

## All Institutions Face New Risks Under ED's Final Borrower Defense Rule

November 10, 2016

In this, the first in a series of client alerts that will explain the workings of the new Borrower Defense to Repayment Rule (BDTR), we explore what promises to be a series of rules, procedures and interpretations to be issued by the Department of Education over the next weeks, months and possibly years. We plan several additional alerts that will provide greater detail on the requirements and risks associated with this extremely significant new rule.

Please note that the BDTR rules apply to *all* institutions that participate in the Title IV programs, whether non- or for-profit, independent and, for the most part, public.

BDTR is likely to be one of the final major regulatory initiatives under the Obama administration, and one that will be in pre-effective date status on January 20th when Donald Trump becomes President. BDTR is a promulgated rule that interprets an existing statutory provision, and even if the new Administration wishes to change or even withdraw it, certain procedures must be followed. This Alert assumes that the rule will go into effect as written; however, as noted above and in more detail below, the implementation of BDTR still requires the issuance of policies and guidelines, and very possibly additional rules, with regard to the procedures to be followed, most notably with regard to the role and responsibilities of affected institutions. We will be watching closely as this phase unfolds.

The Department of Education issued its [final rule](#) governing the implementation of the BDTR provision of the Higher Education Act (HEA) on the last possible day to allow it to become effective July 1, 2017. The new rule *begins* to describe how and under what circumstances students will be able to have all or some of their federal student loans discharged, and, very importantly, what the consequences of such forgiveness will be on the schools they attended. However, the new regulation goes well beyond the implementation of the limited purposes of the BDTR provision of the HEA to very substantially revise ED's financial responsibility rules to allow ED to evaluate the potential financial impact of certain events – many outside an institution's control and for the most part entirely unrelated to the premise of BDTR – that will require the posting of costly letters of credit ("LOCs") for the stated purpose of assuring an institution's ability to pay potential liabilities to the Department as well as impose other potentially onerous restrictions and obligations.<sup>1</sup>

We use the term "begins" to describe this because ED very expressly made clear that much of the nuts-and-bolts as to how students will apply for relief, how their claims will be adjudicated, and particularly how institutions will be able to defend against repayment claims, must await the issuance of another rule or set of procedures. The Department has not explained its time frame to issue this final piece, or if it will even do so before the new BDTR rule's July 1, 2017 effective date. The decisions to be made in this regard will fall to the new leadership of the Department.

Indeed – setting aside the absence of much of the information necessary to understand how the student relief efforts will actually work and how institutions will participate in that process -- the most significant changes in the final rule from the original proposal relate to the financial responsibility provisions. The Department has moved away from a suite of triggering events that would have automatically required an institution to provide a substantial LOC in favor of a new, much more subjective process that generally calls for ED to assess the *potential impact* of a triggering event and the need for an LOC based on the *anticipated* effect on an institution's existing financial position. In most cases, ED will recalculate an institution's composite financial score based on

assumptions about the impact of an event that is still in process, such as a major lawsuit or governmental investigation. This is a seismic change in how ED assesses "financial responsibility." Instead of relying on a rigid formula derived exclusively from the results of an institution's most recent *audited* financial statements, ED will adjust that formula based on its *assumptions* regarding the effects of future events, such as the outcome of a lawsuit. While ED has (we believe wisely) abandoned its previously proposed rigid approach to automatically "stack" LOCs of at least 10% of an institution's prior year Title IV funding for each triggering event, ED will instead now assess what it *believes to be* the potential loss to the Department created by the triggering event as the basis for determining the necessary LOC amount. While shifting from a formulaic to a discretionary approach, ED is maintaining the current requirement that any LOC be valued at a minimum of 10% of the federal student aid funds received by the institution in the prior year. How ED will deal with the size of LOCs when there are multiple causes is unclear.

The final rule applies to all Direct Loans originated after July 1, 2017. However, ED has begun to put in motion processes to address borrower claims from prior years, as well as to expand the process for borrowers who attended schools that have closed to have their federal loans discharged on a group basis, dispensing with the need for individual applications.

