# Rightsizing the Right Way

## Restructuring and Realignment in Higher Education

Weil | Thompson Coburn LLP | Zolfo Cooper

Webinar
September 2014

# Presenters

**Joseph H. Smolinsky**, Partner
Business Finance and Restructuring Department
Weil, Gotshal & Manges LLP

**Aaron D. Lacey**, Partner
Higher Education Practice
Thompson Coburn LLP

**Carol Flaton**, Managing Director
Zolfo Cooper, LLC

# Presentation Overview

# Current Landscape

# A Challenging Time for Higher Education

- Without question, recent years have seen great challenges across all of higher education:
  - Increased political and regulatory scrutiny, and associated litigation, has increased institutional costs.
  - New regulatory requirements have increased administrative burden and inhibited innovation.
  - Decreased enrollments have led to reduced revenues and limited discretionary spending.
  - Prolonged, weak general economic conditions have impacted students' interest in and ability to pay for higher education.
  - Federal budget pressures have affected access to Pell Grants and other forms of federal financial aid.
- As a result, many institutions are starved for capital, facing an uncertain future and may be forced to rethink and retool their current business model and capital structures.

# A Challenging Time for Higher Education

- While there are positive indicators on the horizon:
  - Innovation in platforms and academic delivery models promise reduced costs and improved margins (edtech investment; CBE).
  - Enhanced third-party support promises increased efficiency and cost savings (*e.g.,* placement verification, default management).
  - Cohort default rates (in some sub-sectors) leveling off and even decreasing.
- We have seen and will likely continue to see:
  - Reductions in workforce.
  - Increase in closures, consolidations, and teach-outs.
  - More recently, consideration of restructuring and reorganization.

# Regulatory Limitations: Bankruptcy

- Postsecondary institutions forfeit federal student financial aid eligibility upon declaring bankruptcy.
  - Congress amended the Higher Education Act in 1992 to, among other things, permanently strip any institution of its Title IV eligibility if it filed for bankruptcy protection. 20 U.S.C. 1002(a)(4)(A).
  - The purpose of amending the HEA was to improve the public confidence in the student financial aid programs by raising the quality of eligible schools (*i.e.*, to ensure that only financial responsible schools could participate).
  - USED added its bankruptcy regulations in 1994. An educational institution "does not qualify as an eligible institution" if the institution "files in relief for bankruptcy" or "has entered against it an order for relief in bankruptcy." 34 CFR 600.7(a)(2)(A)-(B).

# Regulatory Limitations: Bankruptcy

- Ineligibility due to bankruptcy is permanent and cannot be reinstated. 34 CFR 600.7(a)(2); 2014 FSA Handbook, 2-11. Even following a change of ownership, future owners would be unable to rehabilitate institution’s eligibility.
- If entity filing bankruptcy “has the power, by contract or ownership interest, to direct or cause the direction of the management of policies” of an affiliated institution, then the affiliated institution also would permanently lose its Title IV program eligibility. 34 CFR 600.7(a)(2).
- The loss of eligibility is effective as of the date of the bankruptcy; schools must immediately stop awarding FSA funds.

# Regulatory Limitations: Bankruptcy

- Courts have upheld USED's ability to strip an institution of Title IV funding upon the filing of a bankruptcy.
  - In re Betty Owen Schools, Inc. (Bankr. S.D.N.Y. 1996) – Bankruptcy Court upheld Dept. of Ed.'s ruling refusing to allow new owner that purchased substantially all of debtor's assets in bankruptcy to immediately reapply for Title IV funding.
  - In re Lon Morris College (Bankr. E.D. Tex. 2012) – Bankruptcy Court upheld Dept. of Ed.'s ruling stripping 158-yr old, non-profit, Lon Morris College's Title IV status upon commencement of its chapter 11 case.

- As a result, currently bankruptcy is not an option and any restructuring must be consensual.

# Restructuring Considerations

# Heading into a New Paradigm

- Institutions are beginning to face a new reality.
  - Oversupply of schools/schools not optimally aligned to meet demand.
  - Closures and consolidations are inevitable.
  - Institutional Darwinism will take over; only the fittest will survive and prosper.
  - Regulators can either champion the evolution to the new paradigm for education or cause friction (*e.g.,* FCC Holdings, Inc.).
  - Public relations is an important element of rebuilding confidence in for-profit education (*e.g.,* restructuring is not a failure, it helps promote efficiency and can lower tuition).

