

HLC APPROVES PURDUE'S ACQUISITION OF KAPLAN UNIVERSITY

BY NEIL LEFKOWITZ

It was publicly announced on March 5 that the Board of Trustees of the Higher Learning Commission ("HLC") approved the acquisition of Kaplan University by an affiliate of Purdue University at its February 22, 2018 meeting. As HLC's consent is the final required regulatory approval, it is anticipated that the transaction will close within the next forty five days. The transferred university will be referred to as Purdue University Global, a name that was recently approved on January 11, 2018, and will be part of the Purdue University system.

Terms of the Parties' Agreements

Purdue University formed a new Indiana public benefit corporation (the "purchaser") to acquire certain assets of Kaplan Higher Education directly pertaining academic operations, including curriculum, certain intellectual property, student records and enrollment agreements and certain real and personal property leases and other contracts pursuant to a Contribution and Transfer Agreement (the "Transfer Agreement") between Kaplan, Purdue and the purchaser. However, other assets are retained by Kaplan to enable it to provide marketing and advertising, student advertising, admissions support, financial aid, international student recruitment, technology support, human resources and financial reporting services to the purchaser pursuant to a Transition and Operating Support Agreement (the "TOSA") between Kaplan, Purdue and the purchaser. The Transfer Agreement requires Kaplan to indemnify the purchaser and Purdue for losses arising out of breaches of Kaplan's representations and warranties as well as liabilities arising out of the operation of Kaplan during periods before closing. The purchaser is only required to pay Kaplan one dollar at closing and is not obligated to assume liabilities of Kaplan, which are retained by Kaplan. The consideration that Kaplan will receive in the future for the transferred assets is a share of the total revenues of Purdue Global University.

The TOSA is a carefully-crafted and balanced agreement that transcends outsourced program management agreements prevalent in United States higher education in complexity, anticipation of future changes, operational

control and payments to Kaplan in most termination scenarios. The TOSA contains a "waterfall" of payments required to be made to the parties from the revenues of Purdue University Global that generally protects Purdue University Global from scenarios in which its operating expenses exceed its revenues. In addition to a first priority distribution of an amount equal to operating expenses, during each of the first five years of the TOSA term, Purdue University Global is entitled to receive \$10 million as a second priority distribution in the waterfall. If the revenues of Purdue University Global are insufficient to make this distribution, Kaplan is above obligated to make-up the shortfall. The penultimate distribution in the TOSA waterfall is to Kaplan in an amount equal the sum of (i) twelve and one half percent of Purdue University Global's total revenues and (ii) the expenses incurred by Kaplan in providing the services. This twelve and half percent of revenue allocation to Kaplan is significantly less than the allocation typically made to service providers in outsourced program management agreements although the TOSA contains other elements that are favorable to Kaplan. If in any year there are insufficient funds remaining to make the required payments to Kaplan, the remaining balance is accrued and payable at future times when funds are available. If there are any funds remaining after making all preceding waterfall distributions, this surplus is retained by Purdue University Global.

The TOSA includes a creative provision to address future events that make changes in the policies of Purdue University Global necessary or desirable, which may in turn adversely impact its revenues. For example, the board of trustees of Purdue University Global approved a change, effective at closing, in the in-state tuition for Indiana residents, that in general will reduce the total tuition to earn a bachelors' degree from approximately \$80,088 to approximately \$39,600. This revised tuition, among other things, is reflected in a Key Academic and Operating Guide that will be included as an exhibit to the TOSA. The board of trustees of Purdue Global University may change the Key Academic and Operating Guide from time to time in its sole discretion. However, if future changes to this guide, such as a reduction in tuition or fees, cause revenues of Purdue Global University to decrease by \$5 million or more, then the TOSA provides for an evaluation process to

compensate Kaplan for the related reduction in revenues. This evaluation process may include the retention of an independent financial expert to review changes in discounted cash flow and other financial metrics.

