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Government Contractors Beware: The 'Secret Handshake' Theory of False Claims Act Liability?

By Glenn V. Whitaker, Esq., and Victor A. Walton Jr., Esq.

Regulations are an inescapable part of business today, and no one knows this better than those who do business with the government. A recent decision from the U.S. Court of Appeals for the 9th Circuit, however, substantially raises the stakes of compliance. The rationale of this opinion, *United States ex rel. Hendow v. University of Phoenix*,[1] could subject government contractors to False Claims Act liability — and the treble damages and substantial fines that come with it — based on *any* knowing violation of *any* regulation.

This is a startling development, even to those of us who have watched the increased use of the FCA over the past 20 years. But it is a development that contractors should consider, especially given the U.S. Supreme Court's decision to let *Hendow* stand, without review, in April 2007.

The *Hendow* case is part of an overall trend marking the growth of the FCA. In fiscal year 2006, for example, the U.S. government recovered more than $2 billion in settlements and judgments associated with the statute, which allows private parties, called "*qui tam* relators," to bring suit on behalf of the government.[2] Since 1986, when Congress substantially amended the FCA, the Department of Justice has recovered more than $20 billion.[3]

Despite the frequent use of the statute, the FCA has always had limits. As the Supreme Court explained long ago, "the False Claims Act was not designed to reach every kind of fraud practiced on the government."[4] Nevertheless, the doctrine of false certification, as applied through the *Hendow* decision, threatens to reach even more kinds of fraud than previously was thought.

In *Hendow* the 9th Circuit, whose district courts have handled almost one-fifth of all FCA cases in the past two decades,[5] considered an FCA action brought against the University of Phoenix.[6]

The university, a private, for-profit entity, participates in the Title IV program of the Higher Education Act in order for its students to receive federal loans.[7] Mary Hendow and Julie Albertson, two former enrollment counselors at the university, alleged that it violated the FCA by violating a portion of the Higher Education Act, which prohibits any participating school from paying incentive compensation to recruiters.[8]

The issue before the 9th Circuit was whether the relators had stated a claim under the FCA. Several years earlier the U.S. District Court of the Eastern District of California had dismissed the complaint, with prejudice, based on its assessment that the relators had failed to allege that the university had submitted a false or fraudulent claim for payment, as required by the FCA.[9]

The 9th Circuit reversed, based on its conclusion that the relators' allegations stated a claim for FCA liability based on the doctrine of "false certification."[10] In interpreting — and expanding — this sometimes controversial doctrine, the court used a rationale that should be troubling to anyone who does business with the government.

The Doctrine of False Certification

Even before the 9th Circuit's decision, the false-certification doctrine stood on the boundaries of FCA liability. Typically, allegations under the FCA involve claims that are "false or fraudulent" in a factual sense.[11] A contractor submits a claim for work that was never performed; a provider inflates the cost of a product that was never purchased. In these kinds of cases, the claim made to the government for payment is false. If the contractor submits an invoice for work that was never performed and costs that were never incurred, that invoice is, as a matter of fact, untrue.

In *Hendow*, though, the relators did not allege that the claims for payment were, in and of themselves, false. After all, the claims for payment at issue in the case were student loan applications, submitted by students and the university, for Pell grants, Stafford loans and other federal loans.[12] There was no allegation that the applications were untrue because, for example, students lied on their applications or the university inflated the cost of tuition.

Instead, the relators relied on a theory of false certification. Under this doctrine, the FCA violation does not depend on the *contents* of the invoice, but on the *act* of submitting the invoice. In submitting the invoice, the claimant "certifies" that it has complied with the legal, regulatory and contractual requirements for receiving payment.

This certification may be express or implied.[13] An express certification occurs when a claimant states that it has complied with the relevant requirements for receiving payment.[14] An implied certification occurs when the act of submitting the invoice can be understood, from the context, as a statement of compliance.[15] Regardless of the form of the certification, though, a "false claim" occurs when a certification of compliance is *false*, if the claimant was not in compliance, as well as *material*, since the government would not have paid the claimant had it known of this noncompliance.[16]

In short, the "false certification" theory of FCA liability can be understood to require two elements: that a certification occurred and that the certification was a prerequisite of payment.

