

Higher Education

Higher Education Mergers and the Two-Step Process

Higher education is at an inflection point as colleges and universities (hereinafter “universities”) face increasing fiscal pressure that threatens their long-term financial viability. A confluence of headwinds has and will continue to accelerate these pressures, including:

1. Operating costs that have exceeded inflation and wage growth over the past 30 years;
2. Lower cost competition from new business models and online institutions which pressures enrollment for traditional institutions;
3. Rising student debt levels and changing job sector needs that have underscored the need for a different financial and operating model;
4. The expected decline in enrollment driven by the 2025 demographic cliff that has been exacerbated by the impacts of COVID-19; and
5. Discount rates which have increased at an average of 1% per annum over the past decade.¹

To address risks emanating from this challenged operating environment, boards and leadership generally implement strategies to: (1) enhance revenue generation (e.g., philanthropy, new programs); and (2) cut costs (e.g., programmatic cuts, defer plant renewal and replacement, debt refinancings).

However, given the challenging operating environment, these strategies will be insufficient for some universities; they will therefore be forced to merge as the only realistic means of mission continuity. Because higher education is a fixed cost business model, scale begets budgetary efficiency.

Recent changes to the regulatory process for university mergers have greatly expanded the time necessary to fully consummate a merger. These changes have sweeping implications on the runway required (and ability) for universities to merge and therefore, how higher education mergers should be approached. This paper serves to provide an overview of the current guidance provided by the U.S. Department of Education (“ED”) and the downstream implications.

Higher Education Regulatory Environment

Higher education is highly regulated, with universities subject to oversight from accrediting bodies, ED, and state education agencies.

This comprehensive regulation derives from unique aspects of the sector:

- **Federal Financial Aid:** Universities pass through funds via the federal financial aid system, representing a substantial university subsidy and taxpayer expense;
- **Tax-Exemption:** Most universities are nonprofit corporations qualified under

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Please see disclosure starting on page 7.

¹2022 NACUBO Tuition Discounting Study.

Section 501(c)(3) of the Internal Revenue Code, by definition, supported by the taxpayer; and

- **Consumer Protection Mission:** A postsecondary degree is an intangible good with long-term returns, requiring significant time and financial resource commitments from students. Regulators provide oversight to protect students and ensure universities are delivering the value they promise.

Universities that participate in federal financial aid programs (almost all higher education institutions) possess a unique ED identifier (“**OPEID number**”) and are party to program participation agreements pursuant to which ED disburses federal student aid. While many provisions of program participation agreements are prescribed by regulation, ED has discretion to mandate university changes to address perceived risks, including closure of the university, or limitations on branch campuses, academic programs and/or enrollment.

Historical Review by ED of Mergers and Other Changes in Control

Before 2000, mergers or other changes in control of universities were infrequent and ED reviewed each change in control on a case-by-case basis. ED generally entered into a new program participation agreement shortly after completion of the merger or other change in control to avoid disruption of federal student aid.

The significant rise in both the number of for profit universities and number of students attending these universities produced significant changes. Private and public capital was invested in these institutions and owners were able to exit their investments via mergers and other changes in control with significant gains. Acquirers of for profit universities (as well as lenders to these acquirers) wanted to know before closing what restrictions, if any, would be imposed by ED in new program participation agreements entered into after closing of the merger or other sale.

ED became concerned about the significant increase in federal student aid disbursed to students at for profit institutions, including whether students would be able to repay their federal student loans and fall out from university closures. In addition to using financial compliance metrics contained in federal regulations, ED’s review of mergers and other changes in control became more systematic with “pre-acquisition reviews” generally completed within 75 days of submission of specified materials.

The outcome of a “pre-acquisition review” was a stylized letter to the universities that summarized, among other things, any special restrictions that would be included in the program participation agreement. These restrictions included: (1) limitations on opening new campuses; (2) stipulations on starting new academic programs; or (3) requirements that the institution post a letter of credit with ED contemporaneously with closing.

