THE SECRETARY OF EDUCATION
WASHINGTON, DC 20202

In the Matter of

STAR TECHNICAL INSTITUTE,

Respondent.

Docket No. 09-22-SA
Federal Student Aid Proceeding

DECISION OF THE SECRETARY

This matter comes before me on appeal by both parties. The office of Federal Student Aid (FSA) and Star Technical Institute (Respondent) file appeals of a decision by an administrative law judge (ALJ) issued on August 5, 2010. The ALJ ruled that for the 2005 compliance audit period Respondent violated the 90/10 rule;[1] in addition, the ALJ rejected FSA's findings that Respondent violated the 90/10 rule for the 2003 and 2004 compliance audit periods.[2]

The ALJ allowed Respondent to include $202,925 in 2003 and $105,447 in 2004 as revenue from non-Federal student aid sources in the respective 90/10 calculations for 2003 and

[1] The "90/10 rule" is a shorthand reference to the statutory requirement, found in section 102(b) of the Higher Education Act of 1965, as amended (HEA), that a proprietary institution must have "at least 10 percent of the school's revenues from sources that are not derived from funds provided under Title IV, as determined in accordance with regulations prescribed by the Secretary." Pub. L. No. 105-244, § 102(b). Title I, § 101(a), Oct. 7, 1998, 112 Stat. 1586 (to be codified at 20 U.S.C. 1022(b)); see also 34 C.F.R. § 600.5(a)(8) (2009). If greater than 90% of an institution's revenue is derived from Federal student aid funds, the school automatically becomes ineligible to participate in Title IV programs for the following year. 34 C.F.R. § 600.5(f) and (g). The 90/10 rule serves as one proxy of a proprietary institution's quality. *See*, 59 Fed. Reg. 2863 (Feb. 10, 1994) (noting that the general purpose of the rule is to ensure that proprietary institutions attract students who will pay for their programs with funds other than Federal student financial assistance funds because of the quality of the program). Consistent with changes established by Congress's 2008 reauthorization of the HEA, the Department removed all of the 90/10 provisions from 34 C.F.R. § 600.5 and promulgated 34 C.F.R. § 668.28(c) in October 2009, which essentially provides that the 90/10 rule shall be enforced pursuant to an institution's program participation agreement. *See*, 74 Fed. Reg. 55937 (Oct. 29, 2009). This change is not pertinent to this case because the change does not apply retroactively.

[2] The ALJ rejected FSA's 90/10 calculations for 2003 and 2004, but did not rule on whether Respondent violated the 90/10 rule notwithstanding the inclusion of the revenue from the sales of receivables in the 90/10 calculation. Nor did the ALJ determine the appropriate amount of Respondent's liability based on his rulings. Notwithstanding the ALJ's rulings, FSA argues that Respondent would still violate the 90/10 rule because the ALJ improperly upheld the gross amounts rather than the net amounts as revenue from the sales of receivables. In Respondent's view: "while the hearing official did not make a specific finding as to the amount of [its] liability as adjusted by his holdings, it is clear that [Respondent] has no liability for its fiscal year 2003 90:10 ratio."

2004.[3] In its appeal, FSA argues that the funds allowed by the ALJ as non-Federal student aid revenue in Respondent's 90/10 calculations do not constitute revenue because the funds were generated from transactions that were not conducted at arm's length. Among other issues, Respondent's appeal urges, as FSA does, that I clarify the ambiguity in the ALJ's findings with regard to the calculation of liability. Both parties also devote significant portions of their briefs to the issue of what impact, if any, my prior decisions on equity should have on the resolution of this case.

The issues before me, therefore, are whether Respondent satisfactorily demonstrated that it had no more than 90 percent of its revenue derived from Federal student aid funds for compliance years 2003 and 2004, and, if not, whether equitable factors warrant reducing the amount of Respondent's liability.[4] The short answer to each question is no. I find that Respondent neither demonstrates that it had no more than 90 percent of its revenue derived from Federal funds for the two years in question, nor convinces me that equitable factors warrant reducing the amount of its liability.

