

CHARTER SCHOOLS AND HIGHER EDUCATION RESTRUCTURING

October 8, 2021

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TAB A



Charter Schools and Higher Education Restructuring

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How Did We Get Here?



How Did We Get Here?

Overall enrollment has declined every year since 2014, with public 2-year colleges experiencing a greater than average decline. The COVID-19 pandemic had a significant impact on the enrollment trend in 2020.

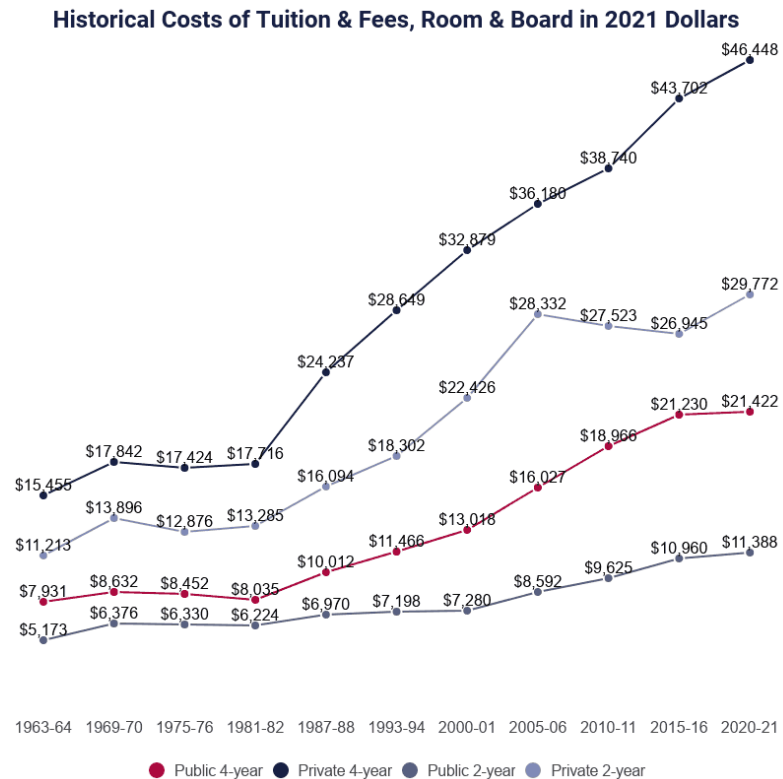
<u>Enrollment Year</u>	<u>Enrollment % Change from Prior Year</u>	
	<u>All Institutions</u>	<u>Public 2-Year College</u>
2014	-1.3%	-4.4%
2015	-1.7%	-2.4%
2016	-1.3%	-2.6%
2017	-1.0%	-1.7%
2018	-1.7%	-3.2%
2019	-0.8%	-1.4%
2020	-4.4%	-10.1%

Source: National Student Clearinghouse Research Center



How Did We Get Here?

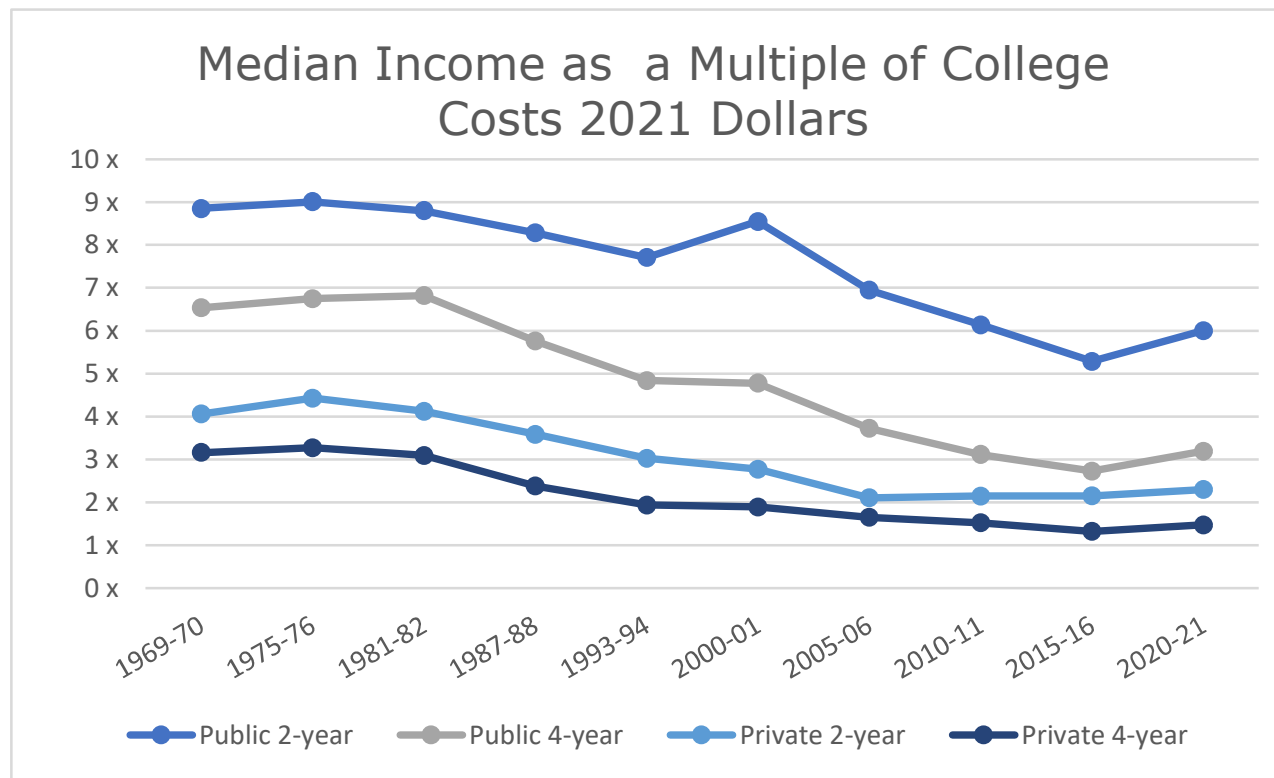
The cost of college has increased steadily over the last 40 years for both private and public institutions....





How Did We Get Here?

....while median income as a multiple of college costs has steadily declined over the same period.

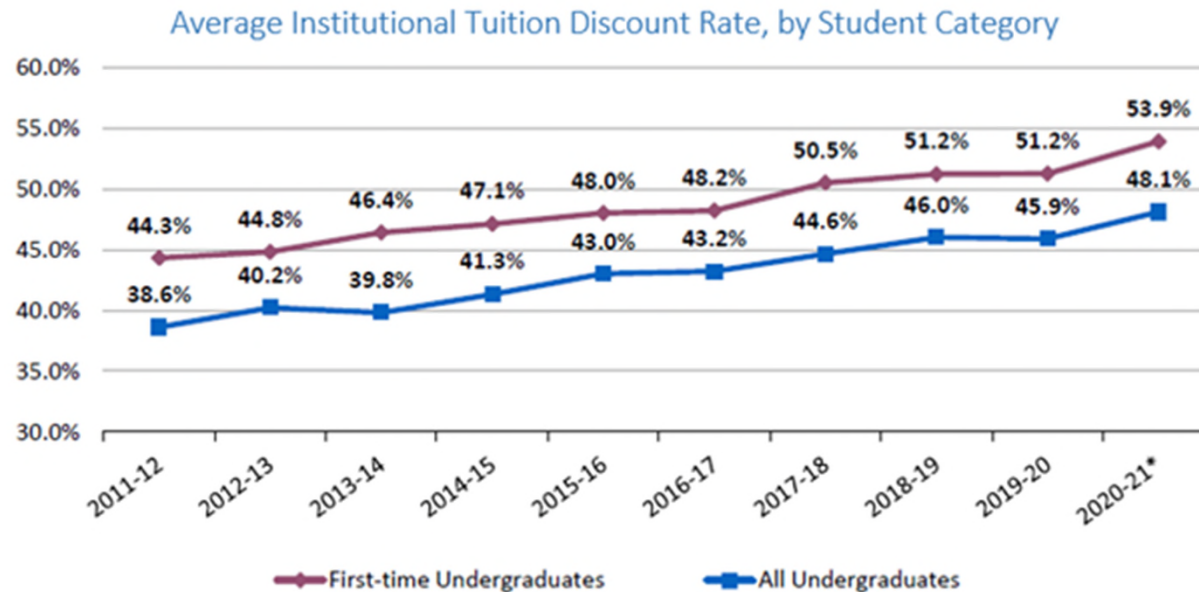


Source: Education Data



How Did We Get Here?