ED experienced increasing pressure to complete “pre-acquisition reviews” within the parties’ stated transaction timeframes. Several mergers or other changes in control were abandoned by the parties after ED had completed its pre-acquisition review. As a consequence, ED revised its change of control process to an “abbreviated pre-acquisition review” in which ED would not inform an institution as to any special terms to be included in a program participation agreement after closing. Instead, ED only advised

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whether universities could complete a merger or other change in control and what letter of credit or other security was required to be posted with ED at closing.

The Two-Step Process

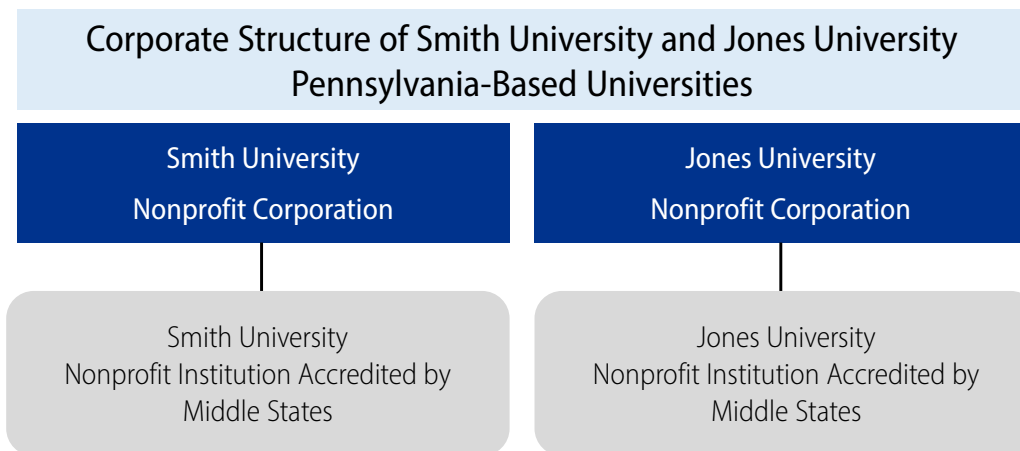
The most recent revisions by ED to its change in control procedures is the Two-Step Process (defined and explained below) and an amendment to its change in control regulations that became effective on July 1, 2023, and required that universities provide written notices to ED, current students, and prospective students at least 90 days before closing. Notably, the Two-Step Process only applies to transactions in which one institution will not have its own OPEID number after completion of the transaction. The most prevalent context for this outcome is one university merging with another, and thereafter one university becoming a “branch campus” or “additional location” (hereafter referred to as “acquired”) of the other university (hereafter referred to as “acquiring”).

While in the corporate world mergers are generally subject to a 30-day antitrust review, regulatory reviews of university mergers often take a year or more after a definitive agreement is executed. Guidance for the current process, first provided by ED in September 2022, requires that mergers be completed in two discrete changes in control, with the acquired university continuing as a separate institution between the first and second changes in control (the “Two-Step Process”). The first change in control occurs when there is a change in the university’s: (1) ownership; or (2) power to appoint board of trustees members.

