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U.S. Department of Education Issues Final Rule on Borrower Defense to Repayment

By John R. Przypyszny and Jonathan D. Tarnow

The U.S. Department of Education (the “Department”) has published its final rule (the “Final Rule”) regarding Borrower Defenses to Repayment (“BDTR”) and related matters.¹ Subject to our continued review, this alert summarizes the key components of the Final Rule and notes, at a high level, significant departures from the Department’s Proposed Rule.

The Final Rule will take effect on July 1, 2017 (the “Effective Date”) but certain elements of the Final Rule will be implemented early. Other portions of the Final Rule indicate that the Department has yet to establish detailed procedural requirements, and will promulgate further procedural rules in the future.

I. BDTR Claims: Standards, Time Limits, Procedural Framework, and Recoupment from Schools

The Final Rule permits both individual and group discharges of Federal Direct Loans made to students under Title IV of the Higher Education Act. Substantive differences in the adjudication of such claims will depend on whether the loan was first disbursed before or after July 1, 2017. Permissible grounds for discharge, their periods of availability, and the corresponding Departmental procedure are as follows:

For loans disbursed on or after July 1, 2017, borrowers can assert any of three grounds on which the Department may grant a defense to repayment under a “preponderance of the evidence” standard.

1. A borrower may ground a claim in a **non-default, favorable contested judgment** against a school, in a State or Federal court or administrative tribunal, relating to the loan itself or to the educational services for which the loan was originally made. Borrowers seeking relief on this ground are not subject to any statute of limitations, and may seek defense to repayment for all amounts already repaid and for those still owed to the Department, regardless of when the claim is made.
2. A borrower may ground a claim in **breach of contract** by the school, if the school has

failed to perform its obligations under a contract with the student (including, but not limited to, enrollment agreements). Borrowers seeking relief on this ground must assert their claims within six (6) years of the breach if they wish to recover amounts previously collected, but may file at any time for a defense to payments still owed.

3. A borrower may ground a claim in **substantial misrepresentation** by the school. The Department has amended its definition of misrepresentation to include any statement that “misleads under the circumstances” or which “omits information in such a way as to make the statement false, erroneous, or misleading.” If the school is found to have made a substantial misrepresentation on which the borrower reasonably relied to his detriment, defense to repayment may be granted. For amounts already paid, a borrower must assert this claim within six (6) years of when he discovers – or reasonably could have discovered – the information constituting a substantial misrepresentation. For amounts still owed, the borrower may assert this claim at any time.

Importantly, these regulations do not depend on any intent (or lack thereof) on the part of the institution. In its accompanying commentary, the Department confirms that negligent or unintentional misrepresentations can give rise to a borrower defense claim, stating, “[w]e believe that an institution is responsible for the harm to borrowers caused by its misrepresentation, even if such misrepresentations cannot be attributed to institutional intent or knowledge and are the result of inadvertent or innocent mistakes.” The Department also clarifies that its definition of substantial misrepresentation requires detrimental reliance by the borrower, so as to conform with other consumer misrepresentation regulations.

For loans disbursed before July 1, 2017, borrowers must ground their claim(s) in State law as provided in the existing borrower defense regulation. Specifically, the borrower must assert that an act or omission by the school, in relation to the making of the Direct Loan or the educational services for which the loan was provided, gives rise to a cause of action against the school under State law. This does not obligate a student to pursue her claim in State court, but requires the Department to rely on independent State law grounds when granting a full or partial defense to repayment.

¹ The Final Rule may be found at: <https://www.gpo.gov/fdsys/pkg/FR-2016-11-01/pdf/2016-25448.pdf>.

Borrowers asserting this claim are subject to the statute of limitations, burden of proof, and evidentiary standards that apply to the underlying State law.

Claims arising out of any time period will be processed by a Department official in the manner described below, depending on whether the claim is from an individual or on behalf of a group, and whether the school has closed or remains open.

