DrinkerBiddle

Client Alert

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Revised Borrower Defense to Repayment Regulations Proposed by U.S. Department of Education

On July 25, 2018, the U.S. Department of Education (ED) released proposed regulations (the "Proposed Rule") to revise its Borrower Defenses to Repayment (BDR) regulations, certain financial responsibility requirements and related matters. The Proposed Rule is available in pre-publication form here and is scheduled to be published in the Federal Register on Tuesday, July 31, 2018. The Proposed Rule applies to all postsecondary institutions that participate in the federal student financial aid programs under Title IV of the Higher Education Act, whether public, private non-profit or proprietary.

The revisions reflected by the Proposed Rule would supersede ED's 2016 revisions to its BDR regulations and related financial responsibility requirements, for which ED previously delayed the effective date. Public comments to the Proposed Rule are due within 30 days of the Federal Register publication. The effective date of the regulatory revisions reflected by the Proposed Rule would be July 1, 2019.

This alert provides a comprehensive summary of the key points of the Proposed Rule, which remains subject to our continued review and analysis.

Overview

The Proposed Rule addresses BDR requirements and several other topics, as follows:

- For Direct Loans originated on or after July 1, 2019, it establishes a new federal standard for borrowers to raise as a defense against loan repayment.
- It amends the prior BDR definition of a misrepresentation to only include acts or omissions made with known falsity, intent to deceive, or reckless disregard for the truth, among other requirements.
- It establishes a process for filing individual BDR claims, and does not permit group claims.
- It establishes a five-year window following decisions on BDR claims for ED to seek recoupment from an institution for the amount of a loan discharge.
- It allows the use of mandatory pre-dispute arbitration agreements and class action lawsuit waivers by institutions, with certain consumer disclosure and counseling requirements regarding such matters.
- It amends institutional financial responsibility standards to (1) include actions and events that would trigger a requirement to provide ED with financial protection, such as a letter of credit; (2) require a new supplemental schedule as part of the required audited financial statements submission; (3) address the composite score impact of new required accounting treatments for operating leases; (4) more specifically define and require disclosures concerning the composite score's inclusion of debt obtained for long-term purposes; and (5) revise limited aspects of the composite score formula to account for changes in accounting terminology.
- It amends the closed school discharge provisions.
- It amends the false certification discharge provisions.

Request for Comment on "Defensive" versus "Affirmative" BDR Claims

Under the BDR regulations adopted in 1994, the ability of a borrower to assert a BDR claim was limited to situations where ED was proceeding with a collection action against the borrower following a loan default (a "defensive claim"). Starting with a revised interpretation in 2015, and under 2016 regulatory revisions that have not yet taken effect, ED permitted borrowers to affirmatively assert that acts or omissions of an institution should relieve the borrower of his or her loan obligations (an "affirmative claim"). The Proposed Rule requests public comment on whether ED should allow only defensive claims, specifically in the context of existing proceedings to collect such as defaulted loan collection proceedings, tax refund offsets, wage garnishments, salary offsets, consumer reporting, or other similar actions, or if it should continue the approach initiated in 2015 to accept both defensive and affirmative claims.

The Proposed Rule contemplates that both defensive and affirmative BDR claims would be reviewed under a preponderance of the evidence standard. However, ED also seeks comment on whether affirmative claims should be supported by clear and convincing evidence, rather than a preponderance of the evidence. In requesting public input on this matter, the Proposed Rule notes that the clear and convincing evidence standard is the standard used in most states for adjudicating fraud litigation and thus could deter some frivolous affirmative BDR claims.

Federal Standard for BDR Claims

Under BDR regulations adopted in 1994, in order to assert a defense to repayment of a federal student loan, a borrower needed to demonstrate that an institution's act or omission leading to an enrollment for which the loan was made would give rise to a cause of action against the institution under applicable state law. Under the Proposed Rule, that "state law standard" would remain in effect for loans disbursed prior to July 1, 2019. For loans disbursed on or after July 1, 2019, the Proposed Rule establishes a single federal standard for BDR claims, which is based on misrepresentations by an institution, its personnel or entities acting on its behalf, related to the institution's provision of educational services.

The Proposed Rule defines a "misrepresentation" as a false, misleading or deceptive statement, act, or omission by an institution, made to a borrower either with knowledge of its falsity, deception or misleading nature, or with reckless disregard for the truth; and which directly and clearly relates to the making of the loan through which the institution's educational services were obtained. The Proposed Rule also provides a non-exhaustive, illustrative list of circumstances that ED may deem to be indications of misrepresentation, including:

- Employment or licensure passages rates which are materially different from those included in marketing material.
- Selectivity rankings or admissions profiles which are materially different from those included in marketing material.
- Inclusion of inaccurate certification, accreditation, or approval information in marketing materials.
- Assertions of general transferability of credits which are in fact materially limited.
- Assertions regarding graduates' earnings or employability which are not supported by evidence of such earnings or employment, an agreement with a relevant employer, or relevant national data regarding earnings in the field.
- Representations regarding the availability, amount, or nature of financial assistance available (from the institution or any other entity) which are not fulfilled upon enrollment.
- Representations regarding the applicable tuition and fees which are materially different from those charged to the student, whether with respect to the amount, method, or timing of such costs.
- Representations regarding endorsements by individuals, organizations, agencies, industries or other entities which the institution is not authorized to make.
- Representations regarding available educational resources which are in fact materially different from the institution's circumstances at the time the representation is made (e.g., institutional size, location, facilities, training equipment, or the number, availability, and qualifications of personnel).
- Representations regarding prerequisites which are materially different from those actually required for a course or program offered by the institution.

