Cooley

Borrower Defense to Repayment Rule 3.0

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After announcing plans for a new rule last summer, only to miss the publication deadline, the Department of Education (ED) has – albeit still unofficially – issued its long awaited new update to the borrower defense to repayment rule (BDTR), first updated and greatly expanded during the Obama administration. As a reminder, the 2016 version of the BDTR rule is currently effective and applies to *all* institutions that participate in the Title IV Direct Loan programs, regardless of their public, nonprofit or for-profit status. Barring the unforeseen, and with one exception noted below, the new BDTR rule will go into effect July 1, 2020.

To recap, triggered by the collapse of the Corinthian Colleges at the tail end of the Obama administration, a new BDTR rule was promulgated, replacing long-standing and truly minimal language that failed to provide effective guidance for implementing the statutory provision that could relieve a student of his or her federal loan obligation. In addition to incorporating substantial procedural provisions, the 2016 rule diverged sharply from the original in adding entirely new elements related to institutional "financial responsibility," intended, as described by then-Secretary Arne Duncan, to better enable ED and the public to identify institutions in imminent peril of failure.

After Secretary Betsy Devos delayed the July 2017 effective date of the Obama-era BDTR rule, ED initiated a negotiated rulemaking as part of its "regulatory reset" later that same year. In accordance with the strictures of the statutory master calendar, in order to implement a new BDTR rule effective July 2019, ED needed to publish a new final rule by November 1, 2018; that did not happen. In the meantime, in September 2018, a federal district court in Washington, DC, issued an order holding that ED's delay of the Obama-era rule was in violation of the Administrative Procedures Act and ordered the 2016 rule immediately effective. ED did not contest the order, and the 2016 BDTR rule went into effect in October 2018. While ED indicated it would provide guidance on implementation of the 2016 rule, that guidance was not issued until March 2019, with institutions having 60 days to come into compliance, including self-reporting certain triggering events discussed below. The Obama-era rule remains in effect until next July, when the new rule will become effective. (See our previous blog posts here and here for more details.)

While the new BDTR rule does follow the same primary themes – providing a federal standard for BDTR student claims, a procedure for processing those claims, financial responsibility triggers, and requirements relating to mandatory arbitration agreements and class action waivers – it also diverges in material respects from the 2016 rule.

Because of the length and complexity of the BDTR rule, we are issuing two reports, the first on its broad and potentially significant effects on all institutions and the second on the process for students seeking to secure relief from the alleged wrongdoings of their schools and how that may affect their (generally former) institutions.

Part I – General institutional effects

Early implementation affecting the application of accounting standards and treatment of long-term debt

The new rule will go into effect July 1, 2020. ED, however, has provided for early implementation, at the institution's discretion, of one subsection, and associated appendices, that could affect an institution's financial responsibility composite score. An update to the Financial Accounting Standards Board (FASB) standards, published in February 2016, changed certain aspects of the accounting treatment of leases, which is addressed in the new rule, and, the amended appendices include updates to the treatment of long-term debt, which was discussed at length during the 2018 negotiated rulemaking sessions. Institutions can choose to opt-in to these new provisions, codified at 34 C.F.R. 668.172(d) and in Appendices A and B to Subpart L of Part 668, as soon as the official final rule is published in the Federal Register.

What it means

The new BDTR regulation provides two different accounting treatments for operating leases. While leases executed prior to December 15, 2018 will be treated as they have been prior to the FASB update, those entered after December 15, 2018 would be treated under the new FASB standards if an institution elects to opt-in. Under the opt-in, a lease executed after the specified date would be recorded as both a right-of-use asset and a current liability, rather than just being

reflected as an operating expense. While in some circumstances this could have a positive impact on the primary reserve and equity ratios included in the composite score, that determination will require a fact-specific analysis. Institutions and their auditors will need to closely examine their particular financial circumstances to determine the impact of this change and whether early opt-in may be beneficial.