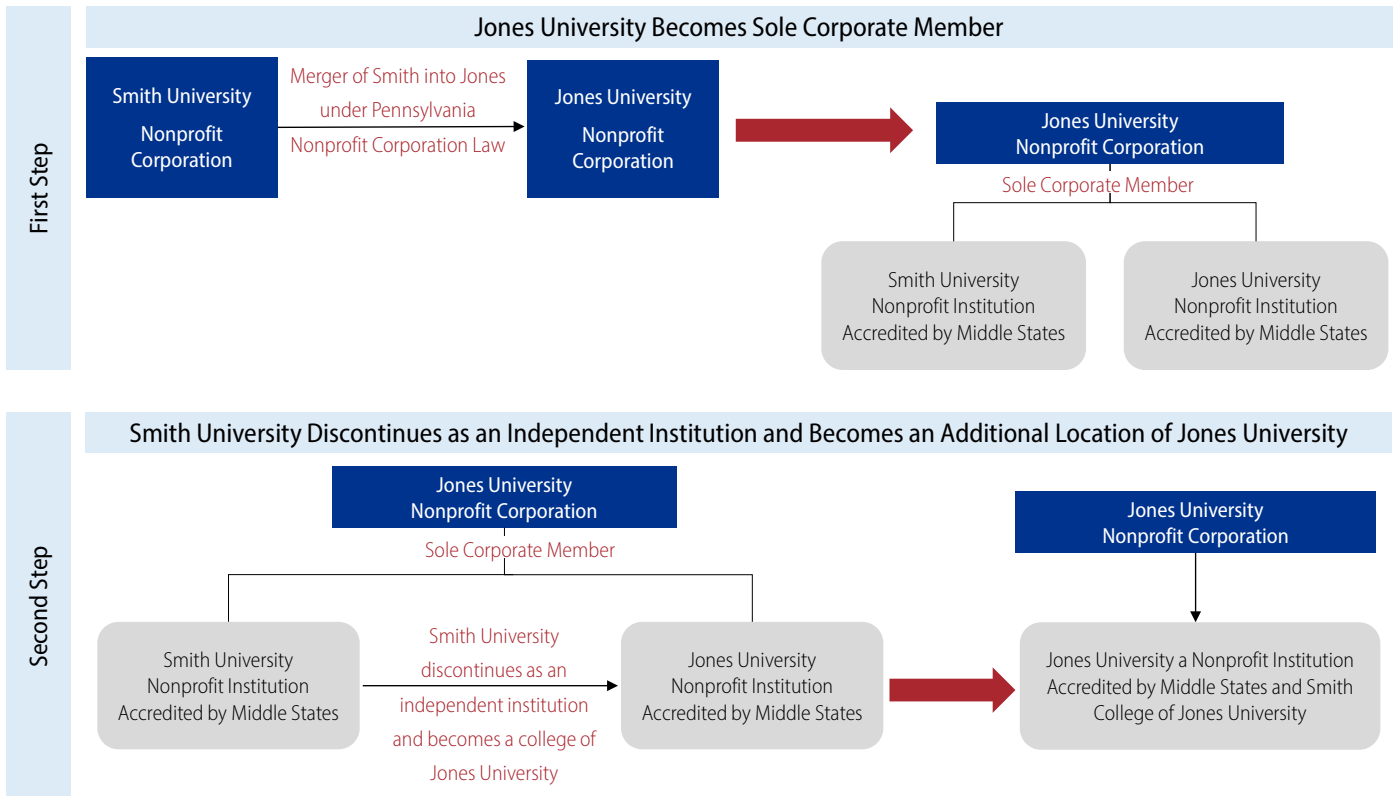
Multiple options are available for the first step of the Two-Step Process. The following graphic illustrates one example of a Two-Step Process. Before the merger, the two universities are owned by their respective independent nonprofit corporations. The first step of the change in control is one university becoming the sole corporate member of the other university. As a consequence of being the sole member, the university elects members of the board of trustees of the other university.

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Source: HilltopSecurities.



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The Process of Merging, Undertaking the Two-Step Process and Regulatory Reviews

The process of merging often includes a courtship phase. The partner search commences as institutional leadership assesses strategic positioning and desired goals. We have found advance strategic transaction planning to greatly aid in the successful outcome of higher education mergers. We call such planning Strategic Transaction Frameworks; these frameworks allow an institution to crystallize desired transaction goals, align leadership, and enable an institution to identify strongest fitting potential partners, often improving the chances of success.

