History Suggests Bankruptcy Is Untenable for Distressed IHEs

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The challenges facing any entity in financial distress are numerous and complex. During the latest recession, the market-wide downturn exposed the underlying weaknesses in the business models of failing enterprises. Institutions of higher education (IHEs), such as private and public not-for-profit and for-profit colleges, graduate schools, and post-secondary vocational schools, were not immune to market forces that battered financial sectors across the board at the onset of the recession.

Many IHEs faced declines in enrollment. In addition, public IHEs confronted significant cutbacks in state funding. The recession also laid bare the failure of IHEs to adapt to demographic shifts, widening disparities in income levels, and the ever-growing significance of technology in the job market.

Some IHEs were able to maintain profitability in the short term through a combination of lower admission

standards, higher acceptance rates, and increased tuition. But as prospective students and their families have themselves continued to struggle in the face of the recession and job placement statistics continue to decline, these measures have proved to be inadequate. And while the market downturn may have highlighted the need for changes to their business model, the challenges to the continued survival of IHEs are systemic and highly resistant to stop-gap initiatives.

So where does that leave an IHE that finds itself contending with insufficient cash flow, a winnowing capital base, and a suffocating debt structure? Added to this, some face the souring of their relationship with a primary lender that has declared one or more monetary and/or non-monetary defaults, and exiled the credit to its workout division. It falls on restructuring professionals to identify and pursue alternatives that can provide sustainable, long-term relief. Among these options is the filing of a Chapter 11 bankruptcy case. At the very least, the mere threat of Chapter 11 typically affords leverage to a distressed entity in its negotiations with its lender and other creditors.

Unfortunately, regulatory hurdles confronting many IHEs make filing Chapter 11 untenable, at least as a means of reorganization. Chapter 11 may be available to effectuate the sale of an IHE as a going concern—but even that option is largely unavailing when federal student-aid funding is implicated.

This article spells out the regulatory pitfalls and provides a brief recap of the seminal court decisions which undermine the use of Chapter 11 as a restructuring device. The imposition of these restrictions on the IHE reflects a fundamental clash in policy: the ability of the troubled IHE to achieve financial stability weighed against the need of the federal government to maintain the integrity of its student-aid programs and to preserve the benefits of its outlays.

Federal Student-Aid Eligibility

Most IHEs rely on federal student aid to subsidize their enrollees. Without this funding, many students simply could not afford to attend these institutions.

Federal student aid originates in Title IV[1] of the Higher Education Act of 1965 (HEA).[2] The U.S. Department of Education (DOE) administers Title IV programs, providing grants (*e.g.,* Pell Grants) and reinsuring Federal Family Education Loans (*e.g.,* Stafford Loans) to students enrolled in IHEs.

Title IV funding is only available to IHEs that meet eligibility requirements. To sustain Title IV eligibility, the two overarching considerations are administrative and financial accountability. From an administrative standpoint, an IHE must be able to show that it has the necessary internal controls to effectively and efficiently manage Title IV programs. From a financial standpoint, an IHE must demonstrate it has the wherewithal to sustain operations, notwithstanding occasional fluctuations in enrollment and other market forces.

In addition, Sections 1001 and 1002 of the HEA require that an IHE satisfy not only the relevant provisions of the HEA itself, but also maintain the necessary licensure and accreditation through any relevant state authority and accrediting body.[3] As to state licensure, the requirements imposed by the relevant state agency may, but do not necessarily, mirror the thresholds for eligibility under Title IV.

Similarly, accreditation agencies establish standards by which member IHEs are expected to conduct business. These standards take into account both the mission of the accrediting body and the financial health of its members. While differences exist, the key takeaway is that Title IV eligibility requires an IHE to maintain good standing on all three fronts—state licensure, accreditation, and the HEA. Upon obtaining Title IV certification, an eligible IHE is assigned an OPE ID number by the DOE, pursuant to which federal student-aid funds are disbursed to eligible students.

With the foregoing as background, specific sections of the HEA and the U.S. Bankruptcy Code[4] merit particular focus when considering an IHE's bankruptcy options in the face of severe financial difficulties.

