

Memorandum

To: U.S. Department of Education
From: Carolyn Fast, Jaylon Herbin, Barmak Nassirian, Amanda Martinez,
Jessica Ranucci, and Johnson Tyler
Date: March 11, 2022
Re: Recent Revisions to the Definition of a Nonprofit Institution in Issue Paper 5

The Education Department's new Issue Paper 5 on changes of ownership includes modifications to the definition of a nonprofit institution that would permit exactly the types of sham for-profit to nonprofit conversions that the original proposal was meant to prevent. The new language would permit institutions to obtain nonprofit status in a conversion deal that includes ongoing payments to the former owners if it involves either (1) a "revenue-sharing agreement" that is at a "market price" that is "reasonable", or (2) a contract or lease agreement with the former owner that is at "fair market value." Because valuation is easily manipulated, this new language creates a safe harbor for the exact type of deals that have proved problematic — deals in which the value of the institution or services is inflated at the time of purchase to benefit the former owner.

"Fair value" is easily manipulated

The Department's latest revisions would endorse exactly the types of for-profit to nonprofit conversion deals that have proved to be problematic — transactions that claimed to be based on independent assessments of fair value or "market" price, but which have been subsequently shown to be based on inflated valuations. For example:

- Keiser University's intangible assets were valued at more than \$535 million at the time of its conversion. The value was later reduced by \$250 million. In describing an unnamed school in a similar situation, GAO said "While such a loss may arise for unforeseen reasons (*i.e.* shifting market conditions), it could also indicate that the college and its assets were knowingly overvalued at the time of the sale to improperly benefit insiders."
- The conversion of Herzing University was originally owner financed at \$86 million. When bank financing was arranged instead, possibly at the Department's encouragement, the former owner was paid less than half the original amount.
- Remington Colleges were originally slated to be purchased from the former owner for an IOU of \$217 million. The note in the financial statements was \$134 million and was apparently later reduced to \$85 million.

- At the time of its sale through an IOU to the former owner, Community Care College was valued at \$29 million. The value of the nonprofit school was later reduced by \$15 million.

Because of the difficulty of objectively evaluating fair-market valuation at the time of conversion, the new language would permit former owners like these to obtain Department approval of converted “nonprofit” institutions.

According to GAO, owner-financed conversions are highly subject to manipulation by the seller, who has a special relationship with the converting school even if appraisals are supposedly arm’s-length. For example, intangible assets — such as the reputation of the school or the financial value of being accredited — “are inherently difficult to value,” making them highly vulnerable to abuse. By adding a safe harbor for deals based on “fair value”, the proposed changes would permit exactly the types of sham conversions that the original proposal was meant to prevent.

Moreover, the new language is unnecessary because the prior version described such arrangements with former owners as “generally” indicative that an institution was not a nonprofit, while allowing for exceptions. That language gave the Department flexibility, while adopting the appropriate general rule that follows [GAO’s finding](#) that conversion involving former owners “pose a heightened risk of improper benefit.”

Endorsing revenue-sharing in conversion deals is the wrong approach

Tuition-sharing arrangements create co-ownership situations that blur lines of responsibility and accountability and risks operation of a nonprofit institution based on the problematic incentives of for-profit owners and investors. When a tuition-sharing agreement is part of a change-of-ownership transaction, the institution has not really changed hands at all, it has merely established a joint operating agreement.

Prohibiting such arrangements in conversion transactions is the right general approach. If there are exceptions that should be allowed, the prior language was a better approach by giving the Department flexibility while adopting the appropriate general rule that follows GAO’s finding that conversion involving former owners should be subjected to a high level of scrutiny given the risk of improper benefit.