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Illustrative Merger Process: Selected Steps At Each Phase

- 1

Partner Identification

 - Development of desired partner criteria and desired objectives in a merger
 - Partner identification and tiering
 - Initial partner outreach
- 2

Mutual Due Diligence

 - Execute non-disclosure agreements with selected partners
 - Begin mutual due diligence and quantify assets, liabilities, and risks
 - Execute non-binding letter of intent with preferred partner
- 3

Negotiation of Key Terms

 - Determine transaction structure
 - Deeper mutual due diligence and negotiate terms
 - Execute definitive agreement
- 4

Merger Execution

 - Engage stakeholder groups
 - Accreditor and Department of Education approvals
 - Perform final due diligence

Source: HilltopSecurities.

Although significant due diligence occurs ahead of any formal contractual agreements, the signing of a non-binding letter of intent (“LOI”), (often providing the courting partners negotiating exclusivity), is the first key milestone on the path to merge and typically the first public disclosure of the potential partnership. The LOI marks the end of the initial due diligence period and the beginning of a deeper due diligence process, as well as negotiations around: (1) what the combined university will resemble; (2) representations and warranties of the parties; and (3) closing conditions. If during this period – typically 3 to 6 months – the parties agree to proceed, they enter into a definitive agreement, a binding contract stipulating the specifics of the merger.

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Throughout this process, determining the structure of the transaction is critical. The earlier schematic depicts a first step in which one university becomes the sole corporate member of the other.

It is also possible for the first step to be a merger under state corporation law. ED distinguishes between legal entities, such as corporations, and universities. Universities have OPEID numbers, are parties to program participation agreements, and are subject to regulation by ED. When a merger under state corporation law is the first change in control under the Two-Step Process, the acquired university continues to exist as an independent university – with its own OPEID number and its own program participation agreement with ED – until the closing of the second change of control (i.e., the second step). During the period between the first and second changes in control, the acquiring institution continues to participate in federal student aid programs independently from the acquired institution. One may think of the steps as follows (although many incantations and possibilities exist): (1) the first step in the process is a change of control (one university becoming the sole member of the other); (2) the second step is the termination of one university’s OPEID number and therefore integration of federal student aid under a singular entity (i.e., full integration).

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The choice of steps in the Two-Step Process and their timing are dependent upon a number of factors, including: (1) the terms of any outstanding bonds; (2) other indebtedness and other material agreements; (3) the presence of collective bargaining agreements; (4) tenure and terms of agreement with faculty; (5) the presence of liabilities outside of the ordinary course; and (6) the financial responsibility and administrative capability of the acquiring university under ED regulations. The partner universities are required to submit to ED: (1) audited financial statements for the two most recently completed fiscal years of each university within ten business days of the first step and (2) an audited consolidated opening day balance sheet of both universities before the last day of the calendar month following the calendar month of the first step (e.g., if the first step occurs on April 15, an audited consolidated opening day balance sheet must be provided by May 31). These processes and timelines are not extendable or flexible, so advance planning of timing is critical.

Review by regional or national accrediting bodies commences upon execution of a definitive agreement (coinciding with the first change in control). Although no accrediting body review can commence before a definitive agreement, we believe active engagement with accreditors and state education agencies greatly improves the chances of success. The acquiring university may choose to initiate discussions with its

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accrediting agency representative (without disclosing the counterparty), which may allow the accreditor to commence preliminary processes internally, helping to accelerate the review process.

To assess whether to approve a merger, accreditors utilize their published substantive change frameworks, which contain guidelines and standards regarding the impacts and outcomes of the merger. These frameworks often serve to evaluate the impact of the merger on students and other constituents (such as faculty and staff), the financial strength of the combined entity, the academic standards and programs of the combined entity, and how overlapping and closed programs will be handled. Evaluation criteria are expansive and often measured qualitatively. While the process for evaluation varies by accreditor, we have observed it to generally include the following steps:

1. **Application:** Submission of a substantive change/change in control application. Typically lengthy, this application requires details on the merger partner, rationale, proposed combined institution, and integration plans. These applications generally require substantial input from both universities, advisors, and legal counsel;
2. **Offsite Review and Optional Onsite Review:** Accreditor meeting with the university and partner, including discussion of the application and often requiring supporting documentation. An optional campus visit may follow.
3. **Decision:** Deliberation and determination by the commission.