These twin requirements are important to limiting the scope of the false-certification doctrine. Given the slippery nature of "certification" and the ubiquity of government payments, it is a doctrine with the potential to reach *any* violation of *any* regulation by *any* government contractor. Indeed, it is a common refrain in FCA decisions, including *Hendow*, that a mere violation of a regulation or a statute does not constitute an FCA violation.[17] In particular, courts have pressed false-certification cases on the element of materiality: whether the false statement of compliance *caused* the government to provide the benefit and incur the loss.[18]

The *Hendow* Approach to False Certification

Where was the "false claim" — or even the "false certification" — in the *Hendow* case? The relators did not say the student loan applications submitted to the government were inaccurate. They did not allege that the university lied about providing incentive compensation to recruiters. Based on the decision from the 9th Circuit, the "false claim" occurred because of the university's "false certification" of compliance with the Higher Education Act. To receive federal funds, the university was required by statute and regulation to sign a "program participation agreement."[19] This agreement, as well as the relevant statute and regulations, conditioned the university's eligibility to participate in the Higher Education Act program on compliance with a variety of regulations.[20]

The 9th Circuit reasoned that, when the university signed the participation agreement, it certified that it was not providing such incentive compensation, and the government would have denied federal funding to the university had it known of such noncompliance.[21]

This application of the false-certification doctrine is significant in two ways. First, it may expand the form of "certification" actionable under the FCA. One limiting principle of the false-certification doctrine is that FCA liability attaches not because of the *activity* of noncompliance, but because of the *certification* of compliance.[22]

Nevertheless, the 9th Circuit rejected the notion that "the word 'certification' has some paramount and talismanic significance."[23] Noting that the judicially created doctrine was not based on any statutory definition of "certification," the court reasoned that "certification" cast a broad net: "So long as the statement in question is knowingly false when made, it matters not whether it is a certification, assertion, statement or secret handshake."[24]

Second, the *Hendow* decision also appears to push the boundaries of the element of materiality. A central question in any FCA case, materiality is a particularly important question in the false-certification context: Would the certification have influenced the government's decision to pay a claim? In other words, if the government had known of the noncompliance, would it have denied the particular payment?

In answering this question, several circuit courts have distinguished between a condition of *payment*, *i.e.*, compliance is a prerequisite to a government's decision to pay a particular claim, and a condition of *eligibility*, *i.e.*, compliance is necessary for an entity to participate in a program but is not connected to a particular claim.[25]

The 9th Circuit, however, rejected this as "a distinction without a difference," based on "grammatical haggling … unmoored in the law."[26] It further found that as long as "a false statement is integral to a causal chain leading to payment, it is irrelevant how the federal bureaucracy has apportioned the statements among layers of paperwork."[27] By this reasoning, *every* threshold condition of eligibility might constitute a condition of payment actionable under the FCA.

The potential reach of this decision was not lost on the 9th Circuit. In discussing the requirement that a false certification be knowingly made, it acknowledged that its ruling could reach the knowing violation of any "one of hundreds of boilerplate requirements," no matter how minor or technical.[28] These requirements include, for example, that a university submit a report regarding student-athletes by July 1 of each year, a requirement that appears on the same list as the ban on incentive compensation.[29]

A typical defense contractor or health care provider must comply with thousands of such regulations, all of which may now raise the possibility of FCA liability. It is unclear whether private parties can enforce these regulations through the FCA, as opposed to the administrative agency often charged to enforce these regulations through certain administrative procedures. To these concerns, the 9th Circuit offered little comfort, since "fraud is fraud, regardless of how 'small.'"[30]

The potential reach of the decision was also not lost on the government's business partners. In 2007 organizations as diverse as the American Health Care Association, the National Defense Industrial Association and the Career College Association submitted briefs in support of the university's writ of *certiorari* to the Supreme Court.[31] On April 23, however, the court declined to grant review.[32]

Potential Implications

The *Hendow* decision continues to be a troubling precedent. Despite its potential reach, though, it is possible the *Hendow* decision can be limited based on its facts and the principles of the FCA.