In addition, the new rule will change the way ED determines whether long-term debt qualifies for potentially positive treatment in the composite score formula. Under the current formula, long-term debt can count in the school's favor in the numerator of the primary reserve ratio up to the value of the school's net property, plant and equipment. Under a "dear colleague letter" issued in 2003, ED has offered this treatment for any long-term debt without inquiry as to the purpose of the debt. However, under the new BDTR rule, long-term debt will count in the school's favor only if the school can show that it used that debt to acquire long-term assets such as property, plant and equipment, which will have to be fully explained in the footnotes to the financial statements and supported with the loan and acquisition records.

It also appears that the early implementation option operates as a package so that if a school wishes to opt-in to the new provisions on leases it would also have to opt-in to these provisions on long-term debt. However, the language is somewhat muddy and that is a point that will require further clarification.

Prohibition against mandatory arbitration and denial of class-action rights lifted

The revised rule reverses the 2016 BDTR rule provision that prohibits an institution from requiring students to agree to pre-dispute mandatory binding arbitration and relinquishment of their class-action rights relating to claims regarding the making of a direct loan.

What it means

Alternative dispute resolution (arbitration, in its most common form) was long considered a way for individuals to avoid the time and cost of litigation. However, mandatory arbitration clauses and class action waivers in student enrollment agreements had become a prime target for those who view the dispute resolution process as unfair to students, leading the Obama administration to prohibit the use of such provisions in relation to student claims against schools based on the making of Direct Loans or the services they pay for. The new rule reverses course on this provision.

The new rule will allow institutions to enter into pre-dispute arbitration agreements and class action waivers with students as part of the enrollment process, subject to certain conditions. If institutions opt to use these types of agreements, they will be required to create a plain language disclosure, posted on the school's publically available admissions information webpage as well as in the catalog. The disclosure must explicitly indicate that the student does not have to participate in an internal grievance procedure or arbitration prior to submitting a BDTR claim to ED, and that the student cannot be forced to waive the opportunity to file a BDTR claim as part of the agreement. In addition, the disclosures must provide a point of contact at the school if the student has questions or a potential claim, as well as other information.

The revised 2020 "financial triggers"

The 2016 BDTR rule contains a complex set of indicators intended to give advance warning that an institution might be at risk of closure due to financial or regulatory events. Under that rule, triggering an indicator could lead to automatic regulatory consequences under ED's financial responsibility standards, including causing ED to recalculate the institution's composite score to determine if a financial responsibility issue exists. While the new BDTR rule maintains the original system of warnings, it reduces the number and complexity of the triggering indicators. There will be three triggers that have either mandatory effects or require a composite score recalculation, with the impact of the remainder at the discretion of ED.

Mandatory triggers

There are now three 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
- For a proprietary institution whose composite score is less than 1.5, an owner withdraws equity from the institution, unless the withdrawal is a transfer to an entity included in the affiliated entity group on whose basis the institution's composite score was calculated
- For publicly traded institutions:
  - The US Securities and Exchange Commission (SEC) issues an order suspending or revoking the registration, or suspends trading, of the institution's securities on any national securities exchange; or

    - The exchange on which the institution's securities are traded notifies the institution that it is not in compliance with the exchange's listing requirements and, as a result, the institution's securities are delisted, either voluntarily or involuntarily; or
    - The SEC is not in timely receipt of a required report and did not issue an extension to file the report

For the first two triggers above, ED will recalculate the institution's most recent annual composite score, factoring in the liability, or amount withdrawn, respectively. As was the case with the 2016 rule, if the recalculation results in a composite score below 1.0, the institution would no longer be considered financially responsible and would need to post a letter of credit of at least 10% of the prior year's Title IV funds, and be subject to provisional certification and some form of Heightened Cash Monitoring. For the SEC category affecting publicly-traded institutions, the occurrence of any of the listed events will automatically indicate a lack of financial responsibility, with the same resulting administrative requirements.

