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A Unique Challenge In Buying For-Profit Schools



Neil Lefkowitz
Partner
Dickstein
Shapiro Morin
& Oshinsky

By Neil Lefkowitz

New owners of educational institutions must make sure they can stay plugged into U.S. grant and loan programs.

The current m&a market has established historically high valuations for private, for-profit companies that operate post-secondary education facilities or offer college- and university-level work online. These valuations have made the sale of private education companies quite attractive to acquirers, including strategic and private equity buyers that are looking to expand their operations or act as consolidators in the for-profit education field, as well as sellers that have the opportunity to reap large proceeds at the peak of the pricing cycle. A considerable amount of deal activity in the education industry has resulted.

However, a change in ownership of an education company presents an unusual regulatory challenge that is crucial to both sides in a transaction. The target company's eligibility to participate in grant and loan programs under Title IV of the federal Higher Education Act terminates with the closing of the sale. The buyer must reapply to the U.S. Department of Education (DOE) for the right to continue the company's participation in Title IV programs, but this continued participation is not automatic and is subject to regulatory scrutiny.

The new owner initially will have to settle for a provisional program participation agreement, which operates on a month-to-month basis until complete eligibility is restored. Obviously, this is an uncertain and interim solution for the buyer and any lender that

their students' tuition and other costs are special cases in that the DOE usually will not approve the new owner until after the deal is completed. The agency may conduct a pre-closing review if the buyer applies for one, but any resulting decisions are not binding.

The target company's track record plays an important role in the determination to issue a new program participation agreement. Under DOE regulations, the department will investigate the pre-sale operation of the company and compliance with DOE financial responsibility and other requirements. On the buy side, the department will check out the buyer's acquisition financing, its participation in Title IV and other government-funded programs through affiliated institutions, and compliance with DOE regulatory requirements.

As a result, either the purchaser or the seller may be "at fault" if a new program participation agreement is not issued or, more likely, the agreement is issued with burdensome or expensive conditions. The party at fault should bear the risk of the problems faced by the new owner in connection with Title IV eligibility.

A fault standard does not provide adequate protection for an acquirer and its lenders that pay significant sums to buy an education company and expect to receive a new program participation agreement without burdensome or expensive conditions. The DOE does not determine who is at fault in deciding against issuing a new program participation agreement that the buyer can live with.

In light of the uncertainty, it is essential that a buyer perform financial, operational, and legal due diligence of all aspects of the target company's compliance with Title IV and DOE regulations. However, due diligence may not uncover all business and legal issues that

the buyer needs to know. Thus, sale agreements for education companies typically contain representations and warranties concerning DOE regulatory and accreditation matters. The scope and post-closing significance of these representations and warranties depend on the relative bargaining power of the buyer and the seller.

Generally, the trend in sales of education companies has been for reps and warranties covering regulatory and accreditation matters to become more comprehensive and detailed. However, the post-closing significance of reps and warranties generally has been diminished by market norms in dispositions of middle-market companies. Thus, the parties have tended to accept a combination of shorter survival periods after closing, smaller "caps" on indemnification obligations

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helps finance the acquisition. In addition, the buyer may be saddled with expensive and burdensome conditions as a condition to obtaining a new program participation agreement, such as a requirement to post a letter of credit with the DOE.

As a result, both sides in the deal are careful to construct an agreement to allocate the risk of liability that may result should the renewed bid for eligibility fall through or be substantially delayed. Risk allocation agreements, of course, are common in the sale of all businesses and deal with events that occur after closing. And in the majority of regulated industries where deals are subject to approval by a government agency, the appropriate regulatory consent is obtained before the sale is completed. But education companies participating in Title IV programs to help finance

of sellers to buyers, and larger “deductibles” for these indemnification obligations, e.g., exempting an agreed-upon dollar portion of the liabilities before obligations to pay begin. The scope of indemnification obligations will vary by deal based on the relative bargaining power of the parties, the purchase price, the presence or absence of regulatory or other issues, and the sophistication of the parties and their advisers.

Agreements for the sale of education companies often contain covenants committing the target and its selling owners to cooperate with the buyer in due diligence and pre-acquisition filings with the DOE and applicable accrediting agencies. These agreements also contain the buyer’s commitment to move after closing to obtain a provisional program participation agreement, a program participation agreement, and the approval of the accrediting agency. The buyer’s covenants contain levels of obligation, such as use of commercially reasonable efforts or best efforts, as well as descriptions of what the parties are not required to do, such as spend money or post a letter of credit with the DOE.

Historically, it was common in sales of education companies to escrow all or a portion of the purchase price until a new program participation agreement was issued. The escrow is undesirable for a seller that has transferred control of its company without receiving any money but retained the risks that a new participation agreement will not be issued and the company will be adversely affected operationally or financially during the transition period. Changes in DOE practice, such as provisional program participation agreements and pre-acquisition reviews of change-of-ownership transactions, as well as greater sophistication of sellers have made escrowing largely obsolete, except when material regulatory compliance issues exist.

