FOR-PROFIT EDUCATION AND FEDERAL FUNDING: BAD OUTCOMES FOR STUDENTS AND TAXPAYERS

Joseph Sipley[*]

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I. INTRODUCTION

The federal government spent an estimated $145 billion in fiscal year 2010 for post-secondary education in the form of grants and loans.[1] Nearly a quarter of such funding now goes to for-profit, post-secondary institutions.[2] While for-profit institutions do increase

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* Editor, *Rutgers Law Review*, J.D. Candidate, Rutgers School of Law-Newark 2012; B.S. Chemical Engineering, Lehigh University, 2003. I would like to thank my wife Christina for all her love and support over the last three years. And I dedicate this Note to my son Charlie (class of 2036) who, hopefully, will not be overly indebted to the federal government upon graduation from college.

1. S. COMM. ON HEALTH, EDUC., LABOR AND PENSIONS, EMERGING RISK?: AN OVERVIEW OF GROWTH, SPENDING, STUDENT DEBT AND UNANSWERED QUESTIONS IN FOR-PROFIT HIGHER EDUCATION 1 (2010) [hereinafter EMERGING RISK], *available at* http://harkin.senate.gov/documents/pdf/4c23515814dca.pdf.

2. *See id.* at 4. In addition, federal funding for some for-profit institutions accounts for over 80 percent of revenues. *Id.*

access to higher education, they also charge higher tuition, have higher drop-out rates, have students graduate with higher debt loads, and spend more on noneducation items such as marketing, administrative expenses, and executive compensation than do comparable not-for-profit institutions.[3]

Given the large amount of taxpayer dollars at stake and the importance of reducing bad outcomes for indebted students, the federal government has enacted various statutory and regulatory mechanisms to govern this industry.[4] However, in light of the unprecedented growth of for-profit schools during the past decade and the increase in bad outcomes for students, such as loan defaults, high debt loads, and nontransferable credits,[5] it has become clear that more is needed. The Obama administration has responded with the proposed "Gainful Employment" regulations, which are designed to link student borrowing to their post-graduation incomes and default rates.[6] While these regulations will have some positive effect, this Note will argue that they do not go far enough and that several additional reforms are needed.

Part II of this Note will describe the history of federal involvement in higher education. Part III will detail the rise of for-profit schools and will survey some of the criticisms that are aimed at the industry. Part IV of this Note will examine the current statutory and regulatory environment that governs for-profit schools, and more specifically, the regulations and laws that govern the availability of federally funded loans to attend these schools. In addition, Part IV will discuss the proposed "Gainful Employment" regulations. Part V will advance a framework for combating some of the problems of the industry, while still maintaining broad access to higher education in the United States.

II. BACKGROUND OF FEDERAL INVOLVEMENT IN HIGHER EDUCATION FUNDING

The appropriate level of federal involvement in higher education can be seen in terms of a cost-benefit analysis that weighs the resources expended on education against the societal benefits of an

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3. *See id.* at 1, 5-6, 8.

4. *See infra* Part IV (discussing the statutory and regulatory environment as it stands today).

5. *See* EMERGING RISK, *supra* note 1, at 8-9; *see also generally* sources cited *infra* note 148 (discussing lawsuits against for-profit schools regarding nontransferable credits).

6. *See, e.g.*, Press Release, U.S. Dep't of Educ., Department of Education Establishes New Student Aid Rules to Protect Borrowers and Taxpayers (Oct. 28, 2010), *available at* http://www.ed.gov/news/press-releases/department-education-establishes-new-student-aid-rules-protect-borrowers-and-tax.

educated populace.[7] From the earliest days of our nation, colleges and universities have received and relied upon government support.[8]

Significant federal involvement in higher education dates back to the Morrill Act of 1862, which granted land—the federal government's most abundant resource at that time—to the states so that they could establish colleges and universities.[9] Even this early step sought to achieve federal policy goals: the schools established pursuant to the First Morrill Act primarily taught agricultural and mechanical arts, an area of education that Congress felt was especially important to our nation at that time.[10] In 1890, Congress again provided assistance to higher education, this time granting money instead of land.[11] The Second Morrill Act pursued an additional policy objective of forbidding the use of race as an admissions criterion.[12]

The federal government's role in higher education increased following World War II. Faced with the prospect of millions of servicemen returning home after the war, Congress enacted the G.I. Bill of Rights ("G.I. Bill") in 1944.[13] The G.I. Bill was hugely successful, with $5.5 billion in funds being disbursed and 2.2 million out of 14 million returning veterans taking advantage of the bill.[14] The G.I. Bill contained two features that made it look more like modern financial aid and less like the earlier federal involvement. First, the funds were portable, meaning that an eligible student could use them at any qualifying institution.[15] This marked a first step in providing aid directly to students, rather than the earlier,

7. *See generally* Julie Margetta Morgan, *Consumer-Driven Reform of Higher Education*: *A Critical Look at New Amendments to the Higher Education Act*, 17 J.L. & POL'Y 531, 536-43 (2009) (discussing the historical development of federal funding of higher education and the public policy goals behind it).

8. *See generally* John R. Thelin, *Higher Education and the Public Trough: A Historical Perspective*, *in* PUBLIC FUNDING OF HIGHER EDUCATION: CHANGING CONTEXTS AND NEW RATIONALES 21, 24-27 (Edward P. St. John & Michael D. Parsons eds., 2004) (describing early instances of government support for higher education in colonies and a young America).

9. First Morrill Act, ch. 130, 12 Stat. 503 (1862) (codified as amended at 7 U.S.C. §§ 301-308 (2006)).

10. Thelin, *supra* note 8, at 27. These early land grants are the source of the A&M acronym. *Id*.

11. *See* Second Morrill Act, ch. 841, 26 Stat. 417 (1890) (codified as amended at 7 U.S.C. §§ 321-326a, 328-329 (2006)).

12. *Id*. § 323. The 1890 Act did, however, allow the establishment of separate colleges for white and black students as long as the funds were divided in a "just and equitable" manner. *Id*.

13. *See* Thelin, *supra* note 8, at 31. The G.I. Bill was officially titled the Servicemen's Readjustment Act of 1944 (G.I. Bill), Pub. L. No. 78-346, 58 Stat. 284 (codified as amended in scattered sections of 38 U.S.C.).

14. *See* Thelin, *supra* note 8, at 31.

15. *Id*.

top-down approach of providing funding to the colleges themselves.[16] Second, the G.I. Bill was an entitlement—the government provided funding for any student who met the conditions laid out in the bill.[17] These features ultimately made the G.I. Bill a huge success—8 million World War II veterans eventually took advantage of the G.I. Bill and went to college using G.I. Bill funding.[18] Further, the G.I. Bill helped spur a 78% increase in total college enrollment—from 1.5 million students in 1940, to 2.7 million students in 1950.[19]

The next major step for federal government involvement in higher education funding,[20] and the most important for the purposes of this Note, was the passage of the Higher Education Act of 1965 ("Higher Education Act" or "Act").[21] The Higher Education Act was an integral piece of the "Great Society" legislation championed by President Lyndon Johnson, who felt that increased educational opportunities could change the lives of people in the lower and middle classes.[22] The Act was composed of Titles I-VII, but the most significant and far-reaching part of the Act was Title IV—the Student Assistance Act, which provided financial aid funds directly to students for the purpose of pursuing higher education.[23]

Title IV of the Higher Education Act was the first aid program for college students that was generally available.[24] The two main elements of Title IV are federal grants and federally-backed loans.[25]

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16. *See id.*; Stephen S. Dunham, *Government Regulation of Higher Education: The Elephant in the Middle of the Room*, 36 J.C. & U.L. 749, 752-54 (2010) (explaining various purposes of federal funding of colleges).

17. Thelin, *supra* note 8, at 31.

18. *The Federal Role in Education*, U.S. DEP'T OF EDUC., http://www2.ed.gov/about/overview/fed/role.html (last visited Nov. 11, 2011).

19. ANGELICA CERVANTES ET AL., TG RESEARCH & ANALYTICAL SERV., OPENING THE DOORS TO HIGHER EDUCATION: PERSPECTIVES ON THE HIGHER EDUCATION ACT 40 YEARS LATER 10 (2005), *available at* http://www.tgslc.org/pdf/HEA_History.pdf.

20. A less significant example of federal involvement in secondary education was the 1958 National Defense Education Act. National Defense Education Act of 1958, Pub. L. No. 85-864, 72 Stat. 1580 (codified as amended in scattered sections of 20 U.S.C.). Congress passed this bill following the Soviet launch of Sputnik in order to encourage American students to pursue degrees in technology and science. *See* CERVANTES, *supra* note 19, at 11.

21. Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219 (codified as amended in scattered sections of 20 U.S.C.).

22. *See* CERVANTES, *supra* note 19, at 17. President Johnson felt that any potential student who was denied an education because of lack of financial resources was a waste of "human capital." *Id*. at 18.

23. 20 U.S.C. § 1070 (2006).

