AVOIDING ILLEGAL LENDER INDUCEMENTS

By Blain B. Butner and Aaron D. Lacey

The Federal Family Education Loan (FFEL) market has changed dramatically in the 20 years since Congress first enacted the "anti-inducement" provision of the Higher Education Act (HEA). Increasing demands by schools for benefits and services, the rising cost of education, and escalating competition for FFEL loans have motivated 21st century lenders to introduce a plethora of innovative, attractive lending arrangements, designed to benefit the school and the lender to the full extent permitted under the law. These changes in the market have made it increasingly difficult to determine what is and what is not an illegal inducement.

In recent years, both Congress and the U.S. Department of Education have declined to provide comprehensive guidance and clarification concerning this potentially high-risk law. Consequently, schools have largely been left to their own educated guesswork. And while some significant industry guidance was developed with the assistance of NASFAA and published in 2004, the precise scope of permissible activities under the federal anti-inducement law, even with that guidance, remains murky at best.

Against this backdrop, this Legal Checkup column will address the current state of the regulatory environment for the federal anti-inducement law.

The HEA Prohibition

The anti-inducement statute, Section 435(d)(5)(A) of the HEA, prohibits a lender from offering incentives to an edu-

cational institution or individual in order to secure applicants for FFEL loans.

The law states:

> The term "eligible lender" does not include any lender that the Secretary determines, after notice and opportunity for a hearing, has
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> (A) offered, directly or indirectly, points, premiums, payments, or other inducements, to any educational institution or individual in order to secure applicants for loans under this part…
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> It shall not be a violation of this paragraph for a lender to provide assistance to institutions of higher education comparable to the kinds of assistance provided to institutions of higher education by the Department of Education.

The term "inducements" was not defined by Congress when it enacted the prohibition in 1986, and Congress has continually declined to clarify this sweeping law, despite the significant transformation of the FFEL industry since that time. The Department issued some helpful guidance in the 1980s and 1990s, but that guidance is now dated. Like Congress, the Department has declined to articulate the exact boundaries of permissible and impermissible inducements in the context of the current lending environment and industry practices.

It is important to note that while the HEA provision only prohibits *lenders giving* inducements, the effect of the law, particularly for schools' Title IV fiduciary obligations, is also to proscribe *schools receiving* inducements. Thus, schools need to be sensitive to this important, and very broad, law.

The OIG Weighs In

The absence of guidance regarding the anti-inducement provision has not gone unnoticed. To the contrary, it has been recognized and publicly criticized. The Department's Office of Inspector General (OIG) issued an "Alert Memorandum" in August 2003, prompted by allegations that certain lenders were offering schools illegal inducements in return for FFEL loan volume. The OIG concluded that the lenders were not violating existing inducement rules, but it warned that "there are bargaining practices between schools and lenders for FFELP preferred loan status and private loan volume that should be addressed through statutory and regulatory changes or further Department guidance. Given the current marketing practices by schools and lenders, the Department should examine the roles and responsibilities of schools, as well as lenders and lender affiliates in the inducement issue."

The OIG report roundly criticized the Department's failure to provide sufficient guidance to schools and lenders. It noted in particular that the Department's interpretive guidance to the community through Dear Colleague Letters had not been updated since 1995, and that the Department's informal guidance provided in individual letters and e-mails had not resolved the concerns of FFEL participants as to what constitutes an illegal inducement.

The GAO Expresses Its Concern

The U.S. Government Accountability Office (GAO) recently noted the Department's reluctance to provide guidance concerning illegal inducements, highlighting the Department's failure to respond to the OIG's Alert Memorandum. A January 2005 GAO report to Congress titled "More Oversight Is Needed for Schools That Are Lenders" reviewed the existing federal controls governing the operation of such schools, including the anti-inducement law, and reached the following conclusion:

> Since the court's decision in [2000 in the lawsuit titled Sallie Mae v. Riley, involving the Department's challenge to a major lender's practices under this law], Education has not clarified its definition of inducements, and according to an Education official, the court's decision makes it much harder for Education to show that school lending arrangements violate the inducement provision. The lack of clarity surrounding the issue of inducements is not solely a problem for school lenders. In an August 2003 memo, Education's Office of Inspector General (OIG) noted that it had concerns about bargaining practices between schools and lenders for private loans that students may obtain to supplement FFELP loans and preferred lender status that may violate the anti-inducement provision. OIG recommended that Education reevaluate the anti-inducement provision and determine if statutory revisions should be proposed during HEA reauthorization, but Education has not taken any action in response to OIG's memo.

The Department was offered an opportunity to respond to the GAO report prior to its publication and did so in a January 10, 2005, letter. The response commented on the GAO's general conclusions concerning oversight, but did not address the statements in the GAO report regarding the anti-inducement provision.