I

As an initial matter, I adopt the ALJ's holding that Respondent violated the 90/10 rule in 2005. Respondent does not directly challenge the ALJ's ruling on this issue, and the evidence in the record is compelling that Respondent derived more than 90 percent of its revenue in audit year 2005 from Federal student aid programs.[5]

The ALJ reasoned that since no statutory or regulatory provision explicitly prohibits the use of "related party" transactions as revenue in the 90/10 calculation, Respondent's revenue derived from its sale of the receivables to a related party (a collection agency) constitutes a permissible transaction for 90/10 purposes since, among other considerations, the receivables were sold at market rates[6] and on a non-recourse basis.[7] In this regard, the ALJ also found that

[3] The non-Federal aid source of funds was United Financial Group, a collection agency, which paid Star Technical Institute for accounts receivable.

[4] FSA argues that the liability for 2005 is $3,227,687 and Respondent urges that the amount at issue is $3,240,009. The ALJ does not identify the appropriate amount of liability for this finding. Respondent does not challenge the ALJ's ruling for 2005, but argues that the amount of liability for violating the 90/10 rule in 2005 should be reduced due to reasons of equity, fairness, and mitigation.

[5] The ALJ's ruling was narrowly drawn. Noting that donated funds cannot be used as revenue under the 90/10 calculation, the ALJ disallowed $70,925.00 in reported cash payments made by the owners of Star Technical Institute for 2005. The ALJ did not rule on FSA's allegation that Respondent engaged in fraud by initially reporting to FSA that the $70,725.00 were direct cash payments from students. Nor did the ALJ rule on FSA's allegation that Respondent provided no credible evidence showing that the cash donations constituted anything other than a paper transaction.

[6] The ALJ's decision does not identify the evidence in the record he relied upon for this conclusion. What's more, the parties vigorously dispute whether the receivables were sold at market rates.

[7] In his decision, the ALJ notes that Respondent "vehemently argues that" the institution and the collection agency are not related parties. But Respondent, in its brief on appeal, asserts that it is an "admitted fact" in the record that the sale of receivables constituted related party transactions. Moreover, as explained, *infra*, the parties do not dispute that Respondent had a clear legal duty to disclose related party transactions in its audit and financial statements.

missing from Federal student aid regulations is an "enforceable definition of the term, related party."

For its part, Respondent argues that even if its sale of the receivables to a collection agency constitutes a "related party" transaction, the sale may be included as revenue under the 90/10 calculation nonetheless because the transaction is an "inflow of actual cash revenue" from the collection agency to the institution and not a mere "paper-only transaction." In this light, the critical question, argues Respondent, is not whether the sale constitutes a related party transaction – it does and Respondent concedes that point -- but whether the related party transaction is in fact legitimate.

II

My analysis begins with the Higher Education Act of 1965, as amended (HEA), which requires postsecondary institutions to obtain annual financial and compliance audits of their participation in Federal student aid programs.[8] These statements must be prepared in accordance with generally accepted accounting principles and audited in accordance with government standards for compliance audits. Moreover, Financial Accounting Standards Board (FASB) Statement No. 57 requires that financial statements include disclosures of related party transactions.[9] This auditing standard follows from the FASB desire to discourage abusive activity in related party transactions. Related or affiliated entities may use related party transactions and ambiguous disclosures to hide debt or inflate revenue in self-serving transactions.[10] In this regard, the FASB specifically provides that an auditor's representations "about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated."[11] As a result of its direct relevance, the Department's audit regulation and its policy guidance to postsecondary institutions specifically refer to FASB No. 57.[12] It is in this regard that I am persuaded by FSA that there is

[8] Section 487 of the HEA requires all institutions participating in the Federal Student Aid programs to obtain an annual financial and compliance audit performed by an independent auditor.

[9] Pursuant to Financial Accounting Standards Board (FASB) Statement No. 57, auditors are required to consider whether sufficient competent evidential matter has been obtained to understand the relationship of the parties in a related party transaction and be satisfied that the transaction is adequately disclosed. Specifically, the auditor must ensure that the disclosure reflects the substance of the transaction, rather than merely its form.

[10] The FASB defines revenue in its Statement of Financial Accounting Concepts in *FASB No. 6 as:* "...inflows or other enhancement of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

[11] *See*, Summary of Statement No. 57, Related Party Disclosures (March 1982), http://www.fasb.org/summary/stsum57.shtml. As the FASB standard makes plain, disclosure is important because the "relevance of information is adversely affected, if a relevant piece of information is omitted, even if the omission does not falsify what is shown."