After a chaotic and at times contentious negotiated rulemaking process, the proposed rule that emerged elicited – over the course of a relatively short public comment period – more than 10,000 written comments from more than 50,000 parties, many from institutions, state attorneys general and other stakeholders. Many comments focused on the potential flood of BDTR claims that could result from changing the definition of misrepresentation to include even inadvertent omissions, the potentially catastrophic impact of the financial "triggers" and LOC requirements, and the potential financial hit to the U.S. Treasury, which ED previously estimated could go as high as \$43 billion (now reduced to \$16 billion).

It is important to recall that the nearly 200 pages necessary to promulgate and explain the new BDTR rule spring from a single sentence in the HEA:<sup>2</sup>

(h) Borrower defenses

Notwithstanding any other provision of State or Federal law, the Secretary shall specify in regulations which acts or omissions of an institution of higher education a borrower may assert as a defense to repayment of a loan made under this part, except that in no event may a borrower recover from the Secretary, in any action arising from or relating to a loan made under this part, an amount in excess of the amount such borrower has repaid on such loan.

This short statement has morphed into a lengthy manifesto that creates a new federal standard for these "acts or omissions" and establishes a financial responsibility framework that could put colleges and universities of every kind and size at very substantial – and possibly fatal – financial risk. Following are brief analyses of the key provisions of the BDTR rule, as currently – if incompletely – promulgated.

## 1. Bases for borrower defense claims

A student presenting a BDTR claim against an institution, regardless of whether it is for- or non-profit, independent or public institution, must show that the claim relates either to the student's Direct Loan or to the institution's educational services and establish one of the following three grounds by a "preponderance of the evidence," meaning that it is more likely than not that one or more of the following occurred:

- a. *A decision of a court or administrative tribunal in favor of the student (whether as a plaintiff, member of a class, or covered party in a proceeding brought by a government agency against the school).* The decision must be contested, meaning that the institution had a chance to substantively defend itself against the allegations in an adversarial proceeding. There is an important note here: Although a default judgment or

non-contested outcome (such as a settlement agreement) does not rise to the level required to support a BDTR claim, either can serve as evidence in a borrower defense claim under the other two grounds.

- b. *The school's breach of contract, which is generally the enrollment agreement, either in its express or implied terms, but may also include other documents such as a program brochures and catalogs that make up the entire contract with a student.*
- c. *A "substantial misrepresentation" by the school or any of its representatives regarding the nature of the educational program, the nature of the financial charges, or the employability of graduates upon which the borrower reasonably relied to his or her detriment.* The Department expanded its current definition of misrepresentation to encompass any statement that has the *likelihood or tendency* to "mislead under the circumstances," and further expanded this concept to include any statement that *omits* information that makes the statement false, erroneous or misleading. ED also clarified that the borrower must demonstrate *actual and reasonable reliance to the borrower's detriment*, two important elements. However, ED did not move away from its position that a misrepresentation (whether direct or by omission) that could result in a repayment obligation by an institution could be entirely unintentional on the part of the institution.

The time limits for student borrowers to file such claims are varied. But, as a general matter, claims based on a court judgment or claims to assert a defense against loan payments that are still due can be made any time (with no statute of limitations), while most other claims (such as to recover loan funds already repaid to ED) must be made within six years of the underlying act by the school.

## 2. Claim resolution process

The final rule outlines a "fact-finding" process for ED to resolve individual and group claims based on the review of the evidence by an "ED official" or "hearing official." Outline is the operative term: the rule *suggests* that the affected institution will have some form of notice and an opportunity to respond, but the procedures enabling an institution to do so are not presented. As an example of the incomplete nature of this aspect of the rule, while the final rule requires ED to provide the *borrower* with any relevant records, there is not in all cases express assurance that the institution can request and receive the same records.