# Restructuring is not a Dirty Word

- Restructuring continues to have a stigma attached to it in the education sector.
- Restructuring does not equate to bankruptcy and constitutes any intentional effort to promote efficiency and financial stability.
- Out-of-court restructurings can assist companies that are underperforming, in a crisis, or are healthy, but with underperforming divisions.
  - Can take many forms, from the most basic review of costs and expenses to a full blown balance sheet and operational overhaul.
  - Can help to stabilize financial and operational performance by developing and implementing comprehensive profitability and working capital plans.



Weil | THOMPSON COBURN LLP | ZOLFO COOPER

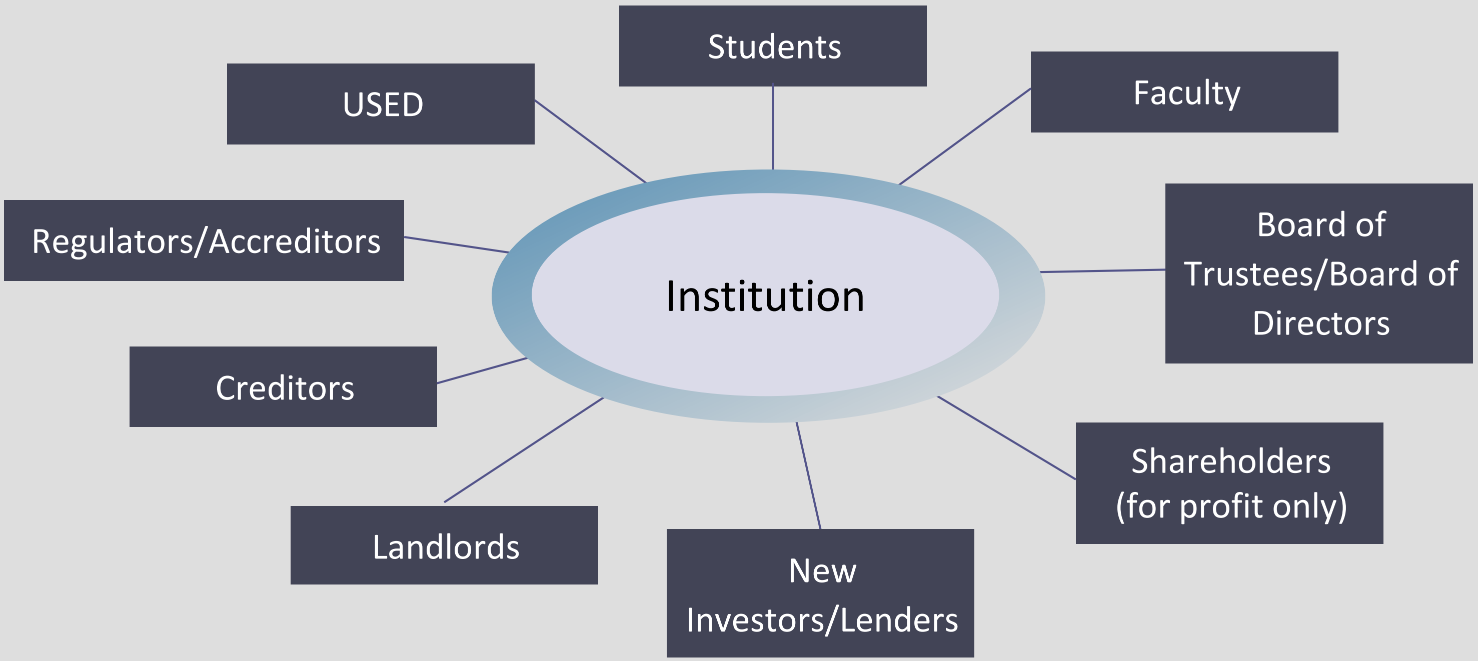
# Approach to Restructuring

- Restructuring involves a different approach than addressing micro and macro issues on an ad hoc basis.
- All crises and obstacles are considered together to create a workable long term global solution.


Weil | THOMPSON COBURN LLP | ZOLFO COOPER

# Key Players

- Restructuring transactions typically entail multi-party negotiations.



# Types of Restructuring Initiatives

- Restructuring efforts in higher education should include:
  - Long-term business plan development and implementation;
    - Key benchmarks: Recruitment, Enrollment, Retention and Placement
  - Liquidity and business stabilization;
  - Contingency planning;
  - Protective actions in anticipation of regulatory changes (*e.g.*, gainful employment regulations).
- Restructuring efforts in higher education may include:
  - Operational restructuring;
  - Debt reorganization/financial restructuring;
  - Capital raising;
  - Sales of non-core assets;
  - Merger or affiliation;
  - Litigation management.

