Case No. 17-15111

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, EX REL.
SCOTT ROSE, MARY AQUINO, MITCHELL NELSON, AND LUCY STEARNS,

Plaintiffs-Appellees,

v.

STEPHENS INSTITUTE, A CALIFORNIA CORPORATION
DOING BUSINESS AS ACADEMY OF ART UNIVERSITY

Defendant-Appellant.

Appeal From the United States District Court
For the Northern District of California
The Honorable Phyllis J. Hamilton
Case No. 4:09-cv-05966-PJH

APPELLEES' RESPONSE IN OPPOSITION TO PETITION FOR REHEARING AND REHEARING EN BANC

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I. INTRODUCTION

In its petition for rehearing en banc, appellant Stephens Institute, dba Academy of Art University ("AAU") misrepresents both the law and the facts of this case. The United States Supreme Court did *not* hold in *Universal Health Servs. v. U.S. ex rel. Escobar* that materiality is determined by agency action or inaction, including non-binding back-office policies or discretionary enforcement decisions. Nor does AAU accurately describe the Department of Education's view of the Incentive Compensation Ban ("ICB"). The record shows that the DOE – as directed by Congress – has consistently emphasized the critical importance of compliance with the ICB as a condition of receiving Title IV funds.

This appeal presented two issues: (1) whether the *Escobar* Court's re-affirmation of the common law test for materiality is clearly irreconcilable with *United States ex rel. Hendow v. Univ. of Phoenix*, 461 F.3d 1166 (9th Cir. 2006), and (2) whether *Escobar* created a mandatory two-part test for determining whether an implied certification theory of liability was viable, and thereby overruled *Ebeid ex rel. United States v. Lungwitz*, 616 F.3d 993 (9th Cir. 2010). A majority of the panel correctly held *Hendow* remains good law. The entire panel erroneously held – against its own judgment – that prior panel decisions deemed *Ebeid* overruled, but that error does not affect the outcome of this case. Neither

circumstance warrants rehearing *en banc* and the resulting continued delay of trial in this nearly decade-old matter. AAU's petition should thus be denied.

II. BACKGROUND

A. Escobar

In *Universal Health Servs. v. United States ex rel. Escobar*, 136 S. Ct. 1989 (2016), the Supreme Court was presented with a circuit split over whether a False Claims Act claim may be based on a theory of false implied certifications or may only be based on false express certifications. A unanimous Court resolved the circuit split in favor of the majority of circuits, including this one, that recognized implied false certification liability. The Court based its holding firmly on the common law, observing: "Because common-law fraud has long encompassed certain misrepresentations by omission, 'false or fraudulent claims' include more than just claims containing express falsehoods." *Escobar*, 136 S. Ct. at 1999.

As with many unanimous decisions, the Court's holding was narrow. The Court did not attempt to define the scope of implied certification liability, expressly stating "We need not resolve whether all claims for payment implicitly represent that the billing party is legally entitled to payment. The claims in this case do more than merely demand payment. They fall squarely within the rule that half-truths . . . can be actionable misrepresentations." *Escobar*, 136 S. Ct. at 2000. Addressing the facts before it, the Court held that "the implied certification theory can be a basis for liability, *at least where* two conditions are satisfied: first, the

claim does not merely request payment, but also makes specific representations about the goods or services provided; and second, the defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths." *Id.* at 2001 (emphasis added).

The Court then discussed how courts should apply the FCA's requirement that misrepresentations be material. Citing centuries-old common law, the Court noted that "[u]nder any understanding of the concept, materiality 'look[s] to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation.'" *Escobar*, 136 S. Ct. at 2002 (citing 26 R. Lord, Williston on Contracts § 69:12, p. 549 (4th ed. 2003) (Williston)). The Court offered further guidance for applying these well-established materiality rules. First, the Court noted that a matter is material "(1) '[if] a reasonable man would attach importance to [it] in determining his choice of action in the transaction;' or (2) if the defendant knew or had reason to know that the recipient of the representation attaches importance to the specific matter 'in determining his choice of action,' even though a reasonable person would not." *Id.* at 2002-03 (quoting Restatement (Second) of Torts § 538 (1977), at 80). The Court cautioned that materiality "cannot be found where noncompliance is minor or insubstantial." *Id.* at 2003.