BDR Claim Process and Adjudication

The Proposed Rule establishes a process for individual BDR claims, as follows:

- The borrower must apply to ED on a prescribed form, signed under penalty of perjury, and permitting the institution to provide the ED with relevant items from the borrower's educational record. At a minimum, the application must:
  - Certify that loan proceeds were received in order to attend the named institution;
  - Provide evidence in support of the claim;
  - State whether the borrower has filed a claim with any other third party on the basis of the same alleged misrepresentation (e.g., a state tuition recovery fund);
  - State the amount of recovery through that third party, if any;
  - State the amount of harm that the borrower alleges to have been caused by the institution's act or omission;
  - Include relevant information to assess the alleged harm; and
  - Affirm the borrower's understanding that if the loan is discharged in full, the institution may refuse to verify or to provide an official transcript regarding the borrower's completion of any credits or credential associated with the discharged loan.
- ED will notify the institution of the BDR claim request, provide a copy of the claim and supporting documents, and invite the institution to provide its own response and supporting evidence.
- Based on the information presented by both the borrower and the institution, ED will determine:
  - Whether the borrower relied on the institution's misrepresentation when deciding to enroll and incur a federal student loan obligation;
  - Whether the borrower's reliance was reasonable under the circumstances; and
  - Whether the borrower suffered financial harm as a result of the misrepresentation.
- ED will notify the borrower and the institution of its decision, provide its reasoning, and inform both the borrower and the institution of the relief that borrower will receive, if any. The Proposed Rule provides that the ED's written decision shall be final and is not subject to appeal. In accepting the relief granted, a borrower is also deemed to

have assigned to the ED any right to a loan refund from a state or private tuition recovery fund, up to the amount of relief granted.

As indicated above, the Proposed Rule requires that a borrower demonstrate financial harm arising from the institution's misrepresentation. As defined by the ED in the Proposed Rule, financial harm means only monetary loss which the borrower suffers as a result of the institution's misrepresentation. It does not include measures of damages, whether for nonmonetary loss, injury, distress, or opportunity costs, nor may it include punitive damages against the institution.

Recoupment from Institutions

For loans disbursed on or after July 1, 2019, the Proposed Rule would require ED to initiate any recoupment action against an institution (for amounts discharged under a successful BDR claim) within five years after its final written determination on a borrower's BDR claim.

Class Action Waivers and Pre-Dispute Arbitration Agreements

The Proposed Rule permits institutions to adopt class action waivers and pre-dispute arbitration provisions in enrollment agreements, but requires additional disclosures and borrower counseling at institutions which utilize such provisions. For instance, if an institution requires as a condition of enrollment that a student receiving Title IV federal student aid must accept a class action waiver or a pre-dispute arbitration agreement, the Proposed Rule states that the institution must also disclose those terms in plain language to current and prospective students and to the public at large. That disclosure must be provided on the institution's website, where admissions and tuition information are otherwise presented, and may not only be provided through an institutional intranet. Similarly, the Proposed Rule requires that additional, detailed information regarding these provisions be provided to borrowers during the entrance counseling process that is currently required before any loan disbursement.

Financial Responsibility and Administrative Capability

Under the Proposed Rule, an institution would be deemed by ED as unable to meet its financial or administrative obligations in any of the following circumstances: if it fails to make required refunds, if it fails to repay to ED any debts or liabilities owed, if it is subject to any of the specified "mandatory" triggering events, or if it is subject to a "discretionary" triggering event that ED deems likely to have a material adverse effect on the institution's financial condition.

Mandatory triggering events include:

- After the end of the fiscal year for which ED has most recently calculated the institution's composite score, the institution incurs a liability arising from BDR discharges or a final judgment or determination from an administrative or judicial action or proceeding initiated by a federal or state entity, and as a result of that liability, the institution's recalculated composite score for the previously completed fiscal year is less than 1.0.
- For a proprietary institution whose composite score is less than 1.5, there is a withdrawal of owner's equity from the institution by any means, including by declaring a dividend (unless the withdrawal is a transfer to an entity included in the affiliated entity group on whose basis the institution's composite score was calculated), and as a result of that withdrawal, the institution's recalculated composite score for the previously completed fiscal year is less than 1.0.
- The Securities and Exchange Commission suspends or revokes the registration of the institution's securities, or suspends trading on the institution's securities, or the exchange on which the institution's securities are traded delists, either voluntarily or involuntarily, the institution's securities.

