Proceed with Caution! Important Changes to Regulations on Changes in Ownership and Financial Responsibility

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Status of Current Rulemakings

- **Affordability and Student Loans Committee** (Oct-Dec 2021)
  - Borrower Defense to Repayment
  - Closed School Discharges
  - Pre-dispute Arbitration Clauses and Class Action Waivers
  - False Certification Discharges*
  - Total and Permanent Disability Discharges*
  - Public Service Loan Forgiveness
  - Elimination of Interest Capitalization*
  - Pell Grants for Incarcerated Students*
  - Income Driven Repayment Plans

Proposed Rule Issued
July 13, 2022

Public Comments Due
August 12, 2022

Proposed Rule Issued
July 28, 2022

Public Comments Due
August 26, 2022

Proposed Rule Expected
Spring 2023

** Consensus reached during negotiated rulemaking*

Status of Rulemakings (cont'd)

- **Institutional and Programmatic Eligibility Committee** (Jan-Mar 2022)
  - 90/10 Rule*
  - Changes in Ownership or Control

  Proposed Rule Issued
  July 28, 2022

  Public Comments Due
  August 26, 2022

  - Gainful Employment
  - Administrative Capability
  - Financial Responsibility
  - Title IV Certification Procedures
  - Ability to Benefit

  Proposed Rule Expected
  Spring 2023

** Consensus reached during negotiated rulemaking*

Intersection of Changes in Ownership & Financial Responsibility

- Critical and intersecting CIO and FR considerations arise from multiple areas of recent rulemakings and guidance:
  - Changes in Ownership and Control (proposed rule issued)
  - Electronic Announcement General 22-70 (September 15, 2022): Updated Guidance and Procedures for Changes in Ownership
  - Financial Responsibility (proposed rule pending)
  - Lease Accounting changes under FASB ASU 2016-02 and ED regulations effective July 1, 2020 ("pre-implementation" leases and "post-implementation" leases)
  - Electronic Announcement General-22-16 (March 23, 2022): Program Participation Agreement signature requirements effective July 1, 2022
  - Title IV Certification Procedures/PPA Signature Requirements (proposed rule pending)

Changes in Ownership and Control Proposed Rule

- Express reporting requirement for direct or indirect ownership interests of 5% or more
- For limited liability companies, limited liability partnerships, limited partnerships, and similar types of legal entities that are neither closely-held or publicly-traded, a change in ownership results in a change of control and thus requires Department approval when:
  - A person, a combination of persons, or a partner in a general partnership acquires or loses at least 50% of the total outstanding voting interests in the entity or partnership or otherwise acquires or loses 50% control
  - Any change of a general partner of a limited partnership or a managing member of a limited liability company if that person also holds an equity interest
  - A person becomes or is replaced as the sole member or shareholder of an entity that has a 100% or equivalent direct or indirect interest in the institution
  - An entity that has a member or members ceases to have any, or one that has no members becomes an entity with a member or members
  - The transfer of 50% or more of the voting interests in the institution or an entity to an irrevocable trust, except where it meets the proposed definition of an excluded transaction

Changes in Ownership and Control Proposed Rule (cont'd)

- (continued...) For **limited liability companies, limited liability partnerships, limited partnerships, and similar types of legal entities that are neither closely-held or publicly-traded**, a change in ownership results in a change of control and thus requires Department approval when:
  - The **addition or removal of any entity that provides or will provide audited financial statements** for the purposes of the Department assessing the institution's financial responsibility
  - Upon the death of an owner who previously transferred 50% or more of the voting interests in an institution or an entity to a revocable trust, except where it meets the proposed definition of an excluded transaction
  - The **Department determines there has been a change in control if a person holds less than a 50% interest in the institution but has actual control over the entity**, whether alone or in combination with other individuals, such as through the establishment of voting agreements among multiple individuals, each with less than a 50% ownership interest
  - Control would also be identified where a **person or combination of persons has the right to appoint a majority of any class of board members** of an entity or institution

Changes in Ownership and Control Proposed Rule (cont'd)