Statutory Considerations

In 1992, Congress amended Section 1088 of the HEA (now Section 1002) "to improve the public confidence in the student financial aid programs by raising the quality of eligible schools."[5] Section 1002 of the HEA currently provides that the filing of a bankruptcy by an IHE or its parent results in the automatic revocation of the institution's Title IV eligibility.[6] The accompanying regulations make clear that the loss of eligibility is permanent.[7]

Just as significantly, two years prior to the 1992 amendment to the HEA, Congress amended Sections 362 and 541 of the Bankruptcy Code to except from those provisions accreditation, licensure, and Title IV certification. As part of the Student Loan Default Prevention Initiative Act of 1990, contained in the Omnibus Reconciliation Act of 1990, Congress amended those sections of the code to effectively shield accreditation and eligibility from the authority of the Bankruptcy Court.[8]

With respect to Section 362 of the Bankruptcy Code, Subsections (b)(15) and (16) were added to the exceptions

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to the automatic stay. Subsection (b)(15) excludes "any action by an accrediting agency regarding the accreditation status of the debtor as an educational institution."[9] Similarly, Subsection (b)(16) excludes "any action by a guaranty agency, as defined in section 435(j) of the Higher Education Act of 1965 or the Secretary of Education regarding the eligibility of the debtor to participate in programs authorized under such Act."[10]

Congress made an even more dramatic change to Section 541 of the Bankruptcy Code, adding the following exclusion: "Property of the estate does not include . . . any eligibility of the debtor to participate in programs authorized under the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.; 42 U.S.C. 2751 et seq.), or any accreditation status or State licensure of the debtor as an educational institution."[11]

Case Law

The impact of the amendments has been severe. Prior to their enactment, the few Bankruptcy Courts that had considered the impact of a bankruptcy filing on Title IV eligibility or accreditation evinced a willingness to consider whether a debtor's eligibility or accreditation status could survive bankruptcy.

For instance, in *Statewide Oilfield Construction, Inc. v. Career College Association* (*In re Statewide Oilfield Construction, Inc.*),[12] the Bankruptcy Court initially ruled that the accreditation status of the debtor was an executory contract subject to the provisions of Section 365 of the Bankruptcy Code.[13] Following passage of the 1990 amendment to the Bankruptcy Code, the court revisited its decision on remand. Ultimately, the court held that an executory contract is an asset of the estate, and as accreditation is no longer property of the estate under Section 541(b)(3), neither could accreditation qualify as an executory contract.[14]

