

**THE GUARANTEED STUDENT LOAN  
PROGRAM: DO LENDER'S RISKS EXCEED  
THEIR REWARDS?**

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In 1965, Congress responded to a growing need for financial assistance to students in higher education by enacting the Higher Education Act of 1965.<sup>1</sup> Among the programs of student assistance created by the Act,<sup>2</sup> Congress established the Guaranteed Student Loan Program (GSLP),<sup>3</sup> under which students may obtain low interest<sup>4</sup> educational loans from private lenders. The loans are guaranteed either by the federal government or by a state or private guaranty agency.<sup>5</sup> In the event of a student's default, death, disability, or bankruptcy, the federal government reimburses the lender for the unpaid principal balance and any interest owed.<sup>6</sup> The student's payment of both principal and interest is deferred during a six-to-twelve-month grace period after the student graduates or leaves school; during that period the federal government pays interest to the lender.<sup>7</sup> In addition to the stated interest on the loans, lenders are paid a special allowance designed to make the rate of return on GSLP loan notes comparable to rates available on other investments.<sup>8</sup>

Although guaranteed student loans were initially limited to low-income students, eligibility for the loans was gradually expanded. In 1978, the program was opened to all students regardless of income,<sup>9</sup> only to be again restricted beginning with the 1982-83 academic year to students with family incomes below \$30,000.<sup>10</sup> With the troubled economic conditions and skyrocketing educational costs of the 1970s and 1980's, more students have come to rely upon guaranteed student loans to finance their educations.<sup>11</sup> The increased need for financial assistance, coupled with the broadening of student eligibility for guaranteed loans, has resulted in an explosion of the number of students applying for and receiving such loans.<sup>12</sup>

As a consequence, guaranteed student loans have become the principal source of student financial assistance.<sup>13</sup> Not surprisingly, a concomitant effect of greater student dependence on guaranteed loans has been the greater dependence of post-secondary schools on the availability of such loan monies to establish and maintain enrollment levels.<sup>14</sup> Without such loans, many students would be unable to pursue higher education and many schools would be forced to close.<sup>15</sup>

The linchpin of the GSLP has been the willingness of private lenders<sup>16</sup> to participate in the program.<sup>17</sup> Their continued participation requires the federal government to make GSLP loans sufficiently attractive investments by achieving a balance between the lenders' risks and the return that they can expect on their

investments.<sup>18</sup> Congress has enacted a number of measures to achieve this balance and to encourage lender participation.<sup>19</sup> In recent years, however, the balance between risk and reward has been upset as a result of the attitude and reaction of the Department of Education (Department),<sup>20</sup> which administers the GSLP, to the unexpectedly high cost of the program.

The initial alarm sounded in the late 1970's, when the default rate on student loans guaranteed under the GSLP surpassed all projections. By the end of fiscal year 1980, over \$1.4 billion in GSLP default claims had been paid by the Department of Education,<sup>21</sup> representing an overall default rate in excess of twelve percent.<sup>22</sup> From 1978 through 1980, default claims averaged over \$200 million per year.<sup>23</sup>

Simultaneously, a second and even more costly source of burgeoning program expenditures emerged, namely, special allowance payments to lenders that are tied to the average quarterly rate of interest for Treasury bills.<sup>24</sup> Unfortunately, the depressed economy during the late 1970's and early 1980's, and the attendant record-setting interest rates, have resulted in enormous increases in the special allowances paid to lenders.<sup>25</sup> Specifically, special allowances rose from a high of approximately 3% in 1977 to 11.5% in 1981, an increase from \$106 million in 1977 to \$1.5 billion in 1981.<sup>26</sup>

Given the budgetary pressures resulting from the rising cost of the GSLP, lenders have been placed in an increasingly precarious position by the Department. Earlier, the Department focused its efforts on obtaining maximum participation from the lending community.<sup>27</sup> Recently, however, at least with regard to the Federally Insured Student Loan Program (FISLP), the focus has shifted to the careful scrutinizing of lenders' default claims, with a view toward allocating more of the risk of loss to lenders and thus minimizing government outlays by denying coverage for any technical violations of program requirements. As the United States Court of Appeals for the Fifth Circuit pointedly remarked in *Hicks v. Harris*,<sup>28</sup> "[t]he government, faced with escalating insurance claims under the [FISLP]. . . evidently has looked to technical infringements of the letter of its regulations as a shield against lenders' claims for reimbursement on loans made pursuant to its invitation."<sup>29</sup>

The reallocation of the risk of loss arising from student defaults may cause lenders to opt out of the program in favor of alternative investments. In fact, this movement may have already started as increasing numbers of lenders liquidate their student loan portfolios by selling their GSLP notes to the Student Loan Marketing Association, commonly known as Sallie Mae.<sup>30</sup> Such sales have increased faster than increases in the volume of new loans,<sup>31</sup> while the number of lenders participating in the GSLP has steadily decreased.<sup>32</sup> Thus, the likely long-term effect of the Department's policies will be that, with decreased lender participation, the Congressional purposes underlying the creation of the GSLP will be frustrated, with students, schools, and the quality of American education being the ultimate losers.

This Article will examine how the reallocation of risk from the federal government to lenders has been effected by the Department of Education through

changes in regulatory interpretation. In particular, the Article will focus on two areas in which the Department has changed its attitude toward lenders: payments of illegal inducements and due diligence requirements for loan collection and default claim submission. As the following discussion illustrates, regardless of whether one adopts an analysis based on the statutory requirements for proper administrative procedure, on contract law, or on the policies underlying particular GSLP regulatory requirements, there are serious questions as to the propriety of the Department's treatment of lenders under the program. In turn, these questions raise important and fundamental questions regarding future financial support for higher education in this country.

