

UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202

In the Matter of

Docket No. 00-55-SA

PACIFIC TRAVEL TRADE SCHOOL,

Student Financial

Assistance Proceeding

Respondent.

ACN: 09-1997-80029

Appearances: Gerald M. Ritzert, Esq., Peter S. Leyton, Esq., Fairfax, Virginia, for Respondent.

Jennifer L. Woodward, Esq., Russell B. Wolff, Esq., Office of the General Counsel, United States Department of Education, Washington, DC, for Student Financial Assistance Programs.

Before: Richard F. O'Hair, Administrative Judge

DECISION

Pacific Travel Trade School (Respondent), a proprietary institution of higher education, was a participant in the various student financial assistance programs authorized under Title IV of the Higher Education Act of 1965, as amended (Title IV). 20 U.S.C. § 1070 *et seq.* and 42 U.S.C. § 2751 *et seq.* These programs are administered by the Office of Student Financial Assistance Programs (SFAP), U.S. Department of Education (ED). On August 9, 2000, SFAP issued a Final Audit Determination Letter (FAD) in which it sought the return of \$7,467,693 in federal funds from Respondent because of alleged regulatory violations of its administration of its student financial assistance programs. Respondent appealed the audit determination. In response to my Order Governing Proceedings, Respondent filed a motion requesting an evidentiary hearing. After oral argument was heard on this issue, Respondent's motion was denied by order dated February 5, 2001. Thereafter, Respondent and SFAP filed briefs and presented oral argument which support their respective positions.

Background

In June 1999 ED's Office of the Inspector General (IG) issued an Audit Report following its examination of Respondent's compliance audits for the fiscal years ending December 31, 1995, December 31, 1996, and December 31, 1997. 34 CFR § 600.5(a)(8). This report concluded that Respondent violated applicable federal regulations by failing to meet the 85 Percent Rule by not deriving at least 15 percent of its revenue from non-Title IV sources for the years ending on December 31, 1996, and 1997. As a result of this finding, the IG determined that Respondent lost its eligibility to participate in the Title IV programs as of January 1, 1997. The IG transmitted its report to SFAP and that office expanded its evaluation of Respondent's audits to include Fiscal Year 1998, which began on January 1, 1998. SFAP agreed with the IG's findings and further found that Respondent also failed to meet the 90 Percent Rule (a prospective modification of the 85 Percent Rule) for Fiscal Year 1998. SFAP issued the FAD which alleged that because Respondent violated the 85 Percent Rule in Fiscal Years 1996 and 1997, and the 90 Percent Rule for Fiscal Year 1998, it lost its eligibility to participate in Title IV funds beginning January 1, 1997. This finding required Respondent to reimburse ED in the amount of \$7,467,693, all Title IV funds disbursed from January 1, 1997, through the end of Fiscal Year 1998.

The 85 Percent Rule in effect during 1996 and 1997 provides that in order to meet the definition of an eligible institution under the 1992 Reauthorization of the Higher Education Act, a proprietary institution must generate "at least 15 percent of its revenues from sources that are not derived from funds provided under this title (Title IV), as determined in accordance with regulation prescribed by the Secretary." Title IV, §481(b)(6); 20 U.S.C. § 1002(b)(1) (F). The applicable regulation, found at 34 CFR § 600.5(a)(8), requires an institution annually to categorize its revenue and place it into a fraction. The numerator of the fraction contains all Title IV funds which the institution received and used to satisfy tuition, fees and other institutional charges to students. The denominator contains the sum of revenues generated by the institution from tuition, fees, other institutional charges for students enrolled in eligible programs, and activities conducted by the institution to the extent not included in tuition, fees, and charges. 34 CFR § 600.5(d)(1). Amounts charged and received for books, supplies, and equipment are not considered to be institutional charges and are not included in either the numerator or denominator. 34 CFR § 600.5(d)(2)(iv). If the resulting fraction is greater than 85 percent, or 90 percent as applicable, for the year, the institution becomes ineligible for Title IV funds for at least the next fiscal year. 34 CFR § 600.5(g).