In order to attract students in a high cost, declining enrollment environment, many institutions have increased their discounts.



Source: NACUBO Tuition Discounting Study, data as of May 2021.

*Preliminary estimates.



How Did We Get Here?

Over time, the government has increased the Stafford Loan borrowing limits, which has been an enabler in the run-up of college costs.

Stafford Loans			
<i>Annual Loan Limits--Dependent Students</i>	<i>PLUS</i>		
<i>Effective Dates</i>	<i>Subsidized</i>	<i>Unsubsidized</i>	<i>Loans</i>
7/2/1967 to 5/31/1973	\$6,000	\$0	
6/1/1973 to 5/19/1977	\$7,500	\$0	
5/20/1977 to 10/16/1986	\$10,000	\$0	
10/17/1986 to 12/31/1986	\$10,000	\$0	\$20,000
1/1/1987 to 6/30/1993	\$13,250	\$0	\$20,000
7/1/1993 to 9/30/1993	\$17,125	\$0	*
10/1/1993 to 6/30/1994	\$17,125	\$0	*
7/1/1994 to 6/30/1996	\$17,125	\$0	*
7/1/1996 to 6/30/2007	\$17,125	\$0	*
7/1/2007 to 6/30/2008	\$19,000	\$0	*
7/1/2008 to the present	\$19,000	\$8,000	*
*Cost of Attendance minus Aid Received			



How Did We Get Here?

Other issues include:

- **Changing demographics** – between 2000 to 2020, the U.S. population increased by 17 percent, from 282 million to 331 million. The traditional college age population, 18- 24-year olds, increased 13 percent between 2000 and 2010 (from 27.3 million to 30.8 million), but remained fairly constant between 2010 and 2020, ending at 30 million. (*Source: National Center for Education Statistics, US Census Bureau*)
- **Migration patterns** - people are moving from the Northeast and Midwest to sunbelt and southern states like Florida, Arizona, Texas, and Georgia. Geographic enrollment trends are following the same patterns. Smaller, private colleges have typically drawn from within their region, and migration towards central and southern states are projected to cause a decrease in high school graduates from the northeast.
 - U.S. census estimates from 2010 to 2020 show that the youth population dropped more than 10 percent in the New England states of Vermont, New Hampshire, and Connecticut. Meanwhile, New England, with over 250 colleges and universities, has disproportionately more four-year private non-profit colleges compared to the rest of the nation. Schools that draw from a wider geographic region, with high selectivity, strong matriculation and revenue diversity don't face the same vulnerabilities. (*Sources: Fitch Ratings, GlobeSt.com*)
- **Increase in supply** – the number of public and private non-profit four-year institutions increased from 2,145 in 2000 to 2,340 in 2020, an increase of 9.09%, while the number of private for-profit 4-year institutions increased from 218 to 339, an increase of 55.5%. (*Source: National Center for Education Statistics*)



Institutions At Risk



Institutions at Risk

Following are common characteristics of institutions most at risk:

- Small liberal arts schools
- Non-urban
- Tuition dependent
- Small endowments
- No differentiation – requiring steep discounts to attract enrollment



Institutions at Risk

Below is an illustrative comparison of the balance sheets of five liberal arts institutions.

	College 1 CNR	College 2 Dowling	College 3 Mt. Ida	College 4 Becker	College 5 Goodwin
Assets	2018	2015	2016	2018	2018
Cash and cash equivalents	\$ 1,840,623	\$ 170,225	\$ 4,001,764	\$ 1,290,979	\$ 24,673,136
Restricted cash	1,000,001	3,514,940		108,629	
Student accounts receivable, net of allowance for doubtful accounts	6,701,212	960,635	488,317	2,689,878	2,404,108
Contributions and other receivables, net	1,919,996	2,088,137	51,148	682,462	6,409,257
Other assets	8,702,891	4,507,612	1,161,508	4,335,742	8,398,932
Investments	4,004,591	6,107,088	23,526,670	5,014,665	
Land, buildings, and equipment, net	57,688,165	50,402,208	54,006,033	34,241,485	205,442,379
Total assets	\$ 81,857,479	\$ 67,750,845	\$ 83,235,440	\$ 48,255,211	\$ 247,327,812
Liabilities and Net Assets:					
Liabilities:					
Accounts payable and accrued expenses	\$ 10,322,893	\$ 8,364,048	\$ 780,466	\$ 2,242,482	\$ 8,874,074
Payroll tax liabilities	20,152,409		2,006,845		
Notes payable	5,344,508	6,757,500	12,518,376	6,955,905	18,148,450
Student deposits and advance fees	923,506				
Deferred revenue	6,963,726	45,828	5,265,449		5,665,395
Interest rate swap	179,023				
Long-term debt	46,689,492	46,675,039	39,353,139	5,935,903	
Accrued postretirement benefit obligation	557,279		5,006,629		
U.S. government grants refundable	4,443,663				
Other Liabilities		2,023,715	1,871,650	8,870,000	2,574,213
Total liabilities	\$ 95,576,499	\$ 63,866,130	\$ 66,802,554	\$ 24,004,290	\$ 35,262,132
Net assets (deficiency):					
Unrestricted	(19,998,842)	(1,242,159)	14,527,692	18,310,705	208,071,257
Temporarily restricted	2,528,107	3,217,303	628,349	1,923,065	3,994,423
Permanently restricted	3,751,715	1,909,571	1,276,845	4,017,151	
Total net assets (deficiency)	(13,719,020)	3,884,715	16,432,886	24,250,921	212,065,680
Total liabilities and net assets	\$ 81,857,479	\$ 67,750,845	\$ 83,235,440	\$ 48,255,211	\$ 247,327,812
<i>Fixed Assets as % of all assets</i>	70%	74%	65%	71%	83%
<i>Endowment (investments) as % of all assets</i>	5%	9%	28%	10%	0%



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Institutions at Risk

Below is an illustrative comparison of the income statements of five liberal arts institutions.

