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ED Issues Sweeping Proposed Rules on Borrower Defense

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Almost four months after the marathon negotiated rulemaking ended in March without consensus, the US Department of Education (ED) has released a massive **Notice of Proposed Rulemaking** describing how it plans to refocus the rules governing the Borrower Defense to Repayment (BDTR) provision of the Higher Education Act (HEA). In our four previous alerts on BDTR, we discussed **new letter of credit requirements**, **the potential for massive loan forgiveness**, and **the panel's proposed process for debt forgiveness**, and, as a precursor to the current proposal, **the collapse of BDTR negotiations**. As predicted, ED aims to completely rewrite the current sparse regulations to open up new avenues for student borrowers to assert a defense to repaying their loans, to allow ED to seek reimbursement for such claims from the affected institutions, and to rewrite the institutional financial responsibility rules to require many more schools to post letters of credit, ostensibly to assure ED of their capacity to pay claims to the Department and students.

Although the media attention and statements by ED have primarily focused on these proposed rules as a means to crack down on for-profit institutions, except for a very few provisions, the proposed regulations apply to all institutions participating in the Direct Loan program, including public and non-profit. The proposed rules would generally apply to all Direct Loans originated after July 1, 2017, but portions of the rules would also reach back to prior conduct.

This new regulatory package, consisting of 20-plus pages of regulatory text with another hundred pages of small-type explanation, springs from one-half of a page in **current regulations** and a single sentence in the **Higher Education Act**:

> (h) Borrower defenses
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> 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.

As we noted previously, over the twenty-plus years that the Borrower Defenses provision has been on the books, until a little over a year ago, less than a half dozen claims were filed by borrowers seeking to avoid paying their loans under this rule. That changed dramatically with the collapse of Corinthian Colleges, and since then several thousand students and former students have filed for relief under a set of procedures that the Department has been forced to create in mid-air. The new rules proposed by the Department have come out of this nearly anarchic situation that has satisfied no one, neither students, institutions, consumer advocates nor those concerned with the orderly administration of government services.

The potential risks and administrative burden associated with this rule will challenge institutions across all sectors. Our discussion provides a select summary of the seven most important elements of the proposed rules. The deadline to file comments with ED is August 1, 2016. If you need assistance with comments or need more information on the impact of BDTR, please let us know.

1. Bases for borrowers to file claims

The most immediate weakness with the existing regulation is the lack of specificity as to what constitutes the "acts or omissions" by an institution that could support a borrower's claim against repayment. While the current rule broadly refers to claims "under state law," the proposed rules would create a new, and very complex, federal standard.

The proposed rule sets out three grounds for a BDTR claim, all of which would require the borrower to meet the relatively low "preponderance of the evidence" (meaning "more likely than not") test:

a. a favorable decision for the student (whether as a plaintiff, a member of a class, or a covered party in a proceeding brought by an agency against the school) in a state or federal court case involving the loan, or the educational services for which the loan was made. To meet the criteria of a BDTR claim, the decision must be a contested decision, meaning that the institution had a chance to substantively defend itself against the allegations in court or administrative tribunal. Additionally, although a non-contested decision, such as a settlement agreement or successful motion to dismiss, does not rise to the level of supporting a BDTR claim, those decisions can serve as evidence in a borrower defense claim under the other two provisions below;
b. breach of contract (generally the enrollment agreement, either in its express terms or implied) by the school; or
c. a "substantial misrepresentation" by the school about the nature of the educational program, the nature of the financial charges, or the employability of graduates.

Very importantly, the Department proposes to enormously broaden the definition of "substantial misrepresentation" to eliminate the need to prove any intent on the part of the institution to deceive, replacing that with a "misleading under the circumstances" standard. The proposed rule also adds that "substantial misrepresentation" includes any statement made by a representative of an institution that *omits* information in such a way as to make the statement false, erroneous or misleading. While the proposed rule does require the borrower to prove that he or she relied on the misrepresentation to his or her detriment, the nature of what could be construed as the "false, erroneous or misleading" statement – particularly where no *intention to mislead* is required to be shown – is so broad as to challenge reasonable interpretation.

The time limits for student borrowers to file such claims are varied and intricate. 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 other claims (such as to recoup loan funds already repaid to ED) must be made within six years.

2. Claim resolution process

The proposed rule calls for ED to set up a "fact-finding" process to resolve claims. The contemplated structure does include providing the affected school notice and an opportunity to submit evidence; however, the exact procedures, including the opportunity to contest particular factual assertions or present any in-person testimony, are still completely undefined. ED has also given itself authority to process claims on a group basis, and even to take the initiative to create groups and include borrowers who have not filed a claim. The proposed regulations include provisions for ED to assign one of its own personnel to advocate on behalf of the group claim and another ED official to adjudicate the group claim. 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.

3. Recovering funds

Of critical importance is ED's proposal setting up a structure to enable it to recoup its losses from the student's former institution.