[12] *See,* Section 668.23(a)(5) setting out the submission requirements postsecondary institutions must follow when obtaining annual compliance audits and annual financial statements, including the requirement that these documents be completed in accordance with the Department's audit guide. Moreover, section 668.23(d), which requires disclosures of related parties in financial statements, explicitly adopts the definition of "related party" as set forth in FASB No. 57. Since auditors are bound to follow FASB standards, government audit standards, and the

substantial evidence in the record showing that Respondent's sales of receivables do not constitute revenue that may be included in the 90/10 calculation; the related party transactions are not arm's length transactions.

For purposes of the 90/10 calculation, what matters most is not whether two independent entities are accurately denominated or labeled as a particular type of formal organization, but whether the related party transaction generates revenue from an arm's length transaction. In examining whether Respondent's related party transactions can be substantiated as legitimate, FSA determined that the transactions involved ambiguous disclosures to an independent auditor and to the Department. According to FSA, once the transactions' underlying information was scrutinized, the related party transactions were exposed as having been "established [by Respondent] for the sole purpose of circumventing the 90/10 requirements."[13] Notably, when Respondent's independent auditor reviewed the source documentation of the transactions the auditor concluded that the disclosures by Respondent represented "numerous material misrepresentations…made…over several [audit] years by [Respondent]." Notwithstanding that the auditor initially viewed Respondent's related party transaction as legitimate, I find no reason to question the credibility of the auditor simply because he has changed his position upon further review.[14] Given the auditor's assertion that all of the prior audits at issue in this case were infirm and required the withdrawal of audit opinions for each faulty audit, I find the auditor's statement compelling evidence of Respondent's failure to substantiate its disclosures.[15]

FSA provides additional reasons why the related party transactions are not legitimate, and argues the transactions serve no purpose other than to circumvent the 90/10 calculation. Consistent with this position, the evidence shows that the sole owner of the corporation identified as United Financial Group (United) was also an 81.9% owner of Respondent. In other words, United and Respondent are essentially owned by the same person, a fact that the Respondent does not challenge, but generally concedes. Further, United provided collection agency services to no client other than Respondent. The collection agency had one employee, and that employee worked out of the Respondent's corporate office and was supervised by the postsecondary Respondent's corporate office staff. This level of common ownership and control between the Respondent and United as well as the singular nature of the corporation's client base provides

Department's regulations governing compliance audits and financial statements, I reject the ALJ's suggestion that Respondent did not "know[] of th[e] limitation" of the term 'related party.' 34 C.F.R. § 668.23 (2009). Bootstrapped to this suggestion are suggestions that Respondent is not at fault for failure to comply with the 90/10 rule, that the application of the rule leaves students vulnerable to liability to institutions, and that due process requires that the 90/10 regulation, as interpreted by FSA, be clearly established before it can be fairly enforced. For the same reasons noted above, I find these suggestions impertinent to this case.

[13] The record reveals that Respondent booked revenue for the 90/10 calculation on the sale of receivables that prior to the sale had been written off. In addition, the Department's Office of Inspector General notes that Respondent's chief financial officer disclosed that the related party transaction was conceived of as "a way to manage the 90/10 ratio."

[14] Respondent argues that the auditor lacks credibility because he changed his position.

[15] Indeed, Respondent's FY 2003 and FY 2004 financial statements indicate that the sales of receivables involved an "affiliated company," which is far short of complying with the specific and detailed disclosure requirements of FASB No. 57. Even when Respondent's independent auditor withdrew its audit opinions due to Respondent's misrepresentations, Respondent failed to inform FSA that its submitted audits were no longer valid.

further evidence that the business relationship did not operate as two enterprises engaged in arm's length transactions that were genuinely autonomous and independent.[16]

I am persuaded that the record contains substantial evidence showing that the sales of receivables from Respondent to United were structured significantly by considerations other than those expected in arm's length transactions, and that the requisite conditions of competitive, rivalrous, free market dealings did not exist. As such, no new revenue was generated by Respondent's sales of receivables, and, as a result, the purported revenue may not be included as non-Federal revenue in the 90/10 calculation. Accordingly, Respondent has not established that it properly disbursed Title IV funds during audit years 2003, 2004, and 2005.