Despite these calls for additional guidance, the Department has declined to offer clear guidance concerning the anti-inducement law, publicly or, as best we know, privately. Our firm filed a request with the Department in 2005 under the Freedom of Information Act for all decisions, advisory letters, and other guidance issued by the Department since 1986 concerning the anti-inducement provision, as well as any other documents relating to the Department's enforcement and interpretation of this law. The Department's response to us contained five documents totaling 10 pages (more than half the pages consisted of two prior Dear Colleague letters). These documents did not provide any additional insight regarding the scope or application of the law.

Current Guidance on the Anti-Inducement Law

We believe there are currently two sources of guidance that, considered together, provide schools with the best available framework for attempting to assess their compliance with the anti-inducement provision.

First, although the Department has steadfastly declined to define those activities that are *prohibited* (i.e., inducements), it has created a limited "safe harbor" for schools by compiling a short list of activities that are *permitted*. Congress added the following exception to the anti-inducement statute in the 1998 HEA Amendments:

> It shall not be a violation…for a lender to provide assistance to institutions of higher education comparable to the kinds of assistance provided to institutions of higher education by the Department of Education.

The Department's implementing regulations (34 CFR § 682.200(b)) refined this exception to permit lenders to provide assistance "comparable to the kinds of assistance provided by the Secretary to schools under, or in furtherance of, the Federal Direct Loan Program."

In an effort to add precision to the scope of this exception, our firm contacted policy officials in the Department's Office of Federal Student Aid (FSA) seeking documentation of the services the Department offers to schools in connection with the Direct Loan Program. The Department officials advised us that they did not have a comprehensive listing of the services offered to schools participating in the Direct Loan Program, but they said that the Department does not provide any services beyond those outlined in the Federal Register commentary accompanying the Department's 1999 proposed regulations.

In that 1999 commentary, the Department offered significant clarification of the exception, and indicated that the following activities do not constitute inducements under the law:

Counseling: A lender may support schools in meeting their responsibilities to provide borrowers with initial counseling, exit counseling, and general debt counseling. In providing this support, lenders may:

- Assist in the development, production, and distribution of materials used by schools in counseling activities.
- Develop, and offer to schools, electronic products and services, including Web-based processes, that can be used to meet counseling requirements.
- Participate in counseling sessions offered by a school, provided that the school maintains control of these events and school staff members are present.
- Participate in initial counseling, provided that the lender's activities reinforce the student's right to choose a lender.

Outreach: A lender may support schools in activities to inform the public or students of the availability of student aid, including student loans. Lender participation might include such activities as: providing publicity for outreach events; preparing, producing, and distributing materials; providing light refreshment; and providing staff to assist the school in the presentation. Permissible outreach activities also include those that are undertaken by a lender in conjunction with a guaranty agency.

Computer Support: A lender may provide computer software, technical support, and training—but not computer hardware—that support the technological processes used by the lender in its administration of the FFEL Program.

Training: A lender may provide specialized training to schools in support of their FFEL Program processes. This training may be provided in person, either on or off campus, or through the use of technology. A lender may not provide school staff additional services or goods (other than items of nominal value) in connection with the training, and it may not pay expenses incurred by school staff for the training.

If an FFEL lender provides services to a school that fall within the Federal Register listing, such services would not be a violation of the anti-inducement law. But, if an FFEL lender provides services to a school that fall outside the Federal Register listing, the lender and the school will not be able to claim the "safe harbor" that the services are also provided by the Department to Direct Loan schools.

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This does not mean that any such activity is necessarily a prohibited inducement. It does mean, however, that its propriety will need to be evaluated in the context of the general terms of the law without regard to the Department/Direct Loan exception.

The 2004 Industry Guidelines

The second source of guidance for schools was created as a part of the lending industry's efforts to self-regulate. Shortly after the 2003 OIG Alert Memorandum referred to above was issued, Assistant Secretary for Postsecondary Education Sally Stroup stated that the Bush Administration had no intention of investigating lenders to

determine if they were complying with the anti-inducement rule. Stroup said that "rather than intervene at this time, we believe that it is preferable to wait to see whether these groups can reach consensus." The Department echoed this sentiment in the following months in its informal communications, repeatedly suggesting to members of the lending community that the industry should attempt to police itself.

In response, after lengthy discussions and negotiations, the primary national organizations representing Title IV student loan lenders, guaranty agencies and secondary markets reached an agreement concerning their interpretations of the scope of the anti-inducement rule. In November 2004, the Consumer Bankers Association (CBA), the Education Finance Council (EFC) and the National Council of Higher Education Loan Programs (NCHELP) announced their endorsement of a set of guidelines titled *Guidelines for FFELP Industry Practices* (hereafter, "*Guidelines*") to be used by lenders and institutions seeking to comply with the anti-inducement rule. NASFAA did not officially endorse the *Guidelines*, but was heavily involved in the drafting process, as were many of its institutional members.