# Restructuring Issues Unique to Education

# Internal Limitations Impacting Restructuring and Realignment

- Certain peculiar characteristics of postsecondary institutions also present challenges:
  - Complex governance structures, particularly where an institution is part of a larger system with multiple boards.
  - Faculty, student, and community stakeholders may have more pronounced roles in decision-making (*e.g.,* faculty senate).
  - Tenure considerations can impact ability to carry out measures.
  - Complexity and variation of data management and reporting systems frustrate planning and action.
  - Public good component of mission can be at tension with creditor protections.

# Regulatory Limitations: Substantive Changes

- Restructurings often involve changes of control, cessation of certain operations and other substantial changes in the way that an institution will operate going forward.
- Numerous regulations at state, accreditor, and federal level impact execution of substantive, operational changes, to include:
  - Material revision to existing programs;
  - Moving or expanding locations;
  - Adding new locations or programs;
  - Compliance with requirements of programmatic accreditors.

# Closure and Teach-Out

- Closure and teach-out of an institution require close coordination with and approval from state, accreditor, and federal regulators.
- Closing entity must decide whether to teach-out on its own or involve outside institution.
  - Costs of gradual closure vs. R2T4, loan discharge, teach out plans.
- Identifying a teach-out partner can prove challenging for troubled institutions.
  - Geographical barriers, programming idiosyncrasies, regulatory risks, negative publicity.
- Even where conditions are favorable, timing and communication can prove challenging.
  - Regulatory delays, governance challenges, student and employee complaints.

# Regulatory Limitations: Financial Responsibility

- Eligibility for Title IV funding is the lifeblood of a post secondary institution.
- To maintain Title IV eligibility, an institution must demonstrate “financially responsibility.”
- Financial responsibility regulations: 34 CFR 668.171-668.175.

# Regulatory Limitations: Financial Responsibility (continued)

**Compliance with the USED Title IV requirements narrows the range of possible restructuring alternatives.**

- Certain USED ratios limit the amount of debt obligations allowed to be placed on the entity post-restructuring.
  - The USED utilizes the Composite Score Test to determine financial responsibility.
  - A Composite score of 1.5 or above is passing, a score of 1.0 to 1.4 is placed in the "zone" and given the option of 50% L/C requirement or "zone alternative," which requires additional reporting and Title IV processing requirements.
  - A score of below 1.0 is failing and requires that the institution post a letter of credit to the USED in amount dictated by the Department, provisional certification, and reporting and Title IV processing requirements.
  - L/C typically between 10% and 50% of the prior year Title IV receipts.

# Regulatory Limitations: Financial Responsibility (continued)

**The Composite Score standard combines three different measures of fundamental elements of financial health to yield a single measure of an institution's overall financial health.**

- The Primary Reserve Ratio represents a measure of a school's viability and liquidity.
  - Primary Reserve Ratio = Adjusted Equity / Total Expenses.
  - 30% of weighted score (for-profits) / 40% of weighted score (non-profits).
- The Equity Ratio represents a measure of a school's capital resources and its ability to borrow.
  - Equity Ratio = Modified Equity / Modified Assets.
  - 40% of weighted score (for-profits) / 40% of weighted score (non-profits).
- The Net Income Ratio represents a measure of a school's profitability.
  - Net Income Ratio = Income Before Taxes / Total Revenues.
  - 30% of weighted score (for-profits) / 20% of weighted score (non-profits).

Source: FedReg/Title 34/Subtitle B/Chapter VI/Part 668/Subpart L

# Regulatory Limitations: Financial Responsibility (continued)

**If a school reports a USED Composite Score below 1.0, the USED may permit Title IV funding under provisional certification.**

- School submits an L/C in an amount mandated by the USED and related to most recent fiscal year's FSA funding.
- Posting a L/C expands the range of workout strategies by deferring the limitations of Composite Score.
- The use of L/C's is a widespread and, often times, remains in place for an extended period.
- The source of cash and timing of posting the L/C should be considered within the larger context of a restructuring.
- Composite Score compliance can significantly narrow restructurings where TDR accounting is applicable.

