NEW AMERICA

The Ins and Outs of the Borrower Defense Rule

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Introduction

In 1994, Congress added to the Higher Education Act a provision directing the Secretary of Education to establish rules to allow students who were misled by their colleges to present a defense against repayment. The Department of Education established a one-page—seriously!—regulation laying out the process, and although the provision was included in all master promissory notes that students have to sign to receive their loans, it lay largely unused for decades.

Then, in 2015, the floodgates opened. Following years of complaints and serious findings by the Department and others of misrepresentation, Corinthian Colleges, Inc. was finally forced to shut down its Everest-, Wyotech-, and Heald-brand colleges. Thousands of students were eligible to have their loans discharged under a "closed school discharge" provision because they had been enrolled when their schools suddenly closed. But thousands more who had enrolled based on their reliance on promising—but falsified—job placement rates would be out the time and money for their education unless they applied for and were granted a borrower defense discharge. Suddenly, the Department of Education had an influx of tens of thousands of borrower defense claims, with little regulatory roadmap or infrastructure to resolve them.

So it launched a rulemaking process. After months of negotiations and thousands of public comments, it published a rule on November 1, 2016, which was (in accordance with the *Higher Education Act*), set to be implemented on July 1, 2017. But just weeks before then, the Trump Administration reversed course and announced it would "delay" the rule, indefinitely suspending its implementation, and renegotiate it anew. In other words, before it ever took effect, Secretary DeVos announced she planned to effectively kill the 2016 rule while establishing a new one.

Heading into a new round of negotiations, the Department will need to balance the many competing interests of stakeholders, including those of students who have been wronged, institutions nervous about future liabilities, taxpayers who will likely pay the bill, and the Department itself as the party responsible for processing borrower defense claims. So it's useful to understand the context of the last negotiations, and the contents of the final rule. This brief provides a guide to what's actually in the 164-page borrower defense rule published last November and where many student advocates and affected institutions stood on its provisions.

The Statute

Congress dictated the following language for borrower defenses to repayment:

> *Higher Education Act §455(h): Borrower defenses. 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.* (Emphasis added.)

While Congress wanted the Department to identify the what/when/where/why/how for borrower defense, the public didn't have guidance as to how they could access this right afforded to them by the law. And with an influx of claims that covered dozens of

circumstances and thousands of students, the Department needed to better meet Congress' expectations that the Department would spell out in which instances—and how—borrowers could present their claims. The new rule attempted to address these issues. Here's a summary of each of the main elements of the final regulation (now delayed indefinitely).

The Standard

The biggest question, of course, is what constitutes misconduct worthy of a borrower defense claim. Under the 1994 regulation, the determining factor is whether a cause of action—a basis to sue—could have arisen under state law. It's a complicated question that effectively required the Department of Education to assess 50 separate standards, and that could lead to unequal treatment for borrowers who experienced the same kind of misconduct but who attended colleges located in different states. Interpreting states' laws is a tricky business under any circumstances, but when tens of thousands of applications are on the docket, and tens of thousands of borrowers are anxiously waiting to hear what will happen with their case, the pressure is on. And borrowers are left with a task so challenging it requires a J.D. to even attempt it: trying to figure out whether or not their state would consider the misconduct a cause of action.

To simplify and streamline that process, the 2016 rule established a new, federal standard for borrowers and the Department moving forward. (The state standard continues to apply to existing loans.) Under that rule, borrowers would be able to argue they shouldn't have to repay their loans under the following circumstances related to the federal loan or the education it afforded a borrower:

1. A substantial misrepresentation (false, erroneous, or misleading statements that the borrower relied on, and that hurt him, like falsified job placement rates);
2. A breach of contract (the school doesn't live up to its obligations to students, as set forth in a contract, like if a school promised to offer tutoring services in a contract but failed to do so); or
3. A favorable judgment against the institution (one in which, based on state or federal law, a judge sides with the borrower).

Throughout the negotiations and public comment period, many of the student advocates largely opposed a federal standard, because the terms in some states could be more favorable to borrowers; and instead suggested that a federal standard should be a floor, so borrowers in states with more generous laws could continue to access those benefits. The problem with this approach is that it suffers from the same challenges of the original regulation: It requires the Department to interpret states' own laws, and creates confusion for schools and for borrowers who need to assess how their states would approach the fraud they'd experienced.