## **Background of Lender's Participation in the Guaranteed Student Loan Program**

### **Lender Incentives**

The premise underlying congressional enactment of the GSLP was that funds would be made available for student financial assistance by leveraging private capital. This result was to be accomplished in three ways. First, private lenders' risks were to be minimized through federal loan guarantees.<sup>33</sup> Second, interest on the loans was to be wholly subsidized while the student borrowers were in school.<sup>34</sup> Third, although the loans themselves were to be made at interest rates substantially below market,<sup>35</sup> lenders would be guaranteed an acceptable rate of return by means of variable special allowances paid by the federal government, over and above the notes' stated interest rate.<sup>36</sup>

In addition to the low risk nature of the loans and the guaranteed rate of return, lenders have participated in the program for intangible reasons. Among the indirect benefits derived from making student loans has been good will in the communities where the lenders do business and, in particular, the good will of parents of the students receiving such loans which often translates into deposits.<sup>37</sup> Also, lenders have been attracted by the prospect of establishing banking relationships with the student themselves, who by reason of their education are more likely to become profitable banking customers.<sup>38</sup>

Throughout the history of the program, beyond the incentives described above, Congress has constantly taken steps to maintain and promote lender participation. For instance, a study commissioned by Congress in 1970 revealed that lenders had very limited funds with which to make student loans, and once these funds were committed, lenders were unwilling to make new loans.<sup>39</sup> Consequently, Congress provided greater liquidity to lenders by fostering an active secondary market for guaranteed student loans. In particular, in 1972 Congress established the Student Loan Marketing Association (Sallie Mae) as a government-sponsored, but privately owned, profit-making corporation.<sup>40</sup> Sallie Mae provides lenders with additional funds for making student loans, either by directly purchasing guaranteed student loan notes, or by advancing funds to lenders while using those lender's GSLP notes as collateral.<sup>41</sup>

To increase the rate of return for lenders, Congress ensured that special allowance payments would be continually revised to keep guaranteed student loans competitive with

other investments.<sup>42</sup> Recently, Congress authorized lenders to charge students a five percent origination fee for making GSLP loans.<sup>43</sup> In addition, in order to accelerate claim processing by the Department with respect to loans insured directly by the federal government, Congress now requires that the Department process and either pay or reject lenders' default claims within ninety days.<sup>44</sup> To compensate lenders for the added cost of making periodic multiple disbursements,<sup>45</sup> Congress has also provided interest and special allowance payments on the entire principal amount, including the undisbursed portion.<sup>46</sup> Finally, Congress has given lenders greater access to the courts by allowing lenders to sue the federal government in any federal district court or state court of record.<sup>47</sup>

With regard to state guaranty agencies, Congress has cleared the way for states to provide lenders with a number of additional incentives as well. For example, state guaranty agencies may act as escrow agents to hold the undisbursed portions of loans, thereby shouldering the administrative cost of making multiple disbursements.<sup>48</sup> Congress has also underwritten the costs incurred by such agencies in providing lenders with accounting services for computing interest and special allowances,<sup>49</sup> pre-default collection assistance,<sup>50</sup> and the monitoring of student enrollment status.<sup>51</sup>

Perhaps just as important as the concrete measures taken by Congress to promote lender participation are those measures rejected by Congress that would have tended to discourage lender participation. For instance, Congress has refused to require lenders to administer financial needs tests to students for the purpose of determining student eligibility.<sup>52</sup> Similarly, Congress has refused to terminate the interest subsidy paid by the federal government while students are in school.<sup>53</sup>

### **Regulatory Ambiguity**

In light of Congress' active recruitment of lenders to participate in the GSLP, and given lenders' obvious need for guidance in meeting the complex GSLP requirements, the Department was surprisingly slow in developing meaningful regulations.<sup>54</sup> The first regulations, promulgated in 1966, provided little more guidance than the statute itself.<sup>55</sup> Somewhat more comprehensive regulations were issued in 1970,<sup>56</sup> then revised in 1979 and reissued in 1982.<sup>57</sup> Until the 1979 revisions, however, critical aspects of lender participation in the program were left unclear.<sup>58</sup>

The principal source of guidance in implementing the FISLP portion of the GSLP has been the *Manual For Lenders*, a program guidebook prepared by the Department and distributed to participating lenders.<sup>59</sup> This manual is also used extensively, with other sources, by the Department claims examiners in reviewing default claims.<sup>60</sup>

From the lenders' point of view, however, the Department's use of the *Manual For Lenders* raises additional questions as to what are or are not regulatory requirements. Unlike the Higher Education Act and the regulations promulgated thereunder, the *Manual For Lenders* can impose no requirements of its own force.<sup>61</sup> It is only a reflection of the Department's interpretation of the Act and the regulations.<sup>62</sup> In a number of instances,

however, the *Manual For Lenders* contains requirements not found in the statute and regulations, and others that are contrary to the statute and regulations.<sup>63</sup> Nevertheless, some courts have taken the approach that the *Manual For Lenders* is binding upon FISLP lenders, as if it were in fact part of the lenders' insurance contracts.<sup>64</sup>

Amid this mosaic of regulatory requirements and quasi-requirements, lenders have often been forced to guess about the nature of their responsibilities.<sup>65</sup> As the following discussion illustrates, problems now encountered by lenders filing default claims with the Department often find their genesis in the ambiguities of the regulatory requirements, and in the Department's own contradictory policies with respect to enforcing those requirements.