	College 1 CNR	College 2 Dowling	College 3 Mt. Ida	College 4 Becker	College 5 Goodwin
	2018	2015	2016	2018	2018
Revenues, investment return, and other support					
Tuition and fees	\$ 61,835,450	\$ 44,972,150	\$ 50,754,219	\$ 59,760,215	\$ 63,557,399
Tuition Discounts	(16,132,486)	(18,417,312)	(18,645,121)	(26,475,017)	(14,361,844)
Auxiliary Enterprises		3,965,094		10,479,282	
Contributions	3,505,862	1,351,261		1,516,326	256,653
Grants and contracts	3,003,978		8,114,300	116,667	8,396,739
Investment income	410,255	41,664	7,543	227,679	220,370
Sales and services of auxiliary enterprises	4,255,185	-	-	(87,439)	279,902
Other revenue	532,477	694,886	1,536,414	459,788	(27,637)
Total revenues	\$ 57,410,721	\$ 32,607,743	\$ 41,767,355	\$ 45,997,501	\$ 58,321,582
Expenses					
Salaries and wages	\$ 24,896,538	\$ 13,436,015	\$ 16,126,892	\$ 18,694,943	\$ 23,906,744
Employee benefits	5,486,393	3,149,052	3,114,954	3,180,961	1,821,488
Contracted services	5,477,314	1,586,632	2,126,389	1,576,158	2,236,357
Payroll tax penalties and interest	2,673,382	958,045	1,345,914	1,312,124	1,942,522
Professional fees	3,218,933				
Supplies	588,203			1,188,852	678,134
Depreciation	1,846,240	3,224,249	2,985,540	3,434,945	6,499,430
Bad debt expense (recovery)	1,357,183				
Interest	3,241,791	3,233,750	1,546,618	1,285,408	632,998
Rent and lease expense	3,080,730	2,602,239	5,004,324	3,551,293	1,678,144
Repairs and maintenance	677,496				2,488,089
Utilities	1,362,861				
Insurance	711,093	1,194,706	817,049	668,354	512,980
Other expenses	4,565,303	7,421,429	10,463,392	11,672,460	10,997,706
Total expenses	\$ 59,183,460	\$ 36,806,117	\$ 43,531,072	\$ 46,565,498	\$ 53,394,592
Net Revenue	\$ (1,772,739)	\$ (4,198,374)	\$ (1,763,717)	\$ (567,997)	\$ 4,926,990
<i>Discount as % of Tuition Revenue</i>	(26%)	(41%)	(37%)	(44%)	(23%)
<i>Net Tuition Revenue as % of overall revenue</i>	80%	81%	77%	72%	84%



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Chapter 11 and Alternatives



Issues With Chapter 11

Chapter 11 does not offer higher education institutions an opportunity to rehabilitate.

§541. Property of the estate

(b) Property of the estate does not include—

(3) any eligibility of the debtor to participate in programs authorized under the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.; 42 U.S.C. 2751 et seq.),¹ or any accreditation status or State licensure of the debtor as an educational institution;

34 CFR § 600.7 - Conditions of institutional ineligibility.

(a) General rule. For purposes of title IV of the HEA, an educational institution that otherwise satisfies the requirements contained in §§ 600.4, 600.5, or 600.6 nevertheless does not qualify as an eligible institution under this part if –

(2) The institution, or an affiliate of the institution that has the power, by contract or ownership interest, to direct or cause the direction of the management of policies of the institution –

(A) Files for relief in bankruptcy, or

(B) Has entered against it an order for relief in bankruptcy;



Issues With Chapter 11

20 U.S. Code § 1002 - Definition of institution of higher education for purposes of student assistance programs

(4) Limitations based on management

An institution shall not be considered to meet the definition of an institution of higher education in paragraph (1) if—

(A) the institution, or an affiliate of the institution that has the power, by contract or ownership interest, to direct or cause the direction of the management or policies of the institution, has filed for bankruptcy, except that this paragraph shall not apply to a nonprofit institution, the primary function of which is to provide health care educational services (or an affiliate of such an institution that has the power, by contract or ownership interest, to direct or cause the direction of the institution's management or policies) that files for bankruptcy under chapter 11 of title 11 between July 1, 1998, and December 1, 1998;



Issues With Chapter 11

There are automatic stay exclusions under section 362(b), (14) through (16):

(b) The filing of a petition under section [301](#), [302](#), or [303](#) of this title, or of an application under section 5(a)(3) of the [Securities Investor Protection Act of 1970](#), does not operate as a stay—

(14) under subsection (a) of this section, of any action by an accrediting agency regarding the accreditation status of the debtor as an educational institution;

(15) under subsection (a) of this section, of any action by a State licensing body regarding the licensure of the debtor as an educational institution;

(16) under subsection (a) of this section, of any action by a guaranty agency, as defined in section 435(j) of the [Higher Education Act of 1965](#) or the Secretary of Education regarding the eligibility of the debtor to participate in programs authorized under such Act;



Chapter 11 Alternatives

The choices available to institutions re: dependent on time and sufficient cash, and they include:

- “Performance improvement”
 - Offering new programs
 - Revamp marketing to drive enrollment
 - Cost reductions
 - Discontinue non-contributing programs
- Declare finance exigency
- Transaction
 - Sale
 - Merger
 - Joint venture
 - Cost sharing
- Teach-out
- Receivership
- Liquidation



Chapter 11 Alternatives

Following are key considerations in choosing alternatives:

- Financial runway
- Gap between appraised and market values
- Dynamics of public vs. private debt
- Regulatory requirements
 - Accreditation
 - Attorney General
 - U.S. DOE
 - State DOE

TAB B

Pitfalls Faced By Higher Education Institutions Seeking Bankruptcy Relief

Matthew P. Ward
Womble Bond Dickinson (US) LLP

These volatile times in which we are living entail the convergence of several factors subjecting institutions of higher education to an environment of financial stress, which could lead to more engagements for insolvency professionals.

First, the forgiveness of tuition obligations is increasing at a steady rate. Since January 2021, the total amount of loans that the Department of Education has approved for discharge is \$9.5 billion, affecting over 563,000 borrowers.¹ Congress also has proposed legislation which, if passed, would ease the burden to discharge student loans through bankruptcy.² The recent increase in student loan forgiveness, as well as the potential for the number of student loans to be discharged through bankruptcy, may indirectly have a negative financial impact on the colleges and universities themselves. In particular, it could cause lenders to be stricter in selecting the student borrowers to whom they will lend, thereby reducing the population pool (and consequently the revenue stream) for colleges and universities. (Query whether this heightening of the standards to obtain tuition loans could have a disparate impact on minorities or other groups that historically have been discriminated against by lenders. Because of the added risk to lenders, it might also cause them to be more careful about monitoring credit quality, including through oversight of which majors its borrowers are choosing and whether those majors lead to better job prospects and result in higher salaries.³)

¹ <https://www.ed.gov/news/press-releases/extended-closed-school-discharge-will-provide-115k-borrowers-itt-technical-institute-more-11b-loan-forgiveness>

² Currently, students face an uphill battle in seeking to discharge their student loans through a bankruptcy, because in order to do so, the Bankruptcy Code requires the debtor to show that such loans are causing the debtor “undue hardship.” 11 U.S.C. § 523(a)(8). However, bi-partisan legislation has been proposed that would lower the burden by removing the requirement of a showing of “undue hardship” with respect to loans more than ten years old. <https://www.durbin.senate.gov/newsroom/press-releases/durbin-cornyn-introduce-new-bipartisan-bill-to-allow-federal-student-loan-borrowers-to-discharge-loans-in-bankruptcy>

³ See Jill Walters, “A Dream or a Nightmare? Who pays in a world without student loans?”, 9 Nat’l L.J. 226 (Aug. 14, 2019) (discussing possibility of student loan forgiveness and dischargeability, and recognizing that “a likely downside is that student loans would no longer be as easy to obtain. Lending sources would likely set a higher bar to qualify borrowers, requiring a good credit score and/or income. We can also assume that many lenders would find the new market too risky, and perhaps disappear entirely.”).

