On November 1, the U.S. Department of Education (ED) published final regulations to establish new standards and processes for determining whether a borrower has a defense to repayment of a Federal Direct Loan based on an act or omission of an institution. The final regulations also add new requirements related to discharge of federal education loans from closed schools, pre-dispute resolution agreements, and financial responsibility. The final rule generally is effective July 1, 2017.

This advisory summarizes selected aspects of the regulations and highlights certain changes ED made in response to public comment from more than 50,000 parties. The regulations are largely a response to developments in the for-profit education sector, including the “collapse” of Corinthian Colleges and the “flood” of borrower defense claims submitted by Corinthian students, and certain aspects of the regulations apply only to for-profit institutions. However, most portions of the rule apply to all institutions that participate in the federal student financial aid programs. The borrower defense to repayment, closed school discharge, and financial responsibility regulations merit particular attention because they seemingly grant substantial discretion and authority to ED and have the potential to subject institutions to significant financial obligations.

I. Background

ED regulations have long included provisions relating to borrower defenses to repayment of Federal Direct loans and discharge of federal education loans from schools that close entirely or at a given location. According to ED, until recently the borrower defense provisions have rarely been used, and commenters argued that the closed school discharge option was underutilized. The borrower defenses provision allows a Direct Loan borrower to obtain a Direct Loan discharge if the institution’s acts or omissions give rise to a cause of action against the institution under state law. The regulation is silent on the applicable process. Based on difficulties related to application and interpretation of the current state law standard—including in relation to distance education where multiple state laws may apply—and lack of clarity regarding the applicable procedures, ED decided to initiate a rulemaking process to modify the borrower defense regulations. In January, February, and March 2016 ED held negotiated rulemaking...
sessions to develop proposed regulations. The rulemaking sessions also addressed other topics, such as institutional financial responsibility and pre-dispute resolution agreements. The committee did not achieve consensus, which meant ED was not bound to use any regulatory language developed during negotiated rulemaking. ED issued a Notice of Proposed Rulemaking (NPRM) in June 2016 and solicited public comment. The final rule reflects several changes from the proposed rule, particularly with respect to institutional financial responsibility.

II. Federal student loan borrower defenses

The final regulations establish a new federal standard for borrower defenses, new limitation periods for borrower defense claims, and new processes for resolution of such claims. The final regulations also clarify ED’s authority to seek recourse against the institution for the loan amounts discharged. The final rule is substantively similar to the proposed rule with respect to borrower defenses, although it still leaves open a number of areas with respect to which ED indicates that it will issue regulations or guidance.

A. Standards

Under the final regulations, “borrower defense” refers to an act or omission of the institution that relates to the making of a Direct Loan for enrollment at the institution or the provision of educational services for which the loan was provided. In addition, the borrower defense must satisfy the requirements of the relevant borrower defense claim set forth below. In particular:

- For loans first disbursed prior to July 1, 2017, a borrower will continue to be able to assert a borrower defense under the existing standard, i.e., the facts would give rise to a cause of action against the institution under applicable state law.

- For loans first disbursed on or after July 1, 2017, a borrower defense will be required to satisfy one of three types of claims, set forth below and in each case subject to the general definition of “borrower defense” above.

1. Breach of contract

- A borrower will have a “borrower defense” based on breach of contract if the institution “failed to perform its obligations under the terms of a contract with the student.”

- The final regulations do not define what constitutes a contract for purposes of the regulations, despite commenters’ request for clarity. In the preamble to the NPRM, ED suggested that it would consider a range of evidence to constitute the contract, including an enrollment agreement, catalogs, bulletins, circulars, student handbooks, and “school regulations.” In response to comment, ED declined in the final rule “to draw a bright line on what materials would be included” and said federal and state law precedent will guide ED’s interpretation.

- The defense will have no materiality limitation and according to ED will allow borrowers to assert a borrower defense for “relatively minor breaches”.


A borrower will be able to assert a defense to repayment of amounts owed to the government at any time after the institution's breach. A borrower will be able to assert a right to recover amounts the government previously collected not later than six years after the breach.