### **Specific Problems Encountered By Lenders: Administrative Fiat Versus Administrative Rulemaking**

Default claims filed by lenders have been denied for a myriad of reasons.<sup>66</sup> Two categories of denial, however, deserve special attention' and scrutiny. The first involves the regulatory prohibition against the payment of inducements by schools to influence lenders to make GSLP loans. And the effect of such violations of the regulations on the Department's guaranty obligations. The second involves the nature of lender's duties to exercise due diligence in the making, servicing, and collection of FISLP loans and in the submission of default claims to the Department.

### **Payment of Illegal Inducements to Influence Lenders to Make GSLP Loans**

In 1970, the Department promulgated 45 C.F.R. §177.6(e), prohibiting the payment of "points, premiums, or additional interest of any kind" to an eligible lender "in order to secure funds for making loan or to induce such a lender to make loans to the students of a particular institution . . ."<sup>67</sup> The regulation further provided that GSLP loans made by educational institutions could not be sold or transferred at discount.<sup>68</sup>

The purpose of prohibiting such payments or discounts was two-fold. First, the Department perceived a need to protect student borrowers by preventing schools from incurring additional costs and then passing these costs on to the students in the form of higher tuition charges.<sup>69</sup> Second, the agency sought to make student loan funds available to all students, and to prevent such funds from being channeled to students at particular schools that offered inducements to lenders.

### *The Department's Broad Interpretation of "Illegal Inducements"*

In recent years, the Department has increasingly utilized the prohibition against illegal inducements as a ground for denying FISLP default claims.<sup>70</sup> Despite the fact that the illegal inducements regulation is punitive in nature and, therefore, subject to narrow construction,<sup>71</sup> the Department has adopted a broad interpretation of the regulations to include inducements of any kind.<sup>72</sup>

Thus, a lender faces a complex series of problems when it has a banking relationship with a school, or with the owners of a school, that is totally separate from its relationship with the student borrowers; anything of value received by the lender from the school pursuant to that separate relationship may be subject to scrutiny. Hence, a lender may innocently engage in conduct as a normal incident to its overall banking relationship with the school, which constitutes a traditional banking practice in other contexts, (for example, compensating balances, standby commitment fees, accounts receivable financing) but which in the context of the GSLP may give rise to allegations by the Department of illegal inducements.<sup>73</sup> In this way, the illegal inducements prohibition has served as a readily available vehicle for cutting the federal government's default losses. In several cases, large blocks of FISLP loans owned by a single lender have been considered "tainted", and the Department has sought to deny all liability claims, based on the illegal inducement regulation.<sup>74</sup> Indeed, in one case alone, the Department dishonored \$5 million in FISLP default claims.<sup>75</sup>

Lenders purchasing student loan notes in the secondary market are also vulnerable. Their default claims may be denied because of the original lender's alleged violation of the regulations.<sup>76</sup> Under general commercial law, it has been argued that FISLP loan notes are not negotiable instruments<sup>77</sup> and, therefore, that purchasers of such notes are not entitled to the protections available to holders in due course.<sup>78</sup> Consequently, purchasers are subject to all the defenses that could be asserted against previous holders.<sup>79</sup> Stated another way, any ground for denial of default claims that arises as a result of a previous holder's conduct can be asserted against the subsequent purchaser's default claims.<sup>80</sup>

Thus, where the originating lender received illegal inducements from a school – a fact unknown to the secondary market purchaser – the purchasing lender may find it difficult if not impossible to recover for the Department. In one pending case, the Department denied over \$600,000 in default claims submitted by a secondary market purchaser, in part because of the originating lenders' alleged violations of the regulation.<sup>81</sup> Although a lender normally can obtain warranties from the seller when purchasing student loan notes in the secondary market,<sup>82</sup> such protections have been rendered useless when originating lenders have gone into liquidation or otherwise ceased operations.<sup>83</sup>

#### *Procedural Contractual, and Policy Problems with the Department's Change of Sanctions for "Illegal Inducement" Violations*

Much of the recent debate between the Department and lenders whose claims have been denied on the ground of illegal inducements has centered on the legal effect of a violation of the regulations. Until recently, the Department had consistently held that a violation of the illegal inducements regulation did not affect the insurability of GSLP loans. In fact, the agency had expressly indicated that compliance with the regulation was not a condition of insurance coverage. For instance, in 1975, then-Secretary of the Department of Health, Education and Welfare (HEW), Caspar W. Weinberger, stated

unequivocally that a violation of the illegal inducements regulation “does not, by itself, affect the insurability of the loan or the obligation of the student to repay.”<sup>84</sup> The Department’s position was simply that a number of other sanctions were available for violation of the regulation, short of denying default claims. These included limitation, suspension, or termination of a lender’s future participation in the program, and a requirement that the lender refund to the student the excess charges attributable to the illegal inducement or discount.<sup>85</sup> Notably, even under the 1979 regulations, neither a mandatory refund nor a limitation, suspension or termination action affected a lender’s rights to insurance benefits.<sup>86</sup> This continued to be agency policy at least until the late 1970’s.<sup>87</sup>

Thus, the shift in agency policy to the present position of denying default claims based on the illegal inducements regulation raises serious legal and policy questions. As a legal matter, any reversal of such a long-standing policy maybe in violation of the rulemaking requirements of the General Education Provisions Act (GEPA), which governs administrative rulemaking procedures for the Department of Education.<sup>88</sup> The GEPA requires that all “rules, regulations, guidelines, *interpretations*, orders or requirements of general applicability” be published in the Federal Register at least 30 days before they become effective.<sup>89</sup> Failure to publish in the Federal Register, regardless of whether a lender has actual notice of the agency’s interpretation, renders that interpretation invalid and unenforceable.<sup>90</sup>