Second, enrollment at colleges and universities has been on the decline for years,⁴ caused at least in part by the increase in tuition over the past several decades.⁵ In light of the rising costs, many students are re-thinking whether college is the best path for them, as opposed to a trade school or other alternative.

Third, during the COVID-19 pandemic, many colleges and universities have been using stimulus funds to help offset expenses and even revenue gaps resulting from tuition forgiveness.⁶ However, the financial runway of stimulus funds is not eternal. When the stimulus programs end, it could leave their current beneficiaries short on cash.⁷ (While even the oldest and most elite universities with huge endowments received federal funds under the stimulus program, it appears that HBCUs may have received greater than their proportionate share⁸, and accordingly, the ending of the stimulus program could have a disproportionately large and unfortunate impact on such institutions.)

Fourth, because of the COVID-19 pandemic, many tertiary schools forced their students to stay home for one or two semesters, thereby foregoing room and board revenue.

Perhaps equally as concerning could be a long term rise in the number of students that choose to continue to attend college remotely on an ongoing basis, having now adapted to

⁴ See Charter Schools and Higher Education Restructuring powerpoint presentation attached hereto, at slide 4 (noting the year-over-year ongoing decline in enrollment, and providing data from National Student Clearinghouse Research Center, “COVID-19: Stay Informed” (Apr. 28, 2021), <https://nscresearchcenter.org/tag/enrollment-trends/>)

⁵ See Charter Schools and Higher Education Restructuring powerpoint presentation attached hereto, at slide 5 (tracking the ongoing increase in college tuition costs over the last sixty years); see also College Board, “Trends in College Pricing and Student Aid 2020”, at p. 12, <https://research.collegeboard.org/pdf/trends-college-pricing-student-aid-2020.pdf> (noting the year-over-year ongoing increase in tuition over the past fifty years).

⁶ Parker Purifoy and Shera Avi-Yonah, “Schools Tap Stimulus Funds to Wipe Unpaid Fees for Low-Income Students” (July 30, 2021), <https://www.bloomberg.com/news/articles/2021-07-30/universities-tap-stimulus-funds-to-reduce-debt-barriers-for-low-income-students> (“Using pandemic stimulus money, nearly two dozen schools across the country are forgiving fees for things like extra courses, parking tickets, lost library books and, in some cases, tuition.”).

⁷ Id. (“But federal funding isn’t a permanent fix. After relief money dries up, fees will continue to force some students to drop out, carrying unpaid bills instead of a diploma.”).

⁸ Melissa Korn, “HBCUs Deploy Covid-19 Pandemic Funds to Forgive Millions in Student Debt”, Wall St. J. (July 28, 2021 5:30 am ET), <https://www.wsj.com/articles/hbcus-deploy-covid-19-pandemic-funds-to-forgive-millions-in-student-debt-11627464602> (“More than 20 HBCUs are using federal pandemic funds for debt relief, according to a tally by the United Negro College Fund, a scholarship organization for private historically Black colleges and universities. HBCUs received \$2.6 billion of the \$40 billion set aside for higher education under this spring’s American Rescue Plan Act.”).

that model, thereby perpetuating the loss of room and board income for schools that continue to offer a “virtual only” option.

Fifth, the eventual end of stimulus programs and tightening of unemployment, coupled with the eventual rise in interest rates, at some point will start to weigh on the economy more generally. As these developments take tolls on families across the country, they may look for ways to escape their financial distress, including creative ways to avoid their tuition payment obligations. Some cases have suggested that parents that file for bankruptcy might be able to claw back tuition payments that they have made for their children’s education. Courts in those cases have, in some instances, found such payments to be voidable transactions for which the parents themselves received no reasonably equivalent value.⁹ Even aside from the ultimate outcome of litigation of this nature, at a minimum schools’ legal costs will increase with the overall rise in litigation that often occurs as an economy constricts.

Sixth, as lenders see the writing on the wall for the higher education sector, they may become more careful about which academies they lend to, or at least require a stronger collateral base to secure any such loans.

For these reasons, it would be prudent for restructuring professionals to prepare for the next cycle of activity in this sector. Unfortunately, the Bankruptcy Code makes it difficult for higher education institutions to seek effective relief through the chapter 11 process. As a preliminary matter, under the terms of the Bankruptcy Code, if a college were to file to relief under chapter 11, the debtor-in-possession would no longer be qualified to participate in federal programs under the Higher Education Act of 1965 or any accreditation or state licensure programs. In particular, Bankruptcy Code section 541(b)(3) states:

⁹ See David Gray Carlson, “Tuition As a Fraudulent Transfer”, 36 Emory Bankr. Dev. J. 15 (2020) for an analysis of such cases. The article also examines cases that reached the opposite result, concluding that a recipient school is not the initial transferee, but instead the student on behalf of whom the payments were made is deemed the initial transferee and the school is a subsequent transferee and shielded from clawback, assuming that it acted in good faith.

(b) Property of the estate does not include— . . .

(3) any eligibility of the debtor to participate in programs authorized under the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.; 42 U.S.C. 2751 et seq.), or any accreditation status or State licensure of the debtor as an educational institution

11 U.S.C. § 541(b)(3).

Similarly, the Bankruptcy Code provides that the automatic stay does not block accrediting agencies from taking adverse action with respect to a higher education institution's accreditation status if it files for bankruptcy. Nor does it prevent state licensing bodies from taking such measures with respect to licensing. And, equally or more importantly, it does not stop a guaranty agency or the Department of Education from terminating such an institution's ability to participate in programs under the Higher Education Act of 1965.

(b) The filing of a [bankruptcy] petition . . . does not operate as a stay—

(14) under subsection (a) of this section, of any action by an accrediting agency regarding the accreditation status of the debtor as an educational institution;

(15) under subsection (a) of this section, of any action by a State licensing body regarding the licensure of the debtor as an educational institution;

(16) under subsection (a) of this section, of any action by a guaranty agency, as defined in section 435(j) of the Higher Education Act of 1965 or the Secretary of Education regarding the eligibility of the debtor to participate in programs authorized under such Act

11 U.S.C. § 362(b)(14)-(16). The “guaranty agencies” referenced in subpart (16) of section 362(b) are those agencies established to guaranty student loans made by lenders (as well as perform certain administrative and oversight functions under the Federal Family Education Loan (FFEL) program).¹⁰

¹⁰ Note, however, that during the pandemic, governmental restrictions have been put in place to pause federal student loan interest and collections on all defaulted loans in the FFEL program. <https://www.ed.gov/news/press->

Additionally, with respect to higher education institutions that are for-profit, the ability of such schools to benefit from a chapter 11 proceeding is further limited by virtue of the institution's loss of participation in the Title IV funding program. Specifically, federal law permanently revokes a school's eligibility to receive federal student aid once it commences a bankruptcy proceeding.¹¹ With federal student aid such a large part of the school's revenue, such a revocation almost universally would be fatal to the school. The federal statute does not appear to provide the Department of Education with discretion regarding the revocation.¹² The revocation occurs through the school's OPEID number going defunct.¹³ Once that happens from a chapter 11 bankruptcy filing, the school may no longer participate in Title IV funding. Without the availability of Title IV funding, a for-profit school that files for chapter 11 often may be left without the ability to confirm a chapter 11 plan.