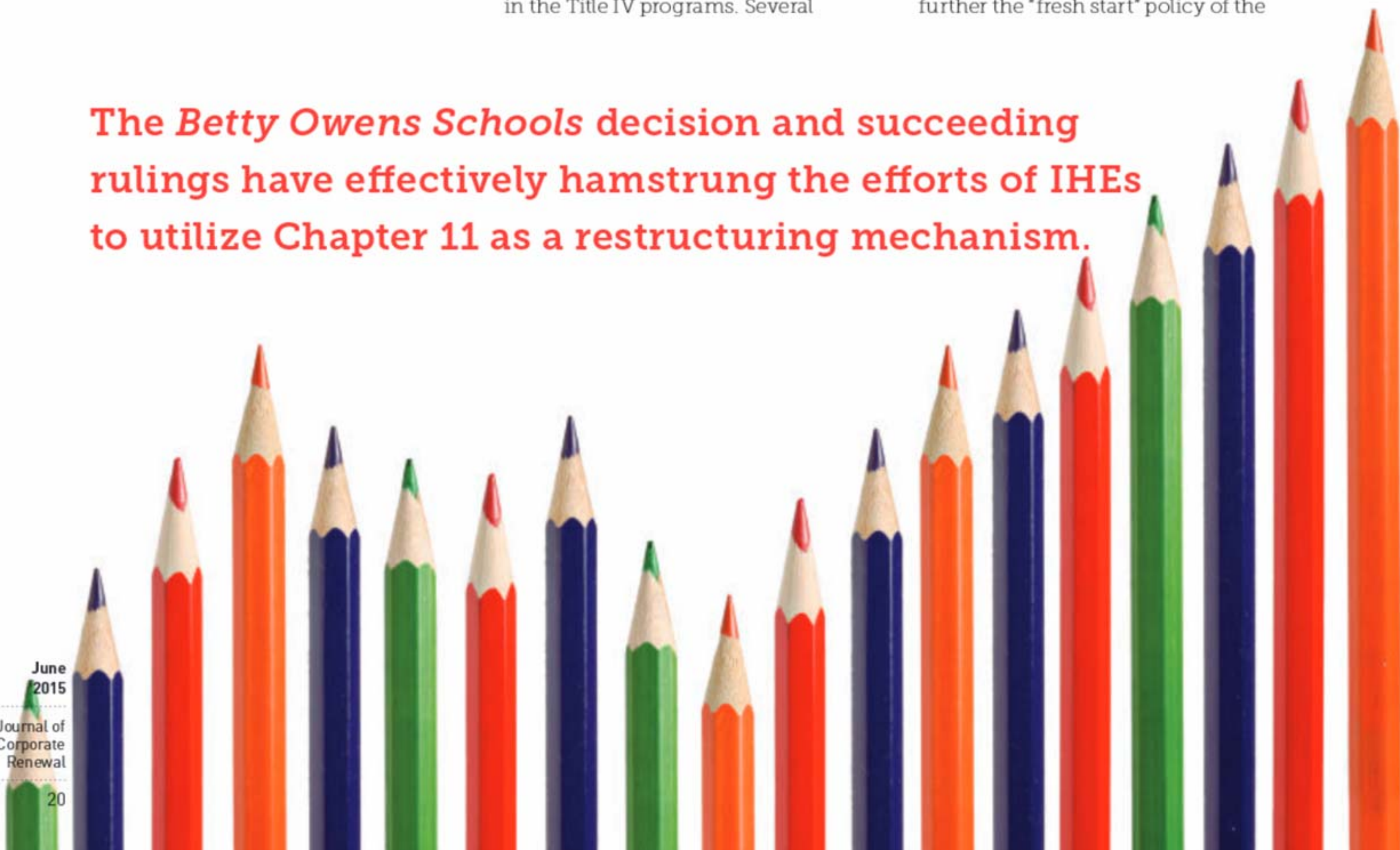
While *Statewide Oilfield Construction* addressed only the exclusion of accreditation as property of the estate, subsequent cases have made clear that the same exclusions apply to Title IV eligibility. The leading case addressing Title IV eligibility in the wake of a Chapter 11 filing is *Betty Owens Schools, Inc. v. United States Department of Education* (*In re Betty Owens Schools, Inc.*).[15]

In *Betty Owens Schools*, the debtor vocational school filed for Chapter 11 protection. Shortly after the filing, the DOE informed the debtor that it was no longer eligible to participate in the Title IV programs. Several months later, the debtor sold its assets to BO Acquisition Corp. d/b/a The Betty Owen Schools, Ltd., pursuant to Section 363 of the Bankruptcy Code.[16]

The buyer applied for recertification for Title IV eligibility with the DOE based on the eligibility of the debtor. The DOE denied the buyer's application on grounds that recertification was not available since prior to the sale, the debtor's eligibility had been automatically and permanently revoked upon the bankruptcy filing. Rather than being eligible for immediate, provisional certification based on the debtor's prior eligibility, the buyer was informed by the DOE that it would have to file an application on its own behalf, which would entail a two-year waiting period.[17]

The debtor and purchaser thereafter asserted objections in the Bankruptcy Court on separate grounds. The debtor, by declaratory judgment action, sought a finding that the DOE's withdrawal of eligibility—which was revoked solely on account of the bankruptcy filing—violated the nondiscrimination provisions of Section 525 of the Bankruptcy Code.