24. *See* CERVANTES, *supra* note 19, at 20. Prior federal aid programs were aimed at specific groups of students—for example, the veterans that were targeted by the G.I. Bill—or were aimed at certain study areas—such as the National Defense Education Act, which gave aid to students pursuing degrees in science and technology. *Id*.

25. *See id.* ("The two most important elements of Title IV were federal

"[G]rants were primarily intended for low-income students, while loans were targeted towards the middle-class."[26] While this may have once been the case, the importance of loans has ballooned and now represents the largest source of college funding, even for low-income students.[27]

The federal loan program enacted in Title IV—now known as the Federal Family Education Loan Program ("FFELP")—provided that the government would guarantee loans made to students by private lenders.[28] There was initially no direct lending by the federal government,[29] but in 1992, Congress created a pilot program where the federal government would lend directly to students.[30] When the credit markets were disrupted in 2008 and 2009, it became difficult for private lenders to find funding for their loans, and as a result, colleges and universities began to switch to the Federal Direct Loan Program.[31] In 2010 Congress acted to completely eliminate guarantees for private loans—all federal student loans are now made directly by the federal government.[32]

As it stands, federal involvement in higher education funding is massive. The Federal Pell Grant Program disbursed $18.3 billion in funds in 2009,[33] while total "financial aid for students exceeded $95 billion."[34] Approximately one-quarter of Pell grants in 2009 went toward students that attended for-profit institutions.[35]

'scholarships' or grants, and federally insured loans with subsidies on interest for eligible full-time students.").

26. *Id*. In fact, President Johnson felt that the creation of a federal loan program for the middle class would help to ensure the political survival of the grant program for the lower-class. *Id.* at 24. But as is discussed in Part III.B, *infra*, low-income students, especially low-income students at for-profit colleges, now rely predominantly on loans to finance their education.

27. *Id.* at 20.

28. *Federal Student Loan Programs – History*, NEW AMERICA FOUNDATION (May 10, 2011, 2:22 PM), http://febp.newamerica.net/background-analysis/federal-student-loan-programs-history.

29. *See id*. The initial aversion to direct lending was due in large part to government accounting rules: "[A] direct loan would have to show up in the budget as a total loss in the year it was made," while a guarantee has no apparent up-front cost and is accounted for only in later years when the government is actually forced to make payments on its guarantees. *See id.*

30. *Id*.

31. *See id*.

32. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §§ 2201-2213, 124 Stat. 1029 (codified as amended in scattered sections of 20 U.S.C.).

33. EMERGING RISK, *supra* note 1, at 3.

34. Dunham, *supra* note 16, at 754.

35. EMERGING RISK, *supra* note 1, at 3.

III. BACKGROUND OF THE FOR-PROFIT EDUCATION INDUSTRY

A. General

The modern for-profit college industry can trace its roots back to the late nineteenth century, when for-profit business and manufacturing schools began to arise as significant suppliers of secondary education.[36] Growth in the industry accelerated upon the passage of the G.I. Bill, which allowed students to use their tuition grants at for-profit schools.[37] The 1972 reauthorization of the Higher Education Act of 1965 further supported the growth of the industry by allowing tuition subsidies, such as what later became known as the Pell Grant, to be used by students enrolled at for-profit colleges.[38]

This increased availability of funding for students at for-profit schools led to the first major scandal in the industry—the nonaccredited "diploma mills" that arose in the 1970s.[39] These schools required minimal academic work (or none at all) and simply awarded degrees based on factors such as past "life experience."[40] Tuition was often paid for with federal money.[41] In response, the FBI launched an investigation (Operation DipScam) that resulted in the closure of many of the worst offenders and in the imprisonment of many of the operators.[42]

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36. DANIEL L. BENNETT, ADAM R. LUCCHESI & RICHARD K. VEDDER, CTR. FOR COLL. AFFORDABILITY & PRODUCTIVITY, FOR-PROFIT HIGHER EDUCATION: GROWTH, INNOVATION AND REGULATION 9 (2010), *available at* http://www.centerforcollegeaffordability.org/uploads/ForProfit_HigherEd.pdf. The 1862 Morrill Act's goal of establishing schools of agriculture and manufacturing implies that manufacturing education was in short supply at this time. *See* Thelin, *supra* note 8 and accompanying text.

37. Servicemen's Readjustment Act of 1944 (G.I. Bill), Pub. L. No. 78-346, 58 Stat. 284 §§ 400-403 (codified as amended in scattered sections of 38 U.S.C.); *see* BENNETT, LUCCHESI & VEDDER, *supra* note 36.

38. BENNETT, LUCCHESI & VEDDER, *supra* note 36.

39. *Id*. at 9, 38; *see generally* Beverly Gerber, *Diploma Mills in the Cyberage*, TRAINING MAGAZINE, June 1, 1999, at 48, *available at* http://wdr.doleta.gov/research/rlib_doc.cfm?docn=5950. While there is no clear-cut definition of a "diploma mill," generally a diploma mill will award diplomas to applicants simply upon receiving money from them. A more recent diploma mill scandal arose in 2004 when it was revealed that senior federal employees—some of whom were responsible for nuclear weapons safety—used taxpayer money to fund their diploma mill degrees. These degrees did not require any of the awardees to attend any actual classes, but they simply required the payment of several thousand dollars. *Some Federal Workers Have Fake Degrees*, MSNBC.COM (May 11, 2004, 10:38 AM), http://www.msnbc.msn.com/id/4951979/ns/us_news/ [hereinafter *Fake Degrees*].

40. *Fake Degrees*, *supra* note 39.

41. *See* BENNETT, LUCCHESI & VEDDER, *supra* note 36.

42. John Bear & Mariah Bear, *Degree Mills*, QUACKWATCH, http://www.quackwatch.com/04ConsumerEducation/dm0.html (last modified Nov. 14, 2004). The "diploma mills" of the late 1980s spurred Congress to enact the 85/15 Rule—the precursor to the current 90/10 Rule—in order to prevent some of the abuses.

The FBI crackdown on the "diploma mills" in the 1980s led to a temporary lull in the growth of the for-profit education industry. Total student enrollment at for-profit schools was essentially flat in the years between 1986 and 1993.[43] More significantly, the share of federal money that went to the for-profit education industry declined dramatically—in 1987 approximately one-quarter of all federal assistance in the form of grants and loans went to for-profit colleges, but by 1998 that number had declined to just above 10 percent.[44]

While the industry stalled out for most of the 1990s, the growth began anew in the 2000s. In fact, the for-profit college industry has seen tremendous growth over the last decade. The number of students enrolled at for-profit colleges and universities has more than tripled to 1.8 million in 2008.[45] For-profit colleges now represent more than 25 percent of all institutions in the country; a decade ago the number was less than 10 percent.[46] The for-profit education industry has also seen a commensurate increase in the amount of federal student loan money going to its students: 23.6 percent of Federal Pell Grants in 2008-09 went to for-profit schools[47], while 23.5 percent of all federal loans went to for-profit schools.[48] Both these figures are roughly double what they were a decade ago.[49]

The past decade has also seen the emergence of the modern for-profit behemoth—a large, publicly-traded company that offers a wide array of degrees,[50] enrolls a very large number of students, and earns

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See infra note 164.

43. *See* BENNETT, LUCCHESI & VEDDER, *supra* note 36, at 10.

44. Steven Eisman, FrontPoint Partners, For Profit Education: Subprime Goes to College, Presentation at the Ira Sohn Conference 9 (May 26, 2010), *available at* http://www.marketfolly.com/2010/05/steve-eisman-frontpoint-partners-ira.html. The total dollar amount of federal money going to for-profit schools stayed roughly level—the for-profit industry saw $3.4 billion in federal money in 1989 and $3.5 billion in 1999. *Id*. However, the amount of federal assistance to students grew dramatically during this time, increasing from $12.7 billion in total grants and loans in 1989 to $34.4 billion in aggregate funding by 1999. *Id*.

45. *See* EMERGING RISK, *supra* note 1, at 2 (noting that in 1998, nearly 600,000 students enrolled in for-profit schools).

46. U.S. DEP'T OF EDUC. INST. OF EDUC. SCIS., DIGEST OF EDUCATION STATISTICS tbl.226 (2010), *available at* http://nces.ed.gov/programs/digest/d10/tables/dt10_226.asp.

47. *See* EMERGING RISK, *supra* note 1, at 3 (noting that $4.3 billion out of $18.3 billion in federal Pell grants go to for-profit schools).

48. *See id.* (noting that $19.6 billion in federal student loans go to students at for-profit schools).

49. *See id.* More specifically, in 1998, 12 percent of Pell Grant money and 9 percent of federal loan money was awarded to students at for-profit schools. Eisman, *supra* note 44, at 9.