2. Substantial misrepresentation

- A borrower will have a “borrower defense” based on substantial misrepresentation if the institution or any of its representatives, or any institution, organization, or person with whom the institution has an agreement to provide educational programs, or to provide marketing, advertising, recruiting, or admissions services, made a substantial misrepresentation on which the borrower reasonably relied to the borrower's detriment when the borrower decided to attend, or to continue attending, the institution. In the final rule, ED clarified that actual, reasonable reliance to the borrower's detriment will be required.

- ED amended the definition of “misrepresentation” both for purposes of the substantial misrepresentation regulation at 34 C.F.R. part 668, subpart F, and for purposes of the borrower defense regulations. First, the final rule replaces “deceive” with “mislead under the circumstances” in the definition of “misrepresentation”, so that the regulation reads: “A misleading statement includes any statement that has the likelihood or tendency to mislead under the circumstances.” ED explained that the reason for this change is to clarify that intent is not required. Second, the final rule provides that a misrepresentation may involve an omission of information where such omission makes the statement false, erroneous, or misleading.

- ED previously has defined substantial misrepresentation as any misrepresentation on which a person could reasonably be expected to rely to his or her detriment. The final rule includes a nonexclusive list of circumstances that will create a presumption of reasonable reliance in the context of a borrower defense:
  - Demanding that the borrower make enrollment or loan-related decisions immediately;
  - Placing an unreasonable emphasis on unfavorable consequences of delay;
  - Discouraging the borrower from consulting an adviser, a family member, or other resource;
  - Failing to respond to the borrower's requests for more information, including about the cost of the program and the nature of any financial aid; or
  - Otherwise unreasonably pressuring the borrower or taking advantage of the borrower's distress or lack of knowledge or sophistication.

- Under the final rule a borrower will be able to assert a defense to repayment of amounts owed to the government at any time based on a substantial misrepresentation. A borrower will be able to assert a right to receive amounts the government previously collected not
later than six years after the borrower discovers, or reasonably could have discovered, the information constituting the substantial misrepresentation.

3. Favorable non-default judgment

- Under the final rule a borrower will have a “borrower defense” based on a favorable contested judgment against an institution obtained by the borrower, as an individual or a member of a class, or by a government agency. Settlements will not satisfy this standard.
- A borrower will be able to assert at any time a defense to repayment or right to receive previously collected amounts based on such a judgment.

The regulations specify that an institution’s violation of an eligibility or compliance requirement in the Higher Education Act or its implementing regulations will not be a basis for a borrower defense. At the same time, such a violation may be the basis for a claim if the violation “would otherwise constitute a basis for a borrower defense.” In the preamble to the final rule, ED reiterated that personal injury tort claims, actions based on allegations of sexual or racial harassment and campus safety and security, and claims related to the quality of a student’s education or matters regarding academic or disciplinary disputes within the judgment and discretion of the institution are outside the scope of borrower defense claims. ED acknowledged in the preamble to the final rule that the regulations do not foreclose the possibility that the facts underlying such claims and actions could nevertheless be used to establish a permitted borrower defense claim based on misrepresentation or breach of contract.

B. Process

The final regulations set forth two procedures for borrower defense claims, one for individual borrowers and one for groups of borrowers. ED will grant forbearance or suspend collection on a loan while it considers a borrower defense claim unless the borrower elects to continue to make payments. Under both the individual process and the group process ED will be able to reopen a borrower defense application at any time to consider evidence that was not considered in making the previous decision. In the preamble to the final rule, ED explained that it is developing rules of agency practice and procedure for the individual and group processes that will be informed by ED’s rules and protections for its other administrative adjudications.

1. Individual borrower process

If an individual borrower submits a borrower defense claim, the U.S. Secretary of Education (Secretary) will designate an ED official to review the borrower’s application to determine whether the application states a basis for a borrower defense and to resolve the claim through a fact-finding process. As part of the fact-finding process, the institution will be notified and the ED official will consider any information he or she has, including any submissions from the institution. The borrower will bear the burden of proving that the claim is valid by a preponderance of the evidence. At the conclusion of the fact-finding process, the ED official will
issue a written decision that is final as to the merits of the claim and any relief granted to the student.