The change of sanctions for illegal inducements violations was clearly a new “interpretation . . . of general applicability” requiring notice and comment under the GEPA.<sup>91</sup> This conclusion is buttressed by the fact that the other previously mentioned sanctions for violation of the regulation<sup>92</sup> were promulgated pursuant to the GEPA notice and comment procedures.<sup>93</sup> Inasmuch as the agency’s new interpretation of the illegal inducements regulation places a substantial number of lenders’ default claims in jeopardy, and because it was implemented without notice and opportunity for comment, any denial of default claims based on that interpretation is improper.<sup>94</sup>

Another legal ramification of the Department’s shift in policy with respect to the illegal inducements regulation is of a contractual nature. Under the GSLP, lenders may sue the Department in any federal court for breach of contract based on the wrongful denial of default claims.<sup>95</sup> In such a contract action, the Department’s prior interpretation of the regulations, which are incorporated as part of a lender’s contract, may be binding against the agency in subsequently construing the lender’s contractual obligations under those regulations.<sup>96</sup> In other words, the Department’s original interpretation of the illegal inducements regulation as not affecting the validity of default claims may, as a matter of contract law, preclude the Department from unilaterally adopting a different interpretation without complying with applicable rulemaking requirements. Moreover, because lenders’ contracts are wholly prepared by the agency, established rules of construction require that, even under federal insurance programs, the contract and regulations be strictly construed against the party who drafted them.<sup>97</sup> Thus, in a purely contractual context, the Department’s attempt to read the illegal inducements regulation as imposing a condition on its insurance obligations is without basis, at least until such a

condition is properly promulgated pursuant to the notice and comment requirements of rulemaking.<sup>98</sup> By improperly changing a once-valid interpretation of the regulations and basing the denial of claims on this new interpretation, the Department may be in breach of lenders' contracts.<sup>99</sup>

Finally, regarding policy considerations, the denial of default claims for violation of the illegal inducements regulation has virtually no basis in the policies underlying the regulation itself. Because the regulation is intended to prevent higher tuition costs and denial of access to GSLP loans due to the channeling of available funds,<sup>100</sup> terminating a lender's participation in the program and requiring that it refund any illegal payments are certainly adequate and appropriate sanctions. The Department has published no finds as to how pervasive illegal inducements are, or whether funds are being channeled. Thus, no justification has been offered for the notion that additional sanctions are necessary to ensure compliance.

Because illegal inducements operate at the institutional level, they are not likely to contribute to student defaults. As former HEW Secretary Weinberger recognized, a violation of the regulation does not adversely affect the student borrower's obligation to repay the loan, nor the federal government's ability to collect from the student.<sup>101</sup> Indeed, the *only* governmental interest that appears to be served by denying default claims under the illegal inducements regulation is that of budgetary restraint; this interest, when balanced against congressional objectives in creating the GSLP,<sup>102</sup> may not be deemed legally sufficient to allow the government to prevail in several pending court cases.<sup>103</sup>

The Department's use of the regulation as a shield to avoid default claim liability is legally defective and without foundation in the policies underlying the regulation itself. Unfortunately, as the following discussion illustrates, such unfounded treatment is not limited to the illegal inducements regulation.

## **The Exercise of Due Diligence in the Making, Servicing, and Collection of Guaranteed Loans**

### *The Lack of a Clear Due Diligence Standard*

The Higher Education Act of 1965, as amended, requires that a lender filing a default claim meet "the standards of due diligence in the collection of the loan," and that the Department pay the lender's default claim upon completion of a due diligence investigation.<sup>104</sup> The statute also requires a lender to exercise reasonable care and diligence in the making of federally insured loans.<sup>105</sup>

Several policies underlie the applicable due diligence requirements. With regard to the making and disbursing of student loans, the due diligence requirement protects the government's interests by limiting its potential exposure in the event of default, and by ensuring that if default occurs, the government receives an enforceable instrument from the lender upon which to pursue the defaulting student borrower.<sup>106</sup> With respect to the

servicing and collection of GSLP loans, the requirement is intended to decrease the likelihood of default and increase the likelihood of recovery.<sup>107</sup>

Under the state guaranty agency programs,<sup>108</sup> states are left to make their own determinations, subject to Departmental approval, regarding the due diligence requirements applicable to lenders making loans guaranteed by the state agencies, so long as such requirements are “at least as extensive and forceful as those generally practiced by financial institutions for consumer loans.”<sup>109</sup> In addition, guaranty agencies themselves are held to standards of due diligence in the collection of loans with respect to which default claims have been paid by the agencies.<sup>110</sup> Although numerous due diligence standards have been established and applied by the states to both lenders and guaranty agencies, the Department has avoided exercising any significant control over the content of state due diligence standards.<sup>111</sup> This situation may change, however, as the FISLP is phased out and state programs become more significant.<sup>112</sup>

The development of due diligence guidelines for the FISLP has been the primary responsibility of the Department and is the area where lenders have had the most difficulty. Before 1979, the regulations only defined due diligence with respect to collection, and then only in the most general terms.<sup>113</sup> Lenders were required to “utilize collection practices no less extensive and forceful than those generally in force among financial institutions.”<sup>114</sup> Given the variety of collection practices prevailing throughout the country, this definition offered little guidance to lenders.

No attempt was made in the regulations to identify or otherwise define the standards for collection practices among financial institutions. Indeed, no specific due diligence guidelines of any kind were provided for commercial lenders until the 1976 publication of *Manual For Lenders*. Those guidelines, moreover, were directory rather than mandatory.<sup>115</sup> Thus, for the first ten years of the GSLP, even after the 1976 *Manual For Lenders* was published, commercial lenders had to determine for themselves what collection measures should be taken that would be consistent with the practices “generally in force among financial institutions.”

