IN THE MATTER OF
PHILLIPS COLLEGES, INC., Docket No. 94-27-ST
Student Financial
Respondent. Assistance Proceeding

DECISION

Appearances: Leslie H. Wiesenfelder, Esq., Dow, Lohnes & Albertson of Washington, D.C., for Phillips Colleges, Inc.

Carol S. Bengle, Esq. and Donald C. Philips, Esq., Office of the General Counsel, for the Office of Student Financial Assistance Programs, United States Department of Education.

Before: Judge Ernest C. Canellos.

In accordance with the direction of the Secretary and the ruling issued by United States District Judge Charles R. Richey in Phillips Colleges, Inc. v. Riley, No. 94 Civ. 179 (D.D.C. Feb. 18, 1994), a termination hearing pursuant to 34 C.F.R. Part 668, Subpart G was held in the above-captioned case on March 14, and March 15, 1994. Although the procedural history of this case is somewhat circuitous, the substantive issue before me is limited to the sole question of whether the appropriate sanction against Phillips Colleges, Inc. (PCI), for the material breach of a Financial Responsibility Agreement (FRA) between PCI and the United States Department of Education (ED), is the termination of eligibility of PCI and its educational institutions to participate in the Federal student financial assistance programs authorized under Title IV of the Higher Education Act of 1965, as amended (HEA).

For the reasons stated below, I find that the imposition of termination of the eligibility of PCI and its educational institutions to participate in programs authorized under Title IV of the HEA is unwarranted under the circumstances of this case.

BACKGROUND

The material facts of this case are both uncontested and clearly established. See footnote 1 *1* On July 24, 1992, ED and PCI entered into a Financial Responsibility Agreement that, among other things, required the establishment of a $5,000,000 Letter of Credit (LOC) in favor of the Department of Education. See footnote 2 *2* Based on a report produced by a certified public accounting firm hired by PCI, Weworski & Associates, which identified approximately $2,200,000 in potential liabilities owed by PCI, ED drew approximately $2,200,000 on the LOC in August 1993. PCI failed to restore the value of the LOC within 20 days of ED's draw as required by the FRA claiming that the draw was improper because it was not based on an administrative determination of liability as required by Title IV of the HEA.

A "Final Agency Decision" was issued on January 28, 1994 by Donald R. Wurtz, the designated agency official. In that decision, Wurtz concluded that PCI was in material breach of the FRA because PCI had not replenished the LOC as required by the FRA. In a collateral action in Phillips Colleges, Inc. v. Riley, No. 93 Civ. 1703 (D.D.C. Feb. 15, 1994), Judge Richey granted ED's motion for summary judgment and held that ED's draw on the LOC was proper because the draw complied with the terms and conditions of the LOC. In addition, Judge Richey noted that paragraph E of Article I of the FRA explicitly stated that ED's right to draw on the LOC was set forth in the LOC and was not conditioned upon or subject to any term in the FRA except the condition, not at issue here, requiring that ED afford PCI an opportunity to make a direct payment to ED prior to the draw on the LOC. The parties do not challenge the rule that requires me to follow Donald Wurtz' final agency decision and the decision of the district court. Accordingly, the binding precedent of those two decisions establishes that PCI's failure to replenish the LOC under the terms of the FRA put PCI in material breach of the FRA.

I

According to ED, PCI should be terminated from eligibility to participate in programs authorized under Title IV of the HEA because the Department has the right to choose to cancel the FRA, and, with this cancellation, PCI's Title IV program eligibility.See footnote 3 *3*

Undoubtedly, the effective termination of the FRA could have a pivotal bearing on whether the termination remedy was warranted in this case. Consequently, as an initial matter, I must determine whether ED has canceled the FRA.

ED argues that PCI's material breach permits the Department to exercise its right to cancel a contract, and when it initiated termination proceedings against PCI on January 28, 1994, it concomitantly notified PCI of its intent to terminate the FRA. According to ED, on January 28, 1994 the Acting Deputy Assistant Secretary, William Moran, issued a letter of termination, and that letter, ostensibly attempting to terminate PCI from eligibility to participate in programs authorized under Title IV of the HEA, also had the effect of terminating the FRA. I do not agree.

It is axiomatic that a material breach does not automatically and ipso facto end a contract. Cities Service Helex, Inc. v. United States, 543 F.2d 1306, 1313 (Ct. Cl. 1976). PCI's material breach of the FRA merely gave ED the right to cancel the agreement. Id. Nothing in the record shows that ED has canceled the FRA. To the contrary, during the hearing, I inquired whether the FRA remained in force on the date of the second day of the hearing and counsel for ED reluctantly conceded that the FRA had not been canceled as of March 15, 1994. I find the court's observation in Cities Service Helex, Inc., supra, particularly relevant here, wherein the court observed:

[w]e cannot understand how, after a material breach, the injured contractor can continue its own performance as well as compel the other side to perform, and still, at the same time, claim that it ended the contract upon that material breach. The inconsistency between the actual course

of conduct and the verbal claim is too stark. The contemporaneous action belies the hollow words.