50. *See, e.g.*, *Degree and Continuing Education Programs*, UNIVERSITY OF PHOENIX, http://www.phoenix.edu/programs/degree-programs.html (last visited Dec. 30, 2011) (providing a range of certificate programs along with associate, bachelor, and graduate degree programs).

a significant amount of revenues and profits. For example, Apollo Group—the parent company of the University of Phoenix and the largest of the for-profit schools—had 438,100 students enrolled as of November 30, 2010,[51] and had revenues of $4.9 billion as of its fiscal year ended August 31, 2010.[52] As a group, the five largest for-profit schools had revenues of $12 billion and net income of $1.34 billion in 2009.[53] And the industry has been largely unscathed by the recent economic recession, for-profit colleges for the most part are recording record enrollment and profits.[54]

B. For-Profit Schools Are the Most Expensive Option, yet Cater to Students with the Least Ability to Pay

Tuition at for-profit colleges is significantly higher than tuition at traditional institutions. Average annual tuition at a for-profit school is about $14,000 per year, while tuition averages $7,000 at a four-year public college and $2,500 at a community college.[55] Students increasingly pay these higher costs by taking on debt.[56]

Alternatively, instead of simply looking at average tuition expenses, the costs can be viewed based on the student's cost to attain a certain degree, and the numbers appear even worse when viewed this way. For example, an associate's degree in business administration would cost around $33,000 from the for-profit Kaplan University, but the same degree from a nearby community college would cost approximately $8,500.[57]

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51. Press Release, Apollo Group, Inc., Apollo Group, Inc. Reports Fiscal 2011 First Quarter Results (Jan. 10, 2011), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=79624&p=irol-newsArticle&ID=1514649&highlight=.

52. Press Release, Apollo Group, Inc., Apollo Group, Inc. Reports Fiscal 2010 Fourth Quarter and Year End Results (Oct. 13, 2010), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=79624&p=irolnewsArticle&ID=1482376&highlight=.

53. *See* Apollo Group, Inc., Annual Report (Form 10-K) (Oct. 27, 2009); DeVry Inc., Annual Report (Form 10-K) (Aug. 25, 2010); Educ. Mgmt. Corp., Annual Report (Form 10-K) (Sept. 1, 2010); Career Educ. Corp., Annual Report (Form 10-K) (Feb. 25, 2010); Corinthian Colleges, Inc., Annual Report (Form 10-K) (Aug. 23, 2010).

54. S. COMM. ON HEALTH, EDUC., LABOR & PENSIONS, THE RETURN ON THE FEDERAL INVESTMENT IN FOR-PROFIT EDUCATION: DEBT WITHOUT A DIPLOMA 2, 4-5 (2010), *available at* http://harkin.senate.gov/documents/pdf/4ca4972da5082.pdf ("[O]ne company doubled its profits from . . . $235 million to $411 million," and another started the 2007 school year with 8,342 students and enrolled an additional 160,000 students).

55. EMERGING RISK, *supra* note 1, at 8-9.

56. *See id.* ("96 percent of for-profit students who graduated in 2008 took out student loans.").

57. *See* Julie Margetta Morgan, *The Real Cost of For-Profit Education: Regulating For-Profit Institutions*, CTR. FOR AM. PROGRESS (Sept. 30, 2010), http://www.americanprogress.org/issues/2010/09/forprofit_regulation.html. These numbers, however, may not be as striking when one accounts for the costs of direct public support of the

Not only do for-profit schools cost more than traditional schools, a larger percentage of students who attend for-profit schools come from backgrounds that tend to increase those students' chances of defaulting on their education debt.[58] The Government Accounting Office ("GAO") has identified several risk factors for an increased risk of defaulting on student loans: lower-income students are at a higher risk, students whose parents have a lower level of education are at higher risk, and older students are also at a higher risk.[59] For-profit colleges have proportionally more of these at-risk students.[60]

As for the first risk factor, it should not be surprising that lower-income students are at a higher risk of defaulting on their student loans than higher-income students. And while it might be expected that students of lesser financial means would tend to gravitate towards the least expensive educational options, the reverse has

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community college. *See id.* In this case, Morgan claims that the cost of the community college degree increases to $16,500 when public support is factored in. *Id.* So while the community college degree is still less expensive, the true gap may be not be as large as it seems. The for-profit industry has tried to highlight the full level of taxpayer support that public and private institutions receive, in order to more accurately compare the costs of an education at various types of institutions. *See, e.g.*, ROBERT J. SHAPIRO & NAM D. PHAM, SONECON, TAXPAYERS' COSTS TO SUPPORT HIGHER EDUCATION: A COMPARISON OF PUBLIC, PRIVATE NOT-FOR-PROFIT, AND PRIVATE FOR-PROFIT INSTITUTIONS 1 (2010), *available at* http://www.sonecon.com/docs/studies/Report_on_Taxpayer_Costs_for_Higher_Education-Shapiro-Pham_Sept_2010.pdf ("For every $1 in direct government support for private for-profit institutions, per-student, at federal, state and local levels, private not-for-profit institutions receive $8.69 per-student and public institutions receive $19.38 per-student.").

58. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-600, PROPRIETARY SCHOOLS: STRONGER DEPARTMENT OF EDUCATION OVERSIGHT NEEDED TO HELP ENSURE ONLY ELIGIBLE STUDENTS RECEIVE FEDERAL STUDENT AID 19-20 (2009) [hereinafter PROPRIETARY SCHOOLS], *available at* http://www.gao.gov/new.items/d09600.pdf. It should also be noted that despite the great burden that student debt can create, student loan debt is very difficult to discharge through bankruptcy proceedings. *See* 11 U.S.C. § 523(a)(8) (2006). A bankrupt debtor can discharge student loan debt only upon a showing that repayment of the student loan debt would constitute an "undue hardship." *Id.* Congress has not defined this term, but a general rule to show an "undue hardship" has been adopted by the Second Circuit: "(1) that the debtor cannot maintain . . . a 'minimal' standard of living . . . ; (2) that additional circumstances exist indicating that this state of affairs is likely to persist . . . ; and (3) that the debtor has made good faith efforts to repay the loans." Brunner v. N.Y. State Higher Educ. Serv. Corp., 831 F.2d 395, 396 (2d Cir. 1987). The "undue hardship" test is strict and does not offer much practical relief for student debtors. As a result, taking on excessive amounts of educational debt to attend college can truly have lifelong negative consequences. *See generally* Rafael I. Pardo & Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Educational Debt*, 74 U. CIN. L. REV. 405, 441-76 (2005) (using empirical data to highlight the practical difficulty of discharging student debt).

59. *See* PROPRIETARY SCHOOLS, *supra* note 58.

60. *See id.*

actually been the case.[61] In fact, the income gap between students at for-profit schools compared to traditional schools is staggering. Students at for-profit schools have an annual median family income of only $24,300, a full 40 percent less than the median income among students at public colleges, and less than half of the median income for students at private universities.[62]

The GAO also found that having parents who do not themselves have a college degree is "closely linked" to increased risk of student defaults.[63] Similar to the median-income statistic, students at for-profit colleges also trail badly for this risk factor. While 52 percent and 61 percent of students at public colleges and private institutions, respectively, have a parent with at least an associate's degree, that number is only 37 percent for students at for-profit colleges.[64]

In addition to the above two risk factors, the GAO found that older students were at a higher risk of defaulting on their student loans, as were students who dropped out of their degree programs before completion.[65] Again, for-profit universities have enrolled an outsized proportion of these two additional types of at-risk borrowers. First, students at for-profit schools are older on average than at traditional institutions (with more than half being above twenty-five years old).[66] Furthermore, the GAO found that students at for-profit universities are more likely to drop out, are less likely to graduate, and when these students do graduate, it takes them longer on average to do so.[67]

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61. *See id.*; EMERGING RISK, *supra* note 1, at 8-9.

62. PROPRIETARY SCHOOLS, *supra* note 58, at 20. Median family income for students at public institutions was $40,400 as of 2004; the number was $49,200 for students at private universities. *Id*.

63. *Id.* at 19.

64. *Id.* at 19-20.

65. *Id.* 20.

66. *See id*. The GAO noted that older students are more likely to have other significant financial obligations besides paying for college—such as mortgage payments or child care expenses—and that these additional obligations create a heightened risk of default. *Id.*

67. *Id*. at 20-21. Another interesting aspect of the GAO's findings is that while finishing a degree program is an important factor in minimizing default rates, finishing a certificate or a license program was not highly correlated with lower default rates, leading to the inference that these types of programs do not substantially benefit the student who earns the certificate or license. *See id*. at 21. Of course, for-profit schools offer an outsized number of license or certificate programs, as opposed to degree programs, when compared to traditional institutions. *See id*. at 6 (finding that for-profit schools award "a small percentage of bachelor's degrees and above, but a substantial percentage of certificates" compared to the total number of schools).

C. The Industry Has Engaged in Questionable and Fraudulent Recruiting Practices

Given the fact that colleges get paid regardless of whether a student graduates, it should not be surprising that there is a focus on getting bodies in the door. As a result, the industry has been accused of using aggressive, misleading, and even fraudulent recruiting practices. This can lead to even worse student outcomes: not only are students paying more for their degree, the degree may not even qualify the students for the types of opportunities that they are seeking and for which were told they would qualify.

