Exhibit 7

EXPERT REPORT OF
PROFESSOR BRADFORD CORNELL
REGARDING PROPOSED GAINFUL EMPLOYMENT REGULATION

I. RETENTION AND QUALIFICATIONS

1. I have been retained by Career Education Corporation to analyze certain proposals contained in the Department of Education's notice of proposed rulemaking ("NPRM") dated July 26, 2010 from the perspective of a financial economist. Specifically, I have been asked to focus on the concept of 'gainful employment' and the related benchmarks proposed by the Department to determine the eligibility of for-profit educational institutions for access to student financial assistance programs authorized under title IV of the Higher Education Act of 1965 ("title IV funds").

2. I am currently a Visiting Professor of Financial Economics at the California Institute of Technology ("Caltech"). Previously, I was a Professor of Finance and Director of the Bank of America Research Center at the Anderson Graduate School of Management at the University of California, Los Angeles for 26 years.

3. I earned a master's degree in Statistics from Stanford University in 1974 and earned my doctorate in Financial Economics from Stanford in 1975. I have served as an editor of numerous journals relating to business and finance and have written more than 70 articles and two books on finance and securities, including *Corporate Valuation: Tools For Effective Appraisal and Decision Making* (1993), published by McGraw-Hill, and *The Equity Risk Premium and the Long-Run Future of the Stock Market* (1999), published by John Wiley and Sons. To complement my academic writing, I have also authored articles for *The Wall Street Journal* and the *Los Angeles Times*.

4. My research has been widely recognized. In 1988, I was cited by the Financial Management Association as one of the ten most prolific authors in the field of finance. I have received prizes and grants for my research from the Chicago Board of Trade, the Chicago Mercantile Exchange, and the Institute for Quantitative Research in Finance.

My article, "Corporate Stakeholders and Corporate Finance,"[1] received the 1987 Distinguished Applied Research Award from the Financial Management Association. In 1999, I was awarded the I/B/E/S prize for empirical work in finance and accounting (with Wayne Landsman and Jennifer Conrad). Richard Roll and I received a Graham and Dodd Scroll Award in 2006 from the Financial Analyst Society for our work on delegated agent asset pricing theory. Recently, my paper entitled "Luck, Skill, and Investment Performance" won an Outstanding Article prize from the 11th Annual Bernstein, Fabozzi/Jacobs, Levy Awards in The Journal of Portfolio Management.

5. I have also been active in my profession. I have served as a Vice President of the Western Finance Association. I am also a past director of both the American Finance Association and the Western Finance Association. I have served as an associate editor of numerous professional journals including: The Journal of Finance, The Journal of Futures Markets, The Journal of Financial Research and The Journal of International Business Studies. I have served as a reviewer for nearly a dozen other professional journals.

6. My teaching and writing have focused on a number of different financial and economic issues, many of which are relevant to the subject matter of this report. I currently teach Applied Corporate Finance and Investment Banking at Caltech. Examples of other classes I have taught over the course of my academic career include Corporate Valuation, the Law and Finance of Corporate Acquisitions and Restructurings, Corporate Financial Theory, and Security Valuation and Investments. I have drawn upon this experience in formulating my opinions in this case.

7. In addition to my teaching, writing, and research studies, I serve as senior consultant to Charles River Associates ("CRA"), an international consulting firm. In my position as a senior consultant, I advise business and legal clients on financial economic issues. Prior to my affiliation with CRA, which began in March of 1999, I operated FinEcon, a financial economic consulting company, through which I also advised business and legal clients on financial economic issues.

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[1] Journal of Portfolio Management, 35, (2009).

8. I have served as a consultant and given testimony for both plaintiffs and defendants in a variety of securities, regulatory and commercial lawsuits. During my many years of experience as an expert witness and consultant, I have provided economic analyses and expert testimony (again, for both plaintiffs and defendants) related to valuation, corporate finance, portfolio management and damages issues. I have been engaged as a damages expert in numerous high-profile cases which revolved around complex financial and securities transactions.

9. My background is described more fully in my curriculum vitae, which is attached as Exhibit 1 to this declaration. A list of my publications may also be found as part of Exhibit 1.