#### *Denial of Default Claims for Breach of the Due Diligence Standard in Collection Practices.*

Despite considerable confusion among lenders as to their due diligence responsibilities, the Department has increasingly relied upon the due diligence requirements as grounds for denying default claims. Common problems encountered by lenders involve the timelines of both due diligence collection efforts and the filing of claims.<sup>116</sup> While delays in collection or claims submission are at times the result of lender neglect, delays also occur because the lender simply did not know when repayment should have begun.

A lender can ordinarily rely on a student’s anticipated graduation date in determining when repayment should begin. If a student ceases to be at least a half-time student before graduation, however, the six-to-twelve-month grace period preceding

repayment automatically begins.<sup>117</sup> Generally, lenders are informed of a student borrower's enrollment status by means of a reporting arrangement between the school and the Department, and between the Department and the lender.<sup>118</sup> For example, the school reports whether a student is still enrolled and attending classes on Student Confirmation Reports.<sup>119</sup> The Department then passes along the information about the student's enrollment or withdrawal to the lender via quarterly Federal Loan Transaction Statements.<sup>120</sup> Problems have arisen where schools have closed or students have withdrawn from school, and the Department has been slow in reporting these changes to lenders.<sup>121</sup> In such instances, through no fault of the lender, borrowers have entered the repayment period without the lender's knowledge.

During the early years of the program, the Department's policy was that the default claims of a lender acting in good faith would not be denied on the ground that the lender failed to ascertain changes in a student's status.<sup>122</sup> More recently, however, the Department has taken the position that the lender is responsible for learning of changes in a student's status, pursuant to the lender's duty to exercise due diligence in the servicing of FISLP loans.<sup>123</sup> Under this new policy, lenders may not continue to rely on anticipated graduation dates. Indeed, collection effort delays due to a lack of notice of changes in student status are considered violations of due diligence requirements, thereby justifying the denial of default claims.<sup>124</sup> The lender's problem is magnified because students who withdraw from school before graduation are more likely to default.<sup>125</sup>

#### *Procedural, Contractual and Policy Problems Related to the New Due Diligence Collection Requirements*

By reinterpreting the due diligence collection requirements, the Department has effected another *de facto* reallocation of risk to lenders. As with the illegal inducements regulation, this policy shift was accomplished without the notice and opportunity for public comment required by the GEPA.<sup>126</sup> In fact, even the 1979 regulations, which purported to define lender responsibilities in greater detail, are silent with regard to any lender duty to monitor a student's enrollment status.<sup>127</sup> By tacitly imposing this additional duty upon lenders, and by then denying claims on that basis, the Department has unilaterally and improperly shifted to lenders the risk of loss when students leave school and default on their loans.

Lenders are now required to shoulder the additional cost and inconvenience of monitoring school enrollments, when such duties are neither included in the insurance contracts nor required by the regulations incorporated into such contracts.<sup>128</sup> Because lenders are not contractually required to monitor school enrollment, the Department's denial of default claims for failure to do so may itself be a breach of the insurance contracts.<sup>129</sup>

Placing the burden of monitoring enrollment status on lenders substantially increases their risk, because often their only source of student status information is the Department. As discussed earlier, the Department has imposed no duty on schools to report changes in student status directly to lenders.<sup>130</sup> Given the moderate returns earned

by lenders on FISLP loans, the added risks and cost burdens of maintaining affirmative contact with schools in order to monitor each student borrower's enrollment status will, contrary to congressional intent, discourage lender participation in the program.<sup>131</sup>

### *Due Diligence and the Timely Filing of Default Claims*

In addition to the foregoing problems involving the timeliness of collection efforts, the deadline for filing default claims presents its own special problems.<sup>132</sup> Under the pre-1979 regulation, the lender had to send the final demand for payment within sixty days of the filing of a default claim.<sup>133</sup> Considerable controversy has centered on whether that regulation imposes a *mandatory* filing deadline or only a *directory* filing requirement. Until the late 1970's, default claims filed more than sixty days after the date of demand letters were never denied for that reason, because the Department did not interpret the regulation as imposing a mandatory deadline.<sup>134</sup> Neither the 1972 nor the 1976 *Manual For Lenders* informed lenders of any mandatory deadline for filing claims.<sup>135</sup>

Initially, the regulation was not interpreted as imposing a mandatory filing deadline because, in part, the circumstances surrounding many student defaults precluded the filing of default claims within sixty days. Specifically, the majority of defaults occurred at one time of the year (thirteen months after June graduation) and the sixty-day period was not considered enough time to prepare and file all claims.<sup>136</sup> In fact, once the Department began denying claims in the late 1970's for untimely filing, it tacitly admitted the unreasonableness of the sixty-day deadline by extending the filing period to ninety days.<sup>137</sup>

Unfortunately, when the Department reversed its interpretation of the regulation to impose a mandatory filing requirement, lenders were never informed. The only signal of the change in policy was an internal bulletin to the Department's regional offices ordering them to deny any claim filed more than sixty-days after the demand letter.<sup>138</sup> Thus, a number of lenders were caught in the middle, without having known of a mandatory deadline and without the benefit of an extended ninety-day filing period.<sup>139</sup>

The only reported case dealing specifically with the filing deadline issue is *American Bank v. United States*.<sup>140</sup> There, the lender failed to file its claims for three to eleven months after the time when the demand letters should have been sent. The Court of Claims ruled that the lender's failure to file within sixty days of the demand letters was adequate grounds for denial of the lender's default claims.<sup>141</sup> Significantly, however, the agency's prior interpretation of the regulation as a directory rather than mandatory deadline was never argued before the court.<sup>142</sup> In fact, there is no indication that the court was even aware of the Department's prior interpretation of the regulation.<sup>143</sup> Consequently, *American Bank* provides little guidance on the question of the legality of the agency's reversal of position.

