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A Closer Look: U.S. Department of Education's Proposed Regulations on Financial Responsibility

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The U.S. Department of Education (the "Department") recently proposed new regulations aimed at "promot[ing] transparency, competence, stability, and effective outcomes for students in the provision of higher education." The notice of proposed rulemaking was published in the Federal Register on May 19, 2023, and the public is invited to comment until June 20, 2023. Cullen and Dykman LLP's Higher Education practice group issued a legal alert providing a general overview of the proposed regulations, which can be read here. The purpose of this legal alert is to summarize some of the key provisions in the proposed regulations regarding the Department's assessment of an institution's financial responsibility that may directly affect institutions facing uncertainty.

Section 498(c) of the Higher Education Act of 1965 ("HEA"), as amended, directs the Department "Secretary to determine whether institutions participating in, or seeking to participate in, the title IV, HEA programs are financially responsible." The Executive Summary of the proposed regulations states, in part:

The Department is also aware of a significant number of instances where institutions shut down with no warning and is concerned about the impact of such events for students…These closures often come at a significant cost to taxpayers. Students who were enrolled at or close to the time of closure and did not graduate from the shuttered institution may receive a discharge of their Federal student loans. The cost of such discharges is rarely fully reimbursed because once the institution closes there are often few assets to use for repaying Federal liabilities…While these closures may have occurred without notice for the students, they were often preceded by months if not years of warning signs. Unfortunately, existing regulations do not provide the Department the necessary authority to rely on those indicators of risk to take action and unfortunately, despite observing these signs, the Department has lacked authority under existing regulations to take action based on those indicators of risk in order to secure financial protection before the institution runs out of money and closes.

Under the current regulations, to determine whether an institution is financially responsible and able to begin or continue participating in Title IV programs, the Secretary is authorized to take into consideration the institution's ability to (1) provide the services described in its official publications; (2) meet its financial obligations; and (3) provide the administrative resources necessary to comply with HEA program requirements. The determination of whether an institution meets its financial obligations is limited to looking at whether the institution failed to pay refunds under its refund policy or returned title IV, HEA funds for which it was responsible or failed to make repayments to the Secretary for any debt or liability arising from the institution's participation in the title IV, HEA program. Under the proposed regulations, however, the Secretary would be permitted under an expanded §668.171(b)(3) to look at the institution’s ability to meet its general financial obligations by focusing on whether the institution fails to pay undisputed debts, fails to make payroll, or borrows from retirement plans or restricted funds without authorization. The Department’s reasoning behind the expansion appears to be that an institution’s inability to meet its day-to day-financial obligations serves as an indicator of its inability to fulfill its obligations to students.

An institution also may be considered not financially responsible if it is subject to either a mandatory triggering event or a discretionary triggering event which the Secretary determines may have a materially adverse effect on the financial condition of the institution. Currently, § 668.171(c) lists several “mandatory triggering events” impacting an institution’s financial responsibility. The Department has proposed to amend § 668.171(c) with “a more robust set of mandatory triggers” by “keep[ing] or expand[ing] the existing mandatory triggers, chang[ing] some existing discretionary triggers to become mandatory and add[ing] new mandatory triggers.” Additionally, the Department “proposes to amend § 668.171(d) to establish a stronger and more expansive set of discretionary triggering events that would assist the Department in determining if an institution is able to meet its financial or administrative obligations.” The notice of proposed rulemaking includes two tables which detail what would be considered a “mandatory trigger” or “discretionary trigger” under the proposed regulations.[i]

Examples of “mandatory triggering events” added by the proposed regulations include:

- Lawsuits against an institution after July 1, 2024, by Federal or State authorities or a *qui tam* pending for 120 days in which the Federal government has intervened;
- The Department has initiated a proceeding to recoup the cost of approved borrower defense claims against an institution;
- The institution is cited by a State licensing or similar authority for failing to meet State requirements and the institution receives notice that its licensure or authorization will be terminated or withdrawn if it does not come into compliance;
- The institution is required to submit a teach-out plan or agreement;
- The institution is either required to or chooses to enter a receivership;
- The institution makes a formal declaration of financial exigency; or
- An institution has a condition in its agreements with a creditor that could result in a default or adverse condition due to an action by the Department or a creditor terminates, withdraws, or limits a loan agreement or other financing arrangement.