Other commenters and negotiators—namely, for-profit colleges and Historically Black Colleges and Universities (HBCUs)—pushed to add "intent" to the regulation, arguing that misrepresentations could be made accidentally, rather than maliciously. But requiring borrowers or the Department to *prove* the school acted intentionally is such a high threshold, it would render the entire provision virtually unusable. And if borrowers are harmed by a mistaken misrepresentation, they could have still been harmed and are therefore could still be owed the right to have their loans discharged. Colleges have an obligation to get it right for the borrowers investing years of their time and thousands of dollars in higher education.

For-profit colleges, during both negotiations and public comments, also raised the idea that breach of contract should have a minimal threshold—a "materiality" element. But the Department argued that borrowers who have experienced even a minor breach of contract are owed at least minor relief, proportional to the breach. For instance, in the earlier example of tutoring services, affected borrowers would likely be owed relief commensurate to the cost of the tutoring services—not a full discharge of all of their loans. (This issue comes back up later.)

Statute of Limitations

Another critical question the Department needed to grapple with was how long borrowers could retain the right to a borrower defense discharge following a case of fraud. To date, the Department has used state statutes of limitations that aligned with the "state cause of action" standard. But like the state standard, relying on a state statute of limitations can mean a burdensome, confusing, uneven path to provide relief.

So instead, with the 2016 federal standard came a federal statute of limitations. The final rule established no statute of limitations for payments a borrower still owed – as long as he still had a balance outstanding, he could raise a claim against the remaining debt. This is a widely accepted structure in other areas of the law. But for amounts already paid, borrowers had six years to file the claim. Importantly, that six-year period was established from the date when the misrepresentation was discovered or should have been discovered.

The statute of limitations was one of the hotly debated items at negotiated rulemaking. Student advocates felt strongly that borrowers should be able to have all of their debt, paid and unpaid, discharged. But colleges—especially for-profits—felt just as strongly that no or too long a statute of limitations would be wildly unfair and would lead to "stale claims," in which it would be tough to provide evidence. In the final rule, the Department sought to find a reasonable middle ground and adopted a six-year statute of limitations. Six years, it said, would give borrowers a fair shake to file their claims, align with the statute of limitations in the plurality of states, and preserve institutions' due process rights with respect to recovering paid-out funds.

FFEL Borrowers

Another big question was whether or not borrowers in the now-defunct bank-based lending program (FFEL) would be able to access the borrower defense rule. But according to the law, the borrower defense provision exists only in the Direct Lending (DL) program. The Department clarified that FFEL borrowers could consolidate their loans into the DL program to access the benefit, as they can for other benefits, like Public Service Loan Forgiveness. Unlike DL borrowers, they wouldn't be able to recover amounts already repaid on their loans if they consolidated (unless they could prove collusion between their lenders and their institution), but they could stop making payments on the remaining balances if the Department approved their claim. While advocates weren't thrilled with FFEL borrowers being forced to take an extra step to access the benefit and still not being able to receive a full loan discharge, the Department argued its hands were effectively tied by how Congress wrote the law. Instead, the Department made changes to support FFEL borrowers, including offering them forbearance while their claims were under review.

The Process

The rule spelled out a few pathways to relief for defrauded borrowers—one for small-scale cases, with an individual applicant or two at a given institution; one for more widespread claims, which carry a larger fiscal impact to the federal government, and where the school

remained open so the Department could recover the costs; and one for widespread instances where the school was closed and any recovery of the costs to taxpayers and the Department was effectively a lost cause. The separate pathways grew out of the Department's experience attempting to resolve claims, and in anticipation of future claims: a massive backlog of tens of thousands of undetermined claims begged for a streamlined process that would let the Department group common sets of facts and power through some of the less-contested cases, while retaining its ability to protect taxpayers who would bear the costs of providing relief to affected borrowers.

