UNITED STATES DEPARTMENT OF EDUCATION

THE SECRETARY

In the Matter of
Cannella Schools of Hair Design,

Docket No. 95-141-ST
Student Financial Assistance Proceeding

Respondent

Decision of the Secretary

This matter comes before me upon Respondent Cannella Schools' appeal of Administrative Judge Richard O'Hair's decision upholding the decision of Student Financial Assistance Programs (SFAP) to terminate Cannella's participation in all Title IV programs. SFAP argued below that Cannella should be terminated due to 1)failure to timely submit audit reports; 2)excessive cohort default rates; and 3)failure to meet financial responsibility requirements. Judge O'Hair properly determined that Department regulations required him to terminate Cannella based on the audit and cohort default rate violations, but recommended that I excercise my plenary authority to mitigate this sanction and instead impose a $100,000 fine The Administrative Judge also found that three of the ten schools involved in this case should be terminated if they fail to provide letters of credit in accordance with the Department's financial responsibility regulations. I accept the Judge's recommendation to fine rather than terminate Cannella Schools, and I remand the case to the Administrative Judge for a determination of the appropriate amounts for the required letters of credit.

Timely Audits

It is uncontroverted that Cannella Schools failed to file with the Department timely compliance audits for the 1986-90 school years. Cannella argues that termination and fine is inappropriate because the issue is *res judicata* in that Department has already sanctioned it for this violation; because SFAP's imposition of the termination sanction in this case is arbitrary and capricious; because the audits were rejected for technical accounting deficiencies that were the responsibility of an independent auditor; and because the automatic termination provision of the regulations applies to untimely, not deficient, compliance audit reports. I agree with the Administrative Judge's conclusion that none of these arguments bars the Department from imposing a termination sanction, and adopt the Administrative Judge's reasoning with respect to all of the arguments except the *res judicata* claim

Cannella Schools bases its *res judicata* claim on the payment of an "informal fine" in January 1992 in settlement of its violation of the regulations. I agree with the Administrative Judge that principles of *res judicata* cannot preclude the Department from imposing additional sanctions in this instance. However, I explicitly decline to reach the issue of whether, under circumstances other than those in this case, a fine of this type could have a preclusive effect under *res judicata*.

SFAP's claim is not precluded in this case. Cannella's payment of an "informal fine" cannot relieve it of the responsibility to eventually file the audits that were the cause of the fine. In the absence of any documentation of the expectations of the parties, it is appropriate to assume that submission of corrected audits was contemplated within a reasonable time Cannella concedes that it failed to resubmit the rejected audits until September 1994, over two and one-half years from the time of the alleged settlement. This clearly is not a "reasonable time," given that the Department's regulations required participating institutions to submit audits within 6 months of the close of the last award year covered by the audit. Cannella Schools is subject to sanction, at least, for its failure to submit audits within a reasonable time after its alleged settlement of its liability for the untimeliness of its initial filing. The liability in this case is for Cannella's *continuing* violation of the regulations. In reaching this conclusion, it is unnecessary to reach the issue of whether a fine such as Cannella paid can have preclusive effect under *res judicata*.

The Administrative Judge recommended that, rather than impose the extreme sanction of termination in this case, I impose a $10,000 fine on each school for Cannella's failure to submit timely audits. Judge O'Hair identified six circumstances that support this recommendation·

> 1. Audits for the 1986-1990 years were rejected because of technical deficiencies in the preparation of the audits, not program errors committed by Cannella Schools.
> 2. Cannella Schools paid an informal fine of $35,000 to the Department because of these late audits.
> 3 Cannella Schools replaced its original auditor with a second one who prepared new audits for all its institutions for the years in question.
> 4 Audits for the years 1986-90 have been submitted and accepted.
> 5. Audits for all years after 1990 were timely submitted and accepted by the Department.
> 6 The most recent compliance audit reports for all of the institutions demonstrate that the institutions are administratively capable.

Initial Decision at 6. I agree that the factors identified by the Administrative Judge indicate it would be inappropriate to terminate Cannella's participation in all Title IV programs due to its failure to submit timely audits for the 1986-1990 award years In arguing strongly against the Administrative Judge's recommendation, SFAP overlooks the ultimate purpose of the regulations -- to ensure that institutions are satisfying their fiduciary responsibility to spend Title IV funds in accordance with the statute. In this light, Cannella's record of timely submission of acceptable audits for the six years following the 1986-90 award years is particularly convincing. This record, when considered with other factors, such as the fact that the audits were originally rejected not

because of program errors but because of technical deficiencies and the fact that the errors were caused by a third-party auditor whom Cannella has since discharged, suggests that Cannella can be relied upon to capably administer its Title IV funds.

Judge O'Hair recognized that the Cannella Schools had been in serious violation of Department regulations with respect to timely audits and recommended the imposition of a reasonable fine for those violations -- $10,000 per school, or $100,000. This fine makes clear that the Department will impose serious sanctions for failure to submit timely audits. The Administrative Judge's review of the facts of this case apparently convinced him that Cannella Schools is capable of administering and in fact is administering its Title IV programs in accordance with the Higher Education Act and applicable Department regulations, and the Judge's determination is well-supported. I therefore accept his recommendation to impose a $10,000 fine on each of the Cannella Schools for this violation, and forego the extreme sanction of termination.