Stories of angry students are not hard to come by. For example, students studying medical assisting at the for-profit Everest College in Hayward, California, were told that if they paid $16,000 for an eight-month course, they would obtain a certification that would enable them to land a job in the medical field.[68] It was only after paying their nonrefundable tuition that students learned that Everest College's program was not accredited by the American Association of Medical Assistants, and as a result, they would be unable to get a job in the medical field or even transfer their credits to a community college or four-year school.[69]

An undercover investigation by the GAO supports many of these complaints.[70] Financial aid officers employed by for-profit colleges encouraged undercover investigators to make fraudulent misstatements on financial aid forms so that they could qualify for federal loans.[71] This investigation also uncovered instances where school employees lied about their school's accreditation, graduation rate, employment prospects, expected salaries, and the duration and cost of the program the student wished to enroll in.[72]

The drive for students is so intense that for-profit schools have even recruited out of homeless shelters.[73] For example, as of 2010, 5

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68. Tomas Roman, *Everest College Students Angry Over Certification*, ABC LOCAL NEWS (Mar. 19, 2010), http://abclocal.go.com/kgo/story?section=news/local/east_bay&id=7339903.

69. See *id*. Everest College is accredited—but by the Accrediting Commission of Career Schools and Colleges. *Id*. For a discussion of the problems posed by lack of accreditation oversight, see Part IV *infra*.

70. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-948T, FOR-PROFIT COLLEGES: UNDERCOVER TESTING FINDS COLLEGES ENCOURAGED FRAUD AND ENGAGED IN DECEPTIVE AND QUESTIONABLE MARKETING PRACTICES (2010) (revealing what the GAO found in its undercover tests), *available at* http://www.gao.gov/new.items/d10948t.pdf.

71. *Id.* at 7. The investigators were told by financial aid officers to fraudulently conceal a $250,000 inheritance they had recently received and to overstate the number of dependents that they had. *Id.*

72. *Id.* at 9.

73. *See* Daniel Golden, *The Homeless at College*, BLOOMBERG BUSINESSWEEK (Apr.

percent of the student body of Newark, New Jersey-based Drake College of Business was made up of homeless students.[74] While Drake claims they are simply "reaching out to the disadvantaged," it is troubling that Drake drives enrollment at its school by paying a $350 biweekly stipend.[75] The stipend is a keen marketing tool (especially to the homeless), and in the meantime, Drake charges a $15,700 annual tuition, 87 percent of which is funded by federal loans and grants.[76] While it would seem that homeless students would be at a great risk of default, the risk is borne by the taxpayer—once Drake receives the tuition money, the college no longer shares in any downside risk.[77]

D. The Cost to Taxpayers of the Current System

As has been shown, for-profit schools receive significantly more in tuition money than their traditional counterparts. Where does this extra money go? If the extra money goes towards student education then the industry would have a legitimate defense to criticisms; however, as will be shown, the increased tuition largely goes to pay shareholders and management. For-profit colleges are vastly profitable for their owners and management, yet the taxpayer takes all the downside risk by providing loan guarantees.

First, consider the amount that has been paid to the executive teams at the six largest for-profit schools. From 2008 to 2010, executives at these corporations received compensation totaling $232 million.[78] When proceeds from stock sales are added to these figures, the number becomes even more staggering: a Bloomberg report states that the executives at the fifteen largest publicly-traded for-profit colleges reaped $2 billion in proceeds from selling company

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30, 2010, 11:00 AM), http://www.businessweek.com/magazine/content/10_19/b41770642197331.htm.

74. *See* Daniel Golden & John Hechinger, *For-Profit N.J. College Halts Recruiting of Homeless*, BLOOMBERG BUSINESSWEEK (May 5, 2010, 3:14 PM), http://www.bloomberg.com/news/2010-05-05/drake-for-profit-college-in-new-jersey-will-stop-recruitment-of-homeless.html.

75. *Id*.

76. *See id*.

77. *See id*. "Moral hazard," or the situation where an institution is not exposed to the downside risk that it creates, has been widely cited as a contributing cause to the 2008 financial crisis, and the analogy here seems clear. *See, e.g.*, Kevin Dowd, *Moral Hazard and the Financial Crisis*, 29 CATO J. 141 (2009) (discussing the impact of moral hazard on the financial crisis).

78. *See* Apollo Grp., Inc., Information Statement (Form DEF-14C) (Dec. 21, 2010); DeVry, Inc., Proxy Statement (Form DEF-14A) (Oct. 8, 2010); Educ. Mgmt. Corp., Proxy Statement (Form DEF-14A) (Oct. 6, 2010); Career Educ. Corp., Proxy Statement (Form DEF-14A) (Apr. 1, 2010); Corinthian Colleges, Inc., Proxy Statement (Form DEF-14A) (Oct. 15, 2010); Strayer Educ., Inc., Proxy Statement (Form DEF-14A) (Feb. 26, 2010).

stock in the seven-year period from 2003 to 2010.[79]

In addition, for-profit colleges expend substantially more on noneducational expenses than do traditional institutions. For example, Apollo Group—the parent company of the University of Phoenix—recorded $4.9 billion in revenues in their 2010 fiscal year.[80] Of this amount, only $2.1 billion—roughly 43 percent of the total—went to actual education and instruction. The remainder went to marketing, management salaries, and shareholders.[81] This compares to traditional institutions that devote 60-70 percent of total spending to education and student services.[82] This additional spending on noneducation items means that the Apollo Group alone cost taxpayers over $1 billion additional dollars compared to a college that devoted 70 percent of spending to education. A similar analysis for the five largest for-profit schools as a group shows that the extra noneducation spending costs taxpayers over $3 billion annually.

IV. THE CURRENT REGULATORY ENVIRONMENT

A. The Accreditation Requirement

In 2005, Franciscan University of the Prairies was struggling financially and had less than 500 students remaining on its sole campus in Clinton, Iowa.[83] Rather than shut down, the eighty-seven year-old Catholic institution sold itself to Bridgepoint Education, a for-profit corporation that was founded in 1999.[84] Bridgepoint changed the name of the school to Ashford University and quickly began to enroll students in online-only degree programs.[85] Five years later, Ashford University enrolled 45,000[86] students and was the main profit engine for Bridgepoint—a public corporation with annual

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79. John Hechinger & John Lauerman, *Executives Collect $2 Billion Running U.S. For-Profit Colleges*, BLOOMBERG (Nov. 10, 2010, 12:02 AM), http://www.bloomberg.com/news/2010-11-10/executives-collect-2-billion-running-for-profit-colleges-on-taxpayer-dime.html.

80. Apollo Group, Inc., Annual Report (Form 10-K) 103 (Oct. 20, 2010). Of this $4.9 billion figure, approximately $4.2 billion came from federal funding. *See id.* at 23.

81. *Id.* at 103.

82. *See* DONNA M. DESROCHERS ET AL., TRENDS IN COLLEGE SPENDING 1998-2008: WHERE DOES THE MONEY COME FROM? WHERE DOES IT GO? WHAT DOES IT BUY? 22-23 (2010), *available at* http://www.deltacostproject.org/resources/pdf/Trends-in-College-Spending-98-08.pdf.

83. Scott Jaschik, *A For-Profit Buys a Catholic College*, INSIDE HIGHER ED (Mar. 2, 2005, 4:00 AM), http://www.insidehighered.com/news/2005/03/02/forprofit3_2.

84. *Id.*

85. *See* Doug Lederman, *Looking West*, INSIDE HIGHER ED (Sept. 24, 2010, 3:00 AM), http://www.insidehighered.com/news/2010/09/24/ashford.

86. *Id.* Forty-five thousand of Bridgepoint's 53,000 students are enrolled at Ashford University. *See* Ann McGlynn, *Ashford University's Parent Company Sees Enrollment Figures Grow*, QUAD CITY TIMES, (Aug. 24, 2009, 4:00 AM), http://qctimes.com/news/local/article_80fc6bac-904f-11de-b85a-001cc4c03286.html.

profits that exceed $46 million and that paid its top five executives nearly $37 million in 2009.[87]

How did Bridgepoint turn a struggling college into the backbone of a large corporate enterprise? The first answer is debt—like the rest of the industry, Ashford's growth was largely funded by federal Title IV funding.[88] But why purchase Franciscan University when Bridgepoint could just as easily have started its own school? Bridgepoint coveted Franciscan's most valuable asset. This asset was not its faculty, its campus, or its student body; rather, it was Franciscan's regional accreditation.

To be eligible for federal financial aid, an institution must be accredited by a regional accreditation agency.[89] So while Bridgepoint could have launched a new institution and sought accreditation, this process would have taken time—a new institution must go through an intensive process that lasts at least several years before it can be accredited.[90] By purchasing Franciscan University, Bridgepoint was able to purchase its accreditation and was therefore able to immediately begin enrolling tens of thousands of students in its online degree programs.