Notwithstanding all of the foregoing statutory hurdles that an institution of higher education faces in the event that it files for chapter 11 relief, occasionally such filings are effective to obtain relief. In those instances, often a school will need to have all the pieces regarding a sale/merger in place before the filing, and then work fast during the case to consummate the sale, in order to minimize disruption to its students. Furthermore, with respect to a for-profit college, any such sale would need to be to another school that has its own OPEID number, since the debtor institution's OPEID number will have been revoked. One of the examples of a successful sale in a chapter 11 proceeding is the jointly administered chapter 11 case of Florida Career Colleges, Anthem Colleges, and U.S. Colleges, in which certain of the

releases/departments-education-announces-expansion-covid-19-emergency-flexibilities-additional-federal-student-loans-default

¹¹ 20 U.S.C. § 1002(a)(4)(A).

¹² However, the Department of Education has discretion to revoke Title IV funding to for-profit schools for reasons other than bankruptcy filing. A recent example is the Department's discretionary revocation of Title IV funding to Florida Coastal School of Law, based on its review of the school's financial statements and its determination that the school's owner, InfilLaw Corp., failed to meet its financial responsibilities. The school sought injunctive relief, attempting to require the Department to reverse its decision. In its request, the school noted that over 80% of its revenue came from the Title IV funding program. See Emergency Motion for Temporary Restraining Order and/or Preliminary Injunction, Fla. Coastal School of Law, Inc. v. Cardona, Case No. 3:21-cv-721-MMH-JBT (M.D. Fla. Aug. 9, 2021) (Docket No. 5), at p. 1. The school was unsuccessful in its effort. See Order, Fla. Coastal School of Law, Inc. v. Cardona, Case No. 3:21-cv-721-MMH-JBT (M.D. Fla. Aug. 9, 2021) (Docket No. 30).

¹³ Note, "Forgive and Forget: Bankruptcy Reform in the Context of For-Profit Colleges", 128 Harv. L. Rev. 2018, 2034-35 (May 9, 2015); Scott F. Norberg, "Bankruptcy and Higher Education Institutions", 23 Am. Bankr. Inst. L. Rev. 385, 386-88 (2015).

debtors were able to consummate post-bankruptcy sales of their campuses to IEC Corporation, which maintained its own OPEID number.¹⁴

In the event that a college or university does embark upon a chapter 11 process, and should it be able to consummate a chapter 11 plan, one upside to creditors could be the preservation of causes of action against the directors and officers whose decision making placed the school in the precarious state that resulted in the bankruptcy. This opportunity materialized in the Florida Career Colleges, Anthem Colleges, and U.S. Colleges cases. There, following the aforementioned sales, the debtors worked with the creditors' committee to propose and obtain confirmation of a chapter 11 plan that preserved causes of action against directors and officers, and allowed a liquidation trustee to pursue those claims in the debtors' stead for the benefit of the colleges' creditors.¹⁵

In order to ensure that creditors maximize their recovery in any such lawsuit, counsel needs to be careful in how they structure the assertion of the cause of action, in order to ensure that the court agrees that the plaintiff has standing to do so. When the trial Court faced the claims asserted by the liquidation trustee in the Florida Career Colleges et al. case against the directors and officers, the trial Court initially dismissed the action, on the grounds that Delaware law did not bestow standing on creditors to pursue direct claims against the directors and officers.¹⁶ In reaching its conclusion, the Court acknowledged that it "recognizes that a trustee 'does have standing to bring direct claims for breach of fiduciary duty on behalf of the Debtors.'"¹⁷ However, in the Court's initial view, the liquidation trustee was acting as a chapter 11 plan fiduciary for creditors and therefore (procedurally improperly) was attempting to bring the action on behalf of those creditors, not on behalf of the debtors.¹⁸ Following that ruling, the

¹⁴ Sale Order, In re FCC Holdings, Inc., et al., Case No. 14-11987 (CSS) (Bankr. D. Del.) (Docket No. 166).

¹⁵ In the interest of disclosure, the author along with his colleague Ericka Johnson (also from Womble Bond Dickinson (US) LLP) and David Posner and Gianfranco Finizio (both currently at Kilpatrick Townsend & Stockton LLP) were counsel to the creditors' committee and, subsequently, to Clingman & Hanger Management Associates, LLC as liquidation trustee. The liquidation trustee engaged Avery Samet and his team (currently at Amini LLC) to handle the preparation and prosecution of the causes of action against the directors and officers.

¹⁶ See Order Granting Defendants' Motions to Dismiss, Clingman & Hanger Mgmt. Assocs., LLC v. Nobel, Case No. 0:16-cv-62028-JAL (S.D. Fla. Apr. 28, 2017) (Docket No. 76), at pp. 6-8 (citing N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (2007)).

¹⁷ Id.

¹⁸ Id.

liquidation trustee requested the Court to reconsider the matter.¹⁹ In its motion, the liquidation trustee explained that it was asserting the claims directly, on behalf of and as assignee of the colleges themselves through their chapter 11 bankruptcy plan, against the officers and directors.²⁰ The Court granted the liquidation trustee's motion and allowed the trustee to amend the Complaint,²¹ thereby giving the trustee the opportunity to clarify in the amended complaint that it was asserting the colleges' claims directly, as the assignee of those claims, against the defendants, rather than directly on behalf of creditors. Ultimately, the liquidation trustee did make those amendments to the complaint, and the amended complaint then survived the defendants' motion to dismiss, following which the case ultimately successfully settled.

Because of the toll that all of this legislation takes on the potential effectiveness of a chapter 11 bankruptcy filing, it is more common that institutions of higher education that are facing economic distress instead choose an alternate path towards rehabilitation. One option is to make performance improvements, such as offering new programs, increasing marketing to drive enrollment, reducing cost, and/or eliminating burdensome programs. Another option is to conduct teach-outs. Teach-outs constitute a regime that a college will put into place pursuant to which its students will be able to complete their studies at another school. It usually entails a written plan or agreement with the other school that will remain open and complete the students' education. While such programs do allow students to finish their education, sometimes they do so in a way that is overly burdensome to the students, such as facilitating a teach-out at a school that is geographically distant from the closing school, or transitioning the student into a program that might have additional hours or credit requirements.²²

Another option available to tertiary schools in financial distress that are unable to navigate the legislative framework of chapter 11 is the appointment of a receiver. Unlike in a bankruptcy, nothing in a receivership prevents the school from continuing to benefit from its key

¹⁹ Plaintiff's Memorandum of Law in Support of Its Motion for Reconsideration, Clingman & Hanger Mgmt. Assocs., LLC v. Nobel, Case No. 0:16-cv-62028-JAL (S.D. Fla. May 26, 2017) (Docket No. 78).

²⁰ Id. at pp. 3-4 ("Here, it is undisputed that the Trustee has standing to bring FCC's direct fiduciary claims pursuant to the [confirmation order] and "clarif[y]ing that the fiduciary claims were being brought pursuant to the Confirmation Order's explicit assignment of FCC's claims").

²¹ Docket entry, Clingman & Hanger Mgmt. Assocs., LLC v. Nobel, Case No. 0:16-cv-62028-JAL (S.D. Fla. June 27, 2017) (Docket No. 83).

²² Mark Podgainsky and Bert Weil, "Higher Education Teachout Plans: Overview and Key Success Factors" (July 19, 2021), <https://turnaround.org/nyc/news/higher-education-teachout-plans-overview-and-key-success-factors>.

funding source, i.e., the federal government (including through Title IV funds and federal grants and loans). A receivership may also reduce professional costs for an institution seeking to effectuate a quick sale in order to keep the lights on. A receiver would take control of the institution and its assets and be given broad latitude to undertake the actions necessary to consummate a sale and pay the school's creditors. However, a receivership also has its drawbacks, including that it is less orderly than a bankruptcy proceeding. Additionally, in a federal receivership, a school may hit headwinds from the court regarding its jurisdiction.²³ At the very least, receiverships are an option worth exploring for financially distressed institutions.

