerful tool to fight allegations of FCA liability—including claims that the government pursues under the Civil Rights Fraud Initiative.

Knowledge of Materiality

The FCA imposes treble damages and penalties on any person who "knowingly presents, or causes to be presented, a false or fraudulent claim" or who "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim." The statute defines "knowingly" to mean acting with "actual knowledge, deliberate ignorance, or reckless disregard." While the FCA expressly requires only false statements to be material, courts have read an implicit materiality requirement into the false claim provision.

In *Universal Health Servs., Inc. v. United States ex rel. Escobar*, the Supreme Court clarified the significance of the materiality requirement. First, it described the materiality standard as a demanding one that looks "to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation.

Second, the court identified limits on what circumstances may support a finding of materiality. It cautioned that a finding isn't warranted just because the government designates compliance as a condition of payment. Nor is it sufficient that the government "would have the option to decline to pay if it knew of the defendant's noncompliance," or if the noncompliance was minor or insubstantial. And if the government fully pays a claim despite "actual knowledge" that certain requirements were violated, or if it "regularly pays a particular type of claim in full despite actual knowledge that certain requirements were violated," there is "strong evidence" that the requirements aren't material.

Third, the Supreme Court explained that the FCA requires proof not just that the defendant violated a requirement that's material to the government's payment decision, but also that the requirement is one that "the defendant knows is material" to the government's decision to pay. In other words, the court stated that the FCA's knowledge requirement modifies the FCA's falsity element as well as its materiality element—making proof of knowledge of materiality a prerequisite to liability.

Since *Escobar*, most courts to address the issue have confirmed, consistent with *Escobar*, that the FCA requires knowledge of materiality, including *United States v. Molina Healthcare of Illinois, Inc.* and *United States ex rel. Prather v. Brookdale Senior Living Communities, Inc.* These decisions have reached various conclusions as to whether the plaintiff satisfied the knowledge-of-materiality element, but the rulings have acknowledged the government's dual obligations to show knowledge of falsity and materiality. These decisions have reached various conclusions as to whether the plaintiff satisfied the knowledge-of-materiality element, but the rulings have acknowledged the government's dual obligations to show knowledge of falsity *and* materiality.

Fifth Circuit Misinterpretation

Montcrief departs from how other courts have interpreted the government's obligation to prove knowledge of materiality. For reasons that don't withstand scrutiny, the Fifth Circuit held that the application of this requirement turns on the nature of the plaintiff's alleged theory of falsity and doesn't apply where the plaintiff has alleged that the defendant made an outright falsehood. The case involved allegations that defendant PVA, a vascular surgery practice in Texas, billed Medicare for the same services twice or for services that hadn't yet been completed. After the court granted partial summary judgment in favor of the relators, the remaining issues were tried by a jury.

The jury found that PVA submitted false claims totaling approximately $2.7 million. On appeal, the medical practice argued that the trial court erred by failing to instruct the jury that it needed to decide whether PVA knew that the falsity of the claims were material to the government.

The Fifth Circuit rejected this claim of error, holding that an FCA plaintiff must prove knowledge of materiality only in cases alleging fraudulent misrepresentations by omission, not in cases alleging outright falsehoods. In reaching this result, the Fifth Circuit relied on strained readings of the Supreme Court's decisions in *Escobar* and *US ex rel. Schutte v. SuperValu Inc*.

The appellate panel observed that in *Escobar*, where the Supreme Court referenced the government's obligation to prove knowledge of materiality, the alleged falsity involved "'fraudulent' misrepresentations by omission." By contrast, in *SuperValu*, the alleged falsity involved outright falsehoods. The Fifth Circuit found this distinction significant, and cited to a single footnote in *SuperValu* rejecting an unrelated argument about whether the reference to "information" in the FCA's definition of knowledge only applied to factual information.

The footnote explained that "information" has a broad definition and that "the scienter requirement of the FCA is plainly directed to the falsity of the claims submitted." The Fifth Circuit invoked this footnote to affirm its conclusion that the knowledge of materiality requirement identified in *Escobar* applied only to fraudulent misrepresentations by omission rather than claims that were outright false.

Montcrief's distinction between types of falsehoods for purposes of applying the FCA's knowledge of materiality requirement is flawed. First, there is no indication in the text of the FCA that Congress intended different scienter requirements to apply based on the alleged reason why the claim is false.