**10.5%, or 356, of schools receiving Title IV Funding had a USED Score below 1.5 and 6.1%, or 207, of schools had a USED Score below 1.0, in fiscal 2012, the latest year of reported data**

Source: FSA Handbook p.2-75
Source: https://studentaid.ed.gov/about/data-center/school/composite-scores

# Regulatory Limitations: Financial Responsibility

**Many credit agreements contain an event of default if the composite score drops below a certain point.**

**A school will be required to include notification to the USED of a default with the submission of the fiscal year audited financials.**

- If subject to “zone alternative” reporting, then the school would need to report a violation of their loan agreement within 10 days of occurrence.
- The USED regulations state that a school is deemed not financially responsible if in default or violation of a loan agreement.
- The USED could request a letter of credit or take other action in response to such a notice.

Source: https://studentaid.ed.gov/about/data-center/school/composite-scores

# Litigation Management

- One driver in educational restructurings is the recent prevalence of litigation (*e.g., qui tam* actions under the False Claims Act, USED and state regulatory enforcement actions, and student class actions).
- Restructuring can create context (and leverage) for negotiating settlements with governmental authorities and third party litigants. Effective negotiating strategy requires the ability to articulate:
  - The importance of the institution to the community;
  - The manner in which the institution has taken appropriate steps to secure its future without the need to resort to prior practices now being challenged;
  - The ability to raise incremental financing to pay a modest amount of fees, penalties and settlements if and only if, everyone commits to resolving all pending issues under a comprehensive global settlement;
  - The commitment of management, with the assistance of third-party advisors, to implementing any restructuring initiative that is warranted by the circumstances;
  - The likely scenario in the event a settlement is not reached.

# Restructuring Takeaways

- By being proactive, management can implement any number of restructuring initiatives to correct balance sheet and operational issues and put the institution in a position of competitive advantage.
- Although it is not currently considered a viable option for higher education institutions absent a revision to the current provisions of Title IV, chapter 11 could be an effective tool to protect educational institutions that provide valuable services and benefits to their students and the community.
- In other highly regulated industries (*e.g.*, airline industry) chapter 11 has been used to create a new norm of efficiency and profitability.

# Rethinking Bankruptcy vis-à-vis Title IV

# Rethinking Bankruptcy vis-à-vis Title IV

- When statute was passed, Congress likely didn't anticipate the ever increasing need for a restructuring alternative for a significant percentage of highly reputable and publicly significant institutions.
- The threat of a bankruptcy filing is often the only leverage in creditor negotiations facing a secured creditor strategy to dismantle the institution.
- As such, it may be that the time is ripe for Congress to reconsider outright ban, or for USED to consider creative alternatives to permit institutions to pass through bankruptcy filing quickly and efficiently so long as they demonstrate that they will operate within acceptable norms post-restructuring.

# Rethinking Bankruptcy vis-à-vis Title IV

- For example, Congress could revise Title IV to provide USED with oversight as a "party of interest" in a bankruptcy setting while allowing it the discretion to revoke funding in egregious situations where the public is being directly and substantially harmed.
- Statute could provide for a 90-day window, subject to extension at the discretion of USED, before funding automatically terminates.
- Would allow a prepackaged or prearranged chapter 11 to proceed while continuing to provide the safeguards against funding abuses that Congress intended to address under the amendment to Title IV.

# Rethinking Bankruptcy vis-à-vis Title IV

- Would recognize the reality that chapter 11 is an effective tool to protect educational institutions that provide valuable services and benefits to their students and the community.
- Would facilitate an efficient change of control without 100% creditor support.
- Often the best preventer of a bankruptcy is the ability to commence one.

# Rethinking Bankruptcy vis-à-vis Title IV

- Such a limited amendment would eliminate the risk that individual creditor holdouts could insist on special treatment. Under the Bankruptcy Code, the institution would have the exclusive right to propose a plan, increasing the ability of owners/managers to retain their financial positions.
- This having been said, a chapter 11 filing should not be undertaken without a thorough review of the pros and cons and an analysis of whether, on balance, a filing would be value creating or value destructive.

# Rethinking Bankruptcy vis-à-vis Title IV

- If permitted, a prepackaged chapter 11 would have following characteristics:
  - Generally 45-90 days.
  - Company negotiates restructuring agreement (lock-up) with certain constituents.
  - Develop plan and disclosure statement.
  - Solicitation of votes on plan prior to filing bankruptcy.
  - File petitions and plan and immediately schedule confirmation hearing.
  - For balance sheet restructuring only (limited operational fixes).
  - Can address long-term lease issues.
  - Does not generally impair trade creditors, tort claims.
- Pre-negotiated Plan
  - Like a prepackaged plan but allows for operational fixes.
  - Can be completed in 60-150 days.