In denying the relief requested by the debtor, the court reasoned that while Congress enacted Section 525's antidiscrimination provisions to further the "fresh start" policy of the



Bankruptcy Code, the subsequent amendments to Sections 362 and 541 excepting funding eligibility meant that Congress prioritized the conservation of scarce HEA program resources over fresh-start considerations.[18]

The purchaser, by motion to enforce the sale order, argued that the DOE's denial of recertification violated the good faith purchaser language of Section 363(m) of the Bankruptcy Code. In response, the court noted that nothing in the sale order addressed Title IV eligibility. In what would no doubt resonate with other prospective purchasers of an IHE's assets, the Bankruptcy Court explained that the DOE's denial of the purchaser's application for recertification "was a business risk that it undertook when it purchased the Debtor's assets."[19]

Since the *Betty Owens Schools* decision, several IHEs have filed for protection under Chapter 11 and, in response to the DOE's subsequent revocation of their eligibility under Title IV, have argued unsuccessfully that such actions violated Section 525 of the Bankruptcy Code, notwithstanding the relevant exceptions in Sections 362 and 541.[20]

The *Betty Owens Schools* decision and succeeding rulings have effectively hamstrung the efforts of IHEs to utilize Chapter 11 as a restructuring mechanism. If the loss of accreditation is preordained by its exclusion as property of the estate under Section 541 and the revocation of accreditation is not protected by the automatic stay or nondiscrimination provisions of the Bankruptcy Code, the prospective reorganization is likely doomed from the start. Similarly, if prospective purchasers cannot succeed to the eligibility of the debtor and must start from scratch, a potential sale under Section 363 will be untenable under most circumstances.

FCC Holdings (Anthem Education Bankruptcy)

The recent Chapter 11 cases of *In re FCC Holdings, Inc. et al.*,[21] represent a unique illustration of the interplay between the Bankruptcy Code and the HEA in the sale context and reflect the complexities an IHE faces in any effort to take advantage of the benefits of Chapter 11. FCC Holdings and affiliated entities owned numerous for-profit IHEs located throughout the United States, including 22 Anthem Education schools, 14 Florida Career College (FCC) schools, and five U.S. Colleges schools. Approximately 90 percent of the FCC/Anthem debtors' revenue prior to the Chapter 11 filing came from Title IV funding.[22]

On August 25, 2014, the FCC/Anthem debtors filed for Chapter 11 in the U.S. Bankruptcy Court for the District of Delaware. In conjunction with the bankruptcy filing, the FCC/Anthem debtors sought approval of a series of transactions designed to accomplish the sale of multiple schools in the face of the many obstacles built into Title IV.[23]

Prior to the Chapter 11 filing, the FCC/Anthem debtors entered into an asset purchase agreement with IEC Corporation,[24] the owner of several other for-profit IHEs. The proposed purchase price for the subject schools was dwarfed by the secured debt, the consequence of a very limited market for the sale of such highly regulated assets. This forced the FCC/Anthem debtors to actively solicit the cooperation of their lenders.

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With the continued Title IV eligibility and accreditation of certain FCC and Anthem schools at stake, the various governing authorities had to provide their assent as well.

To account for the regulatory hurdles, the sale to IEC consisted of both pre- and post-petition components. The prepetition component, which the FCC/Anthem debtors referred to as "Step 1," involved the sale of the FCC schools[25] for which IEC needed to maintain the existing OPE ID number for Title IV program eligibility. Given that the FCC schools' certification would have been revoked automatically upon the filing of the FCC/Anthem debtors' Chapter 11 cases, the sale necessarily preceded the bankruptcy filing.[26]

Following consummation of the Step 1 transaction, the FCC/Anthem debtors filed for Chapter 11, at which time they filed a motion to approve "Step 2" of the sales process to IEC. Step 2 involved the assumption and assignment of certain of the FCC schools' executory contracts, for which consent to assignment was not obtained prior to the bankruptcy. Step 2 also encompassed the proposed sale of (i) U.S. Colleges[27] and (ii) nine Anthem Schools whose purchase by IEC was contingent on post-petition DOE approvals by a date certain.[28] Ultimately, the FCC/Anthem debtors were only successful in completing the sale of U.S. Colleges, as the purchaser was unable to timely obtain DOE approvals for the remaining nine IHEs.[29]

The motivation behind Step 2 was multifold: (1) to utilize the assumption and assignment provisions of Section 365 of the Bankruptcy Code; (2) to sell certain IHEs for which Title IV eligibility was not at issue, free and clear pursuant to Section 363(f); and (3) to obtain the benefits of a good faith buyer finding under Section 363(m) to protect the purchaser "from the effects of a reversal or modification on appeal of the authorization to sell."[30]