Indeed, there are serious questions as to whether the Department's midstream policy shift is at odds with due process and the General Education Provision Act.<sup>144</sup>

While the filing deadline applied to all default claims arising after the 1979 regulation was promulgated, lenders had not been given adequate notice of the Department's new policy. From a due process standpoint, it is imperative that lenders know what the requirements of the regulations are, in order to conform their conduct accordingly.<sup>145</sup> The unannounced shift to a mandatory filing deadline and subsequent denial of default claims for noncompliance amounts to a denial of lenders' constitutional rights to due process. Moreover, the Department's implementation of the mandatory deadline without notice violates the administrative rulemaking requirements of the GEPA as well.

As discussed earlier, the GEPA requires that any interpretation of general applicability be published in the Federal Register before it becomes effective.<sup>146</sup> The imposition of a mandatory deadline is clearly an interpretation of sufficient general applicability for the notice requirements of the GEPA to apply. Consequently, having failed to publish notice of the change in the Federal Register, the Department's denial of claims based on the sixty-day filing requirement is improper.<sup>147</sup>

Thus, as is true of the Department's treatment of the illegal inducements regulations, important changes in lender responsibilities and liabilities have been effectuated without adequate notice to lenders or the opportunity for public comment. Both the shift of the duty to monitor student enrollment status and the imposition of mandatory rather than directory deadlines for the filing of default claims have resulted in the rejection of a substantial number of otherwise valid claims.<sup>148</sup>

The process by which these new policies have been implemented raises the possibility that other new and unknown risks could be imposed on lenders currently holding student loans in their portfolios. If lenders have not been adequately informed of changes in their contractual duties and relationship with the government in the past, there is every reason to believe that similar situations may arise in the future.

Finally, the foregoing problems have implications not only for those lenders still holding student loans, but also for lenders whose default claims have already been paid. The latter lenders are subject to a repurchase requirement if due diligence defects are subsequently discovered by the government.<sup>149</sup> Thus, claims previously paid may be subject to review, and recovery from lenders may be sought.

### **Public Policy Implications of the Department's Treatment of Lender Default Claims**

In direct contrast to the Department of Education's treatment of lenders, Congress has repeatedly manifested its intent to maintain a proper balance between lender risk and lender return on the student loan notes.<sup>150</sup> The approach taken by Congress in recent years to stem losses due to student defaults has been to do so not at the expense of the lenders. Rather, Congress has sought to restructure the program to reduce the likelihood of student defaults and to provide more effective sanctions against those who do default,<sup>151</sup> thus reflecting Congress' perception that student defaults are a problem caused by students, not by lenders.<sup>152</sup>

Unfortunately, given the Department's proclivity toward changing GSLP rules in midstream, lenders may have reason to conclude that the increased risks, coupled with rising administrative cost burdens, are not offset by the moderate rate of return from interest payments and special allowances. Because guaranteed student loans typically represent only a small portion of a lender's loan portfolio, the capital now reserved for student loans could easily be shifted to other more profitable and less risky investments.<sup>153</sup> As noted earlier, this process may have already begun.<sup>154</sup>

Recent developments indicate that lenders under state guaranty agency programs are likely to come under similar scrutiny in the future, as commitments under the FISLP diminish.<sup>155</sup> Historically, default claims submitted to such agencies have almost never been examined by the Department.<sup>156</sup> Guaranty agencies have simply reported aggregate default losses to the Department and have been reimbursed pursuant to their reinsurance agreements with the Department.<sup>157</sup> In 1981, *however*, Congress for the first time authorized the Department to require guaranty agencies to assign to the Department any loan notes for which the agencies have received federal reimbursement.<sup>158</sup>

Once the Department begins reviewing individual default claims for purposes of post-default collection, a necessary step in the process will be the examination of claims for defects affecting the enforceability of the loan notes. Given recent policies, it is highly unlikely that the Department will simply ignore defects in claims, rather than require lenders to repurchase the notes. Consequently, problems now being experienced by lenders under the FISLP may be harbingers of problems to be faced by lenders under the state guaranty agency programs.

The foregoing problems are compounded by the fact that in many instances the Department's treatment of lenders is unlikely to be subject to judicial correction. Lenders may seek judicial review where default claims are wrongfully denied. Owing to the relatively small dollar amounts involved with each claim, however, the high costs of litigation relative to the potential recovery are not often justified.<sup>159</sup> Consequently, lenders may be without an adequate remedy other than withdrawal from the program. When this is the case, the Department's policies threaten ultimately to frustrate basic congressional objectives by reducing the availability of financial assistance to students, thereby denying them access to higher education.

The deterioration of lender confidence in the program is occurring when student financial assistance provided by private lenders is most needed. The current economic recession has resulted in widespread unemployment, with many people electing to return to school because they are unable to find work. Meanwhile, high interest rates and tight credit make alternative sources of education financing unavailable in many cases. Unfortunately, other forms of federal and state student financial aid have been subject to the same budgetary pressures as the GSLP, and some have fared even worse.<sup>160</sup> Thus, the effects of a significant loss of lender confidence and a drop in lender participation could be dramatic.