2. Group borrower process

The final regulations allow ED to initiate a process to determine whether a group of borrowers identified by ED has a borrower defense claim against an institution. In identifying a potential group, ED will consider individuals’ common facts and claims, fiscal impact, and promotion of compliance. Under the final regulations ED may identify members of a group from individually filed applications or from other sources, and borrowers who have not filed an individual claim may be included in a group process. For purposes of the group process, the Secretary will designate an ED official to present the group’s claims to a hearing official responsible for considering evidence presented by the ED official and determining any liability of the institution. The final regulations provide little detail about the conduct of such hearings, although ED explained in the preamble to the final rule that it is developing rules that will be informed by the procedures and protections used in its other administrative proceedings, including related to notice; the opportunity for an oral evidentiary hearing during which the parties may confront and cross-examine adverse witnesses; and the submission and exchange of written materials. The designated ED official will bear the burden of proving that the borrower defense claim is valid by a preponderance of the evidence. The institution and the designated ED official will have an opportunity to appeal the hearing official’s decision to the Secretary. If a group claim is denied in full or in part, an individual borrower who was part of the group will be able to file a claim for relief under the individual borrower process.

C. Relief

Relief may include discharge of all or part of the amounts owed on the loan at issue, including associated fees and costs, and recovery of amounts previously collected. For a borrower defense based on substantial misrepresentation, ED will consider the borrower’s cost of attendance at the school, the value of the education the borrower received (as to which the institution has the burden of proof), and other relevant factors. For a borrower defense based on a judgment against the school, relief will be the amount of the judgment that remains unsatisfied, subject to limits described below. For a borrower defense based on breach of contract, relief will be determined according to the common law of contracts, subject to limits described below. ED may also determine that the borrower is not in default on the loan and is eligible to receive Title IV assistance and may update any adverse credit reports with regard to the borrower’s loan.

The total amount of relief granted with respect to a borrower defense may not exceed the amount of the loan and any associated costs and fees. The amount of relief will be reduced by the amount of any refund, reimbursement, indemnification, restitution, compensatory damages, settlement, debt forgiveness, discharge, cancellation, compromise, or other financial benefit received by or on behalf of the borrower related to the borrower defense. The relief may not
include non-pecuniary damages such as inconvenience, aggravation, emotional distress, or punitive damages.

Within specified time periods based on the type of defense, the Secretary may initiate an administrative proceeding to collect from the institution the amount of relief resulting from a borrower defense.

III. Dispute resolution

The final regulations add specific provisions to the Direct Loan participation agreement – i.e., the agreement between the Secretary and an institution with respect to participation in the Direct Loan Program – related to borrower defense claims in court or arbitration and dispute resolution procedures. Specifically, the regulations:

- Prohibit an institution from requiring a student to pursue certain complaints (i.e., complaints based on acts or omissions of an institution that are related to the making of a federal loan or the provision of educational services for which the loan was provided and that could also form the basis of borrower defense claims under ED’s regulations) through an internal institutional process before the student presents the complaint to an accrediting agency or government agency, including ED, that is authorized to hear the complaint;
- Prohibit an institution from obtaining or attempting to enforce a waiver of or ban on class action lawsuits regarding borrower defense-type claims;
- Prohibit an institution from compelling a borrower to enter into a pre-dispute agreement to arbitrate borrower defense-type claims, or attempt to compel a borrower to arbitrate such a claim based on an existing pre-dispute arbitration agreement. In response to comments, in the final rule ED strengthened this provision by extending it to all pre-dispute agreements, whether voluntary or mandatory and whether or not such agreements contain an opt-out clause. The regulation also requires the institution to remove any confidentiality provision from arbitration agreements; and
- Require an institution to notify ED of the initial filing in arbitration or in court of any claim against the institution concerning a borrower defense-type claim and to provide ED copies of the initial filing, certain subsequent filings, and any decision related to such claims.

ED explained in the preamble to the final rule that the regulations do not forbid an institution to seek to convince a student to agree to arbitrate, provided the attempt is made after a dispute arises. ED also made clear in the preamble that the dispute-resolution provisions extend only to grievances that could form the basis of a borrower defense claim under ED’s regulations and do not apply to other types of claims.