- Require 90-day prior notice of any contemplated change in ownership or control (independent of pre-acquisition review application) to both Department and students
- Codification of current practices with respect to financial protections (i.e., letters of credit), growth restrictions, and other conditions that may be imposed following changes of ownership and control, including but not limited to:
  - Financial protection of at least 25% of the institution's prior year Title IV volume if the institution's new owner does not have two years of acceptable audited financial statements
  - Financial protection of at least 10% of the institution's prior year volume of title IV aid if the institution's new owner has only one year of acceptable audited financial statements
  - As deemed necessary in the Department's discretion, financial protection in the amount of an additional 10% of the institution's prior year Title IV volume, or such larger amount as determined by the Department
- If any entity in the new ownership structure holds a 50% or greater direct or indirect voting or equity interest other institutions, the required financial protection may be based on a percentage of the prior year Title IV volume for all institutions under common ownership

Changes in Ownership and Control Proposed Rule (cont’d)

- Revised definition of “nonprofit institution” for purposes of Title IV participation:
  - Current regulations prohibit net earnings of institution from benefitting any private entity or natural person
  - Proposed regulations would also generally not consider an institution to be nonprofit if it:
    - Is an obligor (either directly or through any entity in its ownership chain) on a debt owed to a former owner of the institution or a natural person or entity related to or affiliated with the former owner of the institution;
    - Either directly or through any entity in its ownership chain, enters into, or maintains, a revenue sharing agreement with
      - A former owner or current or former employee of the institution or member of its board; or
      - A natural person or entity related to or affiliated with the former owner or current or former employee of the institution or member of its board, unless the Department determines that the payments and the terms under the revenue-sharing agreement are reasonable, based on the market price and terms for such services or materials, and the price bears a reasonable relationship to the cost of the services or materials provided;

Changes in Ownership and Control Proposed Rule (cont'd)

- Proposed regulations would also generally not consider an institution to be nonprofit if it (cont'd):
  - Is a party (either directly or indirectly) to any other agreements (including lease agreements) with:
    - A former owner or current or former employee of the institution or member of its board; or
    - A natural person or entity related to or affiliated with the former owner or current or former employee of the institution or member of its board under which the institution is obligated to make any payments, unless the Department determines that the payments and terms under the agreement are comparable to payments in an arm's length transaction at fair market value; or
  - Engages in an excess benefit transaction with any natural person or entity

Changes in Ownership and Control Electronic Announcement General 22-70 (September 15, 2022)

- Discontinuation of "comprehensive" Pre-Acquisition Review option
  - The "abbreviated" option remains but is limited to (1) whether an institution will be required to post an LOC if the institution's prospective new owner is unable to provide two years of acceptable audited financial statements, and (2) if multiple levels of ownership are identified in a prospective transaction, which level of ownership must submit the same day balance sheet and future audited financial statements
- Changes in ownership that are intended to make one institution into an additional location of another institution must occur in two steps:
  - First, a change in ownership must occur for the institution that will become the additional location of the other institution; and
  - Second, after ED has approved the change in ownership for the non-surviving institution, the other (acquiring/surviving) institution must submit an application to add the acquired institution as an additional location
- ED will not permit an institution to establish an "additional location" that is comprised solely of distance education coursework, even if the institution's accrediting agency treats such a change as the acquisition of a "branch campus" under the agency's standards

Financial Responsibility
Neg-Reg Language/Proposed Rule Pending

- Codification of current practices regarding financial statements required for changes in ownership and control:
  - Audited financial statements of the institution's two most recently completed fiscal years prior to the transaction date, at the level of the change in ownership or another level as required by the Department
  - Audited financial statements of the new owner's two most recently completed fiscal years prior to the transaction date, at the highest level of unfractured ownership or another level as required by the Department
    - Required letter of credit (or cash) equal to 25% of the institution's prior year Title IV volume if the institution's new owner does not have two years of acceptable audited financial statements
    - Required letter of credit (or cash) equal to 10% of the institution's prior year Title IV volume if the institution's new owner has only one year of acceptable audited financial statements

Financial Responsibility
Neg-Reg Language/Proposed Rule Pending (cont'd)