# Rethinking Bankruptcy vis-à-vis Title IV

- The Debtor’s ability to reject leases and cap lessor damages to statutory cap.
- The Debtor’s ability to capitalize an under-market leases notwithstanding lease prohibitions by assigning leases.
- The ability to re-characterize sale leasebacks into secured financings in order to stretch out payments.
- The automatic stay of all litigation and the creation of a beneficial forum to resolve or estimate all litigation in an expedited timeframe.

# Appendix
# Closure & Teach-out

# Closure and Teach-Out

- Wide variety of operational changes can accompany a restructuring or realignment. Most dramatic is the closure of an institution.
- Determining whether and when to close is extraordinarily challenging. Numerous regulatory considerations, in addition to practical ones.
- Most critical is that delays do not lead to precipitous closure.
  - Costly (*e.g.,* leases and landlords, loan discharge, statutory liabilities and Letters of Credit, student lawsuits, government investigations).
  - Generate negative publicity that can detrimentally affect other operations.
  - Implicate fiduciary duty concerns.
- Cases like Corinthian Colleges and Anthem highlight the disruption caused by forced closures.

# Closure and Teach-Out

- Deliberate, planned closure with an appreciable time-horizon is most desirable.
  - This requires an ongoing, honest assessment of institutional health (financial, regulatory, cultural).
  - Though an institution may ultimately decide not to teach-out a location, it should be considering the teach-out as an option at first signs of material institutional stress.
- Keep in mind certain core considerations when evaluating closure and teach-out scenarios.

# Closure and Teach-Out

- Is there a viable alternative to closure and teach-out?
  - Are there sale or merger possibilities with an internal or external entity?
  - Is there another institution, or a proximate location or online division of your own institution, that would accept students on transfer?
- Are you able to commit to remaining open until all current students have graduated or withdrawn?
- If another institution must be involved, what options are available in your market (or online)?
  - Can one institution manage the teach-out?
  - Are potential partners accredited by the same accreditor?

# Closure and Teach-Out

- What state and institutional accreditor requirements apply to your institution's closure?
  - Teach-Out Agreements with other institutions must be approved.
  - Arrangements must be made for records storage and management.
  - In the case of not-for-profit institutions, state law must be carefully examined with respect to the disposition of institutional assets.
- Do any programmatic regulators impact your teach-out options?
- What conditions, if any, might impede securing a teach-out partner?
  - Outstanding Financial Obligations (USED may not absolve a teach-out partner from assuming liabilities).
  - 90/10 or Cohort Default Rates (USED).
  - Graduation and Employment Data (Accreditor).
  - State Licensure Pass Rates (Accreditor/State).
  - Negative publicity surrounding school or ongoing investigations by various regulatory entities.

# Closure and Teach-Out

- Consider specific regulatory risks associated with school closure:
  - **R2T4**: Poorly timed closure could result in significant R2T4.
  - **Loan Discharge**: Students enrolled within 90 days of closure may be eligible for discharge of all federal loans obtained for program if school closes and student does not complete program because of closure. USED will pursue recovery against institution, affiliates, and its principles.
  - **Past Performance, Suspension and Debarment**: If School closes owing substantial debt to USED, can prevent owners and executives from owning other institutions. If closure threatens public interest, can result in suspension or debarment.

# Closure and Teach-Out

- If you determine to carry out a teach-out, follow best practices:
  - Develop a through communication plan, control the narrative with stakeholders and regulators alike. Be deliberate and consistent.
  - To the extent possible, take care of the students.
  - Be forthright with stakeholders.
  - Work closely with regulators.
  - Ensure facilities and records are properly managed through closure.

# Contact Information

**Joseph H. Smolinsky**, Partner
Business Finance and Restructuring Department
Weil, Gotshal & Manges LLP
joseph.smolinsky@weil.com
(212) 310-8767

**Aaron D. Lacey**, Partner
Higher Education Practice
Thompson Coburn LLP
alacey@thompsoncoburn.com
(314) 552-6405

**Carol Flaton**, Managing Director
Zolfo Cooper, LLC
cflaton@zolfocooper.com
(212) 561-4073

# Conditions of Use/Disclaimer

The purpose of this webinar is to provide news and information on legal issues and all content provided is for informational purposes only and should not be considered legal advice. Views discussed do not represent the views of the speakers or their respective firms.

The transmission of information from this webinar does not establish an attorney-client relationship with the viewer. The viewer should not act on the information contained in any of the materials or presentation of this webinar without first consulting retained legal counsel.

If you desire legal advice for a particular situation, you should consult an attorney.