Process for individual borrowers: An individual borrower seeking BDTR must submit an application on the Department-approved form. (The Department proposed a universal submission form in September, for which the comment period closed on October 28, 2016. The final form has not yet been issued.²) In the application, the borrower must certify that he or she received the proceeds of a loan to attend a school; can provide evidence that supports the claim; and whether or not the borrower made a claim with respect to the information underlying the defense with any third party and, if so, the amount of any payment received by the borrower or credited to the borrower's loan obligation. The Department will then notify the school that the borrower has filed for a defense to repayment. If the loan at issue is not in default, the Department official will also notify the borrower of a forbearance on payments; if the loan is in default, the official will notify the borrower of a suspension in collection activities.

A designated Department official will then review the borrower's application to determine whether it states a basis for a borrower defense, considering any evidence presented by the borrower and also any additional information, including Department records, responses or submissions by the school, and any additional information that may be obtained by the Department official. The official will weigh the borrower's cost to attend the school against the value of the education the borrower received, the value of the education that a reasonable borrower in similar circumstances would have received, and the value of the education that the borrower should have expected given the information provided by the institution. Under the Final Rule, the Department expressly provides that certain conduct by the school may be considered *prima facie* evidence of the reasonableness of a borrower's detrimental reliance on a misrepresentation, including:

- Demanding that the borrower make enrollment or loan-related decisions immediately;
- Placing an unreasonable emphasis on the negative consequences of delay;
- Discouraging the borrower from consulting an adviser or family member;
- Failing to respond to borrower's requests for additional information regarding program cost; or
- Otherwise "unreasonably pressuring" the borrower or taking advantage of his or her distress or lack of knowledge or sophistication.

When the Department official concludes the fact-finding process, the official will issue a written decision setting out the amount of relief, if any, as well as the rationale for any denial and the evidence on which the official relied in arriving at the decision. That decision is final as to the merits of the claim and any relief that is warranted under the circumstances. However, if the defense is denied partially or in full, the borrower may request reconsideration if he or she identifies new evidence in support of discharge. The Final Rule requires that "new evidence" be information that the borrower did not previously provide, and which was not identified in the decision as an evidentiary source on which the official relied. At any time, the Department may also reopen a previously closed BDTR application to consider new evidence at its discretion.

For amounts the borrower continues to owe after the claim is resolved, any forbearance will cease and any collection activities will resume, as applicable, depending on the status of the loan before the claim was resolved. The Department may also initiate a recoupment action against the school to collect the amount of losses incurred as a result of the borrower defense. Recoupment actions are discussed in greater detail below.

Process for group claims against an open school: A hearing official will resolve BDTR group claims through a fact-finding process similar to that described above. Group claims may be identified by the Department on its own initiative, and may contain borrowers who have not filed individual claims for relief, in which case the Department will notify such borrowers that they may opt out of the group BDTR proceeding but may only do so at this stage. Group claims may also be identified by the Department from among individual filings (or from the filing of class action claims or notice of civil investigative demands), and the Department may choose to address any such claims through a group process if, among other things, "common facts and claims, fiscal impact, and the promotion of compliance by the school" weighs in favor of group treatment. If the BDTR claim is based on a substantial misrepresentation that was widely disseminated, there is a rebuttable presumption that each member of the group reasonably relied on the misrepresentation. This presumption shifts the burden to the school, requiring the school to demonstrate that individuals in the identified group did not in fact rely on the misrepresentation at issue. It is also the school's burden to request records on which the claim is based. The hearing official conducts a fact-finding process and issues a written decision, regardless of the outcome of the group claim, identifying the basis for the determination. Note that this single, streamlined fact-finding process will also determine the relief to which a group of borrowers is entitled (if any) as well as the amount of the Department's recovery against the school. Specific procedural rules for this process, including the manner in which the school may request records and respond, have not yet been promulgated. The Department then notifies members of the group, as well as the school, as to any borrower relief granted or school liabilities to the Department for amounts discharged or reimbursed.