II. FINANCE THEORY UNDERLYING INVESTMENT DECISIONS

10. To place my opinion on the proposed rules to determine the eligibility for access to title IV student financial assistance programs in the proper context, it is helpful to introduce the finance theory underlying capital project investment decisions. My reason for doing this is that finance theory, more specifically Capital Budgeting or Investment Appraisal theory, teaches that a more useful way to analyze the decision to undertake higher education (and the related decision to provide financial assistance for higher education) is by considering education to be a capital project undertaking, similar to a firm deciding to build a factory or a University deciding to fund the construction of new classrooms. Capital Budgeting theory is a long-established sub-field of Economics and Finance theory that considers the problem of allocating limited capital to competing projects and investment opportunities. In making such investment decisions or in deciding whether to undertake further education, the essential issue is the same: is the investment or additional education likely to produce benefits that exceed the cost.

11. Education can be thought of as a special type of capital investment project, aimed at building human capital, which requires substantial expenditures (tuition, opportunity cost of attending school, etc.) in a fairly short period (one to four years) at the start of the project. The benefits from education typically accrue over a lengthy period following the

conclusion of the formal coursework. The direct benefits to education are the increased earnings potential of the student throughout his career, a period that could span decades, but there are also other intangible benefits to the student and society.

12. Capital Budgeting theory has guided capital investment decisions for decades through the concept of net present value ("NPV"). The NPV of a project is the sum of the present values of all incremental cash flows (current and future) related to that project (where cash outflows are treated as negative and cash inflows are treated as positive). To arrive at the NPV, these cash flows are discounted to their present values using the appropriate discount rate. In the example of a firm deciding to build a new factory, NPV would equal the sum of the initial capital outlay, future cash inflows from the factory production, future maintenance costs, etc., all expressed in terms of their present values.

13. Capital Budgeting theory demonstrates the appropriate rule for undertaking projects is to proceed with the project if its NPV is positive. As expressed in a leading finance text book:

> *Firms can best help their shareholders by accepting all projects with positive net present values and rejecting projects with negative net present values. The net present value of a project measures the wealth created by the project.*[2]

14. Although the NPV investment rule is straightforward, there are two factors one should be sure to take account of:

- The NPV calculation must include *all incremental* cash flows arising from the decision to undertake a project in calculating the NPV. The Brealy, Myers and Allen textbook emphasizes this point by stating: "*Estimate the project's incremental cash flows – that is, the difference between the cash flows with the project and those without the project.*"[3] Another leading text book states, "*In calculating the NPV of a*

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[2] Brealy, Richard A., Stewart C. Myers and Franklin Allen, "Principles of Corporate Finance", 9th edition, page 29.

[3] Brealy, Richard A., Stewart C. Myers and Franklin Allen, "Principles of Corporate Finance", 9th edition, page 161.

project, only cash flows that are incremental to the project should be used. These cash flows are the changes in the firm's cash flows that occur as a direct consequence of accepting the project. That is, we are interested in the difference between the cash flows of the firm with the project and the cash flows of the firm without the project."[4] This is an especially important factor as in many cases, such as the rules proposed in the NPRM, decision makers fail to take into account the full period over which the incremental benefits accrue, in this case the full working career of the student.

- The discount rate used to calculate the present value must be consistent with the nature of the project.

15. The above short introduction to Capital Budgeting theory is important for understanding the critique I have of the tests proposed by the Department of Education ("Department") in their NPRM to be eligible for access to title IV student financial assistance programs.

III. PROPOSED TESTS TO DETERMINE ELIGIBILITY FOR TITLE IV STUDENT FINANCIAL ASSISTANCE PROGRAMS

16. It is my understanding that the proposed regulations that the Department has outlined in the NPRM aim to assess the question of whether an educational program or provider offers courses and training to students that leads to their gainful employment after the program. Under the proposals, the eligibility of the educational provider to access title IV student financial assistance programs is in the Department's view based on how successful the program is in providing gainful employment to its students under measures defined by the Department. The Department proposes two tests to measure whether students are gainfully employed following their educational program:

    a. The first test is based upon the debt-to-income ratios of students following completion of the program ("Debt to Income Ratio Test"). Specifically, the test