Consistent with these common law rules, the Court noted that "when evaluating materiality under the False Claims Act, the Government's decision to expressly identify a provision as a condition of payment is relevant, but not automatically dispositive." *Escobar*, 136 S. Ct. at 2003. For example, the Court hypothesized that violation of a requirement to use American-made staplers would not necessarily be material, particularly if "the Government routinely pays claims despite knowing that foreign staplers were used." *Id.* at 2004. The Court described the common law test as a "familiar and rigorous one." *Id.* at 2004 n.6.

B. The Incentive Compensation Ban and *Hendow*

Title IV of the Higher Education Act ("HEA") provides financial aid to eligible students in eligible programs at eligible institutions. *See generally* 20 U.S.C. §§ 1070, et seq. In order for an institution to receive funds from student loans or grants provided under Title IV, it must enter into a Program Participation Agreement ("PPA") with the federal Department of Education ("DOE") in which it expressly agrees to comply with various statutory, regulatory, and contractual requirements. *See* 20 U.S.C. § 1094(a); 34 C.F.R. § 668.14(a)(1) (2011). One critical requirement imposed by the statute, regulation, and PPA is the incentive compensation ban, commonly referred to as the "ICB."

The ICB prohibits schools from "provid[ing] any commission, bonus, or other incentive payment based directly or indirectly on success in securing enrollments . . . to any persons or entities engaged in any student recruiting or

admission activities . . . .” 20 U.S.C. § 1094(a)(20). Congress’s intent in enacting this ban was very clear: for-profit schools (like AAU) were recruiting unqualified students who became a drain on federal student aid programs. *See* 138 Cong. Rec. H 1736-01 (1992), 1992 WL 57307; H.R. Rep. No. 102-447, at 10 (1992), 1992 U.S.C.C.A.N. 334, 343; S. Rep. No. 102-58 (1991), 1991 WL 153999.

The ICB is designed to prohibit schools from incentivizing recruiters or other admissions personnel to “sign up poorly qualified students who will derive little benefit from the subsidy and may be unable or unwilling to repay federally guaranteed loans.” *United States ex rel. Main v. Oakland City Univ.*, 426 F.3d 914, 916 (7th Cir. 2005). In *Hendow*, this Court held that compliance with the ICB was “the sine qua non” of Title IV federal funding, and thus that false assertions of ICB compliance are “material to the government’s decision to disburse federal funds.” 461 F.3d at 1175-77.

C. This Action

This action was filed on December 21, 2009 by four relators. ER 505. The operative complaint challenges AAU’s repeated and significant violations of the ICB and related implied false representations to the federal government that it was in compliance. ER 467-77. AAU’s challenged conduct occurred from 2006 through 2010. ER 23. AAU’s motion for summary judgment was denied on May 4, 2016. ER 13-30. The district court found that Relators had established a triable issue of fact whether AAU violated the ICB. ER 25-28. The district court also

found evidence of "the lengths taken by AAU to hide their compensation practices" which would support a jury finding of scienter. ER 29.

Instead of setting the case for trial, however, the district court first stayed the action at AAU's request pending the United States Supreme Court's decision in *Escobar*, and then allowed AAU to move for reconsideration, which motion was denied on September 20, 2016. ER 1-12. AAU was granted permission to file an interlocutory appeal, ER 35-42, and this Court affirmed the district court's order. AAU now brings its petition for rehearing or rehearing *en banc*.

III. THE PETITION SHOULD BE DENIED

A. The Panel Correctly Interpreted *Escobar*'s Reiteration Of The Common Law Materiality Standard

As referenced above, in *Hendow* this Court held that misrepresenting compliance with the ICB is material under the False Claims Act. *Hendow*, 461 F.3d at 1175-77. The panel split on whether *Escobar* implicitly overruled *Hendow*. The majority correctly held that *Hendow* is consistent with *Escobar* and thus remains controlling law in this Circuit. Op. pp. 13-16. AAU, however, insists that somehow it is entitled to judgment as a matter of law that violations of the ICB are *immaterial*. AAU is wrong.