Both the U.S. Trustee's office and the DOE objected on various grounds. Among other things, the U.S. Trustee argued that the FCC/Anthem debtors were attempting to bootstrap onto Step 1 the benefits of the protections afforded under Section 363 despite the fact that the transferred property was not property of the estates.[31] The DOE voiced concerns that certain of its rights and certain liabilities against the purchased IHEs and, by extension, against IEC, might be adversely impacted by the proposed sale order.[32]

The sale order ultimately approved by the Bankruptcy Court clarified that nothing in the order was deemed to authorize the Step 1 transaction.[33] Moreover, the sale order included broad language expressly reserving any and all rights and remedies of the DOE.[34] And despite the FCC/Anthem debtors' efforts to obtain a Section 363(m) good faith finding as to both the prepetition and post-petition portions of the sale to IEC,[35] the Bankruptcy Court ultimately limited such finding to the post-petition portion of the transaction.[36]

The complicated and convoluted nature of the FCC/Anthem debtors' asset sales to IEC reflects just how difficult it is for an IHE to effectuate a 363 sale. Even with the near-universal cooperation of all relevant parties,[37] the FCC/Anthem debtors and IEC were unable to achieve

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the full complement of goals sought in connection with the filing of the Chapter 11 cases. Absent changes to the HEA and Bankruptcy Code, the likelihood of a similar confluence of circumstances permitting a sale of this nature in the future seems remote.[38]

Key Considerations

Given the hurdles created by Congress vis-à-vis the amendments to the HEA and Bankruptcy Code, what are some key takeaways for the restructuring professional in advising a financially troubled IHE? Among them are the following:

- When Title IV funding is at stake, a straightforward Chapter 11 reorganization appears to be off the table.
- While a sale of an IHE as a going concern in Chapter 11 may be possible, *FCC Holdings* illustrates that in many, if not most, instances, the machinations called for to accomplish the sale will be prohibitive.
- The statutory restrictions governing a going concern sale of an IHE (in or out of bankruptcy) all but limit the market for such an entity to strategic buyers (other IHEs) with the necessary financial wherewithal.
- Even with a qualified buyer, achieving the consensus of all vested parties—the DOE, state licensing agencies, accreditation commissions, and secured lenders—is also a prerequisite to a successful sale. As such, establishing a meaningful dialogue with these constituencies at the onset of the sale process is critical.

Circling back to the negotiation paradigm, the by-product of the barriers to continued funding and the corresponding dilution of restructuring alternatives is the resultant tipping of the scales in favor of the lender and other members of the creditor body. If an IHE cannot wield the threat of Chapter 11, it is confined to an environment in which the lender has the unfettered ability to exercise available remedies in the face of an IHE's resistance to unfavorable loan modification scenarios. At that point, the IHE is left with the threat of mutually assured destruction—*i.e.*, offering to hand over the keys—as perhaps its most compelling negotiating tool. ■

[1] 20 U.S.C. § 1070 *et seq.*

[2] *Id.* § 1001 *et seq.*

[3] See *id.* §§ 1001(a) & 1002(a).

[4] 11 U.S.C. § 101 *et seq.*

[5] *Betty Owen Schools, Inc. v. United States Department of Education (In re Betty Owen Schools, Inc.),* 195 B.R. 23, 32 (Bankr. S.D.N.Y. 1996) (citing S. Rep. No. 102-204, 102d Cong., 1st Session. at 3, 44 (1991)).

[6] 20 U.S.C. § 1002(a)(4); 34 C.F.R. § 600.7(a)(2).

[7] 34 C.F.R. § 600.7(i)(2).

[8] *Betty Owen Schools,* 195 B.R. at 32.

[9] 11 U.S.C § 362(b)(15).

[10] *Id.* § 362(b)(16).

[11] *Id.* § 541(b)(3).

[12] 134 B.R. 399 (Bankr. E.D. Cal. 1991).

[13] *Id.* at 401; see also *In re Draughon Training Institute, Inc.,* 119 B.R. 927, 932 (Bankr. W.D. La. 1990) (holding that Chapter 11 debtor's accreditation, state licensure, and DOE accreditation were property of the estate under Section 541 of the Bankruptcy Code, albeit non-transferable under Section 363).

