UNITED STATES DEPARTMENT OF EDUCATION

THE SECRETARY

In the Matter of

PHILLIPS COLLEGES, INC.,

Respondent

Docket No. 94-27-ST
Student Financial Assistance
Proceeding

Decision of the Secretary

This matter comes before the Secretary on appeal by the United States Department of Education, Office of Student Financial Assistance Programs (SFAP) of the Decision issued by Administrative Judge Ernest C. Canellos (Judge Canellos) on March 24, 1994. In his decision, Judge Canellos ordered "that the eligibility of Phillips Colleges Inc., [(Phillips)] and its educational institutions to participate in the student financial assistance programs under Title IV of the Higher Education Act of 1965, as amended, [(Title IV)] is not terminated." Judge Canellos Decision (Canellos Dec.) at 8. In making his determination, Judge Canellos found that: (1) the material breach of the parties' Financial Responsibility Agreement (FRA or Agreement) is only one instance of violation; (2) that Phillips had at least a colorable good faith challenge to SFAP's draw on Phillips' Letter of Credit (LOC); (3) that Phillips replenished the LOC; and (4) that the Department failed to prove that the Federal government had been harmed by Phillips' material breach of the parties' Agreement. Canellos Dec. at 3-8. SFAP filed a timely appeal and Phillips, a timely opposition to appeal, on April 4 and April 14, 1994, respectively.

SFAP asks the Secretary to reverse Judge Canellos' decision and order Phillips' termination from participation in Title IV programs. Phillips argues that termination -- the harshest remedy prescribed by applicable federal regulations -- is unwarranted and insupportable. For the reasons outlined below, I affirm Judge Canellos' decision, in part, and reverse in part, taking exception to portions of Judge Canellos' reasoning and imposing a lesser sanction as prescribed below.

I BACKGROUND AND PROCEDURAL HISTORY

Phillips Colleges, Inc., founded in 1946, is now the largest chain of proprietary institutions in the country. It operates 40 coeducational colleges in 18 states across the nation. Transcript of Administrative Hearing (Tr.) at 127; Phillips Brief (Phillips Br.) at 4. See also February 15, 1994, Opinion of Judge Charles R. Richey (Richey Op.) at 2 (PCI v. Riley, Civ No 93-1703 (D.D.C)). Phillips enrolls 16,000 students and employs 2,000 individuals. Phillips Br. at 4. It offers a variety of degree and diploma vocational training and post-secondary education programs (including business, paralegal studies, and the allied health professions) to a student population which comprises, in large part, low and moderate income individuals. Phillips Br. at 4. All Phillips' colleges participate in the student financial assistance programs offered by the United States Department of Education (Department) as authorized by Title IV.

There is no dispute that Phillips, in the late 1980's, suffered serious financial problems. Phillips Br. at 5. As a result, and after a program review conducted by the Department, on April 29, 1992, SFAP notified Phillips that neither it nor its institutions met the financial responsibility standards required for participation in Title IV programs. SFAP Brief (SFAP Br.) at 3-4. See 34 C.F.R. § 668.13. SFAP provided Phillips an opportunity to post a Letter of Credit. SFAP Br. at 4. When Phillips declined, SFAP initiated an action, pursuant to 20 U.S.C. § 1094 and 34 C.F.R. Part 668, Subpart G, to terminate Phillips from participation in all Title IV programs. Id.

On July 24, 1992, SFAP and Phillips executed a settlement of the impending termination action, the terms of which constitute the primary issue in this case. In relevant part, the Financial Responsibility Agreement required Phillips to post a Letter of Credit on behalf of the Department in the amount of $5,000,000.00 (five million dollars). The express purpose of the Letter of Credit was to: (1) provide and pay refunds to, or on behalf of, current or former students of Phillips, whether Phillips remained open or closed; (2) provide for the "teach out" or re-placement of students enrolled at Phillips should Phillips close; and (3) pay any liabilities owing to the Secretary of Education arising from acts or omissions by Phillips in violation of Title IV requirements, including applicable regulations, or from any violation of any agreement entered into by Phillips with the Secretary regarding the administration of programs under Title IV.

The Letter of Credit did not limit the Department's right to draw down on the posted amount for any of the purposes prescribed. *Most importantly, however, the terms of the Letter of Credit required Phillips to restore any draw made by the Department within 20 days of the draw.*[1] SFAP Br. at 1. See also February 15, 1994, Richey Op. at 4-5.

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[1] Specifically, the FRA mandates that:

(continued...)

On August 26, 1993, based on a program review report issued by Weworski & Associates (Weworski Report), the Department drew down on the Letter of Credit in the amount of $2,194,554.13. This amount was based upon Weworski's projected liabilities derived from a statistical sample of unpaid delinquent refunds using a confidence level of 95% February 15, 1994, Richey Op. at 6 However, Phillips did not restore the draw down as required by the Agreement.[2]

On September 16, 1993, the Department notified Phillips that it (Phillips) was in material breach of the FRA because of its failure timely to restore the Letter of Credit. On October 13, 1993, Phillips requested administrative review. On January 28, 1994, Don Wurtz, the Department's Chief Financial Officer, issued a Final Agency Decision that Phillips materially breached the FRA for failure to restore the Letter of Credit. On the same day, the Department sent Phillips a notice of termination from participation in Title IV programs, discontinued the provision of Title IV funding under the Agreement, and otherwise ceased performance under the Agreement. SFAP Br. at 32.