Some regional accreditation agencies have begun to clamp down on accreditation shopping,[91] but true change will not be possible without federal oversight of accreditation standards. Ashford University and its accreditor—The Higher Learning Commission of the North Central Association of Colleges and Schools ("HLC")—are cases in point. To combat accreditation shopping, the HLC implemented new "change of control" policies in July 2010 that will subject a school to intensive scrutiny if it plans to significantly

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87. *See* Bridgepoint Educ., Inc., Proxy Statement (Form DEF-14A) 31 (Apr. 12, 2010).

88. *See* Bridgepoint Educ., Inc., Annual Report (Form 10-K) 33 (Mar. 2, 2010) (indicating that greater than 85 percent of total revenues in 2007, 2008, and 2009 came from federal Title IV funding).

89. Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219 (codified as amended at 20 U.S.C. § 1002(b)(1)(A)(ii)(II) (2006)) (an institution must be "accredited by a recognized regional accrediting agency or association, and ha[ve] continuously held such accreditation since October 1, 2007, or earlier").

90. For example, the Higher Learning Commission of the North Central Association of Colleges and Schools—the agency that accredited Franciscan University and that continued to accredit the institution after it was purchased by Bridgepoint and changed to Ashford University—requires a four-year candidacy period before a school can be initially accredited. THE HIGHER LEARNING COMM'N, INSTITUTIONAL ACCREDITATION: AN OVERVIEW 7 (2010), *available at* https://content.springcm.com/content/DownloadDocuments.ashx?Selection=Document%2C19508682%3B&accountId=5968.

91. *See, e.g.*, Scott Jaschik, *Standing Up to 'Accreditation Shopping,'* INSIDE HIGHER ED (July 1, 2010, 3:00 AM), http://www.insidehighered.com/news/2010/07/01/hlc.

change its mission, significantly alter its student body composition, or expand its online degree programs to the point where more than half of the courses in a program are taught online.[92] A school triggering this scrutiny will be subject to review by the Commission and will be required to demonstrate that its primary mission will remain the same.[93]

The HLC quickly followed through on its promise to crack down on the practice of accreditation shopping.[94] Dana College, in Blair, Nebraska, was on the brink of failure when it reached an agreement to be purchased by two for-profit education companies.[95] This transaction triggered the HLC's newly adopted change-of-control scrutiny.[96] After review, the HLC denied continuing accreditation because the HLC Board found that the for-profit purchasers of the school could not demonstrate that the mission of the college would remain the same, could not show that the integrity of the school would be preserved, could not demonstrate that the school could be restored to profitability without recruitment of a substantial number of online-only students,[97] and could not show a likelihood that the institution would continue to be eligible for accreditation.[98] Significantly, Dana College was eventually forced to close because of the HLC's decision to deny accreditation to the potential purchasers.[99] The HLC also denied the continuing accreditation of Rochester College in Michigan after it had reached an agreement to be purchased by a group of for-profit investors and placed certain requirements on Iowa's Waldorf College in order to prevent the school from drifting too far from its current liberal arts focus.[100]

Ashford's response to this increased scrutiny by its accreditor was simply to change accreditation agencies.[101] Only months after the HLC denied accreditation to Dana College and Rochester College,

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92. *See* THE HIGHER LEARNING COMM'N, OVERVIEW OF COMMISSION POLICIES AND PROCEDURES FOR INSTITUTIONAL CHANGES REQUIRING COMMISSION NOTIFICATION OR APPROVAL 1-2, (2011), *available at* https://content.springcm.com/content/DownloadDocuments.ashx?Selection=Document%2C23798084%3B&accountId=5968.

93. *See id.* at 8-9.

94. *See* Jaschik, *supra* note 91 (reporting on the HLC's rejection of two "change of control" requests).

95. Kevin Abourezk, *Dana College in Blair to Close*, LINCOLN J. STAR (June 30, 2010, 9:55 AM), http://www.journalstar.com/news/state-and-regional/nebraska/article_d83eb3e0-847b-11df-9040-001cc4c03286.html.

96. *See id.*

97. *Id.*

98. THE HIGHER LEARNING COMM'N, PUBLIC DISCLOSURE NOTICE ON DANA COLLEGE 2 (2010), *available at* http://www.ncahlc.org/download/_PublicDisclosureNotices/PDN_1483.pdf.

99. Abourezk, *supra* note 95.

100. *See* Jaschik *supra* note 91.

101. *See* Lederman, *supra* note 85.

Ashworth suggested it was seeking accreditation from the Western Association of Schools and Colleges ("WASC").[102] Argosy University—a subsidiary of for-profit Education Management Corp.—also left the HLC after it began increased scrutiny of for-profit schools, and, like Ashworth, it also made the move to the WASC.[103] The ease of an online school in changing accreditation agencies—a school can merely open an office in a region covered by another regional accreditor—means that voluntary, agency-by-agency reform will not have a meaningful effect. There will always be an accreditor that is friendlier to for-profits than other accreditors, and for-profits will gravitate towards that accreditor. The HLC should be lauded for its efforts in stopping accreditation shopping and upholding academic integrity, but without comprehensive federal oversight, there cannot be any real reform in this area.

B. Current Standards in the Higher Education Act

The Higher Education Act sets baseline requirements for Title IV eligibility.[104] Any regulations would supplement, but would not override, these legislative standards.

First, under the so-called "90/10 rule," for-profit institutions must obtain at least 10 percent of their revenues from sources other than the Department of Education.[105] Any school that receives more than 90 percent of their total funding from the Education Department—be it student loans, Pell Grants, or other programs—would be in violation of the rule. An institution that violates the 90/10 rule for two years in a row will lose Title IV eligibility for at least the next two years.[106]

This rule essentially requires students to pay for at least 10 percent of their own education, rather than relying on federal assistance to pay for the full amount. Requiring students to pay even a minimal amount probably does serve to make them more sensitive to the price of tuition at schools and likely is a restraining factor on tuition increases and loan growth.

While it may not seem difficult for a college to get 10 percent of its funding from sources other than the Department of Education, most for-profit schools are currently very close to the 90 percent limit

102. *Id*.

103. *Id*. Argosy University was granted their initial accreditation with the WASC in June 2010. W. ASS'N OF SCH. & COLLS. ACCREDITING COMM'N FOR SENIOR COLLS. & UNIVS., COMMISSION ACTIONS JUNE 201, *available at* http://www.wascsenior.org/findit/files/forms/ Commission_Actions_Jun_2010.pdf.

104. Higher Education Act of 1965, 20 U.S.C. §§ 1070-1099e (2006) (amended 2008) (stating all requirements related to government assistance for students).

105. *See id.* § 1094(a)(24).

106. *See id.* § 1094(d)(2)(A).

and are in danger of being in violation of the rule.[107] For example, Apollo Group—the parent company of the University of Phoenix—received 88 percent of its funding through federal grants and loans in the year ending August 31, 2010.[108]

Second, institutions can lose eligibility if their students default on their loans at too high of a rate. The Act uses the so-called "cohort default rate" ("CDR") as the measure to determine continued eligibility.[109] The CDR measures the number of students who default on their loans within two fiscal years following the year that the loans enter repayment.[110] For example, in order to determine the 2008 CDR for a certain school, you would look at the pool of loans from that school that entered repayment in 2008 and then determine what percentage of those had been defaulted on by the end of 2010. This definition requires looking at default in three fiscal years—in the example above, 2008, 2009, and 2010 would be the relevant three years.

Under the Act, a program will lose eligibility for Title IV funding if its CDR exceeds a certain percentage—25 percent until 2011, and then 30 percent for 2012 and after—for three years in a row.[111] A program will also lose Title IV eligibility if its CDR exceeds 40 percent for a single year.[112] An institution that loses eligibility under

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107. *See* John Lauerman, *For-Profit Colleges Facing Loss of Taxpayer Funds Fighting Aid Limit*, BLOOMBERG (Jan. 12, 2011), http://www.bloomberg.com/news/2011-01-12/for-profit-colleges-facing-taxpayer-funds-loss-fight-aid-limit.html ("Education companies that get more than 90 percent of their revenue from the Education Department's student grants and loans for two years in a row may lose eligibility for the money under the law.").

108. *See id.* The for-profit education industry has been lobbying for relief from the 90/10 rule arguing that without congressional action they could risk losing their Title IV eligibility. *See id*. Congress has not yet acted but did, however, provide a $2,000 per student exemption at the onset of the financial crisis; this exemption expired in June of 2011. *See id*. Further, it is worth noting that the 90/10 rule was originally the 85/15 rule, but Congress relaxed the requirement with the 1998 reauthorization of the Act. *See* Higher Education Amendments of 1998, Pub. L. No. 105-244, 112 Stat. 1581. In addition, the 2008 reauthorization of the Act provided further a relaxation of the 90/10 rule: whereas previously a one-year violation of the rule would automatically result in loss of Title IV eligibility, the 2008 amendment provides that only two consecutive years of being in violation will result in a loss of eligibility, and only after a review by the Department of Education. *See generally* Jonathon Glass et al., *Higher Education Act Reauthorization: The 90/10 Rule*, DOW LOHNES (Aug. 5, 2008), http://www.dowlohnes.com/files/upload/HEA_advisory.pdf (explaining that the 2008 reauthorization of the Act grants significant relief from the 90/10 rule with more definitive guidelines).