Second, while *Escobar* and *SuperValu* involved different theories of falsity, neither decision suggested that the nature of these theories affected the Supreme Court's view of when the government must prove knowledge of materiality. In *Escobar*, the justices broadly stated that, in assessing whether a defendant may be held liable for violating a legal requirement, what matters is "whether the defendant knowingly violated a requirement that the defendant knows is material to the Government's payment decision." Any suggestion that it applies only in the context of misrepresentations by omission is absent from this clear statement of the grounds for liability.

Montcrief's reading of *SuperValu* is even more puzzling. *SuperValu* doesn't purport to address when a defendant has knowledge of materiality but instead focuses on when a defendant may be said to have knowledge of falsity, particularly when the alleged falsity concerns an ambiguous legal requirement.

The *SuperValu* footnote cited in *Montcrief* merely conveys the Supreme Court's view that scienter can be established by showing a defendant was aware of *any* information making the statement false, not only factual information. The *SuperValu* footnote can't plausibly be read to address, much less implicitly overrule, *Escobar's* confirmation that a defendant must have knowledge of materiality to be liable.

Indeed, *SuperValu* cites *Escobar* approvingly after the footnote, noting that a defendant can possess actual knowledge of a material condition without the government calling it a condition of payment. Accordingly, there is no basis to conclude that the *SuperValu* court intended to implicitly remove or reject the knowledge of materiality requirement set out in *Escobar*.

Third, *Montcrief's* limitation on the government's obligation to prove knowledge of materiality misapprehends the purpose of that safeguard.

By requiring knowledge of materiality, the FCA ensures a defendant is aware that failing to comply with a particular requirement has enough nexus to the goods or services provided to the government to warrant the government withholding or reducing payment to a defendant. The statute focuses on the defendant's knowledge of the importance of its noncompliance to the government's payment decision, not on the mechanism by which the defendant allegedly misled the government about its state of compliance.

In some circumstances, the nature of a defendant's false statement can potentially be probative of the defendant's knowledge of materiality. But *Escobar* instructs that such evidentiary considerations should be evaluated and resolved by the factfinder.

Montcrief therefore erred in concluding that the jury is precluded from considering the defendant's knowledge of materiality whenever a defendant allegedly submits a false claim by means of an outright false statement rather than a fraudulent omission.

Accordingly, notwithstanding the result in *Montcrief*, defendants have a compelling argument that the government must demonstrate the defendant's knowledge of materiality to pursue liability under the FCA, and that the government must satisfy this burden of proof regardless of the theory of falsity the government chooses to advance.

FCA Implications

The government's obligation to prove knowledge of materiality offers a powerful defense to cases brought under DOJ's Civil Rights Fraud Initiative. As instructed by *SuperValu*, courts should require the government to satisfy a subjective test that focuses primarily on what defendants "thought and believed" about whether their conduct was material to the government.The government also will have to prove the defendant's subjective knowledge based on "what defendant thought when submitting the false claim — not what the defendant may have thought after submitting it."

The government likely will struggle to meet this burden in cases alleging FCA liability based on supposed DEI or other civil rights related violations. Companies will have a strong argument that they didn't believe any such violations would be material to the government's payment of its claims, given that the federal contract or grant in most cases will involve the provision of goods or services entirely unrelated to such violations. This is likely even if the government can establish that such violations satisfy the test for materiality.

If the government seeks to pursue false claims that predate the current administration, companies can bolster their defense by pointing to the government's payment of such claims despite knowledge, if not encouragement, of the conduct at issue.

Companies can also productively deploy this defense in other cases. Where the question of materiality is uncertain or a presents a close call, companies may have a compelling case that however the underlying materiality issue is resolved, they lacked the required knowledge of materiality.

Defendants may have plenty of opportunities to credibly argue that the government can't establish that the defendant knew its conduct was material, and therefore a core requirement for FCA liability is not met, following the Supreme Court's decision in *Kousisis v. United States*, which creates significant uncertainty about the current standard for materiality under the FCA.

In sum, the Supreme Court has made clear that the FCA requires proof that the defendant violated a requirement that it knows is both false and material. Properly understood, requiring a defendant to have knowledge of materiality provides a strong defense in FCA cases brought by the government in many potential enforcement areas.

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