Student advocates were particularly concerned with the possibility that the Department would attempt to recover funds from the school, especially before it agreed to grant relief to borrowers. Those cases would require more fact-finding from the school, where the college would obviously have an advantage (and likely more legal firepower) in a he-said-she-said situation. Advocates were also concerned it would delay decisions on the borrowers' applications while a more thorough investigation was conducted. But any process that didn't include fair consideration of the school's actions would mean it would be impossible to recover the funds, leaving the taxpayers on the hook for potentially millions of dollars in debt relief. So instead, the Department required potentially high-cost cases (ones with widespread misconduct) to undergo a more in-depth process, while cases of closed schools and individual applications could be resolved more quickly.

See Figure A for a graphic describing the process for borrower defense claims.

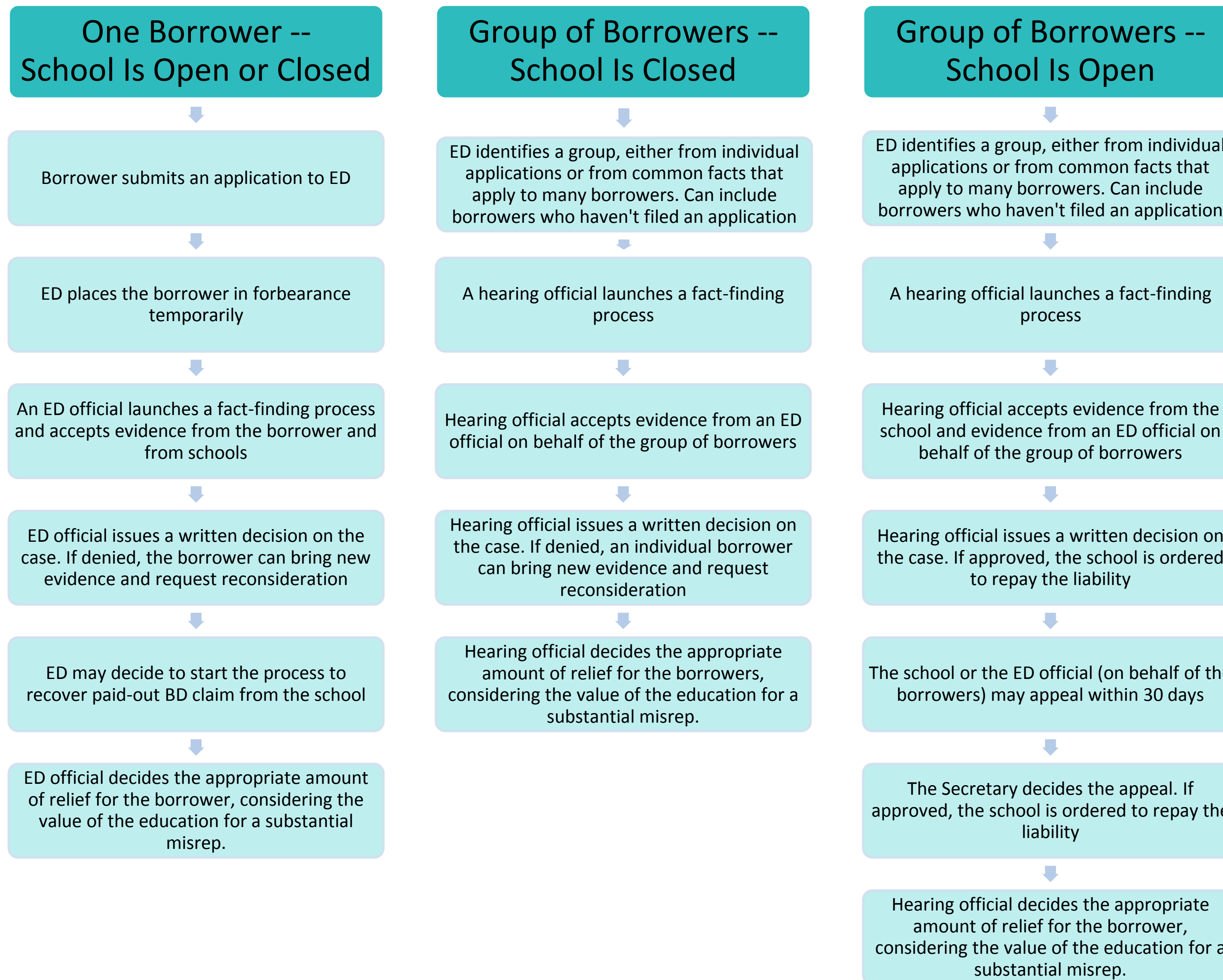
Determination of Relief

With a thousand permutations of ways in which students could be defrauded, one of the biggest concerns was how to calculate the amount of relief for which they should be eligible. Should the Department assume that any misrepresentation is sufficiently bad that the borrower deserves a clean slate—full relief? Or should it try to account for every dollar, requiring it to calculate each element of value received and relief owed? Could it find a way to give both borrowers and institutions guidelines for what to expect, but provide enough flexibility for officials to accommodate the huge range of experiences they might find?

Student advocates argued for the Department to assume full relief in all cases (requiring it to make exceptions for cases that seemed less worthy of full relief). But aside from the question of fairness—providing reasonable assessments of educational value received—the Department noted the costs of doing so would be astronomical. On the other hand, institutions wanted a more prescriptive formula laid out in the rule—one that excluded borrowers' ultimate employment outcomes and excluded debt borrowed beyond tuition and fees, for living costs and other expenses.

Ultimately, the Department opted for a middle-ground: Rather than assume full relief or provide a strict formula, the rule lays out examples for the Department and/or hearing official to rely on in calculating the amount of relief owed to a student, but allows for the possibility that the hearing official might

Figure A: Process for Borrower Defense Claims



instead need to go outside the examples, depending on the circumstances. It requires the Department to consider both the cost of attendance—the amount a student paid to attend the school based on the information he had at the time—and the value of the education the borrower received. In cases where the value of the education received is high, the borrower is not likely to receive debt relief, even if the cost of attendance is also high and the student was, indeed, misled by the school.