- For-profit institutions undergoing a change in ownership and control:
  - Must have passing composite score and meet other financial requirements for its most recently completed fiscal year
  - Must have positive tangible net worth for its two most recent fiscal years, and no operating losses in either or both of those years that in sum result in a decrease in tangible net worth in excess of 10 percent of the institution's tangible net worth at the beginning of the first year of the two-year financial statement period
  - Calculation of tangible net worth excludes all related party accounts receivable/other assets and all assets defined as intangible in accordance with the composite score
  - Department may exclude from operating loss calculation any prior period adjustments and the cumulative effect of changes in accounting principles
  - Failure to meet these standards requires posting of letter of credit (or cash) equal to at least 10% of the institution's prior year Title IV volume

Financial Responsibility
Neg-Reg Language/Proposed Rule Pending (cont'd)

- Nonprofit institutions undergoing a change in ownership and control:
  - Must have passing composite score and meet other financial requirements for its most recently completed fiscal year.
  - Must have positive net assets without donor restrictions, and no excess of net assets without donor restriction expenditures over net assets without donor restriction over both of its two latest fiscal years that results in a decrease exceeding 10 percent in either the net assets without donor restrictions from the start to the end of the two-year period or the net assets without donor restriction in either one of the two years
  - Department will exclude all related party receivables/other assets from net assets without donor restrictions and all assets classified as intangibles in accordance with the composite score
  - Department may exclude from operating loss calculation any prior period adjustments and the cumulative effect of changes in accounting principles
  - Failure to meet these standards requires posting of letter of credit (or cash) equal to at least 10% of the institution's prior year Title IV volume

Financial Responsibility
Neg-Reg Language/Proposed Rule Pending (cont'd)

- Codification of a modified(?) "same day" balance sheet requirement:
  - In order to continue Title IV participation following CIO, an institution must submit, by the end of the month following the month in which transaction occurred, a "same day" balance sheet for a proprietary institution (or a statement of financial position for a nonprofit institution) that shows the financial position of the institution under its new owner, as of the day after the change in ownership, at the level required by the Department
  - Must include a disclosure that includes all related-party transactions, and such details as would enable the Department to identify the related party
  - Must be a consolidated "same day" financial statement at the level of highest unfractured ownership or at another level as determined by the Department
  - *For-profit institutions*: Must demonstrate an acid test ratio of at least 1:1 <u>and</u> positive tangible net worth (excluding related party receivables and intangible assets)
  - *Nonprofit institutions*: Must demonstrate positive net assets without donor restriction (excluding related party receivables and intangible assets)
- Failure to meet these "same day" balance sheet requirements requires posting of letter of credit (or cash) equal to at least 25% of the institution's prior year Title IV volume

Financial Responsibility
Neg-Reg Language/Proposed Rule Pending (cont'd)

- Acquisition Debt
  - Notwithstanding satisfaction of any other financial responsibility standards, "the Department may determine that the institution is not financially responsible following a change in ownership if the amount of debt assumed to complete the change in ownership requires payments (either periodic or balloon) that are inconsistent with available cash to service those payments based on enrollments for the period prior to when the payment is or will be due"

Financial Responsibility Neg-Reg Language/Proposed Rule Pending (cont'd)

- Mandatory letter of credit triggers expanded to include:
  - Composite score of below 1.5 and incurring a liability from legal proceeding results in recalculated score of below 1.0
  - Lawsuits by Federal or State government agencies pending for more than 120 days
  - Department approves Borrower Defense claims equal to 5% or more of Title IV revenue
  - For proprietary institutions with composite score below 1.5, withdrawals of equity including by declaring dividends and composite score results is below 1.0
  - Receiving at least 10% of Title IV funds in most recent FY from programs failing Gainful Employment
  - Institution is required to submit a teach-out plan and/or agreement (including for any branch or additional location)
  - Notice from State licensing or authorizing agency of a violation that could lead to withdrawal or termination of licensure or authorization
  - Failing 90/10 for a single fiscal year
  - Cohort default rates > 30% for two years in a row without an appeal filed
  - Loss of institutional eligibility to participate in another Federal educational assistance program
  - Year-end contributions (last quarter of fiscal year) that are withdrawn in the first two quarters of the following year where the effect of contribution was a composite score of 1.0 or greater
  - Creditor terminates, withdraws, limits or suspends financing arrangement, or calls due balance on any line of credit
  - Occurrence of two of more discretionary letter of credit triggers in the fiscal year (unresolved for > 60 days)