For debts relieved for individual borrowers, ED would have the authority to "initiate a proceeding" to seek repayment from the school for any loan amounts forgiven. The details of this "proceeding" are entirely undefined. For group relief, there is no "separate proceeding"; the due process afforded institutions under that provision is limited to the institution's involvement in the "fact finding process" that ED will initiate following the formation of a group claim. If ED determines a group discharge is warranted, it will automatically assign liability to the institution. Additionally, ED takes on the rights under the loan agreement when the debt is relieved, allowing it to seek repayment from "principals and affiliates" of schools in certain circumstances.

4. New "early warning" letter of credit triggers

In a dramatic step that may prove far more impactful than the BDTR Rule itself, ED has also reached into the existing financial responsibility regulations to describe at least 10 new "early warning" triggers that would allow ED to require institutions to post a letter of credit ("LOC") with the Department to demonstrate their financial stability and, importantly, assure ED of their ability to pay BDTR claims if needed. Each trigger would authorize ED to require an LOC valued at 10% of the school's prior year Title IV, HEA program funding, or other measures, depending on the trigger; the triggers are intended to be cumulative, and therefore could require an institution to post an LOC equal to or even exceeding its Title IV allocations. This means that if a school is found to have invoked four triggering events, it could be required to post an LOC worth at least 40% of its prior year Title IV funding. The proposed regulations would also put institutions on provisional certification immediately upon a trigger being met and, if a school does not provide the LOC required within 30 days of ED's request, ED may offset the school's Title IV funds for up to nine months until it is able to capture the amount of the LOC.

The proposed triggering events include, among others:

a. Lawsuits and other Actions – If the school is subject to a liability based on an audit, investigation or similar action by a state or federal oversight agency, including any debt or liability incurred or asserted at any time during the three most recently completed award years, with a claim or liability exceeding the lesser of 10% of the school's current assets or $750,000.
b. Successful Borrower Defense to Repayment Claims – If the school is required to pay more than 10% of its current assets, or $750,000, whichever is less, to satisfy successful BDTR claims.
c. Accrediting Agency Actions – If the institution or any of its locations is required to submit a teach-out plan or is placed on probation or issued a show-cause in the three prior award years, regardless of the cause.
d. 90/10 Rule – Failure to meet the 90/10 Rule revenue ratio for a single year (even though eligibility is based on two years of failure).
e. Gainful Employment Rates – If more than 50% of the school's Title IV-recipient students in GE program are enrolled in GE programs with failing or zone rates (but prior to any loss of eligibility under the multi-year triggers in the GE Rule).
f. Cohort Default Rates – Two consecutive years with CDRs of 30% or higher (even though eligibility is based on CDRs for three consecutive years).

A number of these events reset the bar very low, and some are based on legal claims that have only been asserted, not proven. It is not hyperbole to say that this new LOC cumulative provision, rather than assisting the institution and its students, could drive many schools into financial distress or even closure. While public institutions *that have the full-faith-and-credit of a state* behind them benefit from broad exemption from LOC requirements, the LOC provisions apply equally to for-profit and non-profit institutions.

5. Required warnings to students of new repayment rate

ED singled out the for-profit sector for one particular requirement, requiring such schools to disclose a new form of repayment rate in a variety of public materials, to serve as a "warning" to current and potential students, when the rate is too low. This repayment rate would be calculated based on the payment performance of an institution's students approximately five years after its students graduate or withdraw from the school. While the Department has generally touted that its rules apply equally to all sectors, it has dealt differently with this repayment rate requirement, justifying the limited application to the for-profit sector alone based on, according to ED, the "frequency of poor repayment outcomes is greatest" at proprietary institutions.

6. Forbidding mandatory arbitration clauses or class action waivers

The new rule package would prohibit an institution from incorporating a class action waiver or provision, or mandatory arbitration clause, in any agreement with students. The idea is to prevent a student from being required to give up claims they could file in court before they have even made a complaint. If a school's contracts currently contain a pre-dispute arbitration provision and/or a class waiver, the school 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. This applies to any existing agreements at the time the rule becomes effective, not just for those agreements entered into after July 1, 2017.

7. Changes to closed school and false certification discharges

While it has a major rulemaking on the table, ED decided to also amend the rules regarding the Closed School Discharge process, so as to require additional information disclosure and outreach to affected students, as well as providing additional forbearance options for borrowers seeking discharge under this provision.

The proposed rules also change the False Certification Discharge provisions relating to the falsification of high school graduation status and documentation and the ability for ED to make such a discharge decision without application or request based on ED's own information, including indications that an institution was falsifying satisfying academic progress in order to maintain a student's eligibility.

Comment period

The deadline to file comments on this proposed rule package is August 1, 2016. Given the broad and potentially draconian effects of these rules, we urge you to read the proposed rule carefully and ensure your voice is heard in the comment period. Please let us know if we can assist in any aspect of your review or comment preparation.

Key Contacts

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