IV. Closed school discharge

ED regulations currently authorize ED to discharge a borrower’s federal education loans if the “school” (including the main campus and any branch campus or additional location) closes while the student is enrolled and the student does not complete the educational program as a
result or if the school closes within 120 days after the student withdraws.

Under the final regulations, if an institution intends to close a location that provides 100% of at least one program and in certain other circumstances, the institution will be required to provide all enrolled students with a closed school discharge application and a written disclosure. The disclosure must describe the benefits and consequences of a closed school discharge as an alternative to completing the students’ educational programs through a teach-out agreement.

Under the final regulations ED will grant an automatic discharge without application to eligible borrowers who attended an institution that closed on or after November 1, 2013 and who have not re-enrolled in another Title IV-eligible institution within three years after the institution's closure. ED will implement this provision, which will be made available to borrowers who attended Corinthian Colleges at its closure, before July 1, 2017 and “as soon as operationally possible”.

As with borrower defenses, ED may collect from the school the amount of the losses that ED incurs and determines that the institution is liable to repay.

V. Institutional accountability for non-public institutions

The final regulations modify ED's financial responsibility standards to provide that a private non-profit or for-profit institution may not be able to meet its financial or administrative obligations, and therefore may not be financially responsible, if it is subject to one of more specified triggering events that occur on or after July 1, 2017. Depending on the category of triggering event, the determination that the institution is not financially responsible will be either automatic, subject to a formula to recalculate the institution’s composite score, or subject to ED’s discretion. This framework is a relatively dramatic change from that presented in the NPRM, which included only “automatic” and “discretionary” triggers and made no reference to the institution's composite score. In addition, the final rule omits some triggering events that were included in the NPRM, makes “discretionary” certain triggers that were “automatic” in the NPRM, and broadens the opportunity to provide context that may affect ED’s analysis of the matter.

A. Automatic triggering events

Under the final regulations, ED will determine automatically that an institution is not financially responsible if it is subject to one or more specified triggering events, including if:

- The institution has a cohort default rate of 30% or greater for each of the two most recent official calculations;
- The institution is a for-profit institution and fails in the previous fiscal year the 90/10 non-Title IV revenue requirement; or
- The institution is publicly-traded and receives certain warnings from the Securities and Exchange Commission (SEC) or the exchange on which the stock is traded or fails to file timely certain required reports to the SEC.
B. Composite score triggering events

ED will determine that an institution is not financially responsible if, after the end of the fiscal year for which ED has most recently calculated the institution’s composite score, the institution is subject to one or more specified triggering events, and as a result of the actual or potential debts, liabilities, or losses that have stemmed or may stem from those actions or events, the institution’s recalculated composite score is less than 1.0. Such triggering events include cases in which:

- The institution is required to pay a debt or incur liability arising from a final judgment in a judicial or administrative proceeding or settlement, or is a defendant in an action brought by federal or state authorities, in connection with borrower-defense related claims;
- The institution is a defendant in a lawsuit or other action that has survived a motion for summary judgment;
- The institution is required by its accrediting agency to submit a teach-out plan for certain reasons related to closure of the institution or any of its branch campuses or additional locations; or
- The institution has gainful employment programs that could become ineligible for Title IV based on their final debt-to-earnings rates for the next award year; or
- The institution is a proprietary institution, has a composite score of less than 1.5, and has a withdrawal of owner’s equity by any means, including by declaring a dividend.

C. Discretionary triggering events

Under the final regulations, ED in its discretion may determine that other events or conditions are reasonably likely to have a material adverse effect on the financial condition, business, or results of operations of the institution. ED may conclude that an institution is not financially responsible on the basis of such “discretionary trigger” events, which include:

- Significant fluctuation from year to year in the amount of Direct Loan or Pell Grant funds received by the institution;
- Citation by a state agency or authorizing agency (i.e., any agency or entity that regulates or governs whether an institution may operate or offer postsecondary education programs in the state; the nature or delivery of those programs; or the certification or licensure of students who complete those programs) for failing state or agency requirements;
- Failure of a stress test developed or adopted by ED to evaluate whether the institution has sufficient capital to absorb losses that may be incurred as a result of adverse conditions;
- High annual dropout rates, as calculated by ED. The final rule does not establish a specific threshold for a “high” annual dropout rate, but in response to comments, ED in the preamble to the final rule stated that it may issue guidance or provide examples of such a determination;
D. Triggering-event consequences