The TOSA has an initial term of 30 years, with 5 year renewal terms unless a party provides 12 months prior notice of its intention not to renew. While public higher education institutions may enter into services agreements with 30 year terms, 15 year terms are generally believed to be the maximum permissible term for services agreements entered into by private nonprofit institutions qualified under Section 501(c)(3) of the Internal Revenue Code. At any time after the sixth anniversary of closing, Purdue University Global may elect to terminate the TOSA. In such event, Purdue University Global is required to pay Kaplan an early termination fee equal to 1.25 times the total revenue of Purdue Global University in the preceding twelve months.^[1] The amount of this required payment is significantly reduced if the TOSA is terminated after the initial term or not renewed by Purdue University Global. This termination fee is payable by a promissory note, rather than cash, secured by the assets of Purdue University Global with a ten year, fully-amortizing term and interest at a market rate. One half of the principal amount of this promissory note must be guaranteed by Purdue or credit-enhanced by a letter of credit.

The TOSA provides for the formation by the board of trustees of Purdue University Global of an advisory committee to coordinate developing strategies and objectives and make recommendations to senior management and the board of trustees on key operating subjects, including the budget, the marketing plan, material changes to the Key Academic and Operating Guide, increases or decreases in tuition or fees and the resolution of legal matters. The advisory committee shall consist of two persons designated by Purdue and two persons designated by Kaplan. Advisory committees are common under outsourced program management agreements but this advisory committee has a broader mandate than customarily found.

Governance of Purdue University Global

Purdue University Global is an Indiana public benefit corporation whose sole member is Purdue University. Purdue University Global will have a six member board of trustees, five of whom are also members of the Purdue board of trustees. The sixth trustee will be an independent member presently serving on the Kaplan University board of trustees. Purdue University Global will have a chancellor, although there may be a lack of clarity as to whether the chancellor reports to the Purdue University Global board of trustees or to the president of Purdue University.

Regulatory Approvals

The Indiana Higher Education statute was amended in 2017 to provide for a "postsecondary SEI (state education institution) affiliated institution" that is a degree-granting institution: (i) organized as a public benefit corporation and controlled by a state education institution; (ii) authorized by the Indiana Commission for Higher Education to provide educational services; (iii)

accredited by a recognized regional accrediting agency and (iv) with its debts and liabilities backed by the controlling state education institution in the form of a contribution or other surety consisting solely of eligible property. Eligible property does not include state appropriations or other public money received through another state education institution or state or local agency.^[2] The Indiana Commission for Higher Education approved Purdue University Global as a postsecondary SEI affiliated institution on August 10, 2017.^[3]

On September 13, 2017, the United States Department of Education responded to the parties' application for pre-acquisition review and confirmed that Purdue University Global will likely continue to be eligible after closing to participate in federal student aid programs under Title IV of the Higher Education Act. However, the response indicates that additional materials would have to be submitted to support the classification of Purdue University Global as a public institution (as opposed to a private nonprofit or proprietary institution). The United States Department of Education's response imposes a number of conditions on the transaction, including a limit on the amount of unpaid fees of Kaplan under the TOSA that may be accrued because of insufficient funds and carried forward as an obligation payable in future years. The United States Department of Education also required that Purdue be prominently and legally associated with Purdue University Global, including adopting a name incorporating "Purdue", co-signing the Purdue University Global's program participation agreement with the United States Department of Education (which co-signature will obligate Purdue to, among other things, return to the United States Department of Education any previously disbursed federal student aid funds that are required to be returned) and assuming responsibility for noncompliance with federal education laws and regulations and obligations to students under enrollment agreements. Purdue and Kaplan have assented to the conditions imposed by the United States Department of Education.

The transaction represents a substantive change, change of control, structure or organization for HLC purposes, which change is reviewed in a comprehensive procedure detailed in HLC policies. The procedure includes the institution that is the subject of the change submitting a completed application with exhibits (including transaction documents), followed by a review of this application, exhibits and other materials by a team of academics, HLC staff and counsel to HLC and fact finding visits by these reviewers to the campus of the institution that is the subject of the change to meet with administration and faculty and ask questions. A summary report is then prepared by the HLC staff that includes, among other things, an analysis of whether HLC's criteria for accreditation would be met after the transaction is complete. This report is then furnished to the HLC Board of Trustees for its review as well as to the institution, which may provide a written response to the report.