Id. at 1316. More important, ED's contention that the termination of the FRA somehow relates back to the January 28, 1994 letter is insupportable because Judge Richey's ruling in Phillips Colleges, Inc. v. Riley, No. 94 Civ. 179 (D.D.C. Feb. 18, 1994) plainly found that the January 28, 1994 letter was facially invalid because the letter summarily terminated PCI from participation in Title IV programs without providing PCI with an obligatory pre-termination evidentiary hearing. Judge Richey nullified the effect of the letter by requiring ED to provide PCI with a Subpart G termination hearing. Nor am I persuaded that the January 28, 1994 letter can be construed as notice to PCI of ED's election to cancel the FRA. It is inconceivable how a notice of termination, itself found

improper, could nonetheless be interpreted as an effective notice of ED's intent to terminate the FRA.See footnote 4 *4* Significantly, nothing in the January 28, 1994 letter refers to ED's intent to terminate the FRA. Accordingly, the January 28, 1994 letter attempting to terminate PCI from eligibility to participate in programs authorized under Title IV of the HEA did not have the effect of terminating the FRA or putting PCI on notice of ED's intent to terminate the FRA.

II

In its posthearing brief, ED argues that the imposition of termination is appropriate for the following reasons: PCI's material breach of the FRA put ED at an unnecessary risk of loss of Federal funds, PCI has had a history of breaching the FRA, and the administrative burdens that flow from those breaches have been too significant to justify continuing the FRA. In addition, ED argues that PCI's attempted cure of its material breach of the FRA on February 25, 1994 was permissibly rejected by ED because PCI's opportunity to cure lasted no later than 20 days from the Department's August 26, 1994 draw.

For its part, PCI argues that since ED had neither terminated the FRA nor put PCI on notice of its intent to terminate the FRA before PCI's attempted cure of its material breach on February 25, 1994, PCI's replenishment of the LOC could not be rejected by ED, and constitutes an effective cure of its material brief.

An election to continue the contract is frequently called a waiver of the material breach. Under the election doctrine, any act indicating an intent to continue the contract is an election, and [an] election to continue may occur simply by failure of the injured party to take action to end the agreement within a reasonable time after becoming aware of the material breach. Cities Service Helex, Inc., supra, 543 F.2d 1313 (citing 5 Samuel Williston, A Treatise on the Law of Contracts §§ 683 - 685 (3d ed. 1961)). If the injured party continues to perform the contract, the right to end the contract is waived. Id. The crucial element of the election doctrine is that the injured party must be deemed to have elected to continue, not to end, the contract. As I have noted above, ED concedes that it has not canceled the FRA. In addition, ED did not rebut PCI's claim that both parties have continued to perform under the agreement notwithstanding ED's March 3, 1994 letter rejecting PCI's February 25, 1994 replenishment of LOC. Furthermore, as I have determined above, the January 28, 1994 letter from William Moran, attempting to terminate PCI from eligibility to participate in programs authorized under Title IV of the

HEA, does not explicitly express ED's intent to cancel the FRA. Consequently, under the law of contracts, PCI's replenishment of the LOC duly cured its material breach of the FRA.See footnote 5 *5*

However, regardless of whether PCI's February 25, 1994 replenishment of the LOC cut off ED's right to cancel the FRA, it remains a fact that PCI materially breached the FRA, and although the remedy of canceling the FRA may no longer be available to ED, ED may bring a termination action pursuant to 34 C.F.R. Part 668, Subpart G seeking to terminate PCI from eligibility to participate in Title IV programs based on the violation. Significantly, under the law of contracts, even though an injured party may be precluded from unilaterally canceling a contract because of the operation of the doctrine of waiver, the injured party retains a claim for damages for the breach. See, Cities Service Helex, Inc., supra, 543 F.2d 1313 (citing 5 Samuel Williston, A Treatise on the Law of Contracts §§ 683 - 688 (3d ed. 1961)). Similarly, pursuant to 34 C.F.R. § 668.86(a), ED may elect to terminate an institution's eligibility to participate in Title IV programs for the violation of any agreement, notwithstanding that ED's conduct may have precluded it from unilaterally canceling the agreement. Accordingly, notwithstanding PCI's right to cure its material breach of the FRA, the question remains whether the material breach, ab initio, warrants the remedy ED is seeking.