In the FAD, SFAP alleges that for fiscal years 1996 and 1997 Respondent generated only 10.61 percent and 3.68 percent, respectively, of its revenues from other than Title IV sources. For Fiscal Year 1998, after the 85 Percent Rule figure was raised to 90 percent, only 1.41 percent of Respondent's revenue originated from non-Title IV sources. This means that for 1996, 89.3 percent of its institutional charges were financed by Title IV funds. For 1997 that figure is

96.33 percent. For 1998 it was 98.59 percent. These percentages vary significantly from those reported by Respondent in its annual financial statement and it argues that it satisfied the requisite percentages for each of the three years being considered. Respondent attempted to convince this tribunal their figures were correct; however, I am unpersuaded by their arguments and find that SFAP's analysis is correct.

In this analysis, SFAP described three general categories of errors in Respondent's calculations of the 85/90 percent rules for each of these years. These were: 1) the improper inclusion of institutional scholarships as general revenue in the denominator of the fraction; 2) a series of unacceptable accounting practices, and, 3) the inclusion of income from an ineligible satellite teaching site Respondent operated in Houston, Texas. SFAP's correction of these three errors brought Respondent's percent of Title IV revenues for each year to levels in excess of 85 or 90 percent, as applicable.

Institutional Scholarships

Because SFAP characterized Respondent's scholarship program as invalid, it therefore maintains that it was improper for Respondent to classify the scholarship funds it awarded its students as non-Title IV income. SFAP based this opinion on the fact that the institution used ambiguous criteria in awarding the scholarships, the criteria were not consistently applied, and in all respects believed it to be a wholly untraditional scholarship program. SFAP found that Respondent's students were unaware of the existence of the scholarship program; the students never applied for or requested a scholarship; the scholarships were awarded after the student graduated, or otherwise discontinued attendance at the institution; they were awarded only to students who had an outstanding indebtedness to the institution; and the amount of the scholarship was the amount of that indebtedness. In SFAP's opinion, this program amounted to no more than a means of forgiving student indebtedness to the institution and coincidentally helping lower the 85 Percent Rule figures. Respondent challenged the maligning of its program by asking that its scholarship program not be viewed in the traditional sense, *i.e.* one where a student applies for a scholarship from funds maintained by the institution contemporaneous with an application for admission to the institution, but as a feature unique to small, proprietary schools that have no endowment funds.

An institution is authorized to treat a valid scholarship awarded to one of its students as non-Title IV revenue which means this award is included in the denominator of the 85 Percent Rule fraction to determine if an institution receives no more than 85 percent of its income from Title IV sources. This issue was specifically addressed in 1994 prior to the adoption of the Higher Education Act's regulation implementing the 85 Percent Rule provisions. In the preamble to ED's regulations the Secretary of Education said:

[a]n institution is not prohibited from including institutional charges that were paid by institutional scholarships... providing that the scholarships...are valid and not just part of a scheme to artificially inflate an institution's tuition and fee charges.

59 Fed. Reg. 22,314 (Apr. 29, 1994). Unfortunately there was no other written guidance on this topic. Educational institutions were permitted to exercise their own discretion as to how a valid scholarship program should operate and whether the amount of the scholarship could be categorized as non-Title IV revenue. The next advice from ED on the inclusion of scholarships in the 85 Percent Rule computation surfaced with the publication in October 1999 of ED's Dear Partner Letter: GEN-99-33 and OIG's Dear Certified Public Accountant Letter: CPA-99-02. Both of these letters

provide supplementary guidance to schools and their auditing firms in evaluating institutional scholarships. In addition to reiterating that the 85 Percent Rule fraction should be reported for the institution's fiscal year using a "cash basis of accounting [where] the institution reports revenues on the date that the revenues are actually received. 59 Fed. Reg. 22,328.", the letters also provide criteria by which a scholarship program should be evaluated by institutions, their auditors, and ED personnel to determine program validity. The criteria set out in the Dear CPA letter include:

- 1) Determine whether a substantial number of students in the same eligible program are paying the same charges without receiving institutional scholarships.
- 2) Evaluate the timing of the scholarships. An indication of invalidity might be if the scholarships are made at the end of the year rather than at recurring intervals. Another indication of invalidity might be if they are awarded after students drop out owing tuition.
- 3) Determine whether students applied for, or knew they received, a scholarship.
- 4) Evaluate the criteria used for awarding the scholarship. Can the criteria be easily manipulated, e.g. lowering the minimum grade point average?
- 5) Determine whether the criteria are consistently followed.
- 6) Determine whether information regarding the scholarships is well publicized.
- 7) Ensure the amount of institutional scholarships included in the 85/15 calculation corresponds to actual adjustments for institutional scholarships in the income statement. If the institution does not recognize the institutional scholarships for financial statements or tax purposes, they should not be recognized for purposes of the calculation.