Process for group claims against a closed school: When the Department identifies a set of borrowers whose claims

² The proposed form may be found at: <https://www.regulations.gov/document?D=ED-2016-ICCD-0075-0026>.

should be adjudicated as a group, but who attended a school that is now closed and for which there is no financial protection available to the Department for recovery of losses related to borrower defense, the Department will treat such claims under the group process above. However, there will be no notice to the school where “impossible or irrelevant,” and the hearing official will consider Department records or a response from a person affiliated with the school in rendering a final decision.

Although closed-school discharges are available to borrowers through the individual process, the Final Rule increases access to closed-school discharges and further increases the likelihood that they will be addressed by the Department as a group. This arises out of three elements of the new regulation:

- First, the Department will send closed-school discharge applications to borrowers both when their school closes and when their first loan payments are due;
- Second, the Final Rule requires that schools submitting teach-out plans must also provide borrowers with a closed-school discharge application and notice of their right to opt out of the teach-out plan and receive a discharge instead; and
- Third, for eligible borrowers who were enrolled at a school that closed on or after November 1, 2013 (three years prior to the publication date of the Final Rule), if those borrowers have not re-enrolled at another Title IV-eligible institution within three years of closure, the Department will automatically discharge those loans. The Department expects to undertake the automatic closed school discharge provisions “as soon as operationally possible,” rather than waiting until the July 1, 2017 effective date of the revised BDTR regulations. This specifically includes eligible borrowers who attended institutions operated by Corinthian Colleges upon its closure.

Examples of Proposed Relief. To illustrate the expected resolution of various types of claims, the Department includes in the Final Rule an appendix of six example pleas for borrower relief and guidance regarding how those claims are likely to be addressed. Many of the examples include total relief for the borrower, including programs in which minimal requirements for State licensure in the advertised occupation were not met, programs at which instructors were deemed unqualified, and programs which were framed as prerequisites to a different, more demanding program of study but which are not in fact required by the other program. The examples also point to partial relief in the amount of \$5,000 where a program was represented as costing \$20,000 but in fact cost \$25,000, and where there is no misrepresentation other than cost and no deficiency in the value of the education.

Availability of Consolidation. For borrowers under the FFEL and Perkins Loan programs, whose loans would not directly qualify for relief under the Final Rule, the Department has determined that such borrowers may take advantage of the BDTR structure above by obtaining a Direct Consolidation Loan. FFEL borrowers enjoy the same entitlement to administrative forbearance that Direct Loan recipients receive under

the Department’s BDTR structure, and the Department has indicated that it will designate this program for early implementation as of November 1, 2016.

Recoupment. The Department may initiate, on a discretionary basis, a recoupment action to collect from the school the amount of losses it incurred based on the borrower defense. For claims by individual borrowers, the recoupment action will be conducted separately from the BDTR claim; for group claims, however, the adjudication of the claim and the value of any recoupment action will be consolidated into the single fact-finding process described above. The ceiling on such losses is “all amounts owed to the Secretary on the loan at issue,” thus entitling the Department to recoupment of any relief that was granted to the borrower(s), including tuition, room, board, fees, expenses, and accrued interest. The time period during which schools remain subject to a potential recoupment action depends on the time at which the loan at issue was made, namely:

- For loans made before July 1, 2017, if the Department approves a defense to repayment in full or in part, the Department may initiate a proceeding to collect within the later of (1) three years from the end of the last award year in which the student attended the institution; or (2) the limitation period that State law would apply to an action by the borrower to recover on the theory on which the borrower’s claim is based. The Department may also initiate recoupment proceedings if (3) the institution received notice of the claim within the later of the periods described as (1) and (2) above.
- For loans made on or after July 1, 2017, if the Department approves a defense to repayment in full or in part, the Department may initiate a proceeding to collect within the later of (1) the six-year period that applies to BDTR claims based in breach of contract or substantial misrepresentation; or (2) at any time if the claim is based on a contested non-default judgment; or (3) at any time if the institution received notice of the claim within the period described as (1) above.
- For any time period, notice to the institution includes (1) actual notice from the borrower, the Department, or borrower’s representative, (2) a class action complaint asserting relief for a class that may include the borrower, or (3) written notice, including a Civil Investigative Demand, from a Federal or State agency that has the authority to investigate the institution’s conduct and underlying facts that may form the basis of a BDTR claim.