[14] 134 B.R. at 402.

[15] 195 B.R. 23 (Bankr. S.D.N.Y. 1996).

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[16] *Id.* at 26.

[17] *Id.* at 27-28.

[18] *Id.* at 33.

[19] *Id.* at 34.

[20] See, *e.g.*, *In re Lon Morris College*, Case No. 12-60557 (Bankr. E.D. Tex. Aug. 20, 2012) (denying debtor's motion under Section 525 for relief against the DOE); *Si Tanka University v. United States Department of Education (In re Si Tanka University)*, Adv. No. 05-3003, Case No. 05-30027 (Bankr. D.S.D. May 5, 2005) [Docket No. 9] (denying debtor's motion for preliminary injunction), leave for appeal denied, CIV 05-3012 (D.S.D. June 24, 2005) [Docket No. 6]. Substantially all of Lon Morris College's assets were sold in multiple lots in connection with a plan of liquidation. Si Tanka University's Chapter 11 case was ultimately converted to a Chapter 7.

[21] Case No. 14-11987-CSS (jointly administered) (Bankr. D. Del. Aug. 25, 2014).

[22] *FCC Holdings*, Declaration of Sean Harding in Support of the Debtors' Chapter 11 Petitions and Requests for First Day Relief [Docket No. 13] ("FCC Declaration"), ¶ 9, at 4.

[23] See *FCC Holdings*, Motion of the Debtors for Entry of an Order (I) Approving Assets Purchase Agreement and Authorizing the Sale of Certain Assets of the Debtors Outside the Ordinary Course of Business; (II) Authorizing the Sale of Assets Free and Clear of All Liens, Claims, Encumbrances and Interests; (III) Authorizing the Assumption, Sale and Assignment of Certain Executory Contracts and Unexpired Leases; (IV) Approving Bid Protections; and (V) Granting Related Relief [Docket No. 27] ("FCC Sale Motion").

[24] Certain of the Anthem Schools were sold prepetition by the debtors to Premier Education Group, L.P., but are not the focus of this discussion.

[25] The sale included both assets and certain liabilities, including any liabilities to the DOE. See FCC Sale Motion ¶ 23, at 8-9.

[26] Generally speaking, a sale of substantially all of an IHE's assets constitutes a "change in ownership" resulting in a "change in control" under the HEA, which can lead to withdrawal of the IHE's Title IV eligibility. However, assuming certain requirements are satisfied, the DOE can provisionally certify the eligibility of the purchased IHE. Obtaining the necessary approvals presents its own difficulties, which in the case of the prepetition sale of 14 FCC schools by the FCC/Anthem debtors, the seller and buyer were able to overcome. While beyond the scope of this article, restructuring professionals should be cognizant of those provisions of the HEA governing (non-bankruptcy) sales and other changes in control of Title IV-eligible IHEs, which can also impact the restructuring options available to a financially distressed IHE. See 20 U.S.C. § 1099c(i); 34 C.F.R. §§ 600.20 & 600.31.

[27] Unlike the FCC schools and Anthem Schools, U.S. Colleges did not derive any revenue from and were not subject to Title IV.

[28] Although the nine Anthem Schools were Title IV eligible, IEC already possessed OPE ID numbers that were compatible with the Anthem Schools' existing accreditation. Despite this lesser hurdle, certain DOE approvals were still a condition precedent to IEC's purchase of the nine Anthem Schools.

[29] The nine Anthem Schools were consequently forced to close down and, in connection therewith, were presumably required to prepare "teach-out plans" for their accrediting authority. See *FCC Holdings*, First Amended Disclosure Statement [Docket No. 375], Section 3.7, at 11; *see also* 20 U.S.C. § 1094(f)(1) (providing that following termination of an IHE's Title IV eligibility, the DOE shall require an institution to submit a teach-out plan to the IHE's accrediting agency). Teach-out plans generally entail the winding down of an IHE's program(s) with a view toward the completion by current students of their studies. The winding down may involve students completing their studies at another IHE. See 20 U.S.C. § 1094(f)(2) (defining teach-out plans); FCC Declaration ¶ 130, at 46.

[30] 3 Collier on Bankruptcy ¶ 363.11 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed.).