An institution will be required to notify ED of any action or event that constitutes a triggering event within ten days after that action or event occurs, except that in relation to the non-Title IV revenue trigger, an institution will be required to notify ED within 45 days after the end of the relevant fiscal year. For all triggering events, an institution will be able to submit information to support a position that the event no longer exists or has been resolved or the institution has insurance that will cover part or all of the debts or liabilities that arise from that event. An institution will also be able to demonstrate that the amount claimed in a state or federal agency lawsuit exceeds the potential recovery the claimant may receive. This institutional ability to submit certain information reflects a change from the NPRM, under which an institution would have been able to provide contextual information for only certain triggering events.

If ED determines that an institution is not financially responsible because of one or more triggering events, ED may permit the institution to continue to participate in the federal student financial aid programs if, among other conditions, the institution provides an irrevocable letter of credit generally equal to at least ten percent of the total amount of the federal student financial aid funds received by the institution for the past year. ED may increase the amount of the letter of credit if ED demonstrates that an added amount of protection is necessary based on the facts and circumstances (e.g., the history of the institution; the nature of the risks posed; the presence of existing liabilities to ED; the presence, amount, and rate at which borrower defense claims are being filed; and the likelihood that the risk will result in increases in borrower defense claims).

This structure is a significant departure from the framework proposed in the NPRM, under which an institution would have been required to provide “stackable” letters of credit for each triggering event (e.g., an institution with three triggering events would have been required to submit a letter of credit for at least 30% of its prior year federal student financial aid funds).

An institution that is required to provide a letter of credit may also be required to disclose the existence of the letter of credit and the reason(s) that the institution was required to provide the letter of credit. The institution will be required to post such disclosures on the homepage of its website until ED releases the financial protection. ED will determine whether to require such disclosures in connection with each type of trigger based on the outcome of consumer testing, through which ED will seek to determine which disclosures are meaningful to students.

VI. Other provisions
The final regulations also clarify certain other matters, consistent with the NPRM. For example:

- Federal Family Education Loan (FFEL) and Perkins Loan borrowers will be eligible to receive borrower defense relief through Direct Consolidation Loans. FFEL borrowers will also have the same access to administrative forbearance as Direct Loan borrowers while ED is evaluating their borrower defense claims;

- If an institution certifies the eligibility of a borrower who is not a high school graduate, the borrower will qualify for a false certification discharge if the borrower informed the institution that the borrower was not a high school graduate and the institution falsified the borrower’s high school graduation status, falsified the borrower's high school diploma, or referred the borrower to a third party to obtain a falsified high school diploma. The borrower will also qualify for a false certification discharge if the borrower failed to meet applicable state requirements (e.g., statute, regulations, other state limitations) for employment due to a physical or mental condition, age, criminal record, or other reason that would prevent the borrower from obtaining employment in the occupation for which the program supported by the Direct Loan was intended;

- Types of documentation that may be used for the granting of a discharge based on the death of a borrower in the Perkins, FFEL, Direct Loan, and TEACH Grant programs are expanded, based on ED’s intent to make the process more convenient for borrowers’ families;

- The final regulations codify ED’s current policy regarding the effect that a discharge of a Direct Subsidized Loan has on the 150 Percent Direct Subsidized Loan Limit; and

- Consolidation of Nurse Faculty Loans will be permitted.

The final regulations will require a for-profit institution to include a loan repayment rate warning in all promotional materials for any award year in which the institution’s loan repayment rate, as calculated by ED, shows that the median borrower has not either fully repaid the outstanding balance of each of the borrower's FFEL or Direct Loans or made loan payment sufficient to reduce the balance of each such loan by at least one dollar. In response to comments that the repayment rate proposed in the NPRM was unnecessarily complicated, under the final rule ED will calculate the loan repayment rate using existing data collected for purposes of ED’s gainful employment regulations. ED will use program-level repayment data to calculate a comparable rate at the institution level.

We are available to respond to questions.


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