Discretionary triggering events include:

- The institution's accrediting agency issues a show-cause order that, if not satisfied, would lead the accreditor to withdraw, revoke or suspend institutional accreditation.
- The institution violates a provision or requirement in a security or loan agreement with a creditor, and as provided under the terms of that security or loan agreement, a monetary or nonmonetary default or delinquency event occurs, or other events occur, that trigger, or enable the creditor to require or impose on the institution, an increase in collateral, a change in contractual obligations, an increase in interest rates or payments, or other sanctions, penalties or fees.
- The institution is cited by a state licensing or authorizing agency for violating a state or agency requirement and notified that its licensure or authorization will be withdrawn or terminated if the institution does not take the steps necessary to come into compliance with those requirements.
- For a proprietary institution, failure to comply with the "90/10" rule in its most recently completed fiscal year.
- The institution's two most recent official cohort default rates are 30 percent or greater, unless the institution files a challenge, request for adjustment, or appeal under that subpart with respect to its rates for one or both of those fiscal years, and that challenge, request or appeal remains pending, results in reducing below 30 percent the official cohort default rate for either or both years, or precludes the rates from either or both years from resulting in a loss of eligibility or provisional certification.

The Proposed Rule requires an institution to report any of the above events to ED within 10 days of their occurrence, with the exception of 90/10 noncompliance, which must be reported within 45 days of such determination. Additionally, the Proposed Rule requires that institutions submit a new supplemental schedule as part of the required audited financial statements

submission, which shall contain all of the financial elements required to compute an institution's composite score.

Composite Score Treatment of Operating Leases. Recent changes in Financial Standards Accounting Board (FASB) requirements will require operating leases of more than 12 months to be recorded under GAAP as both separate liabilities and right-of-use assets. This new accounting treatment for leases could decrease the financial responsibility composite score for many institutions, even without any other change in financial condition. The Proposed Rule acknowledges that the composite score regulations should be updated to take into account this and other FASB changes, but that a future negotiated rulemaking will be required to do so. In the meantime, the Proposed Rule would permit institutions, for a period of six years or until ED adopts a new composite score formula, whichever is shorter, to supply pertinent information and request an alternative composite score that excludes the effects of operating leases subject to the revised accounting treatment. During that interim period, if an institution provides such supplemental information and ED determines that excluding the effects of operating leases results in a higher composite score, ED will use the higher of the two scores to determine the institution's financial responsibility.

Composite Score Treatment and Disclosure of Long-Term Debt. The Proposed Rule includes modified appendices to its financial responsibility regulations, which among other things includes a new requirement regarding the composite score's inclusion of debt obtained for long-term purposes. Specifically, if an institution wishes to include all long-term debt (including debt obtained through long-term lines of credit) as debt obtained for long-term purposes, the institution must include a disclosure in the financial statements that the debt (or line of credit) exceeds 12 months and was used to fund capitalized assets. The disclosure also must include the issue date, term, nature and value of capitalized amounts.

Financial Protection Requirements – Alternatives to Letters of Credit

Under the Proposed Rule, when an institution is required to provide an irrevocable letter of credit, ED may accept alternative forms of financial protection. The Proposed Rule would permit institutions to provide the required amount in cash, to enter into an offset agreement with ED, or to pay through another form specified by ED in a notice in the Federal Register. Under the proposed "offset" option, the amount of offset Title IV program funds must equal the amount of financial protection that the institution is required to provide within a six-to-twelve month period.

Closed School Discharges

The Proposed Rule amends the closed school discharge regulations, such that students who withdrew from an institution within 180 days prior to that institution's closure would be eligible for closed school discharge. (The current period is 120 days prior to closure.) In addition, the Proposed Rule provides that in "exceptional circumstances," ED may extend the period of eligibility beyond 180 days, and such circumstances may include revocation of accreditation, license to operate, or authorization to award credentials. The Proposed Rule also provides that if schools offer an opportunity to complete the borrower's program of study through a teach-out plan that is approved by the institution's accreditor (or, if applicable, by the state authorizing agency), the borrower may not obtain a closed school discharge if he or she declines the teach-out. Similarly, students who ultimately complete the course of study by transferring academic credits or hours earned to another institution would not be able to obtain a closed school discharge.

False Certification Discharges

The Proposed Rule specifies that if a borrower could not provide an institution with a high school diploma or transcript (as a result of home schooling, for instance) at the time of enrollment, but instead provided to the institution a written attestation that the student in fact had completed high school, the borrower may not later obtain a false certification discharge.

Additional Matters

The Proposed Rule also includes provisions to prohibit the capitalization of outstanding interest by guaranty agencies and lenders when a defaulted FFEL loan is rehabilitated; to prohibit the charging of collection costs by guaranty agencies when a borrower enters a repayment agreement within 60 days of the notice of default; and to specify that loan discharges will lead to the elimination or recalculation of the subsidized usage period associated with the discharged loans, whether such discharge occurs on the basis of BDR, false certification, closed school, or unpaid refund claims.

Education Law Team

Primary Contacts

John R. Przypyszny
Partner
Washington, D.C.
(202) 842-8858
john.przypyszny@dbr.com

Jonathan D. Tarnow
Partner
Washington, D.C.
(202) 354-1357
jonathan.tarnow@dbr.com