As a final note, counsel who is advising those with decision making authority at a for-profit higher education institution in distress should also be mindful of, and make their clients aware of, the possibility that in certain circumstances those individuals may face personal liability for losses sustained by the federal government in connection with the closure of a school. Specifically, in 1992, Congress amended the Higher Education Act of 1965 to add a provision allowing the Department of Education to recover such losses from persons who "exercise substantial control" over a for-profit school. The amendment provides:

(e) FINANCIAL GUARANTEES FROM OWNERS.--(1) Notwithstanding any other provision of law, the Secretary may, to the extent necessary to protect the financial interest of the United States, require--

(A) financial guarantees from an institution participating, or seeking to participate, in a program under title IV, or from one or more individuals who the Secretary determines, in accordance with paragraph (2), exercise substantial control over such institution, or both, in an amount determined by the Secretary to be sufficient to satisfy the institution's potential liability to the Federal Government, student assistance recipients, and other program participants for funds under title IV; and

(B) the assumption of personal liability, by one or more individuals who exercise substantial control over such institution, as determined by the Secretary in

²³ See Educ. Corp. of Am. v. U.S. Dep't of Educ., C.A. No. 2:18-cv-01698-AKK (N.D. Ala. Nov. 5, 2018) (dismissing, based on lack of justiciable case or controversy, a for-profit college's lawsuit against Department of Education that sought declaratory relief that a proposed receivership will not interfere with its ability to participate in federal financial aid programs regulated by the Department).

accordance with paragraph (2), for financial losses to the Federal Government, student assistance recipients, and other program participants for funds under title IV, and civil monetary penalties and criminal fines authorized under title IV.

20 U.S.C. § 1099c(e). To date, the Department of Education has very rarely (if ever) pursued personal guaranties or personal assumption of liabilities under this section. However, recently several politicians and advocacy groups have pushed for it to do so, as the number of for-profit college failures increases.²⁴ Counsel must continue to stay informed of legislative and judicial developments in this area of the law in order to advise officers of for-profit colleges knowledgeably and accurately regarding the risks that are entailed.

²⁴ See Daniel A. Zibel & Alice W. Yao, “Protection and the Unseen: Holding Executives Personally Liable under the Higher Education Act”, 100 Day Docket Student Defense (Oct. 2020), <https://www.defendstudents.org/news/body/docket/100-Day-Docket-Personal-Liability-Report.pdf> (discussing options for pursuing claims against decision makers at for-profit colleges); see also Jillian Berman, “Students fight to hold execs personally liable for collapse of college chain”, MarketWatch (Aug. 21, 2021), <https://www.marketwatch.com/story/students-advocates-fight-for-executives-to-be-held-liable-in-collapse-of-major-college-chain-11629218441>; Dan Zibel, “For Profit College Execs Should Be Personally Liable For Their Crimes”, Wash. Monthly (Oct. 19, 2020), <https://washingtonmonthly.com/2020/10/19/for-profit-college-execs-should-be-personally-liable-for-their-crimes/>; Kery Murakami, “Warren Calls for Owners of For-Profits to Be Held Financially Responsible”, Inside Higher Ed (Oct. 6, 2020), <https://www.insidehighered.com/quicktakes/2020/10/06/warren-calls-owners-profits-be-held-financially-responsible>

TAB C

Restructuring Charter Schools in Financial Distress

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Restructuring charter schools in financial distress involves balancing competing interests of public school communities, state charter authorizers, debt holders and trade creditors. While charter schools account for relatively few chapter 7 or 11 bankruptcy cases, charter schools reportedly have a failure rate of approximately fifty percent (50%) at the 15-year mark.¹ Thus, considerations for the causes that lead charter schools to experience financial distress and the opportunities for turnaround warrant meaningful review to reduce the negative impacts on a charter school's failure on the greater school community, including its investors. At the outset of these discussions, it is acknowledged that as with many issues facing our body politic, the mere existence and funding mechanisms of charter schools face increasingly polarized political views. These materials will resist the temptation to delve into politics of charter schools, and instead will maintain focus on the charter schools' financial restructuring tools and opportunities. These materials will first provide a brief background of the structure, operations and financing aspects of charter schools. Next, these materials will consider potential approaches to maximize value for stakeholders (including the students and families that increasingly rely on charter schools).

1. Growth and Demand for Charter Schools.

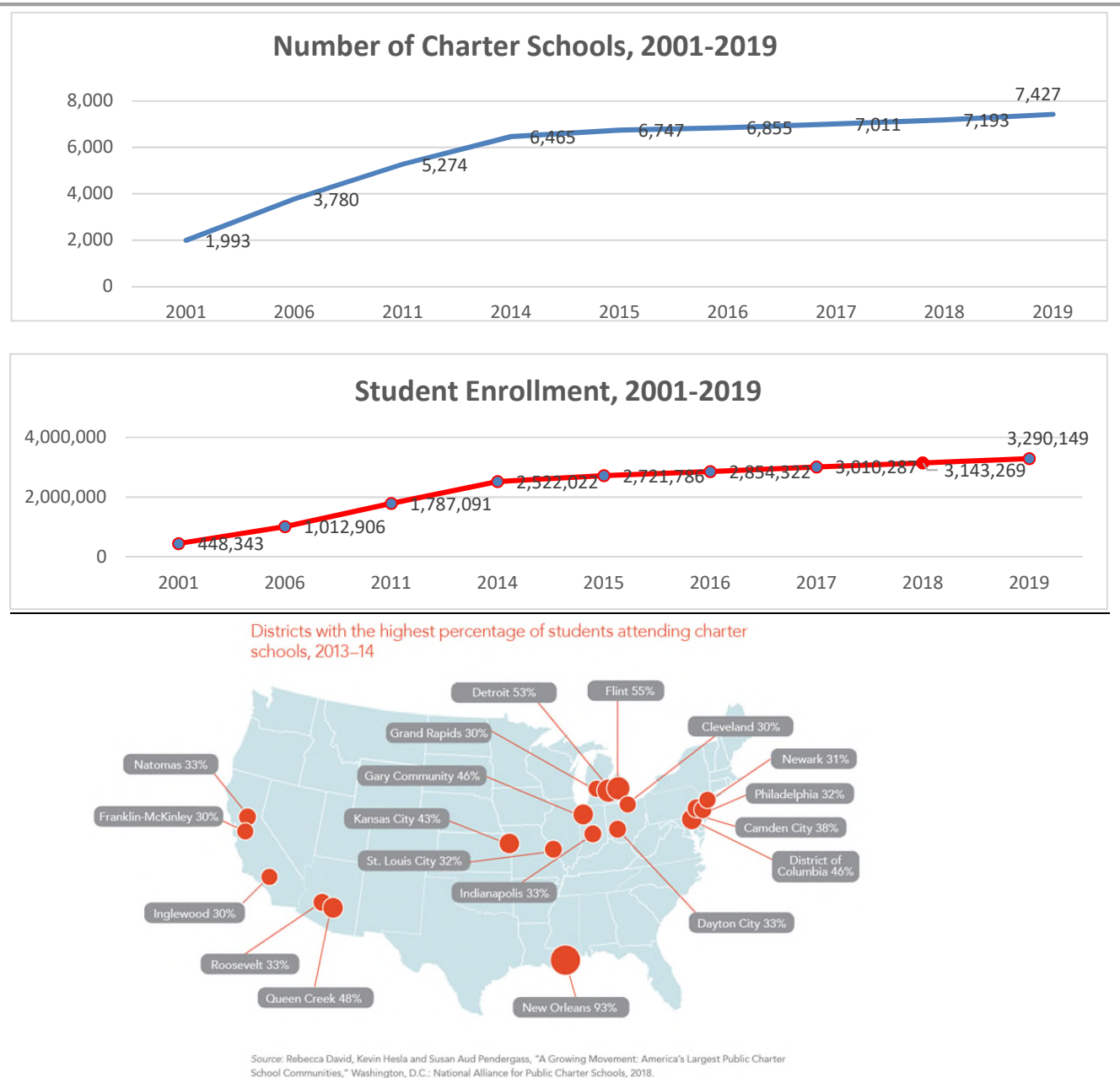
Charter schools are a relatively new model for educating public school students, with the first school opening in Minnesota in 1992.² Each state and the District of Columbia must authorize charter schools to exist in a state. Depending on each state's authorizing laws (to the extent such authorization exists), some charter schools are authorized by a single entity, while other states, such as Ohio, have several independent charter school authorizers. Over the past thirty years, the growth of charter schools has expanded to forty five (45) states and the District of Columbia³ and currently educate approximately seven percent (7%) of public school primary and secondary students. As reflected in the charts below, over the past twenty (20) years, the number of charter schools have nearly quadrupled and student

