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U.S. Department of Education finalizes "borrower defense to repayment" rules effective July 1, 2020

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On September 23, 2019, the U.S. Department of Education (ED) published final regulations concerning, among other things, "borrower defense to repayment" claims for federal student loans first disbursed on or after July 1, 2020, certain "triggering events" under ED's financial responsibility rules, disclosures related to predispute arbitration agreements and class action waivers, and closed-school discharges (the 2019 Final Rules). With very limited exceptions (related to optional early implementation of modifications to ED's composite score methodology), the 2019 Final Rules become effective on July 1, 2020 – meaning institutions must continue to comply with ED's 2016 Final Rules, which are now in effect, until that date. (For more information about the 2016 Final Rules currently in effect, including related reporting requirements under the financial responsibility rules, please see our previous alerts.) Like the 2016 Final Rules, the 2019 Final Rules apply to all institutions that participate in the Title IV federal student financial aid programs. Among other things, the 2019 Final Rules:

- Revise the list of conditions or other "triggering" events that have or may have an adverse, material effect on an institution's financial condition and therefore warrant financial protection.

- Update the definitions of terms used to calculate an institution's composite score to conform with changes in certain accounting standards, and to account for leases and long-term debt.

- Establish a new federal standard by which borrower defense claims can be asserted for Direct Loans first disbursed on or after July 1, 2020, which claims must be based on a revised definition of "misrepresentation."

- Remove prohibitions on predispute arbitration agreements or class action waivers, instead requiring institutions that impose such agreements or waivers as a condition of enrollment to disclose those requirements.

- Modify ED's regulations related to student eligibility for closed-school discharges of federal loans.

Financial responsibility: triggering events and reporting requirements

The 2019 Final Rules revise the framework established by ED's 2016 Final Rules, which require an institution to report to ED the occurrence of certain "triggering" and related events that ED considers to be early warning signs of financial distress. 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 aid programs if, among other conditions, the institution provides an irrevocable letter of credit equal to at least 10 percent of the total amount of the federal student financial aid funds received by the institution for the past year.

As noted above, ED's 2016 Final Rules and the related reporting requirements remain in effect until July 1, 2020. For the new 2019 Final Rules effective after that date, ED has "recalibrated the triggers from the 2016 final regulation to more narrowly focus on actions or events that have or may have a direct adverse impact and eliminated the triggers from the [2016] final regulation that were speculative or not associated directly with making a financial responsibility determination" (84 Fed. Reg. at 49,862).

To that end, the 2019 Final Rules contain a slimmed-down set of "mandatory" and "discretionary" triggering events. ED will consider an institution unable to meet its financial or administrative obligations under ED's financial responsibility regulations if the institution is subject to one of the following "mandatory" triggering events:

- The institution incurs a liability from a settlement, final judgment, or final determination arising from an administrative or judicial action or proceeding initiated by a federal or state entity, and as a result of that settlement, judgment, or determination the institution's recalculated composite score is less than 1.0.
- A proprietary institution with a composite score less than 1.5 is subject to withdrawal of owner's equity (except for certain intercompany transfers), and as a result of that withdrawal the institution's recalculated composite score is less than 1.0.
- For a publicly traded institution, (1) the Securities and Exchange Commission (SEC) issues an order suspending or revoking the registration of the institution's securities or suspends trading, (2) the relevant exchange finds the institution not in compliance with the exchange's listing requirements and the institution's securities are delisted, or (3) the SEC does not timely receive a required report and did not issue an extension.
- For any institution, the institution is subject to two or more "discretionary" triggering events described below, unless a triggering event is resolved before a subsequent triggering event occurs.

Under the 2019 Final Rules, ED may consider an institution not to be financially responsible if ED determines that one of the following "discretionary" triggering events is likely to have a material adverse effect on the financial condition of the institution:

- The institution's accreditor issues an order (e.g., show-cause order or similar action) that if not satisfied could result in withdrawal, revocation, or suspension of the institution's accreditation.
- The institution violated a provision or requirement in a security or loan agreement, which violation enables the creditor to require or impose an increase in collateral, change in contractual obligations, increase in interest rate or payments, or other sanctions, fees, or payments.

- The institution violates a requirement of its state licensing or authorizing agency, and the agency notifies the institution that it intends to withdraw or terminate the institution's licensure or authorization if the institution does not take steps to come into compliance.
- A proprietary institution fails to satisfy the "90/10" rule for its most recently completed fiscal year.
- The institution has "high annual dropout rates" as calculated by ED.
- The institution's two most recent official cohort default rates are 30 percent or higher.

As under the 2016 Final Rules, under the 2019 Final Rules, an institution generally will be required to report to ED within 10 days of the above-listed events occur. With respect to the 2016 Final Rules, ED has instructed institutions to submit such reports by email; ED likely will provide additional guidance on the procedures for reporting under the 2019 Final Rules. An institution that does not supply the required reports may be subject to enforcement action.

Financial responsibility: accounting treatment of leases

The 2019 Final Rules also implement updates to ED's method for calculation of an institution's composite score to reflect certain changes in Financial Accounting Standards Board (FASB) accounting standards (FASB ASU 2016-02, ASC 842 (Leases)). Those FASB standards revise in certain respects the accounting treatment of leases. Accordingly, ED has amended its rules to update the treatment of leases and also the treatment of long-term debt. ED will permit institutions to adopt early the related provisions in the 2019 Final Rules.

