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Client Alert

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Circuit Courts Limit Reach of Federal False Claims Act in Two Defense Contractor Cases

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Two recent federal circuit court decisions demonstrate the importance to defense contractors of the "rigorous" materiality standard for False Claims Act (FCA) cases announced by the Supreme Court last year in *Universal Health Services, Inc. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016). More than a few defense contractors are prevailing by demonstrating that relators have accused them of immaterial regulatory violations, and not infractions that are material to the government's decision to pay a claim.

In *United States ex rel. Kelly v. Serco, Inc.*, 846 F.3d 325 (9th Cir. Jan. 12, 2017), the U.S. Court of Appeals for the 9th Circuit became the first circuit to analyze the *Escobar* materiality standard for claims brought against a defense contractor under the FCA. Subsequently, the D.C. Circuit did so in *United States ex rel. McBride v. Halliburton Co.*, 848 F.3d 1027 (D.C. Cir. Feb. 17, 2017). Both circuits affirmed summary judgment for the defense contractors on grounds that the relators could not demonstrate that any falsity in the claims was material.

The "Demanding" and "Rigorous" Materiality Standard

In *Escobar*, the Supreme Court held that a party that submits a claim to the government can be liable under the FCA by impliedly certifying compliance with applicable laws, regulations, or contractual terms. However, the Court imposed a significant constraint on this legal theory of liability. The false certification of compliance must be material to the government's decision to pay a claim. *Escobar*, 136 S. Ct. at 2002. And, according to the Court, the materiality is "demanding" and "rigorous." *Id.* at 2003, 2004 n.6. Not every false certification of a regulatory violation is material, the Court explained.

Summary Judgment Affirmed for Defense Contractors Where Material Falsity Is Not Established

In *Kelly*, the relator—a former analyst for a defense contractor—brought an implied false certification claim under the FCA. The contractor had an agreement with the Department of Defense, Navy Space and Naval Warfare Systems Command (SPAWAR) to provide project management services for an upgrade of the wireless communications systems along the U.S.-Mexico border. *Kelly*, 846 F.3d at 328. The analyst alleged that the contractor failed to record its costs according to the Department of Defense's Earned Value Management System guidelines. *Id.* at 329. However, the 9th Circuit found no evidence that the defense contractor was required to comply with the guidelines. *Id.* at 331. The agreement between the contractor and SPAWAR made no mention of the guidelines, and there was no regulation that conditioned payment on compliance with them. *Id.*

The court was equally unpersuaded by the analyst's argument that SPAWAR could have refused payment if the defense contractor disclosed the method it used to track costs. Relying on *Escobar*, the 9th Circuit noted that evidence that SPAWAR *could* refuse payment if it knew of the violation is insufficient to establish materiality. *Id.* at 333–34. Moreover, SPAWAR's acceptance of the cost reports despite knowledge of their non-compliance supported the conclusion that no reasonable jury could find for the implied false certification claim. *Id.*

The District of Columbia Circuit came to the same conclusion in *McBride*. There, the contractor had an agreement with the U.S. Army to provide morale, welfare, and recreation services for troops at two military camps located in Iraq. *McBride*, 848 F.3d at 1029. The relator—a former employee—accused the contractor of maintaining false headcount data to overstate the number of troops that used its facilities, and also of destroying sign-in sheets before submitting claims to the Army. *Id.* As in *Kelly*, the employee failed to demonstrate a connection failed to demonstrate a connection between the allegedly inflated headcount data and the defense contractor's claims for payment. *Id.* at 1032–33. The contractor's agreement with the Army did not require it to produce headcount data. *Id.* Rather, the contractor voluntarily recorded this information and sporadically included it in status reports. *Id.* The employee argued that, regardless of contractual terms, the Army may refuse payment for unreasonable or unsubstantiated costs. *Id.* She relied on a federal regulation that specifies costs charged to the government must be reasonable. *Id.*, citing 48 C.F.R. § 31.201-2(a)(1).

The D.C. Circuit found the regulation inapplicable because the employee offered no evidence to suggest

that the headcount data was relevant or material to determining costs. *Id.* To the contrary, the defense contractor showed that its costs were based on the size of each camp's population and the types of services offered at each facility. *Id.* Even if the employee could prove that the headcount data were false, she could not prove that the false information had any bearing on costs billed to the Army or that it affected payment decisions in any way. *Id.* In fact, the Defense Contract Audit Agency did investigate the employee's claims about headcount data and still allowed payment on all the contractor's charged costs. *Id.* at 1034. Quoting *Escobar*, the D.C. Circuit found this was "very strong evidence" that the data was not material to the payment decision. *Id.*

Kelly and *McBride* illustrate how the rigorous materiality standard ensures that defense contractors will not face FCA liability for regulatory violations that are not material to the government's decision to pay a claim. In future False Claims Act cases involving defense contractors, the issue of materiality will likely predominate. In FCA cases, defense contractors should formulate a discovery plan — that may include discovery from the government and from former government employees and experts — demonstrating that the government does not base its payment decisions on compliance with the regulation in question. Evidence that the government has paid claims in the past despite knowing of similar regulatory violations will be extremely important.

If you have any questions about this alert, do not hesitate to contact the authors or your usual Drinker Biddle contact.

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