In addition to individual claims, ED may elect on its own initiative to process claims on a group basis, including creating what amounts to classes of borrowers who have not individually filed an application for relief or for that matter taken any action whatsoever. For group claims, ED will assign one of its own personnel to advocate on behalf of the group, while another ED employee would be assigned to adjudicate the group claim. ED has made clear that in a group claim, the *institution* has the burden to prove the *value* of the education. This is a prime example of when ED has drawn the broad outlines of a procedure but left enormous blanks, presumably to be filled in through further rulemaking or procedural guidance. It is interesting, however, that in suggesting that further guidance or rules will be provided, ED has in several places alluded to Subparts G and H of the Title IV regulations, which prescribe rigid procedures for adjudicating audits, programs reviews and fine or termination proceedings. While in the BDTR rule itself there is no inference of what due process adjudication will look like, ED has implied that such process will be fleshed out later, but exactly what it might – or might not – provide, is still unknown.

Borrowers who file successful claims may have their loans forgiven in whole or in part, with ED reserving the right to calculate the amount of forgiveness in various ways, several of which are entirely subjective. While the proposed rule included specific factors to evaluate in any such calculation, the final rule replaced those with various "conceptual examples" that describe scenarios under which a borrower might be entitled to no relief, partial relief, or full relief. In one example, ED describes a borrower who wanted to become a nurse and was incorrectly told by an admissions counselor that a medical assisting program is "prerequisite for any nursing program." He would be entitled to full relief for loans taken out for the medical assisting program and, as discussed below, his former school could be held responsible to pay the loan back to the government. But, in another example, a borrower would not be entitled to any relief after graduating from a selective, regionally accredited liberal arts school even if she relied to her detriment on the school's ranking that was based on falsified admissions data.

### 3. Recovering funds

The Department appears to be having particular difficulty addressing the critical question of how and when it will require institutions to repay BDTR claims and how it will pursue collections in those situations. The final rule only provides clues, such as the statute of limitations that ED will apply in seeking to recover funds for various reasons (a minimum of six years). In a twist that has puzzled many commenters, ED promises that there will be a "proceeding" in which it seeks to collect from institutions for individual claims, referring in the preamble to existing procedures for adjudicating fines, terminations or repayment of audit or program review liabilities as the model. In contrast, and quite surprisingly given the larger sums at stake for group claims, which will inherently involve far larger sums, the regulation does not include a separate collection proceeding. Rather, it appears that the semblance of due process afforded institutions for group claims is limited to the institution's involvement in the still undefined "fact-finding process" that ED will use to resolve a group claim. If ED determines a group discharge is warranted, the letter of the rule suggests that it will go straight to collections from the institution. Compared to the proposed rule, the only change in this process is the addition of the same time limits outlined above for the individual borrower claims.

The preamble to the rule seems intended to mollify those who have argued that there are insufficient safeguards to protect an institution's due process rights. The preamble announced that ED is developing procedures to ensure that a school can present its evidence and be heard, in the fact-finding and in ED's proceeding to collect from the school, but there are no details on how this will work or how ED can provide an independent review in the collection phase after deciding on the underlying claim in the fact-finding phase. It appears that ED intends to sort out these issues by issuing a supplemental rule or set of procedures, but it is not yet clear if that will occur before July 1, 2017.

Moreover, this leads to the peculiar situation of ED moving ahead to implement the BDTR rule before the procedures for that implementation are in place. Aside from raising practical questions regarding how the processes will work, the absence of complete procedures – and particularly a description of how institutional rights will be protected – raises potentially significant legal arguments respecting the completeness of a rule that was pushed out to meet a statutory deadline.

### 4. Early “triggers” make significant changes to ED’s financial responsibility system

Entirely separate from the regulations that govern the administration of the BDTR claim system, which was the purpose of the rulemaking in the first place, the final rule also rather fundamentally overhauls the Title IV financial responsibility regulations, which determine whether and under what conditions an institution may participate in those programs. The inclusion of this element, which bears no relationship to the BDTR statutory provision, is a source of major concern. While the portion of the rule that would require institutions to post costly LOCs applies equally to both proprietary and non-profit institutions, as a matter of constitutional law the Department cannot require a public institution that has the full-faith-and-credit of its state behind it to post an LOC.