¹ Broken Promises: An Analysis of Charter School Closures from 1999-2017 (Network for Public Education), 5.

² *Minnesota Issues Resource Guides, Charter Schools*. <https://www.lrl.mn.gov/guides/guides?issue=charter>, last visited September 9, 2021.

³ Alyssa Ann Rafa et al., 50-State Comparison: Charter School Policies, EDUC. COMM'N OF THE STATES (Jan. 28, 2020), <https://www.ecs.org/charter-school-policies/>.

enrollment has increased seven-fold.⁴ In addition, concentration of charter schools tend to be clustered in urban centers, with a majority of students in certain cities attending charter schools as reflected in the illustration below.



⁴ Source: U.S. Department of Education, Institute of Education Sciences and National Center for Education Statistics, Digest of Education Statistics: 2019, chap. 2, table 216.20 "Number of Enrollment of Public Elementary and Secondary Schools, by School Level, Type, and Charter and Magnet Status: Selected Years, 1990-91 through 2018-19" Washington, D.C.: National Center for Education Statistics, 2019.

2. Funding and Financing Charter Schools

Funding mechanisms for charter schools vary widely by state authorizing statutes, but generally consist of a combination of “base funding” and “categorical funding” that is provided by federal, state and/or local governmental units. Generally, base funding is the amount of per-student dollars that is meant to cover the basic educational needs (public opinion on whether such funding is sufficient to cover such basic needs is left for another discussion). Categorical funding is based on a particular program or student characteristic, such as special education, summer school or free/reduced lunch programs. As these funding sources are public/taxpayer dollars, they can be affected by state budgets, reporting and achievement benchmarks, and the vagaries of governmental operations (e.g., “governmental shutdowns”).

For initial funding and expansion projects, the U.S. Department of Education’s Charter School Program has funded over \$4 billion to charter school. However, charter schools require additional access to capital to acquire or lease facilities, provide for student transportation, or initial investment in curriculum. Unlike public schools, except for limited grant programs or the D.O.E.’s Charter School Program, most capital expenses will need to be financed directly by the charter school. Depending upon the authorizing laws of the various states, charter schools may have access to debt financing, typically involving tax exempt bond financing. This debt may be issued directly by the charter school, or through a conduit issuer.

In several states, a charter school may issue its own tax exempt bond debt for the purpose of acquiring, constructing, owning/leasing, and operating their facilities, if the school is acting on behalf of a state or political subdivision. Pursuant to Revenue Ruling 63-20, obligations of a nonprofit corporation of a State will be considered issued on behalf of a state or political subdivision if the following conditions are met: (1) the corporation engages in activities which are essentially public in nature; (2) the corporation is not organized for profit; (3) the corporation's income must not inure to any private person; (4) the state or a political subdivision must have a “beneficial interest” in the corporation while the bond debt remain outstanding; (5) the unencumbered legal title in the financed facilities vests in the governmental unit after the bonds are retired; and (6) the corporation is approved by the state or a political subdivision thereof, which must also approve the specific obligations issued by the corporation. *See* Rev. Rul. 63-20, 1963-1 C.B. 24.

Many states, however, prohibit a charter school’s ability to directly own the land or facilities where schools operate, or be obligated on long term funded debt. For these charter schools, they cannot

issue tax-exempt debt on their own behalf, and must use a conduit issuer to issue the tax-exempt bonds that will ultimately benefit the charter school. For example, in Minnesota, the local municipality has authority to serve as a conduit to issue bonds for the charter school. Conduit issued bonds may be governmental bonds or qualified 501(c)(3) bonds.

Other financing options include banks and direct loan investors. These more traditional commercial loan financings will include several of the same attributes as bond financing, but may include more stringent financial covenants and events of default. Key underwriting considerations when evaluating the credit worthiness of a charter school include the financial condition of a charter school, its anticipated liquidity, debt service coverage ratio, strength of the collateral pledged, including the strength of any pledged revenues or intercepts. Special care must be taken to confirm the authority and enforceability of a charter schools assignment or pledge of its revenue stream as security for the bonds.

3. Charter School Failures and Causes of Financial Distress.

Charter schools, like all businesses, occasionally fail. However, the failure rate of charter schools is materially higher than in other businesses. In “*Broken Promises: An Analysis of Charter School Closures from 1999-2017*,” a report authored by the Network of Public Education, an advocacy group critical of charter schools, concluded that 18% of charter schools had closed in the first three (3) years, with many of those closures occurring within the first year. By the ten year mark, 40% of charter schools had closed, and by year fifteen, approximately 50% of charter schools had failed. Overall, between 1999-2017, over 867,000 students were displaced when their charter school closed.⁵ However, some charter school advocates suggest that the high failure rates for charter schools are an essential aspect of the design feature where “market forces are working and that weaker schools are being sloughed off.”⁶ Given the vast range of charter schools and unique aspects, it is not possible to pinpoint any exacting reasons for the approximately 200 charter schools that close each year.

Factors most often cited as causes of school failures include lack of oversight and accountability from charter authorizers, poor school leadership and governance, academic shortcomings, financial mismanagement or malfeasance, and drop in student demand.⁷ While a degree of autonomy is one of

⁵ Broken Promises, 6.

⁶ Peter Greene, “*Report: Are Charter Schools a Big Risk for Families?*” Forbes (August 7, 2020) <https://www.forbes.com/sites/petergreene/2020/08/07/report-are-charter-schools-a-big-risk-for-families/?sh=2494b9fc4986> (last visited September 9, 2021).