Phillips again sought relief in federal district court, this time challenging the termination notice. After a February 2, 1994, hearing, Judge Richey on February 5, 1994, ordered the Department to provide Phillips a Subpart G hearing prior to termination from Title IV programs and, *importantly, to continue to provide Title IV funding pending the outcome of the expedited proceeding*. February 5, 1994, Richey Order (Richey Or.) at 5 (Phillips Colleges, Inc. v. Riley, Civil Action No. 94-179 (CRR)). On February 15, 1994, Richey also issued a summary judgment opinion that the Department's draw on the Letter of Credit was proper.[3]

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[1](...continued)

> PCI shall, within twenty (20) days of any draw by the Department upon said letter of credit, restore the value of the letter of credit five million dollars ($5,000,000) or such greater amount as PCI has been required to post and maintain . . . Failure to post or to maintain said letter of credit shall constitute a material breach of this Agreement.

[2] Prior to and after the draw, Phillips challenged the Department's draw in federal district court. On August 17, 1993, Phillips filed a Complaint and Motion for Temporary Restraining Order and Preliminary Injunction. That motion was denied on August 23, 1993. On August 30, 1993, Judge Richey granted Phillips' Motion for Consolidation of Hearing on the Preliminary Injunction with Trial on the Merits.

[3] Judge Richey's decision that the Department's draw was proper is currently pending appeal by Phillips in the United States Court of Appeals for the District of Columbia Circuit.

On February 25, 1994, Phillips attempted to restore the Letter of Credit. The Department rejected replenishment. On March 14-15, 1994, pursuant to Judge Richey's February 5, 1994, order, Judge Canellos held a Subpart G termination hearing. On March 24, 1994, Judge Canellos issued his "Decision" denying termination. SFAP timely filed the instant appeal.

II. DISCUSSION

A. Phillips College Materially Breached Its Agreement With the Department

When the Department entered into the Financial Responsibility Agreement with Phillips, it expected, rightly, that Phillips would comply with all its terms including the requirement to restore any Department draw. Indeed, failure to restore the value of the Letter of Credit within 20 days of the draw was expressly mandated and specifically assigned penalty for non-compliance in the Agreement. Thus, when the Department drew $2,194,554.13 from the Letter of Credit on August 26, 1993, Phillips was obligated to restore it by September 14, 1993. When it failed to restore the Letter of Credit, Phillips was in material breach of the Agreement.

Phillips argues, and Judge Canellos agreed, that Phillips effectively cured the material breach when it attempted to replenish the Letter of Credit on February 25, 1994. I disagree. As SFAP effectively points out, "[w]hen a contract provides a specific time for performing an act, and the act is neither performed within a specified time, nor is its nonperformance cured within a reasonable time of notification of the breach, unilateral subsequent performance does not cure the material breach." SFAP Br. at 20. Here, the Agreement clearly provides that failure to restore the value of the Letter of Credit within 20 days of any draw constitutes the only material breach defined by the Agreement. Thus, unless the Department waived either the material breach or its cure limitation, failure to timely restore equaled a breach. Judge Canellos' ruling notwithstanding, the Department did neither.

Judge Canellos ruled that the Department's January 28, 1994, notice of intent to terminate Phillips from participation in Title IV programs did not constitute notice that the Department intended to cancel the Agreement. Canellos Dec. at 3-4. He found that in the absence of such notice, the Department's continued performance under the Agreement during the pendency of this action constituted a waiver of Phillips' material breach. Id. at 4. Again, I disagree.

An institution's eligibility to participate in Title IV programs is conditioned upon its written agreement (called a Program Participation Agreement (PPA)) to do so under specified terms. 20 U.S.C. § 1094 (a); 34 C.F.R. § 668.12. When Phillips entered into the FRA with the Department, it effected an amendment to Phillips' PPA. Since Department regulations provide that termination from Title IV programs also terminates a PPA, when the Department notified Phillips that it was terminating Phillips from further participation in Title IV

programs, it effectively notified Phillips that it intended to terminate the FRA.[4]

I do not find, as Judge Canellos has held, that Judge Richey invalidated the notice of termination. Canellos Dec. at 3. Rather, Judge Richey merely ruled that before the Department could effect termination, it was required to provide Phillips with a Subpart G termination hearing.[5]

B. The Department Has A Legal Right to Terminate;
However, Termination Is Too Severe A Sanction In This Case

I do not dispute that, as a legal matter, Phillips' material breach of the Agreement permitted SFAP to terminate Phillips from participation in Title IV programs. But the inescapable backdrop and the tremendous potential consequence of Phillips' termination from participation in Title IV programs to 16,000 students must be considered.[6]

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[4] This is also common sense. As SFAP argues, the Agreement's sole purpose was, along with the PPA, to establish the terms and conditions under which Phillips could participate in the Department's programs. Thus, terminating Phillips from participation in such programs would, necessarily, cancel the Agreement. SFAP Br. at 27. Moreover, the Agreement itself provides that it would remain in effect for a time specified "unless the Department terminates the eligibility of all the Colleges to participate in the Title IV programs . . . in which case this Agreement shall terminate ninety days from the date of . . . termination of eligibility of the last College whose eligibility is terminated; . . . ." SFAP Br. at 27.

