

TYPES NOT MAPPED YET November 14, 2024 | TTR not mapped yet | Lorrie Hargrove, Tres Cleveland, Roger Swartzwelder

# Higher Education: The Road to Nonprofit Status Just Got a Little More Paved

Last Friday, the Ninth Circuit reversed a District Court's decision upholding the U.S. Department of Education's determination that Grand Canyon University did not meet nonprofit status under the Higher Education Act of 1965 ("HEA"). In *Grand Canyon University v. Miguel A. Cardona, et al.*, No. 23-15124 (9<sup>th</sup> Cir. November 8, 2024), a Ninth Circuit three-judge panel, including two Trump 2019 appointees and a Biden appointee, held that the United States District Court for the District of Arizona had applied the wrong standards in determining whether Grand Canyon University ("GCU") met nonprofit institution status under the HEA and in granting the Department of Education (the "Department") summary judgment on the issue of whether the Department's decision denying GCU nonprofit status was arbitrary and capricious under the Administrative Procedures Act ("APA").

GCU is a private, Christian university in Arizona founded in 1949. It was a nonprofit school for most of its history until the early 2000s, when to avoid bankruptcy, GCU sold the school to private investors. After that sale, Grand Canyon Education, Inc. ("GCE"), a Delaware publicly traded corporation, owned GCU and operated it successfully for about a decade as a for-profit entity. Then, GCU's Board of Trustees decided to seek to return the school to nonprofit status under the HEA because of certain "perceived ... competitive disadvantages of a for-profit school, as well as the desire to ensure that GCU would be able to keep its tuition rates low."

Nonprofit status can offer substantial benefits to an educational institution. A nonprofit designation allows charitable donations to be made to the institution, and those funds in turn are invested into the institution and its students, such as through student resource benefits, campus infrastructure upgrades, and greater scholarship opportunities.

Nonprofit status also avoids some requirements and limitations that apply specifically to for-profit institutions. Along with public institutions, nonprofit schools that seek to participate in Title IV of the HEA's federal financial aid programs (through which the Department provides loans and grants to students to help them pay for the cost of their education) are exempt from strict Department regulations that are designed to measure institutional quality and accountability. For example, unlike nonprofit institutions, proprietary institutions must ensure that less than ninety percent of their annual revenues comprise federal education assistance funds (including Title IV funds and veterans benefits) that students use to pay for their education (the 90/10 rule). Proprietary institutions also are subject to the gainful employment rule, which measures the debt loads and earnings of their graduates. Finally, for-profit institutions generally can offer only those programs that lead to employment in a recognized occupation, whereas nonprofit institutions also are able to offer general studies and liberal arts programs.

As GCU's case illustrates, the Department has more closely scrutinized attempts by proprietary institutions to convert to nonprofit status in order to enjoy these perceived benefits. The basis for this position appears to be the Department's skepticism that some of these conversions are legitimate and that some proprietary institutions and their investors in fact are seeking to convert to nonprofit status in name only.

At the time that GCU applied for HEA nonprofit status with the Department, it already had already obtained the Internal Revenue Service's ("IRS") 26 U.S.C. §501(c)(3) recognition as a tax exempt organization. But under both the HEA and its implementing regulations, GCU's conversion to nonprofit status also required that it meet the HEA requirements for a nonprofit institution. The HEA defines a "nonprofit" institution as one that is "owned or operated by one or more nonprofit corporations or associations, no part of the net earnings of which inures, or may lawfully inure, to the benefit of any private shareholder or individual." 20 U.S.C. §1003(13). The Department's implementing regulations add the requirement that the school must be "authorized to operate as a nonprofit organization" under applicable state law and must qualify as an IRS 501(c)(3) organization.

To meet these requirements, GCU established Gazelle University ("Gazelle"), an Arizona nonprofit entity. The IRS recognized Gazelle as a 501(c)(3) tax-exempt organization on November 9, 2015. After Arizona regulators

approved GCU's bid to operate as a nonprofit university, Gazelle bought GCU back from GCE for \$853 million on July 1, 2018, with GCE loaning Gazelle the money through a Credit Agreement. The transaction included a Master Services Agreement ("MSA"), whereby Gazelle outsourced certain services to GCE (such as marketing, enrollment services, accounting services and others) and in return, GCE would receive, as service fees, 60% of the university's adjusted gross revenues. After the acquisition, Gazelle changed its name to "Grand Canyon University."

Prior to the sale, GCU had submitted a request to the Department for a determination that it would agree to reclassify GCU as a nonprofit institution for purposes of Title IV eligibility. After the sale, by letter dated November 6, 2019, the Department denied GCU's application. The letter acknowledged that GCU met the regulatory requirements that it be an authorized nonprofit institution under Arizona law and that it receive recognition from the IRS as a 501(c)(3). But the Department determined that GCU did not meet the requirement that it be "owned and operated by one or more nonprofit corporations or associations, no part of the net earnings of which benefits any private shareholder or individual." The Department concluded that in so determining, the Department's regulation defining a nonprofit "mirrors the statutory language for" 501(c)(3) organizations under 26 U.S.C. §501(c)(3), and that the Department thus independently had to determine whether GCU qualified as a 501(c)(3) organization under the applicable IRS regulations (even though the IRS had already concluded it had).

The Department concluded that such a determination required meeting both an organization and an operational test. The Department found that GCU's organizing documents met the organizational test, but that GCU did not meet the operational test given the revenue GCE was receiving under the MSA and the credit payments under the Credit Agreement. GCU requested reconsideration of the denial while proposing some changes such as eliminating GCE's control over curriculum services and faculty operations. On January 12, 2021, the Department concluded that GCU still had not met the requirement that "both the primary activities of the organization and its stream of revenue benefit the nonprofit itself," as required by IRS regulations.

GCU filed suit in federal court against the Department under the APA, which provides that a "reviewing court" shall "hold unlawful and set aside agency action[] . . . found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise non in accordance with law." 5 U.S.C. §706(2)(A). The district court granted summary judgment to the Department, holding its decision in denying GCU's nonprofit request was not arbitrary and capricious or contrary to law. GCU appealed.

The Ninth Circuit last week reversed the District Court, concluding that the Department used the wrong organizational and operational test standards for determining whether the nonprofit test was met under the HEA. It further determined that the Department's assumption that IRS 501(c)(3)'s language "mirrored" HEA's nonprofit definition in 20 U.S.C. §1003(13) was "incorrect." The Department instead should have used HEA's less demanding standard that the institution be "owned and operated by one or more nonprofit corporations or associations," and that it meet the "no-inurement" requirement (determining "not whether 'net earnings' inured to private benefit," as the Department did, but rather whether "'the primary activities of the organization and its stream of revenue' primarily benefit private parties."). The case has been remanded to the District Court with instructions to remand to the Department for reconsideration with the proper standards.

This case is significant because it could open the door to more proprietary institutions seeking to convert to nonprofit status. So long as an institution meets the HEA's less demanding standard (and satisfies other regulatory requirements such as IRS approval), institutions in theory should be able to successfully obtain nonprofit status.

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