This proceeding determination should end the matter before me, but Respondent's appeal travels along the same path taken by Respondent in *International Junior College*.[17] In that case, Respondent argued that my decision in *Gibson Barber*[18] and my authority pursuant to 34 C.F.R. § 668.113(d) should be applied to the facts to reduce or eliminate the amount of liability owed by Respondent. Here, Respondent raises similar arguments. In Respondent's view, the ALJ's findings should be understood to establish grounds to mitigate or reduce its liability for the 2003 and 2004 compliance years.[19]

III

In *Gibson Barber*, I recognized that the postsecondary institution's effort to execute corrective measures to bring it within compliance of the 90/10 rule may warrant consideration, pursuant to 34 C.F.R. § 668.113(d), of circumstances supporting my exercise of discretion to allow a limited exception to an institution's repayment liability. This exception was conditioned on Respondent showing that it had met multiple factors, including that the institution had effectively corrected or cured the regulatory violation that resulted in liability.

Applying the exception recognized in *Gibson Barber* to the facts in *International Junior College*, I held that Respondent's circumstance did not warrant my exercise of the extraordinary remedial exception of section 668.113(d). It is worth stating, here, as I did in *International Junior College*, that the holding in *Gibson Barber* is purposely restricted; the decision does not leave the door open for many cases to enter, and I do not view violations of the 90/10 rule as routinely subject to the extraordinary remedial exceptions identified in *Gibson Barber*. Rather, *Gibson Barber* stands for the limited proposition that under circumstances that the Secretary deems applicable, the Secretary may exercise his or her authority to accept a corrective action of

[16] FSA characterizes United as a "sham corporation."

[17] *International Junior College*, U.S. Dep't of Educ., Dkt. No. 07-52-SA (Decision of the Secretary Nov. 19, 2010).

[18] *Gibson's Barber and Beauty College (Gibson Barber)*, U.S. Dep't of Educ., Dkt. No. 05-49-SA (Decision of the Secretary Nov. 25, 2009) (In *Gibson Barber*, the postsecondary institution violated the 90/10 rule for one compliance year).

[19] Respondent also proposes that, if its equity arguments are not accepted, its liability for improperly disbursed student loans be calculated by use of FSA's "actual loss formula," rather than requiring repayment of the face value of the student loans.

an isolated regulatory violation that eliminates the basis of liability where the record reveals that there is no evidence of fraud and no allegation of a pattern of errors by the institution.

The facts of this case clearly do not support the application of the extraordinary remedial exception of *Gibson Barber*. More directly, Respondent does not come close to satisfying the factors identified in *Gibson Barber*. First, Respondent exceeds the 90/10 limitation for three years, not one. Second, in each year at issue, Respondent exceeds the 90/10 limitation by a greater amount than the conspicuously small amount identified in *Gibson Barber*.[20] More specifically, the donation of $3,850.00 in *Gibson Barber* used to correct the 90/10 violation reflects the minimal amount at issue in that case whereas Respondent indicates that shareholders provided a donation of $70,925, which I neither find minimal for purposes of equitable relief, nor relevant in a case where multiple violations of 90/10 are shown. Moreover, in light of the fact that Respondent repeatedly violated the 90/10 rule from 2003 through 2005, Respondent failed to adopt an effective corrective measure that would legitimately eliminate the basis of liability.

ORDER

Accordingly, I HEREBY MODIFY the Initial Decision. It is ORDERED that Star Technical Institute pay the U.S. Department of Education $9,830,436.00.[21]

So ordered this 7th day of February 2012.

Arne Duncan

Washington, D.C.

[20] Although in Gibson Barber the postsecondary institution exceeded the 90/10 limitation by $3,850.00, Respondent exceeds the 90/10 limitation by $202,925.00 in audit year 2003, $105,447.00 in audit year 2004, and $70,925.00 in audit year 2005. None of these amounts are conspicuously small in light of Gibson Barber, and certainly the amounts taken together entirely undermine Respondent's position that equity is warranted.

[21] Respondent raises various assertions regarding its position that the amount of liability should be reduced, including assertions concerning offsets for funds it is owed by the Department. As the Department's case law makes clear, none of these positions are pertinent or meritorious. See, e.g., Huston-Tillotson College, U.S. Dep't of Educ., Dkt. No. 99-2-SP (Feb. 10, 2000) and International Junior College, U.S. Dep't of Educ., Dkt. No. 07-52-SA (Decision of the Secretary Nov. 19, 2010).

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