First, *Hendow* can be limited based on its facts. Indeed, some of the district courts interpreting the decision have still granted motions to dismiss based on the distinction between conditions of payment and conditions of participation.[33] Last May a federal court in Hawaii refused to extend *Hendow* to an FCA claim made in the health care context. As in *Hendow*, the relators in *United States ex rel. Woodruff v. Hawaii Pacific Health* alleged that certain medical providers signed certain Medicare participation agreements and, despite their representations of regulatory compliance, used improper codes in submitting reimbursements.[34]

The court rejected the argument that *Hendow* had created "a sweeping new rule that all conditions of participation give rise to liability under the FCA," and it found the 9th Circuit's reasoning inapplicable to the Medicare context.[35] Since the relators could not allege that regulatory compliance was a condition of payment, the court reasoned, they failed to state a claim based on false certification.[36]

More fundamentally, the *Hendow* decision can be limited based on the principles of the FCA. The dispute in *Hendow* arose upon a motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6), when the plaintiffs need only allege, but not prove, their claims. As the 9th Circuit acknowledged, the need to prove the elements of an FCA violation remain; plaintiffs must prove (1) a false statement or fraudulent course of conduct, (2) made with *scienter*,(3) that was material, (4) causing the government to pay out money.[37]

In a case like *Hendow*, for example, it may be possible to produce documentary evidence showing that the government knew of the activities and decided to pay anyway — evidence that would be relevant to show that the requisite *scienter* was lacking, that the claim was not "false" or that the claim was not material to the government's decision to pay.[38] In short, while *Hendow* may encourage relators to bring claims, it does not guarantee that they will prevail on them.

Regardless of the potential arguments to limit the scope of *Hendow*, it remains as a significant precedent. One might reasonably ask, What ever happened after the *Hendow* decision? Despite the fact that the University of Phoenix paid $9.8 million to settle the related administrative action with the U.S. Department of Education while the *Hendow* case was on appeal, the lower court ruled that the relators could continue with their case,[39] and the judge set a trial date for September 2009.[40] You can bet that government contractors across the country will be watching this litigation closely in the years to come.

Notes

[1] *U.S. ex rel. Hendow v. Univ. of Phoenix,* 461 F.3d 1166 (9th Cir. 2006).

[2] Press Release, U.S. Department of Justice, *Justice Department Recovers $2 Billion for Fraud Against the Government in FY 2007; More Than $20 Billion Since 1986* (Nov. 1, 2007), *available at* http://www.justice.gov/opa/pr/2007/November/07_civ_873.html. Of this $2 billion, about $1.54 billion was associated with cases brought by relators.

[3] *Id.* For a discussion of the expanded use of state false-claims laws, *see* James F. Barger, Jr., Pamela H. Bucy, Melinda M. Eubanks and Marc S. Raspanti, *States, Statutes and Fraud: An Empirical Study of Emerging State False Claims Acts*, 80 Tulane L. Rev. 465 (December 2005).

[4] *United States v. McNinch*, 356 U.S. 595, 599 (1958).

[5] U.S. Gov't Accountability Office, *Information on False Claims Act Litigation*, GAO-06-32OR (Jan. 31, 2006) at 27, *available at* http://www.gao.gov/new.items/d06320r.pdf.

[6] *See Hendow*, 461 F.3d at 1168-69.

[7] *Id.*

[8] *Id.*, citing 20 U.S.C. § 1094(a)(20).

[9] *U.S.. ex rel. Hendow v. Univ. of Phoenix*, No. CV S-03-457, 2004 WL 3611690, at *1 (E.D. Cal. May 20, 2004).

[10] The 9th Circuit also considered the doctrine of promissory fraud (or "fraud in the inducement"), which it found to have similar requirements to the doctrine of false certification. *See Hendow*, 461 F.3d at 1173-1174; *see also U.S. ex rel. Main v. Oakland City Univ.*, 426 F.3d 914 (7th Cir. 2005), *cert. denied,* 547 U.S. 1071 (2006).

[11] *See* JOHN T. BOESE, CIVIL FALSE CLAIMS ACT AND QUI TAM ACTIONS §1.06[A] (3d ed. 2007). Indeed, the 9th Circuit said that in an "archetypal *qui tam* False Claims Act action, such as where a private company overcharges under a government contract, the claim for payment is not itself literally false or fraudulent." *Hendow*, 461 F.3d at 1170.

[12] *Id.* at 1169.