1. *Escobar* did not create a new materiality standard and is wholly consistent with *Hendow*

Escobar did not create a new or special False Claims Act standard for materiality. It expressly applied the "familiar" traditional standard, reaffirming the

basic framework for materiality long recognized by the common law, which boils down to the question of whether knowledge of the falsity would likely affect the recipient of the misrepresentation. *See Marsteller for the use and benefit of the United States v. Lynn Tilton, Patriarch Partners, L.L.C.*, 880 F.3d 1302, 1313 (11th Cir. 2018); *Grabcheski v. American International Group, Inc.*, 687 Fed. Appx. 84, 87 (2d Cir. 2017); *United States ex rel. Miller v. Weston Educ., Inc.*, 840 F.3d 494, 504 (8th Cir. 2016). On remand from the Supreme Court, the First Circuit observed that *Escobar* mandated a "holistic approach" to determining materiality, and that "the fundamental inquiry is whether a piece of information is sufficiently important to influence the behavior of the recipient." *United States ex rel. Escobar v. Universal Health Servs., Inc.*, 842 F.3d 103, 110 (1st Cir. 2016) ("*Escobar II*") (internal quotations omitted); *see also United States ex rel. Prather v. Brookdale Senior Living Cmtys., Inc.*, 892 F.3d 822, 831 (6th Cir. 2018).

Escobar is entirely consistent with *Hendow*. In *Hendow*, this Court held that compliance with the incentive compensation ban is material to, and indeed the "*sine qua non* for," the government's payment of Title IV funds to institutions such as AAU. *Hendow*, 461 F.3d at 1177. That detailed, carefully reasoned holding, which no court has subsequently questioned, was based on the specific statutory, contractual, and regulatory scheme at issue in this case. This Court noted that "the eligibility of the University under Title IV and the Higher Education Act of 1965—

and thus, the funding that is associated with such eligibility—is explicitly conditioned, in three different ways, on compliance with the incentive compensation ban." *Hendow*, 461 F.3d at 1175-76. *Hendow* further noted that Congress plainly considered ICB compliance material. "[T]he DOE and the United States Congress, as evidenced by the statutes, regulations, and contracts implementing the Title IV and Higher Education Act requirements for funding, quite plainly care about an institution's ongoing conduct, not only its past compliance." *Id.* at 1176.

Hendow thus properly applied the common law standard to find that ICB compliance is material to, and indeed the "sine qua non" of, receipt of Title IV funds. *Hendow*, 461 F.3d at 1175-78. Nothing in *Escobar* changes that analysis.

AAU's implied representation that it was complying with the ICB when AAU knew it was not was not a "garden-variety breach[ ] of contract or regulatory violation[]," such as the American-made stapler example *Escobar* cited to illustrate immateriality. *Escobar*, 136 S. Ct. at 2003-04. Any "reasonable person" would attach importance to ICB compliance under these circumstances. *Id.* at 2001-02. Unqualified "warm body" students enrolled solely so that a recruiter can meet a bonus quota, who can't graduate, transfer their earned credits, or pay back their federal student loans, are akin to "guns" that "do not shoot" (*id.* at 2002) - not to a technical violation of a rule that does not go to the heart of the bargain with the

government. *See Escobar II*, 842 F.3d at 110 (on remand, holding that allegations of conditioning of payment on compliance and the "centrality of the licensing and supervision" to Medicaid give court "little difficulty" in concluding that materiality was sufficiently alleged); *see also United States ex rel. Badr v. Triple Canopy, Inc.*, 857 F.3d 174, 178 (4th Cir. 2017) (applying "common sense" to find military contractor's omissions regarding guards' failure to meet marksmanship requirements material); *United States v. Celgene Corp.*, 226 F. Supp. 3d 1032, 1049 (C.D. Cal. 2016) ("We are not dealing with an extraneous condition included in a government contract, like the hypothetical requirement to buy American-made staplers . . . [but rather] an essential feature of the Medicare Part D program—a coverage limitation that is central to the balance Congress struck between expanding prescription drug coverage and containing costs."). *Escobar* is thus entirely consistent with *Hendow*'s holding that ICB compliance is material to a claim for Title IV funds.