Importantly, the Department acknowledges that procedural rules for recoupment actions have not yet been established. The Department indicates that “such recovery actions will reflect current regulations for appeals of audit and program review claims and actions to fine the school.” Precisely how such actions will be conducted, however, remains unclear in the Final Rule.

False Certification and Falsified Satisfactory Academic Progress (“SAP”) Discharge. The Final Rule expands the availability of loan discharge based on false

certification of a high school diploma or falsification of a student's academic progress. Specifically, borrowers are eligible not only if a school falsifies the student's high school diploma or other high school graduation status, but also if the school refers the student to a third party to obtain a falsified high school diploma, or if the school enrolls a student for a training program for which the borrower did not meet State requirements for employment (in the student's home state) in the designated occupation because of the student's physical or mental condition, age, criminal history, or other reason accepted by the Department. The Department may also discharge all or part of a loan if it determines, based on information in its possession, that the school has falsified the SAP of its students.

II. Prohibition on Pre-Dispute Arbitration Clauses, Class-Action Waivers, and Gag Rules

Where the Proposed Rule significantly restricted the use of mandatory pre-dispute arbitration clauses and class-action waivers by postsecondary institutions, the Final Rule goes even further. Under the Final Rule, schools may not use *any* pre-dispute arbitration agreements, whether voluntary or mandatory, and without regard to whether the agreement contains an opt-out provision. Once a dispute has arisen, the student and the institution may choose to enter into an arbitration agreement to avoid the cost of litigation. Similarly, the Final Rule prohibits schools from forbidding relief in the form of class actions by student borrowers, and also invalidates any clauses in which a school imposes a requirement that students pursue an internal dispute resolution process before contacting accreditors, regulators, or other authorities regarding their concerns about an institution (independent of whether such concerns relate to borrower defense).

For enrollment or other pertinent agreements between students and institutions that are signed on or after July 1, 2017, the agreement must include expressly-mandated language regarding class actions and pre-dispute arbitration agreements. For enrollment or other pertinent agreements between students and institutions that are signed before the Effective Date of the Final Rule, the school must either amend the relevant agreement to contain the Department's express language, or must provide students to whom the agreement applies with a specified written notice. Within 60 days, the school must submit to the Department a copy of any records, claims, judgments, or communications in connection with an arbitration that is entered into in connection with a borrower defense claim against the school. Within 30 days, the school must submit to the Department any such records, including complaints, counterclaims, dispositive motions or final judgments in connection with any lawsuit filed against the school in connection with a borrower defense claim.

III. Loan Repayment Rate Calculation and Disclosure

For proprietary institutions only, the Department has maintained its earlier proposal that a low

loan repayment rate (LRR) will require specific disclosures to current and prospective students. The Department has changed in the Final Rule, though, the methodology from that set forth in the Proposed Rule. Specifically, the Department will annually calculate LRRs based on the same two-year cohort of borrowers that are generally used for an institution's Gainful Employment rates. (Although Gainful Employment rates are program-specific, the LRR calculation will be for the institution as a whole.)

Using borrowers entering repayment during the applicable two-year cohort period, the Department will calculate the LRR as:

1. The number of borrowers in Gainful Employment programs who are paid in full, or who are in "active repayment" (with "active repayment" defined as having reduced their outstanding loan balance by at least one dollar); divided by
2. The number of borrowers in Gainful Employment programs who entered repayment.

If a proprietary institution's LRR reflects that the median borrower has not reduced the outstanding balance by at least one dollar by the end of the third year after entering repayment (which, under the calculation methodology, is equivalent to a rate of less than 0.5), the institution will be required to include a warning in all advertising and promotional materials. No warning would be required, though, for cohorts of fewer than ten (10) borrowers, or if an institution can demonstrate that not all programs are GE programs and that the warning threshold would not have been triggered if the non-GE program borrowers were included in the LRR calculation.