The procedures for initiating the termination of eligibility of an institution to participate in programs authorized under Title IV of the HEA are set forth at 34 C.F.R. § 668.86. Section 668.86(a) provides that the Secretary **may** terminate or limit the eligibility of an institution to participate in programs authorized under Title IV of the HEA, if the institution violates any provision of Title IV or any regulation or agreement implementing Title IV. However, since the imposition of termination is the most serious form of sanction available to ED, it does not follow, a fortiori, that the termination remedy should be imposed in every case where it may be imposed. See, e.g., In the Matter of Mr. Arnold's Excellence Beauty School, Dkt. No. 92-121-ST, U.S. Dep't of Education (Decision of the Administrative Judge Jan. 3, 1994). In evaluating whether the termination remedy is appropriate, factors such as the severity or seriousness of the violation, the pervasiveness or numerosity of the violation, and the existence of good faith efforts to resolve the violation by the institution are clearly relevant.

In the case at bar, I find that the termination remedy is not warranted.See footnote 6 *6* My finding is

based on four conclusions: [1] the material breach of the FRA is but one instance of a violation of the FRA, [2] PCI had at least a colorable good faith challenge to ED's draw on the LOC, [3] PCI replenished the LOC on February 25, 1994, and [4] ED's failure to prove that the Federal government had been harmed by PCI's material breach of the FRA.

ED asserts that PCI has breached the FRA on at least two prior occasions. According to ED, both of the alleged breaches involved the timeliness of PCI's filing of financial statements as required by the FRA. But, as ED concedes, both breaches were cured by PCI. More important, as I often repeated during the hearing, the issue before me is the material breach of the FRA resulting from PCI's failure to replenish the LOC in accordance with the requirements of the FRA. Under normal circumstances, the existence of prior breaches of an agreement, if proven, could support ED's assertion that the present breach is significant because of a history of prior breaches of the same agreement. However, in the case at bar, the prior breaches that ED alleges are predicate acts that form the basis, in part, of a termination proceeding before another judge. See, In the Matter of Phillips Colleges, Inc., Dkt. No. 94-26-ST.

In addition, I find that PCI had at least a colorable good faith claim that ED's draw on the LOC was improper. In its challenge against ED's draw, PCI argued that the question whether ED's draw on the LOC was proper involves more than a perfunctory evaluation of whether ED followed the formalities required by the LOC, itself. According to PCI, it challenged ED's draw on the LOC because the amount drawn by ED was not based on an accurate determination of liability and a final agency determination had not been issued confirming the conclusions of the Weworski report, which was the basis of ED's determination that a draw on the LOC should be made. Notably, I review these arguments not to reconsider the issue of whether ED's draw on the LOC was proper; that has already been decided. Instead, I review PCI's arguments to show why I have concluded that PCI's challenge to ED's draw was not frivolous, but in good faith.

As the record plainly shows, ED drew on the LOC because of a report issued by an accounting firm hired by PCI, Weworski & Associates, which concluded that PCI had not made timely refunds of Title IV program funds to its students. At the time of the draw, ED certified to Bankers Trust Company, the issuer of the LOC, that the drawn funds would be used to pay refunds owed by PCI. During the hearing, ED conceded that notwithstanding that the draw was made in August 1993, ED had only paid approximately $25,000 in refunds to those who were supposed to receive the benefit of the approximately $2,200,000 draw on the LOC. Notably, ED had to withdraw an earlier threat to draw on the LOC in the amount of $4,400,000 because ED's decision to draw on the LOC at that time had been based on an erroneous interpretation of one of the reports issued by Weworski & Associates. Given just these facts, clearly PCI had at least a colorable good faith challenge to the amount of ED's draw on the LOC.See footnote 7 *7*

Additionally, in a February 25, 1994 letter from the Bankers Trust Company, it stated that the letter of credit amount reinstated effective February 25, 1994 to its original amount of U.S. $5,000,000.00. Although ED "reject[ed]" PCI's replenishment of the LOC, it is uncontrovertible that PCI attempted to cure its breach of the FRA while the FRA was still in force. This is significant because, as I have noted above, PCI's material breach of the FRA evaporated on February 25, 1994 when it cured the breach. Consequently, the replenishment of the LOC on February 25, 1994 clearly mitigates against imposing the harshest penalty on PCI.