[31] See *FCC Holdings*, Objection of the United States Trustee to FCC Sale Motion ¶¶ 21-25, at 6-8. The U.S. Trustee also objected to the sale based on Section 363(b)(1) of the Bankruptcy Code, arguing that given the transfer of "personally identifiable information" of students, the debtors either needed to have a consumer privacy ombudsman appointed or show why one was not required. *Id.* ¶¶ 31-37, at 11-13. Ultimately, the Bankruptcy Court determined that the sale did not violate any privacy laws because (i) it was allowed under the FCC/Anthem debtors' privacy policies and applicable federal law, and (ii) IEC agreed to comply with

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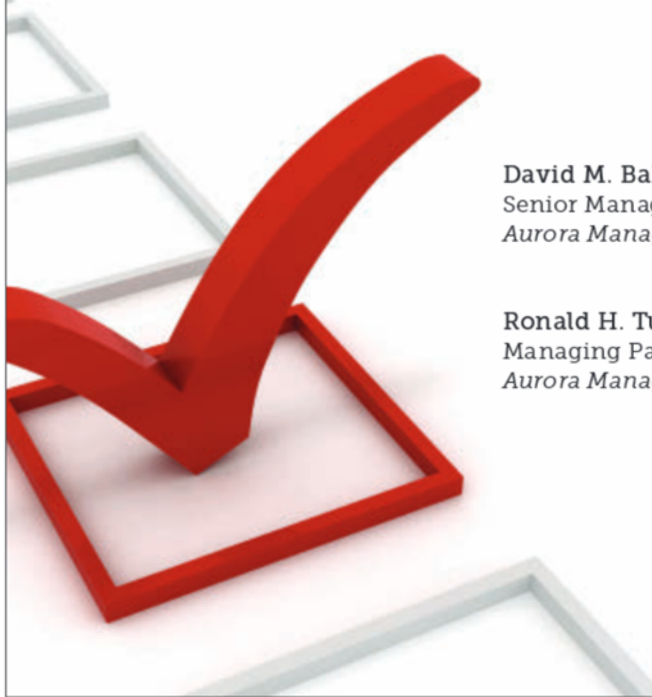

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any applicable privacy policies. See *FCC Holdings*, Order Approving the Sale Motion [Docket No. 166] ("FCC Sale Order") ¶ R, at 9; ¶ 27, at 17. While not the focus of this article, the potential relevance of privacy laws and Section 363(b)(1) of the Bankruptcy Code are another issue of which to be aware.

[32] See *FCC Holdings*, Objection by the United States to the Debtors' Motion Authorizing the Sale of Certain Assets [Docket No. 115].

[33] See FCC Sale Order ¶ 36, at 20.

[34] *Id.* ¶ 24, at 16.

[35] See FCC Sale Motion ¶ 52, at 21 (arguing for a Section 363(m) finding for the entire sale transaction based on the prepetition component of the sale being "inextricably intertwined" with the post-petition component).

[36] FCC Sale Order ¶ 22, at 15; ¶ 36, at 20.

[37] See FCC Sale Motion ¶ 27, at 10-11 (describing efforts to obtain the consent from lenders and regulatory agencies); see also *id.* ¶ 43, at 18 (explaining that Section 363(f) of the Bankruptcy Code is satisfied due to consent of the secured creditors).

[38] Most recently, Corinthian Colleges, Inc., and its subsidiaries filed for Chapter 11 relief, Case No. 15-10952-KJC (jointly administered) (Bankr. D. Del. May 4, 2015), following extensive scrutiny by the DOE and other authorities. See Declaration of William J. Nolan in Support of Chapter 11 Petitions and First Day Motions [Docket No. 10], ¶¶ 19-33, at 10-16. In light of the regulatory hurdles common to all IHEs that rely on Title IV funding and the additional regulatory pressures faced by Corinthian in particular, Corinthian was only successful in securing a buyer for certain of its IHEs, with the remaining institutions subject either to teach-outs or immediate shutdown. *Id.* The purpose of the Chapter 11 filing appears largely focused on the wind-down and sale of Corinthian's remaining operations and assets. *See id.* ¶¶ 32-33, at 16.

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