Where a warning regarding LRRs is required, the Final Rule does not mandate it be provided *individually* to all current or prospective students (as must certain other disclosures under the Gainful Employment regulations). However, this LRR warning must appear on all promotional materials, including but not limited to the institution's Web site, catalogs, invitations, flyers, billboards, and advertising on or through radio, television, video, print media, social media, or the Internet. The warning language must read, "U.S. Department of Education Warning: A majority of recent student loan borrowers at this school are not paying down their loans," unless the Department determines that other language shall be required. The warning must be "prominent, clear, and conspicuous," and when included in television or video materials, must be spoken and written simultaneously. The Final Rule further indicates that the Department may conduct consumer testing to ensure that the warning language is meaningful.

IV. Expanded Financial Responsibility and Administrative Capacity Requirements

The Proposed Rule included multiple automatic and discretionary "triggering events" that would deem an institution "not able to meet its financial

or administrative obligations” and require a Letter of Credit (“LC”) or, in some cases, another form of financial protection from the institution. In the Final Rule, the Department has substantially revised the automatic triggering events, many of which now appear as discretionary triggers. However, failure to meet the composite score remains an automatic trigger, and the Department has also added certain other events into the calculation of the composite score itself. In the event of such occurrences, the affected institution must report them to the Department, which will recalculate the composite score taking certain financial indicators into account. Consequently, the composite score may now be calculated more frequently than on an annual basis.

Automatic Triggers: With respect to each of the following triggers, the Department will now automatically require a Letter of Credit from the institution if:

1. *90/10:* A proprietary institution did not derive at least 10 percent of its revenue from sources other than Title IV program funds in its most recently completed single fiscal year,
2. *Cohort Default Rates (“CDR”):* The two most recent official CDRs are 30 percent or higher, unless (a) the school files a challenge, request for adjustment, or appeal with respect to its rates for one or both of those fiscal years; and (b) that challenge, request, or appeal remains pending, results in reducing the CDR below 30 percent or precludes the rates from either or both years from resulting in a loss of Title IV eligibility,
3. *For publicly traded institutions:* Any of the following occur: (a) the Securities and Exchange Commission (“SEC”) warns the school that it may suspend trading on the school’s stock; (b) the school failed to file timely a required annual or quarterly report with the SEC; or (c) the exchange on which the stock is traded notifies the school that it is not in compliance with exchange requirements, or the stock is delisted.

Composite Score Adjustment: In a departure from the Proposed Rule, the Department will now recalculate an institution’s composite score upon the occurrence of various triggering events. For clarity regarding the manner in which the score will now be calculated, the Department provides an appendix – distinguishing between for-profit and not-for-profit institutions – in the Final Rule. Notably, many items that had been proposed as automatic triggers are now subsumed within the composite score calculation and do not function independently as events requiring an LC. The events that will now require the recalculation of an institution’s composite score, and will require an LC if they result in a composite score below 1.0, include:

- The institution is required to pay any debt or incur liability from a final judgment in a judicial or administrative proceeding, or from a settlement;
- The institution is being sued in an action brought on or after July 1, 2017 by a Federal or State

authority for BDTR claims and the suit has been pending for 120 days;

- All other litigation initiated on or after July 1, 2017 against the institution if the suit has survived a motion for summary judgment/disposition or the institution has not attempted to move for summary judgment and the suit progresses to a pretrial conference or trial;
- The requirement, by an institution’s accreditor, that it submit a teach-out plan, including because the institution is closing a branch or additional locations;
- The determination by the Department that the institution has GE programs that could become ineligible for Title IV funds in the subsequent year based on its final debt-to-earnings (D/E) rates; or
- For a proprietary institution whose composite score is less than 1.5, any withdrawal of owner’s equity by any means, including by declaring a dividend, unless the equity is transferred within the affiliated entity group on whose basis the institutional composite score was calculated.