The examples provided in the final rule include a school that misrepresents in its promotional materials that its program will lead to employment in a field that requires licensure, when the program actually doesn't meet the minimum requirements for students to take the licensure exam. In this case, borrowers got little to no value from the education, so the guidance provides full relief. But in another example, if a borrower enrolls at a selective liberal arts school that he later learns gave falsified data to *U.S. News and World Report*'s college rankings that inflated the school's standing in the rankings, there's no relief owed – the borrower got a quality education anyway, of the level he could reasonably expect. Despite being harmed by the college's falsified data, the value of the education outweighs any harm.

In other words, a misrepresentation alone doesn't grant a borrower a right to relief—full or otherwise. Rather, the Department or hearing official must take into account the degree of the misrepresentation relative to the value of education received.

Financial Responsibility

In addition to establishing a process on the back end for borrowers to apply for discharges after they had already suffered from misconduct, the rule sought to prevent more of these cases on the front end by identifying some of the riskiest behaviors among schools and requiring the school to post a letter of credit as soon as those behaviors are identified, as insurance that taxpayers wouldn't be left holding the bag. These behaviors suggest a school might be at risk of significant financial liabilities that could ultimately force it to close – leaving taxpayers at risk for the closed school discharges and any potential borrower defense discharges given to students.

The proposed rule established a series of triggers which, when tripped, would require colleges to submit a letter of credit as financial protection preemptively in the amount of 10 percent of annual revenue from federal financial aid. And the letters of credit were stacking: A school with three violations would owe 10 percent for each, for a total 30 percent letter of credit. While some of the triggers were left to the Department's discretion, they would mostly happen automatically – a way to ensure consistency across all affected schools.

But noting that some of the triggers were overlapping and might be redundant, and to further embed the financial protection into an existing framework where it fit more neatly, the Department made some changes. Specifically, the final rule shifted some of the triggers around and established a new structure for the financial protection to better align with the existing financial responsibility infrastructure. Instead of cumulative, 10 percent letters of credit, the potential liabilities from each trigger would be factored into the Department's existing composite scores – a -1 to 3 scale that shows the financial health of the school. (Public institutions are exempt from both composite scores and the financial responsibility structures; in the event of closure or borrower defense liabilities, they are instead backed by the full faith and credit of the state.) A score below 1 is considered not financially responsible. If the potential liabilities from the trigger caused the school to fail, it would be required to post a 10

percent letter of credit or other financial protection.