The proposed regulations expand the list of “discretionary triggering events” to include:

- The institution is placed on show cause, probation, or an equivalent status;
- An institution has high annual dropout rates, as calculated by the Department;
- The institution discontinues a program or programs that affect more than 25% of enrolled students;
- The institution closes more than 50% of its locations or locations that enroll more than 25% of its students;
- The institution is cited by a State agency for failing to meet a State requirement or requirements; or

- The institution is cited and faces loss of education assistance funds from another Federal agency if it does not comply with that agency's requirements.

The Department explained that, under current regulations, the determination of whether an institution is "financially responsible" is made annually based on its audited financial statements, along with enforcing the limited number of triggering events set forth in the current regulations. Because of the lag time in producing audited financial statements and the fact that such statements are issued only once per year, relying on audited financial statements to determine whether an institution is financially responsible hinders the Department's efforts to secure financial protection for Federal funds. The proposed regulations, however, would require "[i]nstitutions to report on triggering events on a much faster timeline, giving the Department more up-to-date information about situations that may appreciably change an institution's financial situation." This would allow the Department to determine at the time a material action or triggering event occurs, that the institution is not financially responsible and seek financial protection from that institution, likely in the form of a Letter of Credit, funds put in escrow, or an offset of title IV, HEA funds before the institution closes or runs out of money.

Currently, § 668.171(f) lists the conditions that must be reported to the Department under existing financial responsibility reporting requirements. The proposed regulations would amend § 668.171(f) to expand the existing reporting requirements, add new reporting requirements, and require that events generally be reported to the Department via an email no later than 10 days following the event. Under the proposed regulations, for example, an institution would be required to report to the Department within 10 days if, among other things, it: (1) receives a civil investigative demand, subpoena, request for documents or information, or other formal or informal inquiry from any government entity; (2) discontinues programs that enroll more than 25% of its students; (3) makes a formal declaration of a financial exigency to any federal or state agency or to its accrediting agency; or (4) closes more than 50% of its locations or locations that enroll more than 25% of its students. The Department stated the purpose of these changes is to "allow the Department to initiate actions to either obtain financial protection, or determine if financial protection is necessary, to protect students from the negative consequences of an institution's financial instability and possible closure."

The proposed regulations also would amend § 668.171(h) to clarify that "an institution would not be considered financially responsible, even if all financial responsibility factors in § 668.171(b) are met, if the notes to the institution's or entity's audited financial statements include a disclosure about the institution or entity's diminished liquidity, ability to continue operations, or ability to continue as a going concern." But the Department clarified that if it determines "the auditor's adverse, qualified, or disclaimed opinion does not have significant bearing on the institution's financial condition, we may decide that the institution is financially responsible." Further, if the Department determines that the institution has alleviated concern(s) in the disclosure, it may decide the institution is financially responsible. The Department expressly stated that it would retain discretion to determine whether the issues in the disclosure are alleviated, "even when the disclosure states the alleviation has been completed."

The Department also proposed adding a new regulation, § 668.23(d)(5), which would require institutions to disclose in a footnote to its audited financial statement the amounts spent in the previous fiscal year on recruiting activities, advertisement, and other pre-enrollment expenditures. The Department reasoned that it has observed that some institutions spend institutional funds on student recruitment, advertising, and other pre-enrollment expenditures in amounts greatly out of proportion to expenditures on instruction and instructionally related activities, which "could be a possible indicator of financial instability." The Department explained, "[A]n institution feeling pressure due to a declining financial situation may spend excessive amounts of its resources on recruitment, advertising, or other pre-enrollment expenditures to generate revenue in the short-term, at the possible detriment to the institution in the long-term. Requiring institutions to disclose amounts spent on these types of activities would provide the Department a more comprehensive view into the financial health and stability of institutions."

The proposed regulations, should they be finalized, will undoubtably increase the Department's monitoring and oversight capabilities and place additional reporting burdens on institutions. Cullen and Dykman LLP will continue to monitor developments and provide updates when available.

If you have any questions on how the proposed regulations may impact your institution, please feel free to contact Dina Vespia at (516) 357-3726 or **dvespia@cullenllp.com**, Jennifer McLaughlin at (516) 357-3889 or **jmclaughlin@cullenllp.com**, Deirdre Mitacek at (516) 296-9136 or **dmitacek@cullenllp.com** or Kevin McDonough (**kmcdonough@cullenllp.com**) at (516) 357-3787. Nothing herein creates an attorney-client relationship between the sender and recipient.

Thank you to Ciara Villalona, an Associate, who assisted in the preparation of this alert.

Footnotes

[i] See Table 4.4 "Mandatory Triggering Events" and Table 4.5 "Discretionary Triggering Events."

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