Discretionary Triggers: With respect to each of the following triggers, the Department may still require a Letter of Credit, increase an existing LC requirement, or demand other form of surety from the institution if:

- There is a significant fluctuation in the year-to-year Direct Loan or Pell Grant funds, or a combination of those funds, received by the institution that cannot be accounted for by changes in those programs;
- The institution is cited by a State licensing or authorizing agency for failing to meet its requirements;
- The institution fails a financial stress test developed or adopted by the Secretary;
- The institution has high annual dropout rates, as calculated by the Secretary;
- The institution is or was placed on probation or issued a show-cause order, or placed on an accreditation status that poses an equivalent or greater risk to its accreditation, by its accrediting agency for failing to meet one or more of the agency’s standards;
- The institution violated a provision or requirement in a loan agreement, and a default or delinquency event thereby occurs which triggers a change in contractual obligations or in payments, sanctions, or fees; or
- The institution has pending claims for BDTR or the Department expects to receive a significant number of such claims.

Provisional Certification and Guarantees from Parties Exercising Substantial Control: The Department is retaining the provisional certification alternative standard that allows institutions with a failing composite score to post at least a 10% LC and also

agree to provisional certification. However, the Final Rule also provides that if the institution continues to fail to meet the composite score after three years under provisional certification, the Department may mandate additional financial protection, in an amount determined by the Secretary, from the institution or any party with “substantial control” over the institution. The Secretary may reduce this amount if the institution demonstrates that the amount is unnecessary to protect or is contrary to the Federal interest. Further, the Final Rule requires parties with “substantial control” (as that term is currently defined under the regulations) to jointly and severally guarantee the Title IV liabilities of the institution at the end of the three-year provisional certification period. (As stated under current regulations, a party may be deemed to have “substantial control” over an institution if, among other factors, the party directly or indirectly holds an ownership interest of 25% or more of the institution, or is a member of the board of directors, a general partner, the chief executive officer, or other executive officer of the institution.)

LC Alternative and Set-Aside: As an alternative to providing an LC, an institution can qualify as a financially responsible institution if it secures another form of financial protection (which the Department will determine at a future date) for an amount that will provide as much protection as the LC. If an institution cannot secure an LC or alternative financial protection within 45 days of the Secretary’s request, the Secretary will offset the amount of Title IV, HEA funds that an institution is eligible to receive such that, within a nine-month period, the total amount offset equals the amount of financial protection the institution would be required to provide. The Secretary would release such funds if the institution subsequently provides an LC or other financial protection required.

Reporting Requirements: Any institution required to post an LC must also disclose that fact to current and prospective students. Further, an institution must notify the Department of the existence of the triggers generally within 10 days of their occurrence.

V. Additional Provisions Confirmed in the Final Rule

As part of the Final Rule, the Department also establishes:

1. That Title IV loans and TEACH grant service obligations may be discharged based on electronically-submitted death certificates, or other authoritative governmental databases, rather than only original copies; and that on a discretionary basis, the Department may discharge loans or obligations on a case-by-case basis upon receipt of other reliable documentation (e.g., press reports);
2. That Nurse Faculty Loans may be consolidated into a Direct Consolidation Loan, by permitting loans under part E of Title VIII of the Public Health Service Act to be consolidated, and by eliminating the requirement that a borrower must consolidate at least one FFEL or Direct Program Loan;
3. That holders of outstanding loans under the former Federal Family Education Loan Program may not capitalize unpaid interest when a defaulted loan is rehabilitated;
4. Technical changes to the Pay-As-You-Earn program regulations, confirming the financial hardship standards for married borrowers filing separately; and
5. An increase in the Department’s debt compromise and resolution authority to \$100,000, so as to be consistent with analogous Department of Justice standards.

VI. Conclusion

We will continue to inform you of any developments in this regulatory area. If you have any questions regarding the Final Rule, this summary, or other educational matters, please do not hesitate to contact us.

Education Law Team

Primary Contacts



John R. Przypyszny
Partner
Washington
(202) 842-8858
John.Przypyszny@dbr.com



Jonathan D. Tarnow
Partner
Washington
(202) 354-1357
Jonathan.Tarnow@dbr.com

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Jonathan I. Epstein and Andrew B. Joseph, Partners in Charge of the Princeton and Florham Park, N.J., offices, respectively.