Perhaps as importantly as the additional taxpayer protection, the triggers mean the Department would receive more timely information about colleges' interactions with accreditors, state authorization and licensure bodies, and other federal agencies. Given the Department's role in overseeing the approximately $130 billion in aid that flows to institutions each year, the fact that it doesn't already receive basic warning signs at relevant moments, such as notifications of citations from state licensure boards, makes it difficult for the Department to provide a basic level of oversight.

But not everyone agreed. While the for-profits strenuously opposed many of these items during negotiations and in public comments, they let HBCUs do the lion's share of the arguing. HBCUs' visibility on this debate allowed for-profits to stand somewhat in the background; even though for-profit colleges are probably far more likely to trip these triggers, the HBCUs presented a more sympathetic audience. In particular, HBCUs raised serious concerns about proposed automatic triggers related to accreditor sanctions (such as probation or show-cause), high cohort default rates, and debts or liabilities owed from a court judgment or administrative hearing. The for-profit lobby raised these and other concerns in their comments, as well.

See Figure B for a final list of the triggers.

False Certification

Separate from the borrower defense process, in certain cases, borrowers who never should have been able to take out the loan a school gave them can receive a false certification discharge. For instance, if the school forges

Figure B: List of Financial Responsibility Triggers

Automatic Triggers: If the liability would cause the institution to fail the composite score measure, the Department <u>will</u> require an automatic 10% letter of credit
School owes debts or liabilities from a final court/administrative hearing judgment, including amounts owed for approved BD claims
School is being sued for issues related to the making of a federal loan (including borrower defense-related cases), or in certain other cases
School's accrediting agency requires a teach-out plan that covers the closing of the institution or any of its campuses;
School has programs that are failing under the gainful employment rule and could become ineligible in the next year
School's owner withdrew his equity from the institution, for proprietary schools
School failed the 90-10 rule in a given year, for proprietary schools
A publicly traded college has SEC actions taken against it, fails to submit SEC reports in a timely manner, or has its stock delisted
School has an unchallenged cohort default rate of 30 percent or greater for the last two years
Discretionary Triggers: If the liability would cause the institution to fail the composite score measure, the Department <u>may</u> require a 10% letter of credit
School has significant fluctuations in federal financial aid revenue from year to year
School is cited by a state licensure body or a state authorizing agency for failing to meet requirements
School fails a financial stress test (to be developed by the Department later)
School has high annual dropout rates
School is, or was, under a probation or show-cause order by its accreditor
School violated an element of certain types of loan agreements; has pending claims for borrower defense, or the Department expects an influx of more BD claims for the school

the borrower's name on a loan application, the borrower can receive a full discharge (one including both a refund of amounts paid and forgiveness of the outstanding balance).

The borrower defense rule added a few new circumstances in which borrowers may be eligible for a false certification discharge—all no-brainers based on straightforward falsification examples the Department had seen. If the school falsified a borrower's high school graduation status or diploma, or sent the borrower to a third-party for a falsified diploma, after he said he didn't have a diploma, that borrower can get a false certification discharge. And if the school falsified the student's Satisfactory Academic Progress (SAP)—and the Department has evidence showing it had done so—borrowers would be eligible. It also clarified that, where the Department has enough information to determine that a borrower is eligible for a false certification discharge (including when the school falsified SAP for its students), the Secretary would discharge the loan automatically, without requiring an application from the borrower.

These relatively minor additions fell short of the requests of some advocates, who wanted to expand false certification discharges to include acts like enrolling students in programs that lack a necessary accreditor approval to get employment in the field, enrolling non-English speakers in English-only courses, or enrolling students with criminal records. Advocates had pushed for inclusion of these categories because false certification carries a far easier application process than borrower defense, and no time limit. But these cases are more appropriate for a fact-finding process like that in borrower defense, rather than in the false certification process. Moreover, colleges raised concerns about the burden and appropriateness of such sources of discharge.

Repayment Rate

The borrower defense rule also included a new disclosure requirement. For-profit colleges at which fewer than half of borrowers had paid down at least $1 of their loans three years after leaving school would be required to disclose a warning through all promotional materials. During negotiations, the Department proposed requiring the repayment rate for all institutions, and relying on a new data collection. The proposal wasn't a priority for student advocates, who were more concerned with other provisions of the borrower defense rule; and had great opposition from institutions,[1] including HBCUs, community colleges, and for-profit institutions. But it was proposed as a way to give students easy access to information that could inform their decisions and potentially help them steer away from institutions that have poor outcomes.