The final rule builds on the originally proposed system of "early warning" triggers, integrating those triggers into ED's existing entirely objective composite score formula to determine financial responsibility. However, there are two major departures from the proposed rule: first, some of the triggers become entirely discretionary and, second, most of the automatic triggers, instead of themselves triggering the need for the posting of an LOC, now require ED to incorporate the potential economic implications of the triggering event (such as a lawsuit) to recalculate the institution's composite score to determine their potential impact and the appropriate amount of any LOC. While these changes appear to be in response to the many comments expressing concern that the originally proposed automatic LOC triggers would have failed to take into account an institution's full financial condition and ability to absorb a negative event, they introduce a high degree of subjectivity into financial score calculations that were intentionally designed to be based on objective, *audited* financials.

Under the new system, institutions will be required to notify the Department of specified triggering events that occur after July 1, 2017. Depending on the trigger, ED will then recalculate the institution's composite score using the institution's last-submitted audited financial statements to make adjusting entries based on its assumption of the *potential* loss or liability caused by the

triggering event. This will not be either a simple or, in all likelihood, very accurate task. For events such as a lawsuit or agency action, for instance, ED will assume the amount of loss will be the amount claimed in the complaint or demand if there has not yet been a judicial determination of liability. Of course, what is claimed and what is recovered – if anything – are very different; it is not uncommon for recoveries to be a small fraction – or zero – of the original claim, which more often than not is a vehicle for stoking settlement discussions.

If the recalculation results in a composite score below 1.0, the institution will be required to post an LOC in an amount determined by the Department to ensure a minimum coverage of 10% of the federal student aid the school received in the prior year. Since the amount of an LOC remains discretionary, the 10% level is no more than a benchmark.

There still remain four completely automatic triggers for an LOC: failing the "90/10" revenue limitation rule in one year, a cohort default rate of 30% or higher for two consecutive years, the SEC suspending or delisting the stock of an institution that is publicly traded, or the failure of a publicly traded school company to timely file a required SEC filing. Note that three of the four automatic LOC triggers apply only to for-profit institutions.

While the final rule no longer requires that LOCs be "stacked" for multiple triggering events, the rule gives the Department complete discretion to determine the amount of any LOC that is required. ED will have wide latitude to consider the size of any LOC based on a range of variables such as the institution's attributes and compliance history, the nature of the risks posed, the presence of existing liabilities to ED, and the potential risk of borrower defense claims. Speaking of discretion, the final rule also preserves a controversial provision that authorizes ED to find that "any event," to be determined on a case-by-case basis, may have a material adverse effect on the financial health of an institution that requires ED to recalculate the institution's composite score and, potentially, trigger a demand for any LOC that ED deems appropriate. The new rule does provide an institution with some ability to dispute the amount of or requirement for an LOC by showing that, for example, the event or condition was resolved, the institution has insurance to cover the debts and liabilities arising from the event, a given lawsuit or proceeding could not result in the amount claimed by the plaintiff, or that the amount is unnecessary to protect the federal interest.

Finally, ED promises yet another disclosure requirement to require institutions to publicly disclose the occurrence of triggering events to their enrolled and prospective students.

## **5. Required warnings to students of new repayment rate**

While the heart of the new rule applies to non-profit and proprietary institutions alike (and, with the exception of the LOC requirements, applies to public institutions), ED has reserved one particular provision for the proprietary sector. This is the requirement that such institutions post and deliver a warning to current and potential students if their loan repayment rate falls below a threshold.

ED has used the final rule to change the formula for calculating the repayment rate. Since all proprietary institutions are subject to the Gainful Employment (GE) Rule, which already calls for ED to calculate the repayment rates for their programs, ED has adopted that same method to calculate an institutional loan repayment rate. Under this formula, if ED determines that the "median borrower" in the two-year period used to calculate GE rates has not reduced the principal balance of his or her federal student loan by at least one dollar since entering repayment, the institution will be required to issue specific warnings in all institutional advertising and promotional materials, such as its web landing page, program webpages, financial aid webpages, emails and media, whether print, TV or radio. Indeed, this even includes having to both speak and write the warning *simultaneously* in television or video promotions.