2. AAU's materiality arguments are baseless

AAU insists that misrepresenting compliance with the ICB is *immaterial* as a matter of law under *Escobar*. It makes three arguments, none of which are supported by *Escobar* or the ICB's central importance to Title IV. *See Hendow*, 461 F.3d at 1175-76.

First, AAU insists that the court is required to find ICB compliance immaterial based upon the cursory "Hansen" memorandum that AAU refers to

repeatedly as an "enforcement policy." ER 104-05. The Seventh Circuit observed this "back-office memo" "has no legal effect; it was not published for notice and comment and does not authoritatively construe any regulation." *Main*, 426 F.3d at 917.

Second, AAU claims that the DOE's use of intermediate enforcement measures means that an ICB violation is immaterial. To the contrary, the DOE actively enforces the ICB. ER 138-140. The DOE ensured – whether through settlement, corrective action, or issuing a liability – that schools came into compliance with the ICB (or closed). These efforts show that ICB compliance is "sufficiently important to influence the behavior of the" government. *See Escobar II*, 842 F.3d at 110. The fact that the government didn't immediately shut down every school that violated the ICB (or that was investigated for violating the ICB) is not evidence that "the Government regularly pays a particular type of claim in full despite actual knowledge that certain requirements were violated . . . ." *Escobar*, 136 S. Ct. at 2004; *see Miller*, 840 F.3d at 504. There are myriad reasons why enforcement decisions – made years after the fact – are resolved without debarring a school. AAU makes no argument, and certainly presents no evidence, that the DOE has ever authorized a school to violate the ICB.

Third, AAU argues that the DOE's closing of its investigation of Relator's complaints without action somehow establishes that AAU's misrepresentations

were not material. The letter closing the review – which addressed an array of topics other than compensation practices – expressly states the opposite, cautioning that the letter "must not be construed as acceptance, approval, or endorsement of those specific practices and procedures" and "does not relieve AAU of its obligation to comply with all of the statutory or regulatory provisions governing the Title IV, HEA programs." The letter ends with a reminder that full compliance with the ICB is "imperative." ER 407-08. This bears no relationship to the cases cited by AAU where an agency had full factual knowledge of an ongoing violation at the time it elected to pay a claim.

The "imperative" compliance with the ICB is plainly material, just as *Hendow* held. AAU clearly knew that, because it made substantial efforts to conceal its non-compliance. *See Triple Canopy*, 857 F.3d at 178 ("[W]e found Triple Canopy's omissions material for two reasons: common sense and Triple Canopy's own actions in covering up the noncompliance. That conclusion perfectly aligns with [*Escobar*].."). AAU's attempt to cover up its non-compliance is evidence that it "knew or had reason to know that [the government] attaches importance to the [ICB] in determining [its] choice of action." *Escobar*, 136 S. Ct. at 2003 (internal quotations omitted).

B. Whether *Escobar* Created A "Two Part Test" Will Not Change The Result In This Specific Case

AAU argued that *Escobar* mandated a "two part test" limiting all claims for implied certification, implicitly overruling this Court's decision in *Ebeid*. While disagreeing with that analysis, the panel held that it was constrained by prior panel decisions in *United States ex rel. Kelly v. Serco, Inc.*, 846 F.3d 325, 332 (9th Cir. 2017), and *United States ex rel. Campie v. Gilead Sciences, Inc.*, 862 F.3d 890, 901 (9th Cir. 2017). The panel concluded that "Relators must satisfy *Escobar*'s two conditions to prove falsity, unless and until our court, en banc, interprets *Escobar* differently." Op. p. 12.

The panel went on to hold that the facts of this case satisfy the two-part test; thus, this question of law is not dispositive of the appeal and rehearing is not required. Op. p. 12. Because the issue is not dispositive in this case, Plaintiffs respectfully submit that this is not necessary to correct the error on this interlocutory appeal. "Resources for en banc review are limited, and the complexities of this case and the interlocutory context in which the issue has arisen make deferral the appropriate course." *Asociacion de Subscripcion Conjunta del Seguro de Responsabilidad Obligatorio v. Sec'y of the Treasury*, 484 F.3d 1, 41 (1st Cir. 2007); *Cottier v. City of Martin*, 604 F.3d 553, 556 (8th Cir. 2010) ("The parties have no justifiable expectation that a denial of rehearing en banc at an interlocutory stage resolves issues for all time."). This case was ready for trial in

mid-2016. *See Travelers Cas. Ins. Co. of Am. v. Hirsh*, 831 F.3d 1179, 1185 (9th Cir. 2016) ("Interlocutory appeals . . . undermine the efficient administration of justice when, as here, a meritless appeal stalls a case for years. [citation]").