## **Toward a More Rational Administration of the Guaranteed Student Loan Program: Denial of Default Claims only for Material Defects**

Given the problems associated with the Department's administration of the GSLP over the past decade, there is a pressing need for the adoption of consistent and sound policies toward lenders that will restore lender confidence in the program. First and foremost, the Department must abide by the strictures of the GEPA and provide lenders with adequate notice of changes in the requirements and policies affecting the allocation of risk under the program. This approach would afford lenders who found the additional risks unacceptable an opportunity to adjust their loan portfolios accordingly. In addition, it would eliminate the element of unknown risk generated by unannounced changes in lender duties and responsibilities.

Beyond the question of adequate notice of program requirements, at least with regard to the FISLP portion of the GSLP, is the issue of default claim administration. The Department of Education itself has recognized that the GSLP is comparable to any insurance business.<sup>161</sup> In the area of insurance law, courts, have increasingly recognized that only *material* defects in an insurance claim justify the insurer's denial of the claim.<sup>162</sup> In order to find that a material defect exists, it must appear that the extent of the insurer's liability or the insurer's ability to recover or to evaluate the loss were in some way prejudiced by the noncompliance of the policyholder.<sup>163</sup> Within the context of the GSLP, this would mean that a lender's noncompliance must have either impaired the enforceability of the loan note or contributed to the student's default.<sup>164</sup>

These concepts are not new to the GSLP. The Department's *Regional Claims Procedures* manual, the internal staff manual which establishes operating guidelines for default claims processing, directs claims examiners to deny default claims for lapses in due diligence collection activity *only* where it appears that the lapse contributed to default.<sup>165</sup> Similarly, the 1979 regulations authorize excuse of defects in default claims where the defects have neither impaired the note's enforceability nor contributed to the student borrower's default.<sup>166</sup> Thus, Department officials clearly have authority to limit instances of claims denial to cases involving material defects in default claims.<sup>167</sup> In most cases, however, Department officials have ignored the provisions allowing the excuse or curing of defects. Instead, they have rejected claims in the pursuit of short-term cost reductions, at the expense of the long-term goal of greater lender participation in the program.<sup>168</sup> Where the Department excuses a defect in one case, however, any refusal to do so in a substantially similar case would constitute arbitrary and capricious administrative action.<sup>169</sup> Thus, those few cases where defects have been excused or cured should preclude a different treatment of claims submitted by similarly situated lenders in the future.

When a lender seeks judicial review under the Administrative Procedure Act<sup>170</sup> of a decision by the Department to deny a claim, the lender carries a difficult burden even if it can show that similar defects were excused or cured in other instances. It must show that no prejudice resulted from the defect, pursuant to the 1979 regulations.<sup>171</sup> In such instances, the critical question is likely to be whether substantial evidence supports a

finding that the Department was prejudiced by the lender's noncompliance.<sup>172</sup> "Substantial evidence" has been defined as such evidence as a reasonable mind might accept to support a conclusion.<sup>173</sup> However, the Supreme Court's characterization of substantial evidence as "more than a mere scintilla of evidence"<sup>174</sup> is perhaps more descriptive of the considerable discretion given agency officials in weighing the evidence. Indeed, the burden placed on lenders by this evidentiary standard is tantamount to a requirement that the lender disprove even the possibility that the defect contributed to default or impaired the enforceability of the loan note.<sup>175</sup> Whether this burden can be overcome depends on the character of the alleged violation.

For example, where claims involve lapses in due diligence collection activities, it would be difficult, if not impossible, to disprove any possibility of prejudice, and it is likely that the Department would prevail in such a case.<sup>176</sup> By contrast, other types of defects have no effect on either the student defaults or the enforceability of loans. A violation of the illegal inducements regulation, for example, involves the lender's relationship with the school, not with the defaulting student.<sup>177</sup> In these cases, the principal hurdle is not the substantial evidence standard, but, arguably, the showing of past instances where similar defects have been excused or cured.<sup>178</sup>

In summary, the central issue is still whether the Department should erect obstacles to lender recovery in the first place. A secondary question is whether the denial of a claim, whenever more than a scintilla of evidence shows prejudice to the government, is really conducive to restoring lender confidence in the government's promise to insure student loans. By virtue of the regulation authorizing Department officials to excuse or allow the curing of defects, the Department already has standards for determining whether a defect is material, that is, whether the defect has contributed to default or impaired the enforceability of the loan note. The challenge, therefore, is to apply those standards in a uniform manner, consistent with congressional policies underlying program objectives, not solely for the purpose of achieving short-term fiscal objectives.

## CONCLUSION

It is unfortunate that the Department of Education has developed a shortsighted approach to lender participation in the GSLP. Given the current fiscal climate and massive government outlays for special allowance and claim payments, the Department's efforts to curtail its growing expenditures have focused on the most accessible and vulnerable participants in the program, the lenders. If the Department persists in its pattern of unannounced changes in program requirements, GSLP loans will not be considered the minimal risk investments that lenders came to expect during the first decade of the program. For this reason, lenders should be extremely cautious in undertaking and administering the GSLP portion of their loan portfolios.

By implementing such unannounced changes in lender responsibilities, and by undermining the insurability of many otherwise fully guaranteed loans, the Department of Education has effected a *de facto* reallocation of risks under the GSLP, with the result that the investment security sought by lenders in making or purchasing GSLP loan notes

may have been illusory. In the future, lenders may limit their risk exposure by refusing to participate in the program, and by selling loan notes to Sallie Mae when the notes enter repayment status.

Thus, the Department's treatment of lenders' default claims may have grave policy implications for the future of the program, especially in those states without guaranty agency programs. Certainly, Congress' goal has been to make higher education available to more Americans; however, a continuation of the Department's policies may frustrate that aim, unless lender confidence in the fair administration of the program can be restored. The challenge before the Reagan Administration, therefore, is to rid the program of shackles imposed by an entrenched bureaucracy and, thereby, enable lenders to serve vital educational needs that are now languishing.