Default Rates

Cannella advances a number of points in support of its position that the Administrative Judge improperly imposed the termination sanction on eight of the Cannella Schools institutions based on their excessive cohort default rates: that the decision violates the stated policy of the Department not to pursue termination actions against schools with fewer than five borrowers under the FFEL program; that the cohort default rate finding is arbitrary and capricious; that the Department has no statutory authority to terminate institutions from non-FFEL programs based on FFEL default rates; that the Department must base termination decisions on schools most recent published default rates; and that Cannella satisfactorily instituted default reduction measures identified in the regulations as a defense to default rate-based termination actions.

As the Administrative Judge indicated, Cannella cannot avail itself of my announced policy of not pursuing termination actions based on default rates for schools with fewer than five borrowers in Title IV loan programs. The rationale behind that policy is that it would be manifestly unjust to terminate schools based on default rates that might be significantly effected by the defaults of one or a few borrowers. Hence, the policy effects schools with fewer than five borrowers entering repayment, not fewer than five borrowers receiving disbursements, within the relevant period. In 1992, seven of Cannella's schools had between 21 and 101 borrowers entering repayment; an eighth, Cannella Schools -- Cermak, had only two borrowers entering repayment in 1992, but had had enough in the two previous years, also part of the relevant period, to bring it above the five-borrower threshold.

SFAP's excercise of discretion to institute termination proceedings was not arbitrary and capricious in this case; as SFAP points out, default rates at the eight Cannella Schools terminated were among the highest in Illinois for the relevant period. With respect to Cannella's claims regarding the use of the most recent published default rates, I adopt Judge O'Hair's reasoning. In response to Cannella's argument that SFAP lacks statutory authority to terminate a school's participation in non-FFEL programs based on FFEL default rates, I note that 20 U.S.C. §1094 clearly authorizes such action.

I do agree with Cannella that the Administrative Judge's decision failed to address adequately Cannella's implementation of the default reduction measures outlined in Appendix D of the regulations. While an exhaustive review of a school's implementation of the measures clearly is not required in the text of a decision, the Judge's conclusion that "testimonial evidence indicates a less than dedicated and complete implementation of the Appendix D measures" (Initial Decision at 12) should have been supported by direct reference to some of the areas in which Cannella failed to carry its burden. Under other circumstances, I might remand this matter for a more thorough discussion of this issue. However, because I intend to accept Judge O'Hair's recommendation to reject the termination sanction, a remand is unnecessary on this issue

I accept the Administrative Judge's determination that Cannella "came to the realization that its students were having repayment difficulties and that this is why it has been out of the FFEL program, with one exception, since 1992." Initial Decision at 10 I will defer to the Judge's conclusion that Cannella's decision to withdraw from the FFEL program prior to SFAP instituting this action amounts to Cannella taking, on its own initiative, the ultimate default reduction measure, and demonstrates that it takes seriously its responsibility to properly administer its remaining Department funds. Notably, Cannella made the determination to withdraw two years in advance of the calculation and publication of the default rates for which SFAP wishes to terminate its participation in other Title IV programs, so Cannella's action cannot be interpreted as a tactical attempt to preempt the termination action by withdrawal from the FFEL program. I accept Judge O'Hair's recommendation and set aside his order terminating Cannella Schools for its excessive default rates.

Financial Responsibility

The Administrative Judge found three of the Cannella Schools' corporations have failed to meet the standards of financial responsibility established in 34 C.F.R. §668.15(b)(7) (i) and should be terminated unless they provide letters of credit based on the Title IV funds received by these institutions during the 1994-95 award year. Cannella objects to the Administrative Judge's financial responsibility finding on the grounds that it was not properly notified of the grounds of SFAP's financial responsibility claim. For the reasons set forth by the Administrative Judge, I reject this argument and hold that Cannella had adequate notice of the grounds of the claim.

Cannella also argues that, because the Administrative Judge held the amount of the letter of credit demanded by SFAP to be "unreasonable" because it was not based on the most recent award year, the Judge should have dismissed the financial responsibility under 34 C.F.R. §668.90(a)(3)(iii). However, the language of the regulation cited does not require this result. The regulation states that:

> If an action brought against an institution...involves its failure to provide surety in the amount specified by the Secretary under §668.15, the hearing official finds that the amount of the surety established by the Secretary was appropriate, unless the institution can demonstrate that the amount was unreasonable.

The regulation is a burden-allocating provision that in no way limits the discretion of the Administrative Judge if he does find that the amount established was unreasonable.

Finally, Cannella argues that the Administrative Judge required the school to post letters of credit for amounts in excess of the amounts contemplated by Title IV. However, Judge O'Hair's decision included neither specific amounts nor a formula for their caluculation, but merely indicated that amounts should be caluculated based on the amounts of Title IV funds each school received in the 1994-95 award year. I agree that Cannella must provide letters of credit, based on the most recent award year for which data are available, for the three schools identified by the Administrative Judge, and I remand this case for a determination of the appropriate amounts.

ORDER

Accordingly, I set aside the Initial Decision of March 20, 1997, and impose upon each of the ten Cannella Schools a fine of $10,000 for failure to file timely audit reports. I also hold that Cannella Schools at Archer, Aurora (Broadway) and Westlawn (Cermak) must supply letters of credit or face termination, and remand this case for a determination of the appropriate amounts of these letters of credit.

So ordered this fifth day of September, 1997.

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