Updates

A defendant's knowledge of and subjective beliefs about the meaning of legal requirements—not what an objectively reasonable person may have believed—are what matters when determining whether a defendant "knowingly" submitted false claims for payment in violation of the False Claims Act (FCA), the U.S. Supreme Court ruled on June 1, 2023. The Court's decision in *United States ex rel. Schutte v. SuperValu, Inc.* (Case No. 21-1326) and *United States ex rel. Proctor v. Safeway, Inc.* (Case No. 22-111) resolves an important legal issue with significant implications for future FCA cases—while also presenting interpretive issues for lower courts.

In a unanimous opinion written by Justice Clarence Thomas, the Court held that what "matters for an FCA case is whether the defendant knew the claim was false." Rejecting the U.S. Court of Appeals for the Seventh Circuit's knowledge standard using an objective test, the Court agreed with the whistleblower (relator) that knowledge under the FCA turns on "what the defendant thought when submitting the false claim—not what the

defendant may have thought *after* submitting it."

The Court's widely anticipated opinion addresses a key requirement of the FCA, which imposes liability on anyone who knowingly submits false or fraudulent claims to the government. The Court's decision has significant ramifications for companies and litigants involved in FCA/*qui tam* investigations and litigation. Among other things:

- The decision highlights the risks of FCA liability for companies and their employees. After *Schutte*, a defendant cannot alone rely on a *post hoc* interpretation of ambiguous law to defeat FCA liability, even if such an interpretation may be objectively reasonable. Scienter will instead turn on what the defendant believed the applicable statutory, regulatory, or contractual requirement meant at the time the claims were submitted.
- As explained below, the decision also leaves open interpretative issues for litigants and practitioners in FCA cases. For example, the lower courts will be left to explore issues such as the meaning of the Court's explanation of the term "reckless disregard" and the extent to which a company is obligated to seek out clarity on ambiguous provisions. Companies will also be faced with difficult decisions regarding attorney-client privilege.

In this Update, we analyze the Court's decision in *Schutte* and its practical significance.

Procedural Background in *Schutte* and *Proctor*

The consolidated *Schutte* and *Proctor* cases arose out of a *qui tam* suit under the FCA alleging that retail pharmacies (SuperValu and Safeway) defrauded the federal government by knowingly submitting false reports of their drug prices when seeking reimbursement under Medicaid and Medicare. Those federal insurance programs generally cap reimbursement for drugs at the pharmacy's "usual and customary" charge to the public. The petitioners alleged that SuperValu and Safeway for years offered pharmacy discount programs to their cash customers, yet reported higher retail prices, rather than their discounted prices, as their usual and customary charges to government payors in alleged violation of the FCA.

To be held liable under the FCA, a defendant must have knowingly presented (or caused to present) a false or fraudulent claim. 31 U.S.C. § 32729(a). Thus, liability requires both (1) falsity and (2) knowledge, or scienter. The statute defines "knowingly" as encompassing not only actual knowledge, but also deliberate ignorance or reckless disregard of the truthfulness of the submitted claims. And it specifies that specific intent to defraud is not necessary to establish liability.

In *Schutte*, a divided panel of the Seventh Circuit held that a defendant cannot be found to have acted "knowingly" if (1) it has an objectively reasonable reading of the statute or regulation and (2) there was no authoritative guidance warning against its interpretation. The Seventh Circuit relied heavily on a 2007 Supreme Court decision, *Safeco Insurance Company of America v. Burr*, 551 U.S. 47 (2007), which had interpreted the Fair Credit Reporting Act (not the FCA). According to the Seventh Circuit, under *Safeco*, a defendant's "subjective intent is irrelevant for purposes of liability." Affirming the district court's decision in favor of the company on summary judgment, the Seventh Circuit found that the company could not have acted "knowingly" if its actions were consistent with an objectively reasonable interpretation of the phrase "usual and customary." In *Proctor*, decided on August 5, 2022, a split panel of the Seventh Circuit affirmed the district court's grant of summary judgment in favor of Safeway following *Schutte*.

The Supreme Court granted certiorari in both cases to decide whether and when a defendant's contemporaneous subjective understanding or beliefs about the lawfulness of its conduct are relevant to whether it "knowingly" violated the FCA.

The Supreme Court's Opinion

As the Supreme Court explained, the Seventh Circuit's standard asked whether a "defendant's acts were consistent with an objectively reasonable interpretation of the relevant law that had not been ruled out by a definitive authority or guidance." And the court of appeals applied that standard "regardless of whether the defendant actually believed such an interpretation at the time of its claims."

Schutte resolves a split among the lower courts over how to interpret the FCA's scienter requirement. The Fourth Circuit Court of Appeals and three other circuits had embraced an objective scienter standard following *Safeco*, whereas four other circuits considered a defendants' subjective understanding to determine whether they acted knowingly.

Rejecting the Seventh Circuit's approach, the U.S. Supreme Court held that both the FCA's text and the common law of fraud refer to a defendant's knowledge and subjective beliefs.