Finally, ED's failure to prove that the Federal government has been harmed by PCI's material breach of the FRA also mitigates against imposing termination.See footnote 8 *8* According to ED, allowing PCI to go unpunished would have two devastating consequences. First, ED argues, if PCI goes unpunished, the provision of the FRA defining PCI's failure to replenish the LOC as a material breach of the FRA would be rendered meaningless. The second consequence, according to ED, is that PCI's continued participation in Title IV programs would encourage other institutions subject to limitation/settlement agreements with the Department to make light of their responsibilities under the [a]greement. I find that these arguments are unavailing. See footnote 9 *9*

ED's first "devastating" consequence has already been answered. As I noted supra, the material breach of an agreement does not ipso facto end a contract. The breaching party may, as occurred here, cure the material breach prior to the injured party canceling the contract. Or, the injured party may simply decide to continue performance of the contract. More important, whether PCI goes "unpunished" depends on factors other than the material breach provision of the FRA. As Judge Richey's decision, in Phillips Colleges, Inc. v. Riley, No. 94 Civ. 179, supra, pointed out, ED could have easily ensured that it could summarily terminate PCI from eligibility to participate in Title IV programs, upon the finding of a material breach of the FRA, by including a clause in the FRA that would have waived PCI's right to a Subpart G hearing, just as it has done in other limitation agreements. Consequently, it simply does not follow that because PCI is not sanctioned for its material breach of the FRA, the material breach provision is, itself, rendered meaningless. Nor does this decision give the green light to other institutions under limitation agreements to make light of their responsibilities under those agreements. As with any administrative decision, if an institution chooses to violate its limitation agreement with the Department, it does so at its own peril.

ORDER

On the basis of the foregoing findings of fact and conclusions of law, it is hereby ORDERED, that the eligibility of Phillips Colleges, Inc. and its educational institutions to participate in the student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended, is not terminated.

Judge Ernest C. Canellos

Issued: March 24, 1994
Washington, D.C.

Footnote: 1 1 A comprehensive review of the underlying facts in this case is in the "Final Agency Decision" issued by Donald R. Wurtz and in the district court's decision in Phillips Colleges, Inc. v. Riley, No. 93 Civ. 1703 (D.D.C. Feb. 15, 1994), which are both a part of the record in this case.

Footnote: 2 2 In June 1993, the LOC was increased to $5,500,000.

Footnote: 3 3 In its Posthearing brief, ED suggests that I review its decision to terminate PCI's eligibility under the deferential standard of review announced in Chevron, U.S.A. v. NRDC, 467 U.S. 837 (1984). ED's reliance on the Chevron doctrine, however, is misplaced. The Chevron doctrine is a rule of statutory interpretation that requires

*Article III **courts** to defer to an executive branch agency's interpretation of a statute it administers when the words of a statute are ambiguous. See, Larry Evans, Jarrell Wright & Neal Devins, Congressional Procedure and Statutory Interpretation, 45 ADMIN. L. REV. 239, 240 - 241. Consequently, Chevron is inapposite to this case, which is, itself, a part of the administrative process which ultimately results in a final agency action.*

Footnote: 4 *4 ED's position may be based on the ill-conceived notion that in order to cancel the FRA, the Department must first or concurrently terminate PCI's eligibility. Yet, as I have noted supra, under the law of contracts, in the face of a material breach of an agreement, the injured party has a right to cancel the contract. Consequently, ED has a contractual right to cancel the FRA that exists separate and apart from its election to seek termination of PCI's Title IV eligibility.*

Footnote: 5 *5 O'Connel Management Co.,Inc. v. Carlyle-XIII Managers, Inc., 765 F. Supp. 779, 784 (D. Mass. 1991) (whether a material breach was cured is a question to be determined by the trier of fact).*

Footnote: 6 *6 ED has not pursued any alternative remedy available to it under 34 C.F.R. § 668.86(a). Given the nature of PCI's violation of the FRA, I find that no other sanction is warranted.*

Footnote: 7 *7 Notably, in reviewing whether PCI had a good faith challenge to ED's draw on the LOC, I have not assumed that PCI's obligation to replenish the LOC should be temporarily discharged, if PCI has a good faith claim on the merits of the underlying contract dispute. As the federal courts have made plain, the "whole purpose of a letter of credit would be defeated by examining the merits of the underlying contract dispute to determine whether the letter should be paid." Centrifugal Casting Machine Co. Inc., v. American Bank & Trust Co., 966 F.2d 1348, 1352 (10th Cir. 1992). Rather, I have relied on the principle that "proper presentment requires that the documents presented strictly comply with the terms in the letter." Breathless Associates v. First Savings & Loan Association of Burkburnett, 654 F. Supp. 832 (N.D. Texas 1986).*

Footnote: 8 *8 Pursuant to 34 C.F.R. § 668.88(c)(2), ED has the burden of persuasion in this proceeding.*

Footnote: 9 *9 Nor am I persuaded by ED's argument that the costs of administering the FRA are burdensome and onerous, and thus harmful to the Federal interest. Assuming, without deciding, that the costs of maintaining the FRA are excessive, the costs would not be less than they are now had PCI not breached the FRA. To the contrary, in the face of PCI's breach, ED could have mitigated its costs by canceling the contract. More important, I know of no legal principle that would countenance as a harm to the Federal government, the fact that experienced and skilled government negotiators entered into a bad bargain.*