In certain circumstances, sellers of education companies have granted buyers the right to rescind or unwind a closed deal if a new program participation agreement is not issued or if the new agreement contains burdensome or expensive conditions. Giving the buyer the right to unwind the transaction is obviously undesirable to the seller. The company may be adversely impacted operationally or financially between the closing and the rescission and the seller may not be able to recover the company’s working capital financing.

If the buyer receives the right to unwind the transaction, the seller should specify that the right does not apply if the DOE denies a new agreement or grants one with burdensome conditions because of any problem with the buyer, including the post-closing



capital structure of the acquired company. From the seller’s perspective, the acquirer should have material obligations to take actions necessary to obtain a program participation agreement with tolerable conditions. These actions could include limiting the amount of acquisition debt financing to ensure that the acquired company complies with acid test ratios and tangible net worth requirements of the DOE and posting a letter of credit with the DOE within contractually specified time periods. Sellers often negotiate a right to be notified of material events in obtaining a new program participation agreement and an opportunity to participate in the process and to cure regulatory issues. The unwind rights are often complex and difficult to negotiate in light of the uncertainties associated with obtaining a new program participation agreement.

In some deals, particularly when regulatory problems exist, the seller may indemnify the acquirer for

its losses if the company is unable to obtain a new agreement or must accept one with burdensome or expensive conditions. The conditions are similar to the conditions of the unwind right. In addition, there is a limit on the amount of the seller's indemnification obligation — usually less than the amount of the purchase price — for, among other reasons, the seller's payment of capital gains taxes.

The buyer of an education company may, by application, ask the DOE to perform a pre-closing review of the proposed transaction, but this review does not obligate the DOE to issue a provisional or permanent program participation agreement. So the buyer cannot completely rely on the absence of negative statements from the DOE. However, the seller can use the existence of the application as the basis for rejecting any request by the buyer for an unwind or an indemnification if an acceptable new agreement is not issued.

Two recent sales of significant education companies illustrate allocations of the risk that were favorable to the seller.

In the acquisition of **Whitman Education Co.** by **Career Education Corp.**, there was no escrow of the

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purchase price, Career Education did not receive unwind rights, and Whitman did not have any indemnification obligations to Career.

Whitman made a representation that, to its knowledge, there was no fact pertaining to it or any of its schools that could reasonably be expected to have a negative impact on Career Education's ability to obtain a new agreement from the DOE. However, this representation did not survive the closing of the transaction and, therefore, did not provide much protection to Career Education.

Both Whitman and Career Education had an obligation to use commercially reasonable efforts to assist each other in obtaining regulatory and accrediting body approvals. This covenant also did not survive the closing of the deal.

Career Education's primary protection from the risk that it would not receive a good program participation

agreement was the following condition precedent:

"[Career Education] shall have obtained a written statement from the DOE providing, without unduly burdensome limitations, that the DOE does not see any impediment to issuing a Temporary Program Participation Agreement with respect to each Institution following the Closing."

The DOE will not always provide this limited assurance before closing, so sellers generally should resist including the pre-closing application requirement in the buyers' obligations.

In another major education deal this year, owners of **Ross University** agreed to sell to **DeVry Inc.** This deal also did not call for an escrow of any part of the purchase price and DeVry was not granted unwind rights. The sellers did have indemnification obligations for limited representations and warranties concerning the compliance by Ross University with DOE regulations. The sellers' maximum indemnification obligation to DeVry is 15% of the \$310 million purchase price, with a deductible of the first \$1.5 million of DeVry's losses.

The sellers had an obligation to use commercially reasonable efforts to assist DeVry in filing an application for pre-acquisition review with the DOE. In contrast to the Career Education/Whitman transaction, there was an obligation to close even if the DOE had not completed a pre-closing review. In all probability, the sellers successfully resisted a DeVry attempt to have closing conditioned on a favorable the DOE decision.

In summary, it would be very desirable for buyers and sellers of education companies to have a formal, pre-closing approval process. The DOE could charge a fee to review the applications, similar to the way the FTC charges to defray its costs for reviewing m&a on competitive grounds.

For the time being, participants in education deals should be aware of the acceptable program participation agreement risk and obtain maximum protection from a combination of due diligence, contact with the DOE and accrediting agencies before closing, and appropriate provisions in the sale documents. The author is currently exploring the availability of a product in the insurance market to provide partial coverage of this risk. □

Neil Lefkowitz is a Partner in the Washington office of the law firm of Dickstein Shapiro Morin & Oshinsky specializing in middle-market m&a transactions.