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[4] Ross, Stephen A., Randolph W. Westerfield and Jeffrey Jaffe, "Corporate Finance", 7th edition, page 179.

states that students should not devote more than 8 percent of their annual earnings towards repaying their student loans, with the loan amount calculated as the median loan among all students of the program. Further, a 12 percent or higher ratio of repayments to earnings is considered excessive. Alternatively, the Department proposes that the debt repayment cannot exceed 30 percent of the discretionary income of the student, defined as the amount of total income above 150 percent of the poverty level for the applicable year. If the Department permits the use of earnings data from four to six years out, the debt cannot exceed 20 percent of the discretionary income. These ratios are calculated based on a 10-year loan repayment plan and the average annual earnings, in the most recent year for which post-completion data are available, for the program's graduates from the previous three years.[5]

b. The second test is based upon repayment rates, i.e., what percentage of students who enrolled in the program (regardless of whether they completed the program or dropped out) in the previous four years have repaid some portion of the principal in the most recent fiscal year ("Loan Repayment Rate Test"). Under the proposal, a repayment rate of 45 percent and higher leads to eligibility for title IV funds while a rate of below 35 percent may lead the program to become ineligible for title IV funding.

17. The two proposed tests summarized above are applied in tandem, for example a program could have a repayment rate of below 35 percent and still qualify for title IV funding if the ratio of student loan repayments to earnings of its recent students is less than 8 percent. A matrix of the relationship between these two tests and their outcomes leading to eligibility for title IV funding is included in the NPRM on page 43621.

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[5] Under the proposed regulation, an institution may seek to measure earnings of earlier graduates (four to six years prior) if graduates typically experience "large earnings increases" after an initial period of employment. NPRM at 43661.

IV. THE DEPARTMENT'S PROPOSED METHODOLOGY IS ECONOMICALLY IRRATIONAL

18. Neither the Debt to Income Ratio test nor the Loan Repayment Rate Test is based on the NPV methodology. Consequently, both tests are economically irrational and will lead to sub-optimal decisions and outcomes whereby students who would benefit from educational programs will be denied access to funds that would help them enroll in such programs.

19. As pointed out earlier, education is an investment whose benefits typically accrue over a lengthy period that could span three to four decades. Neither of the Department's two tests takes into consideration the increase in the lifetime earning capacity of a student who is deciding whether to enroll in a program.

20. The Debt to Income Ratio Test is based on ratios calculated using the average annual earnings in the most recent year for which post-completion data are available, for the program's graduates from the previous three years. This approach introduces two errors in the estimate of cash flows arising from the proposed rule:

    a. A very significant amount of the positive incremental cash inflows to the student are ignored. The increase in lifetime earnings of the student after the three year period is not taken into consideration in deciding whether to the fund the education or not. This is a significant distortion since the Department's own figures demonstrate that substantial increases in earnings occur after the first three years. *See* Chart F, NPRM at 43666.

    b. By focusing on the total earnings for the first three years and not the incremental lifetime earnings, errors can be made that hurt effective programs and/or help under-performing programs. That is, certain programs may not affect the already high earnings of their students and yet have access to title IV funding under the proposed tests, while other programs that dramatically increase the much lower earnings of their students could be denied access to the funding.

21. The correct approach according to finance theory would be an NPV based approach that considers the present value of ***all incremental lifetime earnings*** due to the educational program and compares this to the present value of the total costs of the program. If the present value of the benefits is higher than the present value of the costs, it makes economic sense for the student to enroll in the program and for the federal government to provide access to title IV funding ***even if in the first three years the debt repayments might exceed 12 percent of the student's annual income or during the first four years the student might not be able to make a repayment on the principal amount of the loan***.