The introduction to the *Guidelines* states that the *Guidelines* "were developed to provide guidance to postsecondary institutions and loan industry participants for compliance with the statutory provisions of the Higher Education Act. These guidelines were developed by institutional and lending representatives and are intended to supplement the Department of Education's existing guidance."

The *Guidelines* set forth the following principles, which are far from exhaustive, but which offer specific guidance for determining whether a proposed lender relationship is consistent with the industry's understanding of the anti-inducement rule.

1. FFEL borrowers have the right to choose the eligible lender of their choice and institutions cannot intentionally delay or refuse to process the loan application based on the borrower's choice.

2. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to work with institutions, students, and others to help promote increased awareness of financial aid opportunities and generally to promote access to postsecondary education.

3. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to engage in philanthropic activities, including providing scholarships or financial contri-

butions; however, they should not be conditioned on the existence of, or the expectation of, an FFEL business relationship between the industry participant and the institution, nor should institutions or their related organizations request or accept philanthropic contributions based on such a relationship.

4. Lenders, guarantors, servicers, secondary markets, and their related organizations should not offer, directly or indirectly, nor should institutions or their related organizations request or accept private loan products in exchange for a specified dollar amount of FFEL loan or guarantee volume, a percentage of FFEL loan or guarantee volume, or FFEL exclusivity. Notwithstanding the above, institutions may choose a single preferred FFEL lender or a single preferred FFEL service provider.

5. Institutions and their related organizations should not request or accept referral or marketing fees for FFELP loan applications. Institutions and their related organizations are encouraged to coordinate all matters related to student loans through the designated campus financial aid office.

6. Lenders, guarantors, servicers, secondary markets, and their related organizations should not offer referral or marketing fees for FFEL loan volume to educational institutions or other entities; however, they are permitted to offer reasonable referral and processing fees to other lenders and other non-institutionally-related entities for FFEL loan applications.

7. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to work with schools to implement new technologies and to offer training sessions and financial instructional materials that assist students and staff members; however, except as part of a philanthropic effort, lenders, guarantors, servicers, secondary markets, and their related organizations should not offer, nor should institutions or their related organizations request or accept equipment, commercially available software or funds to procure such.

8. Subject to applicable state law, lenders, guarantors, servicers, secondary markets, or their related organizations may provide reasonable financial reimbursement to institutional personnel for travel, lodging, meals, and miscellaneous expenses, associated with their participation in school advisory group meetings held by the sponsor.

9. Lenders, guarantors, servicers, secondary markets, and their related organizations are encouraged to sponsor approved activities open to all eligible attendees during regularly-scheduled conference periods. Every effort should be made to conduct private functions during times that do not conflict with any portion of the scheduled conference program.

10. Institutional personnel should not request or accept, nor should lenders, guarantors, servicers, secondary markets, or their related organizations offer gifts, meals, or tickets to entertainment events if the value of such is greater than what would be offered in a normal business setting. Further, institutional personnel should be aware of state ethics laws to ensure they are in compliance.

The *Guidelines* represent the lending industry's attempt to self-regulate with respect to the anti-inducement law, and are the only significant documentation generated by the industry in recent history.

Our firm also made inquiries to officials at several large lenders, seeking additional information on their individual practices and activities in light of the anti-inducement rule. The officials we spoke to said they did not have any written policies that they could share with us, and were not aware of any letter rulings or opinions from the Department to their companies addressing any specific activities. These organizations advised us that they seek to adhere to the *Guidelines* discussed above. None of these entities wanted to discuss their particular practices and activities with us.

So, Guidance Remains Vague

The continued thriving of the FFEL market gives us every reason to believe that lenders will continue to add to the array of innovative, appealing lending arrangements and techniques being offered to schools. Against this evolving landscape, the precise scope of permissible activities under the federal anti-inducement law remains unclear.

The Department has provided some guidance and limitations, but has declined to revise and particularize its guidance. The 2004 industry *Guidelines* are very helpful, but they could change over time based on emerging industry practices. The Department has not endorsed the *Guidelines*, so compliance with them does not protect a lender or a school from being cited for an illegal inducement. And while the Department has signaled that it does not currently plan to actively monitor lenders' compliance with the anti-inducement law, that position could, of course, change at any time.

The line between permissible and impermissible activities remains fuzzy. As a result, schools should carefully evaluate any proposed activity that is not squarely within the Department's *Federal Register* listing.

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This article is intended to provide general information on lender inducements, but should not be considered legal advice. For such advice, readers should consult with qualified counsel familiar with their particular circumstances.