During negotiations and in the proposed rule published afterwards, the Department instead proposed limiting the repayment rate to for-profit institutions. One of the biggest concerns from institutions was the burden required to engage in another data challenge process. Analysis showed that for-profit colleges had notably worse repayment outcomes than other sectors, so limiting it to only for-profit institutions would reduce burden on sectors where all schools would have to report and check the data but few would ultimately fail the test. In their public comments on the

[1] See "§668.41 Reporting and disclosure of information, Issue Paper 5, submitted by Shannon Sheaff, Alyssa Dobson, David Sheridan, Sharon Oliver, Emily London-Jones, Mark Justice, Dennis Cariello, Becky Thompson, non-federal negotiator9, 2016s representing various school sectors and state higher education executives, March 7, 2016."

proposed rule, for-profits unsurprisingly continued to strenuously oppose the measure.

In the final rule, the Department retained the measure, applied it only to for-profit institutions, and switched from requiring a new data collection to basing the measure on existing Gainful Employment (GE) data to eliminate virtually all burden on proprietary institutions short of providing the required warning in advertising and promotional materials. Later, for-profit colleges made the repayment rate one of the bases of their lawsuit against the borrower defense rule that closely preceded its delay; an error in College Scorecard repayment rates undermined the argument that the warnings could be applied only to the for-profit sector, they argued (though the rule itself relies on GE, not Scorecard, data to highlight poor performance on repayment outcomes in the sector).

Closed School Discharge

The Secretary already had the authority to discharge loans without an application when s/he had evidence that the borrower was eligible for a closed school discharge—i.e., he had been enrolled when the college or campus closed, or withdrew within 120 days prior to closure, and hadn't transferred his credits to another college or teach-out. Yet the provision had only rarely been used, and exceedingly low take-up of the application process by borrowers suggested that thousands of borrowers whose schools had closed while they were enrolled were entirely missing the benefit Congress granted them of having their loans discharged.

The borrower defense rule added a provision that, if an otherwise-eligible borrower hadn't reenrolled at another financial aid-eligible institution within three years of his school closing, the Department would automatically discharge his loans. In just the time period from 2008 through 2011, nearly 2,300 borrowers were enrolled when, or withdrew shortly before, their schools closed, and almost half of those (47 percent) hadn't re-enrolled or received a discharge.

During negotiated rulemaking, there was some discussion of the appropriate time period before the Department would automatically discharge the loans. But many of the major comments addressed the issue only briefly. Some schools raised concerns about the liabilities that would result from automatic discharges, and student advocates remained strongly supportive of the provision. But while it was scheduled for early implementation prior to July 1, 2017, it was instead made part of the overall delay of the borrower defense rule announced by Secretary DeVos prior to July 1.

Arbitration

The Department also added a prohibition on predispute arbitration agreements—fine-print in students' enrollment contracts requiring them to enter into closed-door arbitration proceedings with a school in the event they have a borrower defense-related complaint. While unquestionably a win for student advocates who wanted students to have the right to go to court when harmed by a school, the provision serves a substantive purpose for the Department, as well. In arbitration cases, borrowers' grievances are typically hidden from the public. Where those cases might relate to more widespread instances of misconduct that could wind up as borrower defense liabilities for the school, more time hidden from public view means those liabilities pile up while the Department and other law enforcement bodies remain unaware and unable to take action.

There's no question the institutions still using these clauses would rather not be required to air their dirty laundry. But the Department argued in the final rule that states, accreditors, and the Department of Education—not to mention other state and federal law

enforcement bodies—need transparency to perform their oversight responsibilities well.

Conclusion

As the Department of Education prepares to undertake a rewrite of the borrower defense rule, it's important to remember the context of its recent past. With hours of public hearings, lengthy negotiations, and over 10,000 public comments received on an early draft of the rule, the lessons learned from this experience are invaluable—and show the borrower defense rule is a reasonable balance of the competing demands of borrowers, institutions, and taxpayers.

The author worked at the Department of Education during construction of this rule.