22. To illustrate this point with an example, consider a hypothetical average student who is considering enrollment in a 2-year associate degree program that will have a total present value cost equal to $30,000.[6] This program will enhance the earnings capacity of the student throughout his working life, and assume that the present value of the ***entire stream of incremental earnings*** is equal to $150,000.[7] After deducting tuition costs of the education of approximately $30,000, and allowing for additional opportunity costs (assumed to be approximately $20,000), the degree still represents a net present value in excess of $100,000.[8] Thus, financing the education is clearly an easy investment decision to make under the NPV rule – the student should go ahead with the enrollment and the

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[6] College Board, a membership association composed of more than 5,700 schools, colleges, universities and other educational organizations, estimates the annual tuition and fees at for-profit institutions to equal $14,174 for the 2009-10 academic year. See College Board's Trends in College Pricing 2009, page 6.

[7] Data from US Census indicates that students with associate degrees earn $1.6 million over their lifetimes, whereas students with high school diplomas make $1.2 million (See, "The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings" by Jennifer Cheeseman Day and Eric C. Newburger). The present value of the $400,000 of incremental earnings is approximately $150,000, assuming a 40-year period and 6% discount rate. The discount rate accounts for the interest costs attributable to loans used to finance the education. As noted previously, under the proposed regulation, an institution may seek to measure earnings of earlier graduates (four to six years prior) if graduates typically experience "large earnings increases" after an initial period of employment. NPRM at 43661. However, the Department could not have intended this proviso to apply to the average additional earnings of $400,000 noted above, since these represent average cumulative figures over the full working career of a student.

[8] The NPV calculation should also include opportunity costs. While opportunity costs might include income lost due to attending school, many students attending for-profit schools are unemployed at the time they commence their education, many continue to work while attending school, and many may be able to augment their income during the course of their school attendance by virtue of their increased skills. I assume the opportunity costs for students enrolling in an associate degree program to be approximately $20,000.

associated costs and the government should provide access to funding through loans if the student requires it.

23. But under the proposed test, there will be cases where such a student is denied access to funds/loans. Extending the example, suppose that the student borrowed $20,000 at 6.8 percent[9] from the federal government under the title IV program to partially fund the associate degree program and found a job after the program with a salary of $25,000. Under the proposed Debt to Income Ratio Test, based on a 10-year repayment plan, the ratio of student loan repayments to total earnings equals 13.4 percent, which is higher than the maximum 12 percent permissible under the NPRM. Similarly, under the Department's alternative Debt to Income Test relating to discretionary income, the ratio is 38.4%, again higher than the proposed mandate of 30%.[10] If this example is extrapolated to the entire program, many worthwhile educational programs will be denied access to title IV funding under the proposed rules.

24. Similarly, applying the Loan Repayment Rate test to the same hypothetical example leads to equally irrational results. In our example, even though the direct benefit of the education is approximately $400,000 of average incremental earnings over the working life of the student ($150,000 in present value terms) and has an NPV of approximately $100,000, if the repayment rate is below 35 percent for students enrolled in the program (regardless of whether they completed the program or dropped out) in the previous four years, the program is ineligible.

25. Therefore, in my opinion the proposed rule is arbitrary and capricious from an economic point of view. If the Department wants to implement a regulation addressing the economic value of an educational program, the rule should be based on an NPV based

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[9] The current interest rate charged on Stafford Loans is 6.8%. See http://www.staffordloan.com/stafford-loan-info/interest-rates.php. Also, the 6.8% rate is suggested in the NPRM on page 43662.

[10] The HHS poverty level for a single-person-family in 2010 is $10,830. Discretionary income equals earnings minus 150% of the poverty level i.e. discretionary income with earnings of $25,000 equals $8,755.

benchmark.

V. THE USE OF THREE TO FOUR YEAR DATA TO EVALUATE GAINFUL EMPLOYMENT IS ABRITRARY, CAPRICIOUS, AND UNREASONABLE

26. The Department's proposed regulation is arbitrary, capricious, and unreasonable for another reason. Even if it were economically rational to base the regulation on a non-NPV basis (which it is not), the Department's proposed regulation is economically irrational because the Debt to Income Ratio Test and the Loan Repayment Rate Test are based on an arbitrary three and four year period respectively that is unreflective of the value of the education because it takes a truncated snapshot in which the student is at the entry level and hence his or her income is the lowest.

27. This period is too short to fairly reflect the benefits of education to earnings potential (as explained in section IV). The data contained in the NPRM itself demonstrates that the Department's arbitrary selection of a three to four year period in which to measure the Debt to Income Ratio Test and Loan Repayment Test is economically irrational even under the Department's flawed methodology.