Borrower defense to repayment

The 2019 Final Rules establish a federal standard by which borrower defense claims can be asserted for Direct Loans first disbursed on or after July 1, 2020. This standard applies and is available to borrowers who might seek to assert a claim either defensively (i.e., in a collection action) or affirmatively. To assert a defense to repayment under the 2019 Final Rules, the borrower must establish, by a preponderance of the evidence, that:

- The institution made a misrepresentation of material fact upon which the borrower reasonably relied in deciding to obtain a Direct Loan, or a loan repaid by a Direct Consolidated Loan, and which directly and clearly related to enrollment or continued enrollment at the institution, or the provision of education services for which the loan was made.
- The borrower was financially harmed by the misrepresentation.

Notably, unlike the 2016 Final Rules (which apply to loans first disbursed on or after July 1, 2017 and before July 1, 2020), the 2019 Final Rules do not permit a borrower to base a borrower defense application on a breach of contract or a favorable judgment against the institution. However, ED has indicated that a borrower could use a breach-of-contract finding or a favorable judgment as evidence to support a claim based on misrepresentation. Highlights of the 2019 Final Rules include:

- *Definition of misrepresentation:* The 2019 Final Rules define "misrepresentation" differently from the 2016 Final Rules. Under the 2019 Final Rules, a "misrepresentation" is a statement, act, or omission by the institution to a borrower that is false, misleading, or deceptive, and that was made with knowledge of its false, misleading, or deceptive nature or with reckless disregard for the truth, which goes in the direction of a common law fraud standard. This definition is notably different from the 2016 Final Rules, which set a lower threshold: under those rules, a borrower is required to demonstrate that a misrepresentation had the "likelihood or tendency to mislead under the circumstances," which ED had said could include unintentional misrepresentation. The 2019 Final Rules also contain a nonexhaustive list of evidence that a borrower might submit as evidence that a misrepresentation may have occurred, including representations related to licensure pass rates; employment rates; institutional selectivity or rankings; specialized, programmatic, or institutional certifications, accreditations, or approvals; widespread or general transferability of credits; employability and earnings; and availability, amount, or nature of financial assistance.

- *Economic harm:* Under the 2019 Final Rules, a borrower may provide evidence of financial harm related to, among other things, the borrower's periods of unemployment unrelated to national or local economic recessions; inability to secure employment in the field of study for which the institution "expressly" guaranteed employment; inability to complete the program because required program elements were not available; or a significant difference between the actual costs of the program and the amount represented by the institution.

- *Exclusions:* ED will not accept claims arising from certain types of disputes, which are explicitly excluded as the basis for a borrower defense to repayment, including claims about: violation of the Higher Education Act or its implementing regulations (unless the violation would otherwise constitute the basis for a misrepresentation-based claim); personal injury; violation of civil rights, including sexual harassment; slander or defamation; property damage; the general quality of the student's education or the reasonableness of an educator's conduct; informal communications from other students; academic disputes and disciplinary matters; and breach of contract (unless the violation would otherwise constitute the basis for a misrepresentation-based claim).

- *Time limits and process for review:* Under the 2019 Final Rules, an individual borrower generally must assert a defense to repayment claim within three years after the date the student ceased to be enrolled at the institution. The 2019 Final Rules do not include a "group" process, unlike the 2016 Final Rules. Once a borrower has submitted a claim, ED will provide a copy of the application and supporting evidence to the institution, which will have 60 days to respond. Then, in turn, ED will provide the borrower with a copy of the institution's response and supporting documentation, to which the borrower may respond within 60 days. Upon consideration of the full record, ED will issue a written, final decision regarding the amount and rationale for relief, if any.

Predispute arbitration clauses and class action waivers

The 2019 Final Rules permit an institution, after July 1, 2020, to include mandatory predispute arbitration clauses and class-action waivers under certain conditions. (The 2016 Final Rules had prohibited use of such clauses and waivers.) An institution that requires students receiving Title IV aid to accept or agree to a predispute arbitration agreement and/or a class action waiver as a condition of enrollment must provide a plain-language disclosure of those conditions to prospective and enrolled students and the public (e.g., on the institution's website, in the institution's catalog) and must provide the same disclosure during entrance counseling. The institution cannot require the borrower to participate in arbitration or any internal dispute resolution process prior to filing a borrower defense to repayment application with ED, and any arbitration required by the institution will toll the three-year limitations period for filing such an application.

Closed-school loan discharge

The 2019 Final Rules revise ED's regulations related to borrower eligibility for a closed-school discharge to specify that if offered the opportunity to complete their educational program through a teach-out arrangement, the borrower may elect the teach-out opportunity or may decline it at the beginning of the teach-out. However, if the borrower accepts the teach-out arrangement, the borrower will be ineligible for a closed-school discharge unless the school fails to meet the material terms of the teach-out plan or agreement approved by the school's accreditor and, if applicable, the state authorizing agency. The 2019 Final Rules extend the time period for a borrower to qualify for a closed school discharge: under the 2019 Final Rules, to be eligible a borrower must have withdrawn in the 180 days before the institution closed (previously, the eligibility window was 120 days). Under the 2019 Final Rules, there will be no "automatic" closed-school discharges as were available under the 2016 final regulations for schools that closed on or after November 1, 2013 and before July 1, 2020.

We are available to respond to questions.

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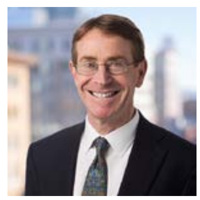

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