Addressing the FCA's text, the Court explained that each part of the statutory term "knowingly"—actual knowledge, deliberate ignorance, and reckless disregard—focuses "primarily on what respondents thought and believed." Citing the Restatement (Second) of Torts and other sources, the Court explained that the forms of scienter in the statute track traditional common-law fraud, which ordinarily focuses on a subjective test. The Court added, "the text and the common law ... point to what the defendant thought when submitting the false claim—not what the defendant may have thought *after* submitting it." As such, the Court explained, "the focus is not, as respondents would have it, on post hoc interpretations that might have rendered their claims accurate. It is instead on what the defendant knew when presenting the claim."

According to the Court, the term "reckless disregard" "captures defendants who are conscious of a substantial and unjustifiable risk that their claims are false but submit the claims anyway." Noting in a footnote that it need not decide whether the FCA adopts conceptions of recklessness used in some civil contexts, the Court stated that "it is enough to say that the FCA's standards can be satisfied by a defendant's subjective awareness of the claim's falsity or an unjustifiable risk of such falsity."

The Court next explained that even though the phrase "usual and customary" used in federal pharmaceutical reimbursement limits may be ambiguous on its face, such facial ambiguity alone is not sufficient to preclude a finding that defendants knew their claims were false. The Court stated that even if "usual and customary" is ambiguous, defendants "could have learned its correct meaning." The Court noted the relator's allegations that the companies received notice that the phrase "usual and customary" referred to their discounted prices but nevertheless tried to hide their discounted prices.

The Court held that *Safeco* was inapplicable and that the companies' reliance on *Safeco* to interpret the FCA was misplaced. The Court explained that *Safeco* involved a different statute with a different scienter requirement involving "willful" conduct. Also, the Court stated *Safeco* did not purport to set forth the purely objective safe harbor that the companies invoked. According to the Court, nothing in *Safeco* suggests that one should look to facts or legal interpretations that the defendant neither knew nor had reason to know at the time he acted. The

Supreme Court essentially confined *Safeco* to its Fair Credit Reporting Act context.

Finally, the Court rejected the defendants' argument distinguishing between misrepresentations of law and misrepresentations of fact. The defendants argued that their conduct was not actionable under the common law of fraud or the FCA because it involved alleged misrepresentations of law (i.e., a dispute over the meaning of the phrase "usual and customary"). The Court disagreed, stating that even assuming that the FCA incorporated some version of this rule, the defendants did not make a pure misrepresentation of law—they made a statement of implied facts about their prices.

Summarizing its decision, the Court held that FCA relators can establish scienter by showing that defendants: "(1) actually knew that their reported prices were not their 'usual and customary' prices when they reported those prices; (2) were aware of such a substantial risk that their higher, retail prices were not their 'usual and customary' prices and intentionally avoided learning whether their reports were accurate, or (3) were aware of such a substantial and unjustifiable risk but submitted the claims anyway."

Key Takeaways

The Court's decision is a significant development for litigants and counsel involved in FCA matters, including *qui tam* whistleblower cases. Several practical observations can be made.

- *Schutte* underscores the importance of contemporaneous evidence of a defendant's state of mind when submitting claims for payment. Evidence of timely and robust efforts within companies to address uncertainty about the meaning of applicable legal requirements when submitting claims to the government will be critical.
- The Court's emphasis on what the defendant knew, or should have known, about the relevant legal standard will have important implications for related legal advice that companies receive about applicable statutes, regulations, and government guidance. This naturally gives rise to practical concerns about the attorney-client privilege. Indeed, in *Schutte*, the Court was warned that ruling against the defendants would force companies to waive the attorney-client privilege to demonstrate that their subjective beliefs were reasonable, an implication the Court's decision essentially ignores. Going forward, it will be important to think through the consequences of a future privilege waiver when relying on legal advice in submitting a claim under an ambiguous statute or regulation.
- The Court's focus on subjective intent and beliefs will create challenges for defendants seeking to obtain dismissal of *qui tam* or FCA litigation on a motion to dismiss or at summary judgment, at least as it relates to the issue of knowledge. The issues of falsity and materiality will no doubt remain prominent in FCA dispositive motion practice.
- The Court's relatively narrow decision will generate new interpretive issues for lower courts, particularly as to the meaning of the Court's conception of "reckless disregard." The Court stopped short of clarifying what it means for a defendant to be "aware of ... a substantial and unjustifiable risk" that its claims are false when submitting claims. The Court likewise left open questions raised by the Justices during oral argument about whether aggressive but reasonable legal interpretations provide a defense against scienter.
- Another issue raised in *Schutte* that will likely generate disputes is whether, to defeat an allegation of scienter under the FCA, a company has an affirmative obligation to attempt to resolve ambiguity about the meaning of a regulation by seeking guidance from the government. The Court suggested that the defendants in *Schutte* and *Proctor* could be held to have acted knowingly if they were "aware of a substantial risk" that the drug prices reported to the government were not their "usual and customary"

prices and "intentionally avoided learning whether their reports were accurate[.]"

Authors

Alexander O. Canizares

Partner
ACanizares@perkinscoie.com 202.654.1769

Michael R. Huston

Partner
MHuston@perkinscoie.com 202.434.1630

David B. Robbins

Partner
DRobbins@perkinscoie.com 206.359.6745

Angela R. Jones

Partner
AJones@perkinscoie.com 206.359.8041

Barak Cohen

Partner
BCohen@perkinscoie.com 202.654.6337

David W.T. Daniels

Partner
DDaniels@perkinscoie.com 202.654.6364

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