Prior to November 2017, in contrast to other regional accrediting agencies, HLC had no policy on shared services agreements with unaccredited entities. Guidelines for Shared Services Agreements were adopted by HLC

in November 2017. The TOSA generally complies with these guidelines, with the possible exception of showing broad campus involvement in selecting the shared services provider and finalizing the terms of the agreement.

HLC staff issued its report to the HLC Board of Trustees on the proposed change of control, structure or organization of Kaplan University on or about January 24, 2018. The report concludes that HLC's criteria for accreditation and other substantive HLC requirements for a change of control, structure or organization were generally met. However, some criteria of accreditation were met with concerns. These concerns include the presence of a student code of conduct for students in the Purdue University system, but no student code of conduct for Purdue University Global students; the absence of an articulation agreement or policy for transfer of students between Purdue and Purdue University Global and recognition of credits earned at the two institutions; ambiguity in the reporting lines of the Purdue University Global chancellor; confirmation of the autonomy of the Purdue University Global board of trustees; confirmation that integration of Purdue University Global will be supported by Purdue administration generally, not just the two members of the advisory committee established pursuant to the TOSA and confirmation that Purdue has revised its strategic plan to reflect this transition, including addressing allocation of resources.

The Transaction in Context

Critics and advocates of the transaction have articulated many valid concerns and supporting points, which have been reported in detail. Secretary of Education DeVos cited the transaction as one example of positive innovation in higher education in a keynote address at SouthxSouthwest.edu on March 6. It is inarguable that the present cost of higher education in the United States is not sustainable, especially with the new jobs anticipated to be created in the United States between 2016-2026 and the median annual compensation of these positions.^[4] The total number of students enrolled in United States colleges and universities decreased from approximately 18,000,000 in 2010 to approximately 17,000,000 in 2015, which numbers include declines in enrollment at public institutions.^[5] There is significant demand for higher education programs delivered in online modalities, with approximately 4,900,000 or twenty five percent of all undergraduates participating in at least one fully online course in 2015 and approximately 2,100,000 or twelve percent of students exclusively enrolled in online courses in 2015. In fall 2016, approximately 1,078,822 international students were enrolled in United States colleges and universities, representing approximately six percent of total enrollment. Recent data suggests that the number of new enrollments by international

students in United States colleges and universities is declining.^[6] In light of these trends in United States higher education, Purdue's launch of Purdue University Global represents a reasoned response to a challenging environment.

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[1] For the twelve month period ended December 31, 2017, Kaplan Higher Education reported total revenues of \$547,264,000.

[2] In public discussions of the transaction, the president of Purdue University has stated that Indiana tax revenues will not be used to support Purdue University Global.

[3] This designation is significant as the Higher Education Act and rules promulgated under this statute provide for different categories of higher education institutions, including public, private nonprofit and proprietary, and impose different substantive standards depending upon the classification of the institution. In at least one conversion of a for-profit institution to nonprofit status, the United States Department of Education asserted after the transaction closed that the institution continued to be a proprietary institution despite being owned by a nonprofit corporation qualified under Section 501(c)(3) of the Internal Revenue Code.

[4] See "Occupational Outlook Handbook," Bureau of Labor Statistics, <https://www.bls.gov/ooh/most-new-jobs.htm>. Seven of the ten occupations with the largest job growth, representing 1,347,300 out of 2,346,000 total positions, had median 2016 compensation of less than \$26,000 per year.

[5] "Undergraduate Enrollment," "The Condition of Education," National Center for Education Statistics, https://nces.ed.gov/programs/coe/indicator_cha.asp.

[6] Elizabeth Redden, "New International Enrollments Decline", Inside Higher Education, November 13, 2017, <https://www.insidehighered.com/news/2017/11/13/us-universities-report-declines-enrollments-new-international-students-study-abroad>.