Discretionary triggers

Substantively, the discretionary triggers largely follow the 2016 rule, but some of the automatic triggers from the 2016 rule will become discretionary in 2020. Under the new rule, ED will review a discretionary triggering event and determine if it is likely to have a material adverse effect on the institution before determining that financial responsibility is at issue. There are six discretionary triggers:

- The institution's accrediting agency issues a show cause order (or similar action) that, if not satisfied, could result in the withdrawal, revocation or suspension of institutional accreditation
- The institution violates a provision or requirement of a security or loan agreement with a creditor; and as provided under the terms of that agreement, a default, delinquency, or other events occur that allow the creditor to impose on the institution an increase in collateral, a change in contractual obligations, an increase in interest rates or payments, or other sanctions, penalties, or fees
- The institution's state authorizing agency notifies the institution that it has violated an agency requirement and that the agency intends to withdraw or terminate the institution's authorization if the institution does not take the steps necessary to come into compliance
- For its most recently completed fiscal year, a proprietary institution did not meet the requirements of the 90/10 rule
- The institution's two most recent official cohort default rates are 30 percent or greater, unless:
    - The institution files a challenge, request for adjustment, or appeal with respect to its rates for one or both of those fiscal years; and
    - That challenge, request, or appeal remains pending, results in reducing below 30 percent the official cohort default rate for either or both of those years, or precludes the rates from either or both years from resulting in a loss of eligibility or provisional certification.
- As calculated by the secretary, the institution has high annual dropout rates

The sixth trigger is particularly open-ended since ED has not specified how it will calculate drop-out rates or what standard will be applied to determine if such a rate will be considered "high." We will be very closely following implementation of this particular provision.

When discretionary becomes mandatory: cumulative discretionary triggers

While a number of the triggers lose their initial automatic effect, if an institution reports two or more discretionary triggers during the period between official composite scores, the events become "mandatory" unless the circumstance of the first a trigger is resolved prior to the subsequent triggering event.

Trigger reporting

As is the case in the 2016 rule, institutions will need to self-report the occurrence of any of the triggers, generally within 10 days of their occurrence. However, the reporting process will be simplified in a number of these situations. For instance, with respect to litigation matters, the institution will only have to report a final judgment, as opposed to reporting at multiple steps in a lawsuit. And, as is the case with the 2016 rule, the new BDTR regulations allow institutions to include mitigating information respecting the reported triggers, such as insurance coverage for liabilities, when they submit the report.

What it means

By rolling significant operating and financial indicators into the BDTR rule, ED is making clear that it does not intend to stand idly by as accreditors, state regulators or creditors initiate any form of adverse action, even if conditional at the time.

Likewise a rise in cohort default rates above the threshold or a "high annual dropout rate" would immediately raise an alarm, and if any two occur in the same year, the rule as written would require immediate action by ED. This is all in direct reaction to the charge that ED failed to respond in timely manner to what many argued were clear signs of impending multiple institutional failures. While it was the Obama administration that drafted the 2016 rule, it is notable that Secretary DeVos has pursued the same, albeit somewhat kinder, gentler path in the 2020 version.

It is particularly important to bear in mind that with only a few exceptions for public institutions, the triggers apply to all institutions, regardless of their control. To focus on just one mandatory trigger, substantial regulatory liabilities based on final administrative actions are being regularly levied against all categories of institutions, from the mightiest to the smallest organizations. And because these triggers are likely to have direct and immediate financial impact, the negative effects of, for example, an adverse accreditation action, even if years removed from a final result, can be exacerbated by letter of credit or other restrictions imposed by ED at the inception of the action.

We await the official publication of the new BDTR rule, and any guidance from ED, and will supplement this post as new information becomes available. Please reach out to us if you have questions.

The second part in this series, covering borrower defense claims basis and process, will follow shortly.

Kate Lee Carey focuses on the legal, accreditation, administrative and regulatory aspects of regionally and nationally accredited higher education institutions and companies that provide services to the education industry.

Jonathon Glass specializes in higher education law, with concentrated emphasis on the institutional eligibility and financial responsibility requirements for institutions to participate in the Title IV federal student aid programs.

Mike Goldstein has been a pioneer in the development of new and more effective and efficient approaches to education in general and eLearning in particular through the creation of innovative approaches to combining the resources and interests of the various sectors of the education, technology, financial and governmental communities.

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