Financial Responsibility Neg-Reg Language/Proposed Rule Pending (cont'd)

- Discretionary triggers for Letter of Credit expanded to include:
  - Accrediting actions including probation, show cause or equivalent
  - Creditor event (subject to a default) resulting in change in collateral, interest rate, fees, contractual obligation, etc.
  - Significant fluctuations in Title IV volume
  - High annual dropout rates
  - For institutions on interim financial reporting: negative cash flows, failure of other liquidation ratios, cash flows that significantly miss the projections submitted to the Department, or withdrawal rates that increase significantly, or other indicators of a material change in the financial condition of the institution
  - Department forms group claims process for pending Borrower Defense claims
  - Discontinuation of programs affecting 25% of students
  - Closure of most ground-based locations (even if maintaining online programs)
  - State agency citations for failing to meet licensure or authorization requirements
  - Short-term borrowing under loan or line of credit in last quarter of fiscal year and repaid during first two quarters of next fiscal year
  - Loss of program-level eligibility to participate in another Federal educational assistance program
- Audited financial statements must be submitted by the earlier of 30 days following completion or 6 months following the fiscal year end

Financial Responsibility
CIO Impacts from Lease Accounting Changes

- New lease accounting standard requires companies to record both right-of-use (ROU) assets and lease liabilities (LL) for most leases that are longer than one year
- In most cases, the total amounts of the ROU and LL will be roughly equal
- Important difference is that LL will have a portion that is current while ROU will not
- Department applies Acid Test (cash plus student receivables versus current liabilities) to the audited same-day balance sheet as one of two main financial responsibility tests upon the occurrence of a CIO (the other being "tangible net worth")
- Current portion of the LL hurts the Acid Test:
  - **More difficult to comply with the Acid Test**, increasing letter of credit requirements
  - Need to reconsider working capital adjustments as part of any purchase agreement
  - **Different treatments for "pre-implementation" and "post-implementation" leases** for both audited same-day balance sheet and composite score requirements
  - May also impact compliance with certain loan agreement covenants

Electronic Announcement General-22-16 (March 23, 2022)

- Effective July 1, 2022, presumptive Program Participation Agreement co-signing required for proprietary and private nonprofit institutions when:
  - Institution has had a financial responsibility composite score below 1.5 since its last certification (initial or recertification);
  - Institution is on provisional certification status by the Department;
  - Institution is on HCM2;
  - Institution goes through a change of ownership;
  - ED has approved a significant number of borrower defense or false certification claims for the institution, or if there are a substantial number of these types of claims under review that, if approved, would result in the potential for significant liability;
  - ED has recently identified systemic or significant audit or program review findings, or has unpaid liabilities resulting from an audit or program review; or
  - Institution or any of its principals or interest holders has consented to or has a judgment of fraud or misrepresentation entered against it by a federal or state court, foreign tribunal, or arbitration body

Electronic Announcement General-22-16 (March 23, 2022) (cont'd)

- Where Program Participation Agreement co-signing is required, the additional signatories are upper-level entities that have or could have a direct or indirect effect on the institution's administrative capability or financial responsibility, including but not limited to entities that:
  - Are the sole member of, or hold a 100 percent direct or indirect equity or voting interest in the institution;
  - Hold less than a 100 percent interest but otherwise exercise (either directly or indirectly) substantial control over the institution, with "substantial control" being any direct or indirect equity, membership, or voting interest of 50 percent or more in the institution, including in combination with other interest holders, whether by affiliation, contract, proxy, or other arrangement; or
  - Provide the audited financial statements or other financial submissions on behalf of the institution

Title IV Certification Procedures
Neg-Reg Language/Proposed Rule Pending

- Program Participation Agreement for proprietary and private nonprofit institutions must be cosigned by the institution and any entity with control over the institution, including entities:
  - With at least 50% control through direct or indirect ownership, by voting rights, or by board appointments, whether alone or in combination with affiliated entities, or pursuant to proxy or similar voting agreements
  - With power to block significant action
  - That are 100% direct or indirect interest holder of the institution, or
  - That provide financial statements to the Department upon which the institution's financial responsibility is assessed

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