109. *See* 20 U.S.C. § 1085(m).

110. *See id*.

111. *Id*. § 1085(a)(2).

112. *See* 34 C.F.R. § 668.187(a)(1) (2010).

this test cannot regain it for two additional years.[113]

It is worth highlighting that in the 2008 reauthorization of the Act, Congress changed the definition of CDR in a way that made it more onerous for the schools. While the current formula for CDR measures defaults in a three-year period after the loan enters repayment, the previous definition measured only the two-year period after repayment.[114] In order to partially compensate for this change in definition, the Act was also amended to increase the three-year violation threshold to 30 percent from the previous level of 25 percent.[115] This change will go into effect only after three full years of CDR data are available, i.e., the change will go into effect in 2011. In conjunction with the requirement that a school will lose eligibility only after three years of greater than 30 percent default rates, this means that 2014 is the earliest that a program can lose its eligibility under the revised 30 percent test (although a program could lose its eligibility under the 40 percent test following 2012).[116]

This change in definition is expected to have a significant impact on reported CDRs. To get a sense of the impact of the new rule, the Department of Education compiled statistics to show what the 2005-2007 CDRs would have been had the three-year definition been in effect at that time.[117] The statistics show that for-profit schools will be impacted significantly by this new definition.[118] To illustrate, the 2007 rate (the most recent year for which data are available) of for-profit institutions as a whole would have increased from 11.0 percent to 21.2 percent, a 93% increase in the number of defaults and a 10.2% increase in the CDR.[119] Had the new definition been in effect in 2007, 14.1 percent of for-profit campuses would have been above the 30 percent threshold at that time.[120]

Despite these changes, it still remains to be seen how large of an effect the 2008 amendments to the Higher Education Act will have on Title IV eligibility of for-profit schools. CDRs will undoubtedly go up, and, based on preliminary data, are likely to roughly double

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113. *See id.* § 668.187(b).

114. *See* Higher Education Opportunity Act, Pub. L. No. 110-315, § 436(e)(2)(B), 122 Stat. 3078, 3254 (2008) (codified as amended at 20 U.S.C. § 1085(e)(2) (2006)).

115. *See id.* § 436(a)(1)(A)(iii-iv).

116. *See id.*

117. *See Cohort Default Rates*, FINAID, http://www.finaid.org/loans/cohortdefaultrates.phtml (last updated Dec. 21, 2010) (tabulating Department of Education data).

118. *See id.*

119. *Id.* The data for traditional schools shows a smaller but still significant effect. For example, four-year public schools would see their 2007 CDR increase from 4.4 percent to 7.1 percent, and four-year private schools would see their CDR increase from 3.7 percent to 6.3 percent. *Id.*

120. *Id.*

based on the new three-year measurement period.[121] Even with this increase, none of the largest schools will be above the threshold. For example, Apollo Group—the largest for-profit college in the nation—recently reported that its latest CDR was 12.9 percent, even after seeing it increase over the past several years due to the weakening economy.[122] Doubling this rate to account for the changes would still leave Apollo Group below the 30 percent threshold. The result is similar for the next four largest schools—none will be above the 30 percent threshold even after doubling their CDRs.[123]

Even if the change in definition forces a school to report a CDR in excess of 30 percent, schools will have a variety of methods to mitigate the effect. First, because the revised definition will not come into effect until 2011, for-profit schools will have until 2014 to attempt to reduce their CDR in the event that it is above the threshold.[124] Second, the CDR is considered separately for each campus; thus, a college with multiple campuses may only be at risk of losing Title IV eligibility to a fraction of the college's entire enrollment.[125] Third, colleges with multiple locations will be able to transfer certain programs from campuses with a high default rate to campuses with a low default rate in order to "average down" the default rate at a high-default campus.[126]

C. The Proposed Regulations

The "Gainful Employment" regulations would require proprietary schools to meet two additional tests in order to remain eligible for funding: a debt-to-income test and a repayment rate

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121. According to the Department of Education data, under the new definition, cohort defaults at for-profit institutions would have increased 93% in 2007, 100% in 2006, and 115% in 2005. *Id.* Thus, it seems likely that, going forward, the CDR will roughly double once the new definition is put into place.

122. *See* Apollo Group, Inc., Quarterly Report (Form 10-K) 33 (Jan. 10, 2011) (noting that 2008 is the latest year for which official Department of Education default rate statistics were available).

123. The next four largest for-profit schools are DeVry Inc. (9.0% cohort default rate using the 2-year definition), Education Management Corp. (7.5%), Career Education Corp. (19.6% estimate using the three-year definition), and Corinthian Colleges, Inc. (9%-12% estimated using the two-year definition). *See* Devry Inc., Annual Report (Form 10-K) 54 (Aug. 25, 2010); Educ. Mgmt. Corp., Annual Report (Form 10-K) 50 (Sep. 1, 2010); Career Educ. Corp., Current Report (Form 8-K) 3 (Dec. 14, 2009); Press Release, Corinthian Colleges, Inc., Corinthian Colleges Updates Guidance for Q3 11 New Student Enrollment and Provides Estimated Average 2010 Cohort Default Rate (Mar. 14, 2011), *available at* http://newsroom.cci.edu/releasedetail.cfm?ReleaseID=557668.

124. *See Cohort Default Rates*, *supra* note 117.

125. *See id.*

126. *Id*. In addition, "[i]f a college is unable to improve the default rates at one of its schools, the college could always choose to opt-out the at-risk schools from the federal loan programs in order to preserve eligibility for the Pell Grant program." *Id.*

test.[127] A program that passes both tests would retain eligibility without restrictions, while a program that fails both tests would lose access to Title IV funding.[128] A program that fails one test but passes the other would have restricted eligibility.[129]

The proposed repayment test requires that students who attended a program repay at least 45 percent of their loans in the aggregate.[130] A loan is in "repayment" as long as the borrower has made principal payments in the recent fiscal year.[131] A program with a repayment rate below 45 percent, but above 35 percent, would retain eligibility with certain restrictions placed on it.[132] A program with a repayment rate below 35 percent may lose eligibility, but only if it also fails the debt-to-income test.[133]

The debt-to-income ratio would measure the ability of students to make their loan payments upon completing the program.[134] A program would pass this test if the loan payments for a typical student completing school in the past three years were less than 30 percent of discretionary income or 12 percent of average annual earnings.[135]

Significantly, a program would be rendered ineligible only if its repayment rate fell below 35 percent *and* its debt-to-income ratio exceeded 12 percent of gross income or 30 percent of discretionary income.[136] So while many programs may fail one of the tests,[137] only

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127. Program Integrity: Gainful Employment, 75 Fed. Reg. 43,618 (proposed July 26, 2010) (to be codified at 34 C.F.R. pt. 668) [hereinafter Proposed Regulations].

128. *Id*. But note that if a program's debt-to-income ratio is sufficiently low, it retains eligibility under the proposed regulations even if it does not meet both tests. *Id*.

129. *Id*. Note that a program that fails both tests, but has a sufficiently high repayment rate, would not lose eligibility. *Id*.

130. *Id*. at 43,619.

131. *Id*. Notably, borrowers who are legally in compliance with their loan obligations, but who are not actively repaying their student loan (e.g., borrowers who are in deferment), are deemed not to be repaying the loan. *See id*.

132. *Id*. For a discussion of restrictions, see 75 Fed. Reg. 43,623.

133. *See id*.

134. *See id*. at 43,620.

135. *Id*. Alternatively, a program that can show that its students' earnings will "increase substantially after an initial" period of lower earnings can use the current income of "students who completed the program four, five, and six years prior" to the current year when calculating the debt-to-income ratio. *Id*. Under this alternate test, however, the program would fail if loan payments exceeded 20 percent of discretionary income or 8 percent of average annual earnings. *Id*. Further, it is unlikely that for-profit schools can in fact show that their students' earnings are likely to significantly increase. *See supra* Part III.B (describing for-profit schools as an expensive option catering to low-earning students).

136. *See id*. at 43,621 (summary chart).

137. For example, approximately forty 40 percent of four-year for-profit institutions currently have a repayment rate below thirty-five. *See id*. at 43,619.

about 4 percent of programs would actually be rendered ineligible by the Gainful Employment rule.[138]

A much larger number of programs will remain eligible but will be restricted or will be required to provide a debt warning to students.[139] A program will be on "restricted" status if it fails one of the tests, but not both.[140] A program will be required to issue the debt warning unless it has a repayment rate above 45 percent *and* its debt-to-income ratio is less than twenty percent of discretionary income and 8 percent of gross income.[141]

D. Student Lawsuits

While the government may try to regulate the abuses in the industry from the top down, it is also possible that student lawsuits may apply bottom-up pressure on the industry. Students who believe they have been misled have brought class-action suits against schools in the industry, and these lawsuits may be able to deter the industry from engaging in certain questionable tactics.

