August 1, 2016

The Honorable John B. King, Jr.
Secretary of Education
Lyndon Baines Johnson Department of Education Building
400 Maryland Avenue SW
Washington, DC 20202

Re: Notice of Proposed Rulemaking, 81 Fed. Reg. 39,330 (June 16, 2016)
RIN 1840-AD19; Docket ID ED-2015-OPE-0103
Comments on proposed amendments to 34 C.F.R. § 600.2, § 685.300

Dear Secretary King:

Thank you for the opportunity to comment on the Department of Education's proposed rule on borrower defense. Our comments discuss the need to recognize the structural differences between for-profit and nonprofit (including public) institutions, and recommend changes to three parts of the proposed rule: those relating to financial responsibility triggers, dispute resolution procedures, and disclosures regarding low repayment rates.

Recognizing current-law restrictions on nonprofit entities

In the NPRM the Department takes note of the fact that students are at far greater risk of bad outcomes at for-profit institutions than at public and other nonprofit institutions. However, the Department fails to point out the legal structures that *cause* nonprofit entities to behave differently. By failing to acknowledge the restrictions placed on nonprofit entities, the Department opens itself up to the spurious claim that any distinction it may choose to make in its own regulations amounts to "discrimination" based on the "tax status" of an institution. The lobbyist for Corinthian Colleges, for example, complained that differential treatment of for-profit colleges amounts to "regulatory second-class citizenship," a complaint that conveniently ignores the fact that nonprofit corporations are subject to *much stricter* rules on spending and responsible governance.[1] It would be inappropriate for the Department *not* to take into consideration those legal/structural differences as it drafts its regulations.

The consumer protection challenge that the Department has identified in education is a type of market failure that legal scholar Henry Hansmann calls "contract failure." When it is difficult to evaluate the quality of the promised or provided product, he points out, a profit seeker can more easily charge too much or deliver inferior goods or services. "As a consequence,"

[1] Mark L. Pelesh, "Markets, Regulation, and Performance in Higher Education." In Guilbert C. Hentschke, Vicente M. Lechuga, and William G. Tierney, eds., *For-Profit Colleges and Universities: Their Markets, Regulation, Performance, and Place in Higher Education* (Sterling, VA: Stylus Publishing, 2010), page 100.

says Hansmann, "consumer welfare may suffer considerably."[2] The remedy is an enterprise that puts non-owners in the driver's seat, which is what nonprofit governance attempts to accomplish by prohibiting trustees from sharing in the spoils. As a result, as the president of the American Enterprise Institute explains, nonprofit boards seek to balance "a double bottom line" of financing the organization's operations while also pursuing their social impact, in contrast to for-profit owners whose singular bottom line drives every decision.[3] Control by non-owners functions as an internal regulatory mechanism that mutes the temptation to take advantage of vulnerable consumers, making nonprofit entities "more immune against moral hazards than for-profit firms would be under similar circumstances."[4] This regulatory structure is particularly effective when the quality of a product is difficult to measure; in education, customers "can easily be taken advantage of;" by the time an adult figures out the value of the education he or she purchased, it is too late to do anything about it.[5]

Under 34 CFR 600.2, a nonprofit institution is prohibited from distributing its assets to private individuals ("no part of the net earnings . . . benefits any private shareholder or individual"). At a for-profit corporation, the opposite is the case: the assets are the property of private individuals, whose strong incentive is to commit as little spending as possible to education because any remainder they can keep or can use for marketing and growth, thereby increasing the value of their ownership stake. This non-distribution constraint (as it is sometimes called) is mirrored in the Internal Revenue Code, in state nonprofit corporation law, and in conflict-of-interest rules that apply to officials at public institutions.