## **6. Forbidding mandatory arbitration clauses or class action waivers**

The final rule remains true to the proposed rule in prohibiting an institution from incorporating in its agreements with students a class action waiver or provision restricting class actions, or requiring mandatory arbitration.

The ban on arbitration provisions puts ED in an awkward position. Both federal and state law has favored "alternative dispute resolution" as a faster, better and cheaper way to resolve disputes without resorting to the judicial system. Indeed, a federal agency may not simply prohibit arbitration in purely business transactions, such as contracting for educational services. ED therefore needed to link its desired ban on mandatory arbitration to the making of Direct Loans or the educational services that are related to those loans. In theory, an institution could require arbitration in all other situations. However, ED has sought to cut off this approach by requiring that any arbitration clauses include language that only a court can decide whether a student claim falls into or outside of the covered category, thus effectively defeating a primary purpose of arbitration, avoiding formal litigation in the first place.

If an institution's enrollment agreement *currently* contains a pre-dispute mandatory arbitration provision or a class-action waiver, the institution will be required to amend the agreement or provide a specific notice to students, using language provided by ED that explains that those provisions have been changed, on or before the rule's effective date.

## Effective date

Speaking of which, unless a court or Congress decides otherwise, or the new administration takes action to modify or withdraw the rule, the new regulations will become effective on July 1, 2017. While it is not clear if ED's delay in issuing critical parts of the rule necessary for its implementation, such as the procedures for collection actions against institutions, might affect that timing, the July 1st date should be assumed as accurate.

The new BDTR rule will have wide-ranging impact on *every* institution whose students receive Title IV assistance. For some, it will require fundamental changes in the relationship with students; for others, minor clarifications in language. It is essential that all schools, of all types, conduct a thorough operational assessment to determine what changes to policy, process and procedure may help mitigate the risk claims and financial damage. Of paramount importance is a very careful examination of student-facing policies, procedures and – most of all – publications and other student-facing information to ensure their accuracy and clarity. Bear in mind two striking parts of BDTR:

- It is a "no-fault" regulation: a borrower can walk away from his or her student loan, and his or her institution may end up paying the student's debt, without being required to show any intentional wrongdoing whatsoever on the part of the school.
- While in significant measure derived from the existing regulatory prohibitions against misrepresentation, it effectively creates a "private right of action" that enables students to assert that they were misled by what their school said or did – or did not say or do – and that can directly result in financial liability to the institution.

*Caveat emptor* – let the buyer beware – is steadily being replaced in higher education by *caveat venditor*. This is not wrong as a matter of policy. But it represents a new high water mark in assessing institutional risk. While Mr. Trump is clearly not a fan of government regulation, and, according to Politico, he has not given any indication how he would approach the issue of debt relief for defrauded borrowers, he has sympathized with the plight of struggling student loan borrowers at various times on the campaign trail.

We will be providing much more information and guidance in the coming days and weeks. Please let us know if we can assist in any aspect of your review or preparation.

## Notes

1. See our prior client alerts on this subject: [ED Issues Sweeping Proposed Rules on Borrower Defense](#);

## [What Independent Colleges Need to Know About the Forthcoming BDTR Rules.](#)

2. [20 U.S.C. §1087e\(h\)](#) (enacted in 1993).
3. In one welcome clarification, ED eliminated the three-year "look back" for triggers under the proposed rule, so the triggers only apply to events that occur after July 1, 2017. It appears, however, that if these prior events generate liabilities to be paid after July 1, 2017, those liabilities could trigger ED's new financial calculation.
4. Under ED's composite score system, a score below 1.0 is considered failing, while a score between 1.0 and 1.5 is in the zone, and a score above 1.5 is passing.

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