⁷ Zachary Jason, “The Battle Over Charter Schools” Harvard Ed. Magazine (Summer 2017) <https://www.gse.harvard.edu/news/ed/17/05/battle-over-charter-schools> (last visited September 9, 2021).

the key attributes of charter schools, lack of sufficient public oversight and/or charter school board oversight may result in lack of accountability and potentially financial mismanagement (either due to inexperience or malfeasance). In analyzing deficiencies in oversight of Michigan charter schools, the Citizens Research Counsel published a report calling for more state oversight, school transparency and financial accountability. With the majority of Detroit public school student attending charter schools, the report recommended requiring stronger reporting and accountability.⁸

While there are significant charter school failure, the default rates on funded bond debt is relatively low. There is approximately \$25 billion in bond obligations outstanding related to charter school borrowings. According to data gathered by the Equitable Facilities Fund, the default for bond obligations remained steady in 2019 at 5% based on the number of transactions, but only 2.7% when measured on original par amount.⁹

4. Restructuring Charter Schools.

Achieving a financial turnaround of a charter school often requires a collaboration with all the key financial stakeholders and generally is not consummated in a bankruptcy proceeding. As discussed above, the primary funding source for a charter school's operational expenses is from the state or local school district for a per-student expense. Thus, maintaining enrollment numbers that exceed the operational costs of the school is paramount. If a school reports subpar academic results, it should see a corresponding drop in enrollment. Similarly, if a school lacks strong leadership and transparency, students may not tolerate it and transfer to a district public school. These behaviors often result in death spiral for charter schools, often resulting in no other options than to close. Further, most charter school bankruptcy filings are liquidations and not reorganizations. This is because a bankruptcy filing also signals to a community that the school is a failure, which often results in a drop in enrollment.

The most successful charter school turnarounds are consummated through out of court restructurings that include both financial and operational improvements, often requiring the support of the charter authorizer, financial stakeholders and the greater school community. Below are a non-exhaustive list of considerations facing a charter school turnaround:

⁸ See generally, *Improving Oversight of Michigan Charter Schools and Their Authorizers*, Citizens Research Counsel (Levin Center at Wayne State University Law School, February 2020).

⁹ Wendy Berry, *Charter School Bond Sector: 2019 Year in Review* (November 2020), p. 1.

- a. **Leadership; Consider Need for a Receiver.** Charter schools benefit from informed and engaged boards of directors and school directors. A thoughtful and engaged board that understands charter school funding, oversight and tools to be accountable and to make positive change is essential. Leadership also is best if it has a strong relationship with its board, the charter authorizer, staff and other key community members. While some charter schools have significant autonomy from their charter authorizer, working cooperatively with the authorizer when the school is in financial distress may be essential to mainlining the school's charter. If the authorizer is not sufficiently engaged in the turnaround, in some states it may be able to quickly pull the school's charter, resulting in near immediate shutdown. In addition, if the leadership is not capable of implementing the actions required for a successful turnaround, other stakeholders should consider transitionary leaders, including a court appointed receiver over both the assets and operations of the charter school. A receiver may be authorized in the bond or debt documents governing any long term debt issuance. Depending on the terms of the financing documents, stakeholders may need to petition for a statutory receiver. To the extent permitted by applicable state law, the scope and powers of a receiver appointed by the court may be limited, or could be far reaching to operate all aspects of the charter school. Ultimately, it is the terms of the state court's receivership order that will control the receivers powers over the charter school. Stakeholders that are not prepared to petition for a receiver to manage the day to day operations of the charter school may be at an economic disadvantage if significant change in leadership are required but not forthcoming by incumbent leaders.
- b. **Academic Improvements.** Most families leave public, district schools and seek enrollment at charter schools for the perceived academic benefits. Charter schools have greater autonomy over their instructional schedules and curriculum development than traditional public schools that are required to follow a common core. For charter schools, academic turnarounds to improve outcomes and enrollment may include: (1) extended time, strategic use of data, and high expectations for academic achievement; (2) recruitment, retention, and cultivation of better teachers and proven partners; and (3)

strengthened support and engagement for students beyond academics to include co-curricular and community learning opportunities.

- c. **Change in Management; Greater Financial Oversight and Protection Against Malfeasance.** In a 2016 audit report commissioned by the US Department of Education, it concluded that “charter school operations pose a serious ‘risk of waste, fraud and abuse’ and lack of ‘accountability.’”¹⁰ For secured creditors, credit agreements likely include financial covenants and operational restrictions (e.g., required ‘days cash on hand’ and prohibition on additional indebtedness) that are designed to preserve the charter schools value and raise alerts if a charter school is in, or approaching, financial distress. Investors in charter schools know the risk profile and must maintain close relationships with the charter school operators to protect the value of the schools. Given the relatively high risk of school failure, investors should scrutinize debt documents before making the investment to familiarize and perhaps improve the reporting mechanisms. After a charter school is in financial distress, but while it continues to maintain a positive going concern value, a secured creditor may require additional oversight and reporting under a forbearance agreement designed to facilitate a turnaround. A forbearance agreement is not a “cookie cutter” agreement, but rather is specially designed to meet the needs of the particular charter school and its stakeholders to undergo a consensual restructuring.
- d. **Foreclosure or Liquidation.** If the charter school is not capable of turning around, whether due to poor leadership, lack of faith in management to complete a turnaround, or failure to maintain going concern even under a turnaround plan, the charter school should plan for closure and eventual liquidation. Alternatively, the secured creditor may exercise remedies to foreclose on its collateral to maximize the collateral value and ultimately recovery on its investment. In either scenario, students may be displaced and their education will certainly be interrupted. Where possible, timing of such significant

¹⁰ Charter Schools Exploit Lucrative Loophole that Would be Easy to Close, February 19, 2019, <https://theconversation.com/charter-schools-exploit-lucrative-loophole-that-would-be-easy-to-close-111792> (last visited September 9, 2021).

workout situations should be implemented to minimize the disruption to the students and their families.

- e. **Bankruptcy; or Maybe Bankruptcy Remote.** It is unsurprising that there are few reported charter school bankruptcy cases. First, most charter schools are non-profits and cannot be involuntarily petitioned into chapter 7 or 11.¹¹ Second, given the risk of enrollment declines from a school in bankruptcy, chapter 11 is not an ideal option when more efficient turnarounds are achievable in out of court consensual plans, or a state court receivership. Another potential risk is whether the charter school is even eligible for chapter 7 or 11. In a thoughtful Notre Dame Law School article,¹² Parth Parikh posits that charter schools may be bankruptcy remote if they are determined to be “governmental units”: under 11 U.S.C. § 101(27). As Parikh identifies, the level of governmental control varies widely, but there may be a plausible argument that a charter school meets the factors applied by bankruptcy courts to determine if an entity is a governmental unit or municipality. As the charter school is unlikely to be a municipality for chapter 9 purposes, if it is otherwise determined to be a “governmental unit” it may be a “bankruptcy remote” entity and be excluded from chapter 7 or 11. While the case law analyzing these factors has played out in the context of eligibility for quasi-governmental entities to proceed under chapter 11 or chapter 9, an equally thoughtful argument could be advanced for certain charter schools. To date, there have been no reported decisions challenging the eligibility of a charter school, with most charter schools resorting to bankruptcy to complete an orderly liquidation.

5. Conclusion.

Charter school leaders, their investors and other stakeholders in charter schools require a comprehensive understanding of the applicable state authorizing process and funding methodology associated with the particular charter school in financial distress. Charter schools, and their authorizing and funding regimes, vary widely, but the statistics establish that while some charter schools are very successful, many will not survive their first few years of operations. To reduce the risk of failure, having

¹¹ 11 U.S.C. § 303(a).

¹² Parth Parikh, *Charter School Bankruptcy Eligibility under the “Governmental Unit” Exception*, Notre Dame Journal of Law, Ethics & Public Policy [Vol 34, 2021], 549.

strong leadership, academic achievement and accountability, and strong financial oversight have been identified as essential for long term viability. When facing a charter school in financial distress, the charter schools and their key stakeholders most often maximize value when working cooperatively to put in place a turnaround plan that is balanced and requires accountability.