For example, in 2007, former students of the California Culinary Academy ("CCA") brought a class-action suit "against [the school] and its parent company, Career Education Corporation" ("Career Education").[142] The students alleged that CCA engaged in fraud in its recruitment of students by misrepresenting the quality of education the students would receive and by not giving students an accurate assessment of their job prospects upon graduation.[143] After three years of the lawsuit working its way through the courts, Career Education settled the suit for $40 million in November 2010.[144] It is worth noting that the settlement amounted to over half of Career Education's third-quarter operating income.[145] Therefore, it does

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138. BEN MILLER, EDUC. SECTOR REPORTS, ARE YOU GAINFULLY EMPLOYED? SETTING STANDARDS FOR FOR-PROFIT DEGREES 2 (2010), *available at* http://www.educationsector.org/publications/are-you-gainfully-employed-setting-standards-profit-degrees.

139. *Id.* at 5.

140. *See* 73 Fed. Reg. 43,623.

141. *Id*.

142. *See, e.g.*, Mary Spicuzza, *Students File Class-Action Lawsuit Against California Culinary Academy*, SF WEEKLY (Oct. 10, 2007), http://www.sfweekly.com/2007-10-10/news/students-file-class-action-lawsuit-against-california-culinary-academy/.

143. *Id*. A former student at CCA who "graduated in 1999, before the school was purchased by [Career Education]" felt that "the school has definitely changed," and another former student said that it essentially became a "body factory" designed to get as many students in the door as possible. Eliza Strickland, *Burnt Chefs*, SF WEEKLY (June 6, 2007), http://www.sfweekly.com/2007-06-06/news/burnt-chefs/.

144. Ameet Sachdev, *Career Ed Settles Student Lawsuit, Takes Charge*, CHICAGO BREAKING BUSINESS (Nov. 2, 2010, 5:11 PM), http://chicagobreakingbusiness.com/2010/11/career-ed-settles-student-lawsuit-takes-charge-against-earnings.html.

145. *See id.*

seem that lawsuits of this nature do threaten large enough liability to make the industry take notice.

While lawsuits of this nature have not yet posed an overly large threat to the industry, there are some signs that an increased number of suits are on their way.[146] One such case, a suit brought in 2008 against Sanford Brown College, which alleged that the school misrepresented students' ability to transfer their credits upon graduation and their ability to find jobs, was recently granted class-action certification.[147] This will allow over 1,500 former students to join in the suit.[148]

Lawyers have begun to see lawsuits against the industry as "low-risk, high-reward opportunities,"[149] and there has been an increase in the number of suits being brought.[150] While these lawsuits do not yet seem to have impacted the recruitment tactics of the industry, student lawsuits do have the potential to force the industry to eliminate some of its most egregious recruitment practices.

V. THE FUTURE OF THE INDUSTRY

While it seems clear that students and taxpayers require more protections in this area, the Gainful Employment regulations will likely not do enough. In light of congressional opposition, it remains to be seen if the proposed regulations will even be passed in their current form or if they will be further watered down.[151]

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146. *See* Tim Barker, *For-Profit Colleges Under Fire in Lawsuits*, STLTODAY.COM (Mar. 14, 2011), http://www.stltoday.com/news/local/education/article_3c4cb200-9ea1-5656-aa18-8dac41ddfa3f.html.

147. *See id.*

148. *See id.*

149. *Id.*

150. *See, e.g.*, Truman Lewis, *Another For-Profit College Faces a Student Lawsuit*, CONSUMERAFFAIRS.COM (Mar. 30, 2011), http://www.consumeraffairs.com/news04/2011/03/another-for-profit-college-faces-a-student-lawsuit.html (discussing a lawsuit against a Kentucky for-profit college claiming that fraudulent misrepresentations were made regarding cost of tuition and transferability of credits); *Lawsuit by Students of Everest College Alleges Omissions and Misrepresentations Concerning Accreditation, Transferability of Credits, and Placement Rates*, PR NEWSWIRE (Mar. 8, 2011), http://www.prnewswire.com/news-releases/lawsuit-by-students-of-everest-college-alleges-omissions-and-misrepresentations-concerning-accreditation-transferability-of-credits-and-placement-rates-117599333.html (discussing a lawsuit alleging that Everest College failed to inform potential students that credits are not recognized other institutions and, thus, are not transferable). In addition to student lawsuits alleging fraud, the industry has also faced securities fraud lawsuits alleging that the corporations made misrepresentations to investors about the fact that they make misrepresentations to students. *See Apollo Group Loses Bid to Cancel $277.5M Verdict*, COURTHOUSE NEWS SERVICE (Mar. 9, 2011), http://www.courthousenews.com/2011/03/09/34781.htm (discussing a $277.5 million verdict against the owners of a for-profit university for committing securities fraud).

151. *See* Daniel Malloy, *Hearing Targets New Regs Governing For-Profit Colleges*,

First, the current regional accreditation system must be reworked. While the current system may have worked with traditional brick-and-mortar colleges (if a college lost its accreditation, it would remain unaccredited until it remedied the problems identified), the calculus has changed with the advent of modern for-profit colleges that provide the vast majority of their instruction online.[152] A regional accreditation requirement carries little import when a school has the ability to change its region without a significant burden.[153]

While secondary-education institutions—both for-profit and traditional—argue that federal standards in this area are not necessary, the fact remains that regional accreditors are currently the "gatekeepers" to approximately $150 billion in annual federal funds.[154] To put this amount in perspective, $150 billion is 5 percent of the total federal budget and is approximately the same amount that the federal government annually spends to pay all of the members of all branches of the Armed Forces.[155] The federal government has a strong and clear interest in ensuring that this money goes only to deserving institutions. While the statutory and regulatory framework does allow for government oversight, in practice, this regulatory framework has not prevented many abuses from occurring, and in some cases it has been up to the regional accreditors to attempt to stop bad practices.[156]

Despite a clear argument for the government supporting this "gatekeeper" role, past attempts to reform the accreditation system have failed,[157] and it may be unlikely that the current system is

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PITT. POST GAZETTE, Mar. 18, 2011, at A9 (noting that the House has voted to block the proposed regulations from taking effect, although this measure is unlikely to pass the Senate).

152. For a discussion of the dangers of a "race to the bottom" by regional accreditors to attract online schools that can easily change regions, see *supra* Part IV.A. Note that preventing such "race to the bottom" scenarios has been seen by the Supreme Court as "a traditional role for congressional action under the Commerce Clause." Hodel v. Va. Surface Mining and Reclamation Ass'n, 452 U.S. 264, 281-82 (1981).

153. For example, Ashford University changed its regional accreditor from the HLC to the WASC simply by opening an office in the new region. *See supra* Part IV.A.

154. Eric Kelderman, *Advisory Panel Hears Concerns as It Again Considers Changes in Accreditation*, THE CHRONICLE OF HIGHER EDUC. (Feb. 3, 2011), http://chronicle.com/article/article-content/126251/ (mentioning faults and complaints with the current accreditation system in America).

155. *See Table 3.2—Outlays by Function and Subfunction: 1962-2016*, OFFICE OF MGMT. AND BUDGET, *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/hist03z2.xls (looking at the estimate for 2010 and estimated 2011 spending for military personnel).

156. For a discussion of Ashworth University's "accreditation shopping" and the attempt by its regional accreditor to put an end to the practice, see *supra* Part IV.A.

157. *See* Kelderman, *supra* note 154. An effort in 1992 to reform the system resulted in "little impact," and a 2008 recommendation by then-Education Secretary

overhauled. At the least, a compromise solution would be to maintain the current system of regional accreditors and allow these accreditors largely to set their own requirements, but for the federal government to set certain minimums. One effective minimum would be to mandate that all accreditors adopt the "change-in-control" rule that has been adopted by the HLC.[158] This would serve to prevent most attempts at blatant accreditation shopping and would have almost no impact on the independence of the regional accreditors.

Second, the 90/10 rule[159] may seem like it serves to keep for-profit schools honest by requiring that not all of their funding come from federal funds. However, the practical effect may be simply to force for-profit schools to raise tuition to the point where students are forced to pay some costs out of their own pocket. Thus, the 90/10 rule may actually exacerbate the harm that it seeks to prevent and may need to be rethought.

For example, assume a student is eligible to borrow up to a maximum of $10,000 per year in Title IV loans. If a for-profit school charges $8,000 in annual tuition, the student will likely pay for the entire amount with student loans,[160] thus causing the school to violate the 90/10 rule. However, if the college raises tuition to $11,111, then the student will be forced to pay $1,111 out-of-pocket, and as a result, the school would be in compliance with 90/10.