This general guidance without specifics was prepared and disseminated to participating institutions in late 1999, after several years of audits of participating institutions in which SFAP focused on the use of including institutional scholarships as non-Title IV funds in the 85/15 calculations. Although it is unknown how many scholarship programs SFAP found to be invalid when its program reviewers applied these criteria, it is certain that Respondent's scholarship program has some serious deficiencies when evaluated in this light. The following is an application of SFAP's findings as they relate to the seven general criteria set out above:

1) For Fiscal Year 1996, all of its students in the English as a Second Language class were scholarship recipients. Overall, for that year, however, only 18 percent of the student body received scholarships. In Fiscal Years 1997 and 1998, the percentages of all students receiving scholarships were 9 percent and 11 percent, respectively.

2) All scholarships were awarded after the student had either graduated or dropped out. It was Respondent's accounting office practice to send a letter to those students no longer enrolled who had an outstanding debt to the school. If the student failed to respond, a second letter was sent, informing the student he or she could apply for a scholarship. If there was no response to that, the accounting office sent a letter to management asking that a scholarship be awarded in the amount of the balance due the school. Management consistently awarded the requested scholarships without any apparent involvement by the admissions office.

3) SFAP attempted to contact every scholarship recipient to determine how much information he or she had regarding the scholarship program. Although they were able to make contact with only very few students, those students they reached responded they were unaware of the scholarship program and did not know they had been recipients. This is not surprising because there was no information about the program in the school catalogues.

4) and 5) SFAP found that although Respondent's scholarship eligibility standards required that students maintain an 80 percent grade point average and have graduated, there were numerous instances where one or both of these criteria were ignored by management. Additionally, the students were not required to show any financial need; in fact, the records indicate some recipients definitely did not have a financial need.

6) As noted above, there was a significant absence of effective advertisement of this scholarship program.

7) Most significantly, SFAP found that the scholarship funds did not originate from any source outside of the institution, but involved no more than internal money transfers from one institutional bank account to another. As such, these transfers did not constitute revenue or an inflow of cash to the institution which would result in corresponding adjustments to its income statement. Therefore, these transfers were not recognized for income statement or tax purposes.

Respondent objected to not only these conclusions reached by SFAP, but also the use of these 1999 criteria in evaluating its programs between 1996 and 1998. It claimed that, during the years in question, there was no definitive regulation or other guidance setting limits on the characterization of institutional scholarships as sources of non-Title IV funds and that the schools were left to develop their own interpretations of what was permissible, guided only by what was included in the preamble to the 85 Percent Rule regulations. Respondent says it acted in good faith and believes it is unlawful for SFAP to apply the criteria spelled out in the Dear CPA and Dear Partner letters because this amounts to a retroactive application of standards which are treated as having the force and effect of regulations. In the absence of subjecting these criteria to notice and comment rulemaking, Respondent asserts that their application here amounts to a violation of the General Education Provision Act. 20 U.S.C. § 1232a. Respondent, citing *In re Baytown Technical School*, Dkt. No. 91-40-SP, U.S. Dep't of Educ. (Apr. 12, 1994), further argues that SFAP cannot create a regulatory requirement where none exists.

I disagree with Respondent's interpretation because I find that these are not newly manufactured standards and they do not have the force and effect of law. On the contrary, these seven criteria represent nothing more than a restatement of a common sense means of examining an institutional scholarship program to determine, as the Secretary suggested, whether it is "valid and not just part of a scheme to artificially inflate an institution's tuition and fee charges." The criteria described in those letters do not establish bright line rules or specific standards which must be met, but rather highlight various aspects of a program which should be examined in a rational search for validity.

No scholarship program is entitled to blind acceptance as valid; the challenged institution must, at a minimum, make a *prima facie* showing of legitimacy. In the case before me, only in 1996 was there an entire group of students, the ESL students, which were recipients of the scholarships. Looking at the entire student body for each of the three years, however, the percent of students receiving scholarships does not suggest any disproportionality. The program was an evolving one which was poorly publicized, if at all, had standards which were not consistently followed, its scholarships were awarded after students left the school, and awarded only if they had tuition/charges due the school.