[13] *See generally* Boese § 2.03[G][1]; Claire M. Sylvia, The False Claims Act: Fraud Against the Government § 4.43 (2004).

[14] *See* BOESE § 2.03[G][1][b]; *U.S. ex rel. Schmidt v. Zimmer Inc.*, 386 F.3d 235, 243 (3d Cir. 2004) ("A certificate of compliance with federal health care law is a prerequisite to eligibility under the Medicare program."); *U.S. ex rel. Mikes v. Straus*, 274 F.3d 687, 696 (2d Cir. 2001) (describing "the 'certification theory' of liability … is predicated upon a false representation of compliance with a federal statute or regulation"); *U.S. ex rel. Thompson v. Columbia/HCA Healthcare Corp.,* 125 F.3d 899, 902 (5th Cir. 1997) ("Thus, where the government has conditioned payment of a claim upon a claimant's certification of compliance with, for example, a statute or regulation, a claimant submits a false or fraudulent claim when he or she falsely certifies compliance with that statute or regulation.").

[15] *See* BOESE § 2.03[G][1][a]; Richard J. Webber, Exploring the Outer Boundaries of False Claims Act Liability: Implied Certifications and Materiality, PROCUREMENT LAWYER (Winter 2001); *U.S. ex rel. Pogue v. Diabetes Treatment Ctrs. of Am.,* 238 F. Supp. 2d 258, 264 (D.D.C. 2002) ("Where the government pays funds to a party and would not have paid those funds had it known of a violation of a law or regulation, the claim submitted for those funds contained an implied certification of compliance with the law or regulation and was fraudulent."); *Hendow*, 461 F.3d at 1173 n.1 (describing, in implied-certification cases, "if a party submits a claim for payment under a government program with requirements for participation, that claim is taken as an implied certification that the party was in compliance with those program requirements"); *United States v. Rogan,* 459 F. Supp. 2d 692, 717-718 (N.D. Ill. 2006) ("Even in the absence of an express certification of compliance, the knowing submission of claims by a person who has violated a statute or regulation that contains, on its face, a direct nexus to the government's payment decision is also actionable under the FCA.").

[16] *See Hendow*, 461 F.3d at 1171 (underlining "the necessity of a *false* claim, rather than a mere unintentional violation"); *see generally U.S. ex rel. A+ Homecare v. Medshares Mgmt. Group*, 400 F.3d 428, 444-45 (6th Cir. 2005) (discussing "outcome materiality" and "natural tendency" tests for determining materiality); *see generally* BOESE § 2.04 (discussing materiality), § 2.03[B] (discussing falsity).

[17] *See Hendow*, 461 F.3d at 1171 ("We have also held that '[m]ere regulatory violations do not give rise to a viable FCA action,' but rather, '[i]t is the false *certification* of compliance which creates liability when certification is a prerequisite to obtaining a government benefit.'") (quoting *U.S. ex rel. Hopper v. Anton*, 91 F.3d 1261, 1266-67 [9th Cir. 1996]); *see also Thompson*, 125 F.3d at 902 ("claims for services rendered in violation of a statute do not necessarily constitute false or fraudulent claims").

[18] *See* W. Bradley Tully, *Materiality as a Constraint on False Claims Actions Based upon Regulatory Non-Compliance*, 15 No. 4 HEALTH LAWYER 1 (July 2003); *Anton*, 91 F.3d at 1266 (quoting Boese and describing two major considerations for the false certification theory: "(1) whether the false statement is the cause of the government's providing the benefit; and (2) whether any relation exists between the subject matter of the false statement and the event triggering government's loss") (internal citation omitted); *Hendow*, 461 F.3d at 1171, 1175 (quoting Boese and noting that "[m]ost of the argument in this case centers on whether and how much the university's alleged fraud was material to the government's decision to disburse federal funds").

[19] *Hendow*, 461 F.3d at 1168-69.

[20] *Id.*

[21] *Id.* at 1175-1177.

[22] *See, e.g., Anton*, 91 F.3d at 1266-67.

[23] *Hendow*, 461 F.3d at 1172 (stating that the "facile distinction" between a false certification and a false statement "would make it all too easy for claimants to evade the law").