If, however, the Court chooses to use this case as a vehicle to clarify the law, it is clear that *Escobar* did not create a mandatory two part test. Addressing the facts before it, *Escobar* held that "the implied certification theory can be a basis for liability, *at least where* two conditions are satisfied . . . ." *Escobar*, 136 S. Ct. at 2001 (emphasis added). When the Supreme Court stated that "We *need not* resolve" it did not mean "we *do* resolve." When the Supreme Court stated "*at least* where two conditions are satisfied" it did not mean "*only* where two conditions are satisfied." This Court should not conclude that the Supreme Court meant the opposite of what it said. *See Triple Canopy*, 857 F.3d at 178 n.3 (holding that *Escobar* did not create a mandatory two-part test); *Comedy Club, Inc. v. Improv W. Assocs.*, 553 F.3d 1277, 1290 (9th Cir. 2009) (Supreme Court decision was not "clearly irreconcilable" with prior Circuit law on an issue the Supreme Court "did not reach," and "thus we are bound by our prior precedent.").

Neither of the decisions that the panel in this case found itself bound by discussed *Ebeid* or engaged in any analysis of whether it had been overruled. In *Kelly*, 846 F.3d 325, the panel merely quoted what AAU calls the "two-part test" (including the "at least" qualification). *Id.* at 332. The briefing before this Court in

Kelly was complete in June 2015, a year before *Escobar*. The only written reference to *Escobar* presented to this Court in *Kelly* was in an August 25, 2016 Rule 28(j) letter. That letter makes no reference to *Ebeid*. *See* Case No. 14-56769, ECF No. 34. Nor was the issue raised during oral argument; although *Ebeid* was addressed during Appellees' argument on another point, at no time during oral arguments did anyone suggest that *Ebeid* or any other Ninth Circuit precedent had been overruled by *Escobar*. *See* Ninth Circuit Archived Oral Argument in Case No. 14-56769, *available at* https://youtu.be/OcUCj4yrzGA.

The same is true for *Campie*. The *Campie* panel does state in passing that "two conditions must be satisfied" and that "the claim must not merely request payment, but also make specific representations about the goods or services provided." *Campie*, 862 F.3d at 901. The panel then goes on to find these conditions met. *Id.* at 902-04. The *Campie* panel does not, however, analyze in any way (or even mention) *Escobar*'s reservation of the question "whether all claims for payment implicitly represent that the billing party is legally entitled to payment." *Escobar*, 136 S. Ct. at 2000. Nor does *Campie* discuss *Escobar*'s "at least where" qualification. *Escobar*, 136 S. Ct. at 2001. Nor does *Campie* discuss in any way whether *Escobar* overruled *Ebeid* and its progeny in this Circuit. As with *Kelly*, no one presented this argument to the *Campie* panel. The briefs were completed before *Escobar*, none of the Rule 28(j) letters cite *Ebeid*, and the topic

did not come up at oral argument which, as with *Kelly*, focused on materiality.[1] If the Court grants rehearing *en banc*, it should confirm that *Ebeid* was not overruled by *Escobar* and remains the law in this Circuit.

IV. CONCLUSION

Escobar is consistent with both *Hendow* and *Ebeid*. Trial of this action has already been delayed for more than two years. This Court should deny the petition for rehearing *en banc*. If, however, the Court grants rehearing, it should reaffirm that both *Hendow* and *Ebeid* remain good law.

DATED: November 1, 2018

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[1] *See* ECF Docket, Ninth Circuit Case No. 15-16380; Ninth Circuit Archived Oral Argument in Case No. 15-16380, *available at* https://youtu.be/m7K4hpLb4Qc.

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