28. In this regard, Chart F demonstrates a substantial increase "by as much as 43 percent between the first few years out of post secondary education and the sixth to tenth years out." NPRM at 43666. Thus, it makes little sense to artificially limit the period to the first three or four years.

29. Furthermore, the Department's explanation for its selection of such a short period makes no economic sense. The Department states that: "Some would argue that a more appropriate income measure would occur a few years after completion of the degree or certificate, since incomes increase with age and experience." NPRM at 43666. But it claims that "this increase is true for high school diplomas as well as postsecondary education; in other words, the income gaps measured in the early years generally serve as good indicators of the income gaps in the later years." *Id.* The Department thus seeks to justify these very short time periods on the basis that the relative income gap between

high school graduates and those students who receive post-secondary education remains relatively constant.

30. But this observation is beside the point. The Loan Repayment Rate Test and Debt to Income Ratio Test do not (as a rational NPV methodology would) even purport to evaluate the additional income attributable to post-secondary education over the working life of the student. Rather, both of these tests take a snapshot of certain metrics during a specific short term period. The fact that salaries rise for high-school graduates over time does not mean that students who have obtained post-secondary education at for-profit schools should be assessed solely on the basis of their lower salaries over the period immediately following completion of their programs of study.

31. A simple hypothetical is sufficient to demonstrate the fallacy in the Department's reasoning. Assume, consistent with our prior hypothetical example, that a student has total loans of $20,000 at 6.8 percent from the federal government under the title IV program and has found a job after the program with a salary of $25,000. As previously noted, under the proposed test, based on a 10-year repayment plan, the ratio of student loan repayments to total earnings equals 13.4 percent, which is higher than the maximum 12 percent permissible under the NPRM.

32. However, if the student obtains the associate degree, assume that his income reaches $42,000 by his tenth year following completion of the program (consistent with data presented in NPRM's Chart F), at which point his loan repayments would constitute 8 percent of his annual income (assuming no principal repayment in the years 1 to 10 after the completion of the program). Similarly, under the Department's alternative Debt to Income Test, the ratio of debt payments to discretionary income by the tenth year is only 13%, far below the proposed threshold of 30%. This is true despite the fact that the income differential between high school graduates and associate degree students remains constant. Thus, the Department's proposed rationale for selecting the truncated three year period on the basis that it does not make any difference to the application of the Debt to Income Ratio Test because the income gap remains relatively constant is demonstrably false.

33. Moreover, the period is too short to smooth out externalities such as recessions and periods of high unemployment including the current downturn. While the cost of enrolling in a particular education program and the assumed 10-year loan repayment costs are relatively constant, the employment opportunities available to students and their earnings levels are adversely impacted in the short term by recessions and labor markets with high unemployment. Furthermore, it is during periods of slow economic growth, when opportunity costs are less that many students contemplate getting further education to expand their skill set and gain access to more employment opportunities.

34. Because the proposed rules ignore external factors such as the state of the economy, wage growth and the rate of unemployment, they could in effect be counter-productive in that programs would be denied access to title IV funding during periods of slow economic growth – exactly the time when society should be encouraging education and re-training of the workforce.

VI. LOSS OF SOCIETAL BENEFITS

35. As explained above, the average direct benefit per student for an associate degree in my hypothetical example is approximately $400,000 of incremental earnings over the working life of the student ($150,000 in present value terms) and the NPV of the degree is approximately $100,000 (considering the cost of tuition and other opportunity costs faced by the student). Other educational programs are also likely to have substantial benefits and NPV associated with them. By excluding a large number of students from access to funding for these educational programs, the excluded students and society as a whole will suffer substantial losses in value (the actual amount of value lost will depend upon the total number of students who discontinue or limit their education as a result of the proposed regulation, the percentage of those students that would have graduated but for the proposed regulation, and the net present value of the education these students would have received but for the proposed regulation).

36. Thus, the Department's proposed regulation is not only potentially ruinous to the lives of tens of thousands of students, it is economically irrational on a macro-economic scale as well.

Bradford Cornell

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