JONES DAY

COMMENTARY

NOVEMBER 2017

Third Circuit Confirms Government Knowledge Can Defeat Scienter and Materiality Requirements for False Claims Act Liability

IN SHORT

The Situation: In *Spay v. CVS Caremark Corp.*, the Third Circuit became the latest court of appeals to hold that, in False Claims Act litigation, scienter can be lacking when the government has knowledge of "the facts underlying an allegedly false record or statement"—so long as the defendant has knowledge of the government's knowledge. The court further held that the formal materiality standard added to the FCA in 2009 merely clarified the preexisting, common-law materiality standard. Under *Spay*, case law construing the materiality standard codified in the current statute applies to older conduct that predated the formal standard's enactment.

Looking Ahead: *Spay* adds to a growing consensus that government knowledge can defeat both scienter and materiality in False Claims Act suits.

Defendants in False Claims Act ("FCA") suits have long argued they should not be liable if they can show that the government paid their claims despite being aware of the alleged falsehood. Last week, in *U.S. ex rel. Spay v. CVS Caremark Corp.*, the Third Circuit underscored the vitality of this argument, which can negate scienter and materiality, both of which are essential elements of FCA liability. Specifically, in *Spay*, the Third Circuit became the latest court of appeals to hold that scienter can be lacking when the government has actual knowledge of "the facts underlying an allegedly false record or statement"—so long as the defendant knows the government knows.

The Third Circuit also joined a chorus of courts of appeals holding that—as the Supreme Court itself said in its recent landmark decision in *Universal Health Services, Inc. v. Escobar*, 136 S. Ct. 1989 (2016)—materiality may be lacking where the government has knowledge of allegedly false statements and yet continues to pay the claims.

In that context, the Third Circuit held that the formal materiality standard added to the FCA in 2009 merely clarified the preexisting, common-law materiality standard instead of adding a new materiality requirement. As a result, under *Spay*, case law construing the materiality standard codified in the current statute applies to subsections of the statute that do not expressly define "material" and to older conduct that predated the formal standard's enactment. Finally, *Spay* underscores that lower courts take seriously the Supreme Court's *Escobar* directive that the FCA's materiality requirement is "rigorous" and, though fact intensive, is appropriate for resolution on a motion to dismiss or a motion for summary judgment.

In *Spay*, a former pharmacist and pharmacy auditor alleged that the use of "dummy" Prescriber IDs in the submission of Medicare Part D claims constituted a violation of the FCA. Insurers ("Sponsors") and pharmacy benefit managers ("PBMs") submitted Prescriber IDs to Centers for Medicare and Medicaid Services ("CMS") as part of year-end reconciliation processes in 2006-2007. Because CMS's automated system would reject any submission with a blank Prescriber ID, the defendants began using dummy IDs where needed to ensure claims were accepted. But the district court in granting summary judgment to the defendants rejected this as a basis for FCA liability, finding that the government knew about defendants' purported misconduct:

> CMS officials knew, in 2006-2007, that Sponsors and PBMs were having trouble obtaining the unique physician identifier number necessary to populate the associated field … [;] CMS prioritized the filling of valid pharmacy claims over the administrative requirement of populating the physician identifier field and did not want valid claims rejected due to the absence of that number; [and] CMS knew that … Sponsors and PBMs were submitting … dummy prescriber identifiers, yet never sanctioned any Sponsor [or] terminated any Sponsor[.]

On this basis, the district court concluded that the "government knowledge inference," previously recognized by six other circuits, defeated the FCA's scienter requirement.

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scienter, but found that the defense had not been satisfied. In particular, the Third Circuit held that the defense required showing not only that the government knew about the alleged falsity (which defendants had done) but also that the defendant knew the government knew (which defendants had *not* done). Emphasizing the need to show both the government's and the defendant's knowledge, the court stated that the defense might more aptly be described as "government acquiescence."

But the Third Circuit nevertheless affirmed on an alternative ground, holding that the alleged falsity (i.e., the use of dummy IDs) was not material because the government regularly paid the claims in full despite knowledge of the alleged false statements.

To begin, the court relied on *Escobar* to conclude that the 2009 amendments to the FCA simply codified and clarified the preexisting, common-law materiality requirement applicable to FCA claims. Accordingly, the court determined that the materiality standard articulated in *Escobar* applied to the pre-2009 conduct at issue in *Spay*. The court then explained that, because CMS routinely paid claims "even though it knew the information identifying the prescribers was not accurate," this was "strong evidence" under *Escobar* that any misstatements about the identity of the prescribers were not material. The court's materiality analysis also looked to the context of the alleged falsity: the purported misstatements were a technical "workaround" to prevent the denial of legitimate claims for reimbursement, and had the unobjectionable effect of merely "allow[ing] patients to get their medication." In light of the technical nature of the violations and the government's knowledge of the misstatements, the court found nothing in the text or purpose of the FCA to support making the alleged misconduct actionable.

Spay adds to the growing consensus that government knowledge can defeat both scienter and materiality in FCA suits. But the *Spay* court made clear that the scienter defense requires showing not only the government's knowledge but also the defendant's awareness of the government's knowledge. Given that the corresponding materiality defense does *not* turn on the defendant's awareness, it remains to be seen whether government knowledge will continue to be a prominent scienter defense, as courts construe and expand upon *Escobar*. *Spay* will further help materiality arguments where the alleged misstatements involve a technical violation that do not undermine the governmental goal being advanced by the program.

THREE KEY TAKEAWAYS

1. In *Spay*, the Third Circuit held that the scienter defense required showing not only that the government knew about the alleged falsity (which defendants had done) but also that the defendant knew the government knew (which defendants had not done).
2. The Third Circuit also joined a chorus of courts of appeals holding that materiality may be lacking where the government has knowledge of allegedly false statements and yet continues to pay the claims
3. According to the court in *Spay*, case law construing the materiality standard codified in the current statute applies to older conduct that predated the formal standard's enactment.

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