[24] *Id.*

[25] *See U.S. ex rel. Siewick v. Jamieson Science & Eng'g*, 214 F.3d 1372, 1376 (D.C. Cir. 2000) (noting "the rule, adopted by all courts of appeal to have addressed the matter, that a false certification of compliance with a statute or regulation cannot serve as the basis for a *qui tam* action … unless payment is conditioned on that certification); *Harrison v. Westinghouse Savannah River Co.*, 176 F.3d 776, 693 (4th Cir. 1999) (affirming dismissal of FCA claim because relator "never asserted that such implied certifications were in any way related to, let alone prerequisites for, receiving continued funding); *Thompson*, 125 F.3d at 902 ("false certifications of compliance create liability under the FCA when certification is a prerequisite to obtaining a governmental benefit"); *Mikes*, 274 F.3d at 699 (noting that the "False Claims Act was not designed for use as a blunt instrument to enforce compliance with all medical regulations — but rather only those regulations that are a precondition to payment"); *Anton*, 91 F.3d at 1266 (requiring that "certification is a prerequisite to obtaining a government benefit").

[26] *Hendow*, 461 F.3d at 1176; *see also Main*, 426 F.3d 914 (rejecting distinction between conditions of eligibility and conditions of payment).

[27] *Hendow*, 461 F.3d at 1174 (quoting *Main*, 426 F.3d at 916).

[28] *Hendow*, 461 F.3d at 1175.

[29] *See* 34 C.F.R. §§ 668.14(b)(20) and 668.48(a); *see generally Univ. of Phoenix v. U.S. ex rel. Hendow*, Br. of Amicus Curiae Career Coll. Ass'n (Mar. 26, 2007), 2007 WL 935019, at **5-10 (describing potentially implicated regulations).

[30] *Hendow*, 461 F.3d at 1175.

[31] *See Univ. of Phoenix v. U.S. ex rel. Hendow*, Br. of Amicus Curiae Am. Health Care Ass'n and Nat'l Ass'n for the Support of Long Term Care (Mar. 26, 2007), 2007 WL 935018; *Univ. of Phoenix v. U.S. ex rel. Hendow,* Br. of Amicus Curiae Career Coll. Ass'n, 2007 WL 935019; *Univ. of Phoenix v. U.S. ex rel. Hendow*, Br. of Amicus Curiae Nat'l Def. Indus. Ass'n (Mar. 26, 2007), 2007 WL 935020.

[32] 127 S. Ct. 2099.

[33] *See Herndon v. Science Applications Int'l Corp*., 2007 WL 2019653, at *2 (S.D. Cal. July 10, 2007) (citing *Hendow* but granting motion to dismiss for failure to allege, *inter alia*, false certification and materiality); *U.S. ex rel. Woodruff v. Haw. Pac. Health*, No. 05-CV- 00521, 2007 WL 1500275, at *4 (D. Haw. May 21, 2007) (citing *Hendow* but granting motion to dismiss on distinction between conditions of eligibility and conditions of participation); *but see U.S. ex rel. Tyson v. Amerigroup Ill.*, 488 F. Supp. 2d 719, 725 (N.D. Ill. 2007) (after jury verdict, citing *Hendow* for proposition that "[a] condition [of] participation is a condition [of] payment").

[34] *Woodruff*, 2007 WL 1500275 at *1.

[35] *Id*. at *7.

[36] *Id.*

[37] *Hendow*, 461 F.3d at 1174.

[38] *See generally* Boese § 2.03[F] (discussing defense based on government knowledge), § 2.04[F][1] (discussing potential defenses in false certification context).

[39] *See Hendow*, 2007 WL 2389842 (E.D. Cal. Aug. 20, 2007).

[40] *Hendow*, No. 2:03-cv-457-GEB-DAD, Status Pretrial Scheduling Order (E.D. Cal. Aug. 6, 2007) (Docket No. 83) at 5.

Glenn V. Whitaker, *a partner at* ***Vorys, Sater, Seymour & Pease*** *in Cincinnati, has represented defendants in complex civil litigation, white-collar-crime matters and a wide variety of* qui tam *False Claims Act actions.* ***Victor A. Walton,*** *a partner at the firm's Cincinnati office, has represented defendants in complex civil litigation and has extensive experience defending corporations against alleged violations of the False Claims Act.*