Furthermore, there is no evidence that the funds to support the scholarship program were revenue which originated outside the institution. The SFAP analysis indicates the funds were exclusively internal funds which were transferred from one school account to another. The unavoidable conclusion is that Respondent's scholarship served only two purposes. It allowed the school to eliminate or write off student bad debts and permitted it to attempt to elevate the amount of its non-Title IV revenue to enhance its 85 Percent Rule calculations. Without a cash inflow to support this program, Respondent's institutional scholarship funds cannot be categorized as non-Title IV revenue for purposes of computing the 85/15 percentage. Consequently, it was improper for Respondent to categorize its institutional scholarships as non-Title IV income and include that amount in the denominator of the 85 Percent Rule calculation.

Unacceptable Accounting Procedures

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The regulations provide some fundamental rules governing the allocation of an institution's Title IV and non-Title IV income to the numerator and denominator of the 85 Percent Rule calculation. One basic rule is the presumption that, with regard to the numerator, any Title IV program funds the institution receives shall be used to pay the student's tuition, fees, or other institutional charges, regardless of whether the institution credits those funds to the student's account or pays those funds directly to the student. 34 C.F.R. § 600.5(d)(2)(v). Through what appears to be a convoluted method of accounting, Respondent repeatedly ignored this requirement by reversing the presumptions. It applied a practice whereby Title IV funds first paid non-institutional charges (such as parking and transportation or living expenses) and all non-Title IV funds it received first paid institutional charges. As a result, Respondent improperly reduced the amount of Title IV funds reported in the numerator of the 85/15 fraction. Through its failure to apply the presumption correctly, Respondent was able to grossly distort, in its favor, the percentages of its Title IV income.

A second accounting error Respondent committed was the improper deduction of non-institutional charges from Title IV revenues in the numerator. 34 C.F.R. § 600.5(d)(1). These deducted charges were for such items as student parking fees and bus tokens. A school can make these deductions from Title IV revenue for non-institutional charges only if it can prove the existence of student credit balances and Respondent was unable to do so in this instance.

Income from an ineligible site

SFAP discovered that Respondent made additional errors in its 85 Percent Rule calculations by including revenues which it received from students at a satellite campus in Houston, Texas, as non-Title IV income in the denominator of the fraction. This site was not included in Respondent's Program Participation Agreement under which it received Title IV funds. Additionally, SFAP found that the Houston site was not accredited. Adding the non-Title IV revenues from the Houston site to the denominator of its 85/15 fraction seriously distorted the fraction in favor of the Respondent and it was improper. 34 C.F.R. § 668.13.

Conclusion

Respondent has the burden of proving the accounting methods it employed for computing the 85/15 and 90/10 fractions comparing Title IV revenues to total revenues were proper and represented sound accounting practices. 34 C.F.R. § 668.116(d). It has failed to meet this burden for all three years in question. After months of communicating with Respondent's administrative personnel, requesting and examining its student and institutional financial records, SFAP analyzed these materials and recomputed the percentages for these years. The correct percentages of Title IV funds Respondent received and applied to institutional charges, as compared to all revenue it received for these years, are: Fiscal Year 1996 – 89.39%; Fiscal Year 1997 – 96.32%; and, Fiscal Year 1998 – 98.59%. According to these calculations, Respondent violated the 85 Percent Rule for 1996 and 1997 and the more relaxed 90 Percent Rule for 1998. As a result of violating the 85 Percent Rule for 1996, Respondent became ineligible to participate in Title IV programs as of January 1, 1997, and remained ineligible for the remainder of the audited periods. 34 C.F.R. § 600.40(a)(2). SFAP calculated the amount of Title IV funds Respondent disbursed during the audited period between January 1, 1997, and November 30, 1998. From this amount, SFAP computed Respondent's liability to be \$7,467,693. This figure is comprised of the amount of grants and the estimated actual loss of the loans Respondent disbursed during this period of ineligibility.

ORDER

On the basis of the foregoing, it is hereby ORDERED that Respondent pay to the Department of Education \$7,467,693.

Judge Richard F. O'Hair

Dated: January 24, 2002

SERVICE

A copy of the attached initial decision was sent by certified mail, return receipt requested to the following:

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