Whenever comparisons are made between sectors of higher education, someone invariably points to public and nonprofit institutions with low graduation rates or poor employment outcomes. One valid response to this objection is to dismiss these institutions as outliers, exceptions that prove that financially disinterested governance is *generally* effective at promoting quality, even if it is imperfect. But another valid response is that any attempt to measure educational outcomes is imperfect, and that nonprofit governance itself is an alternative measure – a data point – that provides additional information. Trustees, without a financial reason for doing so, are *vouching* for the institutions based on their analysis of a broad array of factors. Particularly at institutions enrolling large numbers of disadvantaged students, outcome measures may reflect the challenges of the population rather than bad practices by the institution. While for-profit colleges frequently claim their bad outcomes are a function of who they enroll, their claim is self-serving – the owners lose out financially if they admit to anything else – and therefore suspect. Nonprofit colleges trustees, on the other hand, do not have the financial conflict of interest that drives for-profit colleges. They therefore deserve some deference regarding their perspective on the educational value of the institution, taking into consideration the college's history, its students, and the local community.

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[2] Henry B. Hansmann, "The Role of Nonprofit Enterprise," *Yale Law Journal* 89 (5) (1980): 835–901.
[3] Arthur C. Brooks, *Social Entrepreneurship: A Modern Approach to Social Value Creation* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009).
[4] Helmut K. Anheier and Jeremy Kendall, "Trust and voluntary organisations: Three theoretical approaches." Working Paper 5 (Centre for Civil Society, 2000), available at http://eprints.lse.ac.uk/29035/.
[5] Gordon C. Winston, "Subsidies, Hierarchy and Peers: The Awkward Economics of Higher Education," *Journal of Economic Perspectives* 13 (1) (1999): 13–36.

These underlying regulatory and financial differences at for-profit and nonprofit institutions should not be ignored in analyzing the causes of risks to consumers and taxpayers, and in identifying and targeting the appropriate remedies.

Financial responsibility triggers

Because nonprofit entities are required to spend their funds only on their educational mission, nonprofit institutions are less prone to large-scale, precipitous closure (abandoning students in the middle of a term with little or no warning) than are for-profits. For-profit colleges more frequently leave students and taxpayers in the lurch because the moment that owners see their institution's demise on the horizon, they take steps to protect their personal investments by shifting the institution's revenue and spending in self-interested ways, imposing costs and risks instead on other people – students, taxpayers, and creditors. As a result, ultimate closure becomes even more imminent, and at a greater cost to others. At nonprofits, the trustees – if the non-distribution constraint is adequately enforced – have no personal financial stake to protect or enhance, so closure tends to be much more orderly and responsible, at less cost to students and taxpayers.

Due to these differences in the underlying structure of nonprofit versus for-profit entities, we recommend that the Department adjust the rule *for institutions with financially disinterested governance, all of the triggers are treated as discretionary*. An institution's governance should be considered financially disinterested if it is nonprofit and, in the five most recent tax years, it was not required to report to the IRS, with regard to more than ten percent of the members of the board of directors or trustees, either (1) any compensation from the institution or from related entities, or (2) any business transactions with the institution involving trustees/directors or their family members. (This information is reported in schedules J and L of the IRS Form 990). Alternatively, the Department could amend the definition of a nonprofit institution, in 34 CFR 600.2, to be only those with financially disinterested governing boards. Simply using an IRS nonprofit designation is inadequate because lax enforcement by the IRS and Education Department has allowed some colleges to continue to claim to be nonprofit even with excessive control by individuals with a personal financial interest in the institution.[6]

In addition, for all types of institutions, we recommend that accreditor actions and borrower-defense findings be considered discretionary rather than mandatory triggers, for similar reasons: the potential effect on the integrity of the accreditation and borrower-defense decisions themselves. In accreditation, there is no standard approach to the type of violation that can lead an accreditor to apply a "probation" or "show cause" label to a situation. Second, probation or show cause are sometimes the result of violations of standards that do not indicate any major risk to taxpayers or students. Third, accreditors are already too lenient on institutions, and adding additional automatic consequences of their actions could cause accreditors to be less inclined to raise the concerns in the first place. In the context of a discretionary trigger, the six-month provision is unnecessarily limiting and should be eliminated.

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[6] For a discussion of this problem, see Robert Shireman, *The Covert For-Profit*, September 2015, https://tcf.org/content/report/covert-for-profit/.