As such, the practical effect of the 90/10 rule may be to simply prevent most for-profit colleges from lowering their tuition or from charging more reasonable amounts in the first place. Consider Apollo Group, Inc. ("Apollo"), which obtained 88 percent of its revenue for its most recent fiscal year from the federal government and, thus, is in danger of violating the 90/10 rule.[161] The 90/10 rule essentially makes it impossible for Apollo to lower its tuition by any appreciable amount—a 2 percent tuition reduction would likely cause it to be in

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Margaret Spellings—e.g., the federal government set academic requirements that accreditors must follow—was rebuffed by Congress. *Id.*; *see also* Doug Lederman, *Stacking the Deck?*, INSIDER HIGHER ED (May 1, 2007, 4:00 AM), http://www.insidehighered.com/news/2007/05/01/naciqi (describing the Bush administration's Education Department panel tasked with making recommendations as to how to reform the accreditation system).

158. *See supra* Part IV.A for a discussion of HLC's "change-in-control" rule.

159. *See supra* Part IV.B for a discussion of this rule.

160. Schools cannot dictate the amount that students are able to borrow, and as a result, if the student in this example wished to borrow the entire $10,000 tuition, then the school would have no ability to prevent him from doing so. *See Direct Stafford Loans*, DEP'T OF EDUC.: STUDENT AID (last visited Nov. 11, 2011), http://studentaid.ed.gov/PORTALSWebApp/students/english/studentloans.jsp (providing an explanation of Direct Stafford Loans currently available). Currently an independent undergraduate student can obtain up to $12,500 per year in Stafford loans, and a graduate student can obtain up to $20,500 per year in Stafford loans. *Id.*

161. *See* Lauerman, *supra* note 107.

violation of the rule.[162] Indeed, because lower-income students tend to borrow a higher percentage of their total education costs,[163] as the proportion of low-income students at for-profit colleges increases, these schools will be forced to raise tuition in order to remain in compliance.

So while the 90/10 rule was originally intended to combat the fraud and abusive practices that were widespread at for-profit colleges in the late 1980s,[164] the rule now serves to exacerbate the issue that is currently most troublesome—the excessive debt loads of students at for-profit colleges, especially in relation to their future earnings potential. In light of these developments, Congress should seriously consider a repeal of the 90/10 rule or a relaxing of its requirements.[165] The goals of the 90/10 rule can be achieved through other means that do not have the same negative secondary effects.

Additionally, in order to combat the "moral hazard"[166]—the incentive to enroll as many students as possible, because the schools themselves get paid upfront and do not suffer any consequences of a default—for-profit schools should be required to retain some of the risk or should otherwise be forced to share at least some of the consequences of excessive defaults on federal loans made to students enrolled at their schools.

There are several methods that can be used to accomplish this, and it should be noted that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[167] has adopted similar

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162. This is assuming, of course, that students would borrow a constant amount even if tuition were reduced.

163. *See* SUSAN CHOY, U.S. DEP'T OF EDUC., NAT'L CTR. FOR EDUC. STATISTICS, LOW INCOME STUDENTS: WHO THEY ARE AND HOW THEY PAY FOR THEIR EDUCATION 1 (2000), *available at* http://nces.ed.gov/pubs2000/2000169.pdf.

164. *See* REBECCA R. SKINNER, CONG. RESEARCH SERV., RL32182, INSTITUTIONAL ELIGIBILITY AND THE HIGHER EDUCATION ACT: LEGISLATIVE HISTORY OF THE 90/10 RULE AND ITS CURRENT STATUS 3-5 (2005), *available at* http://www.policyarchive.org/handle/10207/bitstreams/1904.pdf (discussing the legislative history behind adoption of the 85/15 Rule in the 1992 amendments to the Higher Education Act, and the adoption of the 90/10 rule in the 1998 amendments to the Act).

165. One interesting consequence of for-profit schools nearing their 90/10 rule limit is that some colleges have begun to make their own in-house student loans to students. *See* Chris Kirkham, *For-Profit Colleges Offer High-Risk Loans to Keep Fed Dollars Flowing, Consumer Group Says*, HUFFINGTONPOST (Feb. 1, 2011, 3:03 PM), http://www.huffingtonpost.com/2011/02/01/for-profit-colleges-high-risk-loans-fed-money_n_816888.html (last updated May 25, 2011, 7:30 PM). These in-house loans do not come from the federal government, and consequently do not count against the school's 90/10 rule ratio. *Id.* This has the effect of forcing schools to retain some of their risk, thus decreasing the risks of moral hazard. *Id.* But, in-house loans are generally less favorable to students—some in-house loans carry credit-card like interest rates of up to 25 percent. *Id.*

166. *See supra* note 77 and accompanying text.

167. Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§

means designed to combat moral hazard in the financial services industry.[168] One option would be to make schools retain a certain portion of the default risk on loans made to students at their school. Schools could be required to retain, for example, a certain percentage of the credit risk of the loans that are extended to their students, as is now required of mortgage-originating firms under the Dodd-Frank Act.[169]

Another interesting option would be to require schools to "claw back" incentive-based payments to executives that were earned in years where the cohort default rate exceeds the statutory limits.[170] To illustrate, assume School XYZ has $1 billion in revenues in Year 1, with $900 million of this coming from federal student loans. Further assume that the executives of XYZ receive bonuses at the end of Year One based on XYZ's revenue. In Year Three, it is determined that XYZ's cohort default rate for Year One is 45 percent.[171] While the school in this case would be in grave risk of losing Title IV eligibility, executive compensation that was paid in Year One will still remain in the pockets of those who received it, and the taxpayer will remain on the hook for the high number of defaults at the school.

5301-5641 (West 2011).

168. The current activities and incentives in the for-profit education industry—i.e., an industry driven by debt, with the parties that make the loans not bearing the risk of default—have been compared by many commentators to the forces that inflated the housing bubble. *See, e.g.*, Jennifer Epstein, *Does the Messenger Matter?*, INSIDE HIGHER ED (July 15, 2010, 3:00 AM), http://www.insidehighered.com/news/2010/07/15/shorts (discussing the testimony of investors who were betting on a decline in the share prices of the for-profit education companies at a Senate hearing on the industry).

169. The Act requires that lending firms who originate mortgages may not simply sell off the mortgage to a third-party investor, but instead must retain 5 percent of the risk of any loan that is subsequently sold to investors. The Dodd-Frank Act does, however, provide an exception to this risk-retention rule when the firm originates a qualified residential mortgage. *See generally* S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (mentioning prohibition of unfair lending practices and reducing risks posed by securities).

170. This measure has also been instituted in a similar manner by the Dodd-Frank Act. The Dodd-Frank Act requires that any incentive-based compensation that is earned based on financial results that are later restated will be clawed back from executive officers. *See generally* Luis A. Aguilar, Commissioner, S.E.C., *Financial Regulatory Reform: The SEC Moving Forward*, Address for Loyola Management University's Center for Accounting Ethics, Governance, and the Public Interest Distinguished Speaker Series (Sep. 21, 2010), *available at* http://www.sec.gov/news/speech/2010/spch092110laa.htm (discussing general clawback provisions of the Dodd-Frank Act).

171. A school loses Title IV eligibility if its cohort default rate for any one year exceeds 40 percent. 34 C.F.R. 668.187(a)(1) (2010). *See supra* Part IV.B for a discussion of the cohort default rate limits contained in the Higher Education Act.

As a result, a clawback provision that would help to change this short-term focus would require XYZ to determine what its revenue would have been if they had not recognized revenue from the 'extra' 5 percent of loans in default, and then to calculate what the XYZ executives' bonuses would have been based on that adjusted revenue number. The amount that should be clawed back is the difference between what the executives actually received and what they would have received had the cohort default level been at an acceptable level.

This type of clawback provision would directly affect decision-makers at for profit schools and therefore could help change the motivating factor from enrolling as many students as possible to ensuring that their students get a good education at a price that will allow them to pay back their loans.

VI. CONCLUSION

Heavy student debt loads are not a problem confined to the for-profit education industry.[172] However, with a disproportionate amount of federal student loans going to for-profit colleges and a disproportionate amount of loan defaults by students at these colleges, it has become necessary to place more stringent requirements on for-profits.

The "Gainful Employment" regulations may have some positive effect, but as discussed in this Note, the effect will likely be minor and will not go far enough. A system needs to be in place that (1) allows for-profit colleges to charge a more reasonable level of tuition,[173] and (2) forces them to be held accountable for the fact that students at their schools incur higher debt loads and future economic challenges arising from the debt than graduates of traditional schools. The "Gainful Employment" regulations are a first step toward remedying some of the industry's problems, but Congress and the Department of Education need to go further in order to protect students from excessive debt loads and the resulting economic challenges they present.

172. *See, e.g.*, *Student Debt Crisis Threatens US Economy*, INT'L BUS. TIMES (Dec. 28, 2010, 11:42 AM), http://www.ibtimes.com/articles/95633/20101228/student-debt-crisis-threatens-us-economy.htm (noting that total student loan debt in the United States in 2010 stood at $875 billion, which exceeded the total balance on credit cards held by Americans).

173. *See supra* Part V for a discussion of how the 90/10 rule effectively prevents for-profit colleges from reducing their tuition levels.