[5] Judge Canellos also reasoned that the Department waived Phillips' breach when it continued to perform under the Agreement after January 28, 1994. Without belaboring what seems to me an obvious point, I will not hold that the Department's compliance with Judge Richey's February 5, 1994, order to continue to provide Phillips Title IV funding pending the outcome of the termination proceeding constitutes continued performance after the breach and, therefore, a waiver of the breach. It does not.

[6] That applicable regulations provide for alternative sanctions (i.e., fine, suspension, limitation, and termination) for violation(s) of relevant statutes necessitates consideration not only of the legal viability of the sanction, but also the appropriateness of the sanction under the circumstances. Moreover, there is ample administrative precedent for this tribunal's consideration of the appropriateness of what may otherwise be a legally supportable action.

First, let me say that Phillips' characterization of its failure timely to restore the value of the Letter of Credit as a harmless "technicality," see Phillips Br at 27, portends an inadequate recognition of the seriousness of its behavior. Thus, Phillips must note that my imposition of a sanction lesser than termination is not a determination that it may continue to conduct its business as usual. As Phillips well knows, as a participant in Title IV funding, it must act with the requisite standard of care applicable to a fiduciary. This requirement is non-negotiable and this tribunal will not abide further violations of this or any other prescribed standard or condition.

But I am concerned that Phillips' attempt to replenish the draw, albeit untimely, demonstrates a willingness on Phillips' part to comply with the terms of the agreement and that aside from this failure, Phillips has demonstrated a "general effort to comply." See Tr. at 85-86. I am also troubled by the fact that Phillips' representation that its financial condition is improving is countered merely with the conclusory argument, by SFAP, that Phillips' "financial condition has not improved . . ." (emphasis added). SFAP Br. at 17. See also Tr. at 67. Without more, I feel compelled at least to consider Phillips' representation.

Further, admissions by SFAP's "sole witness in its case-in-chief," in support of termination, see SFAP Br. at 9, concern me. For example, when the witness was asked about the administrative burdens (attendant to Phillips' breach of the Agreement) which SFAP argues clearly militate in favor of the termination decision, SFAP's witness was not so clear. In fact, upon questioning by Judge Canellos, the witness admitted that the administrative burdens and expenditures attendant to administering the Agreement would have been the same whether the Agreement was violated or had gone full force in effect. See Tr. at 57.

It is within this framework -- i.e., the record below -- that I have weighed the consequence of termination to 16,000 students and it is precisely this framework that constrains me from imposing such sanction.

Finally, while I certainly understand SFAP's concern that Phillips' breach "caused the Department the loss of an important benefit of its bargain in entering into the Agreement," SFAP Br. at 40-41, I am not convinced that imposition of a lesser sanction in this case "would also encourage other parties who enter into agreements with the Department to breach those agreements for strategic or economic benefit, with little concern for the consequences or the institutions' fiduciary obligations under 34 CFR 668.82." SFAP Br. at 41. I am not holding, as SFAP rightly worries, that no sanction is appropriate where a party asserts that its material breach of a settlement agreement was motivated by a good faith belief that it was justified. Indeed, I find no merit whatever in Judge Canellos' finding that Phillips had a colorable good faith claim that the Department's draw was improper because the draw was not, according to Phillips, based on an accurate determination of liability. See Canellos Dec. at 6.

Rather, I am imposing a sanction that I believe comports with the record below, considers the potential consequences to an enormous group of students, and, at the same time, demonstrates to this participant that it may not enjoy the benefit of participation in Title IV programs without requisite responsibility.

Accordingly, I order as follows:

(1) Phillips Colleges shall go forward with and execute the restoration of the Department's $2,194,554.13 draw on the Letter of Credit, and the Department shall accept such replenishment;

(2) Because of serious questions regarding Phillips' financial responsibility, I further order Phillips to post an additional $1,000,000.00 (one million dollars) to the Letter of Credit in the same manner and under the same conditions as prescribed by the Financial Responsibility Agreement and the Department shall accept such additional funds; and

(3) I order that Phillips work cooperatively with SFAP to identify and locate students to which Phillips still owes refunds, and expeditiously provide such refunds. Phillips continued cooperation with SFAP in identifying, locating, and helping to ensure the issuance of refunds shall constitute a condition of Phillips' continued participation in the Department's Title IV programs.

So ordered this 29th day of April, 1994.

Richard W. Riley

Washington, D.C.

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