Dispute resolution

We support the Department's intent to stop colleges from preventing students and former students from seeking fair resolution of complaints they have about a college. In our report "How College Enrollment Contracts Limit Students' Rights," we found that restrictive clauses were frequently imposed by for-profit colleges participating in the federal financial aid program- including mandatory arbitration clauses, class action bans, and mandatory internal processes. Of the 158 for-profit colleges we examined that participate in Title IV, 93 of them, making up 98% of enrolled students from those colleges used restrictive clauses in their enrollment contracts. Of the 49 for-profit schools not participating in the federal aid program, only 1 uses forced arbitration. We found that nonprofit and public colleges almost never deny students their right to file and pursue complaints in whatever manner they choose. We are attaching our report and a sampling of the enrollment contracts we examined.

By preventing students from effectively pursuing their grievances, colleges are able to hide bad behavior and prevent or delay the oversight that is needed from law enforcement and regulatory agencies, including the U.S. Department of Education. The Department is right to recognize this as a serious problem that must be addressed by this regulatory package. However, several changes to the proposed rules must be made for the regulations to be effective.

First, to be effective, the rule must apply to any student who could participate in the federal aid program, whether or not the student currently has a loan. The rule relates to agreements that students sign at the time of enrollment, but students can seek federal aid for their education after enrollment, even after the end of the term up until the beginning of the next award year. It is not practical, and may be impossible, for schools to change students' terms of enrollment after they have enrolled. Furthermore, when any students' disputes are hidden from the view of law enforcement and regulatory officials, the Department is nonetheless being denied information that could directly affect the eligibility of the institution for federal aid. For example, aggressive recruiting may signal a violation of the incentive compensation rule, a ban that is applicable to all domestic students not just those on federal aid. Complaints may also signal problems with institutional quality that are being hidden from the federally-recognized accreditor.

Second, by failing to fully prohibit pre-dispute agreements to arbitrate, the proposal creates a huge loophole by inviting predatory institutions to claim their arbitration agreements are "voluntary" but to direct students sign them as a routine matter, before the students have any idea what kind of dispute they may have with the institution. In attempting to monitor this approach, the Department would be in the impossible position of trying to determine whether students feel the arbitration agreement is conditional on enrollment. It is a line that cannot be reliably drawn. See for example the enrollment contract of the Paul Mitchell School: the final page is an arbitration agreement that the student signs separately. Would the school enroll the student even if the student did not sign that particular page? It is impossible for the student (or the Department, in a program review) to tell. Even if the school put the word "voluntary" somewhere it would be signed as a routine matter like everything else and the school would claim to be “in compliance.” Avoiding this problem is simple: ensure that students have a real right to choose by *prohibiting arbitration agreements prior to the dispute*. It should be left up to the student and institution, after the nature of the dispute is known, to make the decision of how to proceed with the resolution of the dispute.

Third, the rule should make clear that the dispute resolution requirements relate to all programs or educational services provided by an institution, whether or not they were technically paid for by Direct Loan funds or are related specifically to borrower-defense claims. Many types of conduct, can interfere with a student’s ability to receive or complete an education and should not be exempt from these provisions.

With these problems addressed, adoption of this rule would be taking a big step toward preventing institutions from hiding complaints that offer evidence of poor quality education, unethical behavior, or even deception and fraud. Taking this step protects future students and improves incentives for honest and caring treatment of students and potential students in market for higher education. In addition, closing these loopholes will undoubtedly address taxpayer concerns by limiting future unforeseen borrower defense claims.

Repayment rate disclosure

As we have already noted, it is appropriate for the Department to make distinctions that recognize the consumer and taxpayer protections that are built into the finance and governance structures of different types of entities. These are no doubt the reasons behind the Department’s observation that “negative repayment outcomes are endemic to the proprietary sector, but are relatively rare in the public and nonprofit sectors.” If the Department is going to apply the repayment rate disclosure only to for-profit colleges, the final rule should provide more background about the factors that cause public and nonprofit entities to pose less of a hazard to consumers. Alternatively, the Department should consider applying the disclosure to institutions at which a majority of the students are enrolled programs subject to the gainful employment rule. The rationale for the latter approach is that career-focused institutions are the ones where students are too often under erroneous impressions about likely earnings, and therefore where students most deserve a warning when a school’s rate is low.

Thank you for the care and attention you have shown in developing these proposed regulations. The work will pay off in terms of justice for past students, and better outcomes for students in the future.

Sincerely,

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