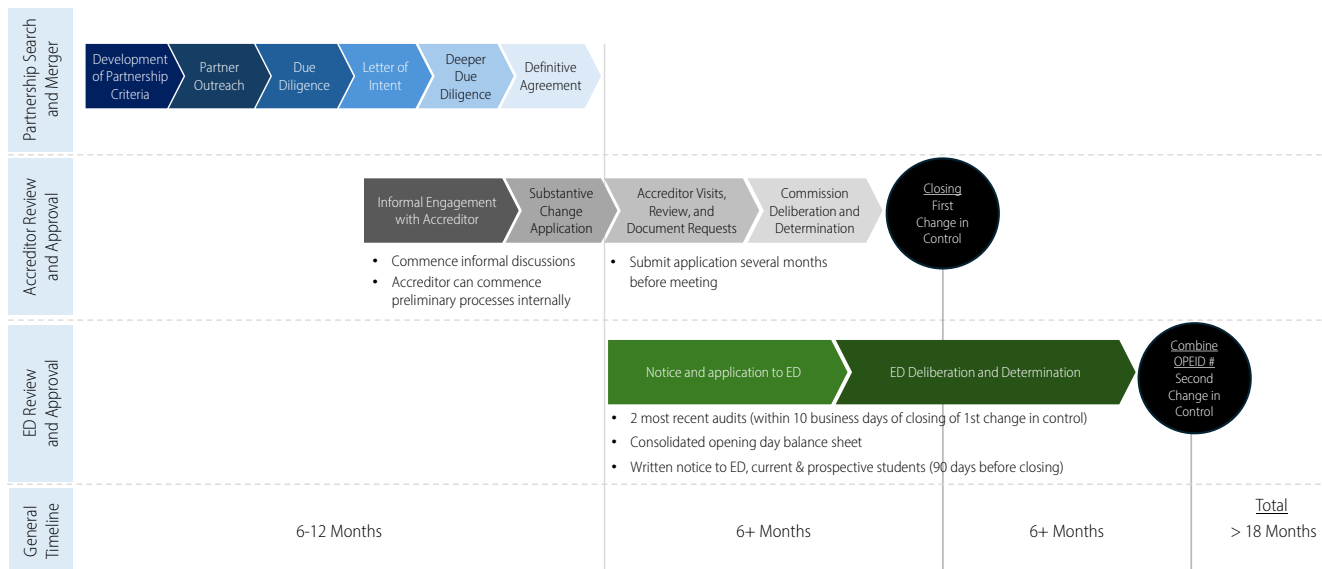
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The accreditor review process can take between three and six months and may extend longer in situations without prior accreditor engagement. Accreditors have periodic standing meetings and universities should plan to submit applications months before a standing meeting to provide the accreditor with appropriate review time before providing a recommendation to their respective commission.

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The state education agency review and approval process also typically take between three and six months and often includes submission of the same materials as submitted to the accreditor. The state education agency may also visit the acquired university.

Merger Partner Search, Two-Step Process, and Accreditor and ED Review and Approval



The Implications for Institutions Undergoing or Contemplating Mergers

The Two-Step Process introduces substantial time and complexity to mergers. Given headwinds in the sector, many universities enter a merger with limited financial resources and therefore with a limited ability to continue normal operations through a lengthy review process. In certain circumstances, the additional time inherent in the Two-Step Process can prove to be a hurdle too high, without sufficient advance planning. As such, universities are best served through deliberate and thoughtful strategic planning prior to commencing a merger process and in some cases, contemplating merger opportunities at an earlier point than would have been desired prior to the adoption of the Two-Step Process.

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