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<sup>1</sup> Higher Education Act of 1965, Pub. L. No. 89-329, tit. IV, 79 Stat. 1219 (codified as amended at 20 U.S.C. §§1060-1098 (1976 & Supp. V 1981)); *see also* S. Rep. No. 673, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess. 41-46, *reprinted in* 1965 U.S. CODE CONG. 7 AD. NEWS, 4059.

<sup>2</sup> Most federal funds are channeled through five principal aid programs: (1) the Pell Grant Program (formerly the Basic Educational Opportunity Grant Program), (2) The Supplemental Educational Opportunity Grant Program, (3) the College Work-Study Program, (4) the National Direct Student Loan Program, and (5) the Guaranteed Student Loan Program which is the focus of this article.

The Pell Grant Program provides grants to needy students on the basis of the financial resources of the student and/or his or her family, the student's enrollment status, and the cost of his or her education. Generally, such grants are transferred to the educational institution for disbursement to the recipients.

The Supplemental Educational Opportunity Grant (SEOG) Program supplements the Pell Grant Program. Unlike the Pell grants, however, participating schools administer this program. Institutions apply annually to the federal government for necessary funds, and the school's financial aid officer selects the recipients and determines the size of their grants. Such grants are provided to students who demonstrate exceptional financial need, and who otherwise would not be able to obtain post-secondary instruction.

The College Work-Study (CWS) Program is designed to promote part-time employment of students needing funds to attend post-secondary institutions. While CWS has been restructured to provide more assistance to students from middle-income families, low-income students are the usual participants.

Under the National Direct Student Loan (NDSL) Program, schools are provided with loan funds so that *the school* may provide low-interest (5%), deferred-repayment loans to students who are in financial need. The school puts up only 10% of the money used for these loans, and the federal government contributes the remaining 90%. The student-borrower does not pay interest on the NDSL loan while attending school and is given a grace period after attendance ends before repayment begins. *See Tate, Federal Aid to Postsecondary Students*, 18 J. Fam. L. 147 (1979); OFFICE OF STUDENT FINANCIAL ASSISTANCE, U.S. DEP'T OF EDUC., OSFA Program Book 32-33 (1981).

<sup>3</sup> The Guaranteed Student Loan Program (GSLP) was established by the Higher Education Act of 1965, Pub. L. No. 89-329, tit. IV, pt. B, 79 Stat. 1219 (codified as amended at 20 U.S.C. §§1071-1097 (1976 & Supp. V. 1981)).

<sup>4</sup> The Education Amendments of 1980, Pub. L. No. 96-374, 94 Stat. 1367, established new interest rate ceilings for GSLP loans that cover periods of instruction commencing on or after January 1, 1981. With respect to such loans the interest rate (1) may not exceed 7% annually if the borrower already has an outstanding balance of principal or interest with respect to any loan made, insured, or guaranteed under the GSLP and (2) may not exceed 9% annually if the borrower, on the date of entering into the obligation, has

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no outstanding balance with respect to any GSLP loan, except that if the average rate of 91-day Treasury bills auctioned in any 12-month period on or after January 1, 1981 is equal to or less than 9%, the interest rate for the GSLP loan will be 8% annually. For all other GSLP loans made after August 3, 1968, the maximum rate of annual interest may not exceed 7%. 20 U.S.C. § 1077(a), (b) (1976 & Supp. V. 1981).

<sup>5</sup> 20 U.S.C. § 1071(a) (1976 & Supp. V 1981). The GSLP is comprised of two components: the guaranty agency programs pursuant to which state agencies guarantee loans under a reinsurance agreement with the federal government, and the Federal Insured Student Loan Program (FISLP) through which the federal government guarantees student loans directly in those areas where state guaranty agency loans are unavailable. Although most guaranteed student loans were made through the FISLP during the first decade of the GSLP, the FISLP share of the federal government's guaranty commitments has diminished as more states have established guaranty agency programs. At present less than 10% of all new GSLP loan commitments are made through the FISLP. The remaining 90% represent federal guarantees of state guaranty agency commitments (i.e., reinsurance). See OFFICE OF STUDENT FINANCIAL ASSISTANCE, U.S. DEP'T OF EDUC., GUARANTEED STUDENT LOAN PROGRAM: LOAN VOLUME UPDATE, FY 1981 (1981).

<sup>6</sup> See 20 U.S.C. §§ 1080(a), 1087 (1976 & Supp. V 1981).

<sup>7</sup> Section 413(c) of the Education Amendments of 1980 defers the repayment of GSLP loans, which cover the period of instruction beginning on or after January 1, 1981, for six months after the date See 20 U.S.C. § 1077(a)(2) (1976 & Supp. V 1981). For loans covering periods beginning prior to that date, the borrower's grace period may extend not less than nine, nor more than twelve, months following the borrower's graduation or withdrawal from school. The precise length of the latter "grace period" is determined by the lender at the time the loan is made. *Id.*

<sup>8</sup> 20 U.S.C. § 1087-1 (1976 & Supp. V 1981); 34 C.F.R. §§ 682.301-302 (1982). See *infra* notes 24-26 & accompanying text (discussion of special allowances).

<sup>9</sup> The Middle Income Student Assistance Act of 1978, Pub. L. No. 95-566, § 6(c)(1), 93 Stat. 2402, removed the income guidelines so that *all* borrowers were entitled to receive interest subsidy payments under the GSLP.

<sup>10</sup> Section 532 of the Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, 95 Stat. 451 (codified at 20 U.S.C. § 1089 (1976 & Supp. V 1981)), reimposed a "financial needs test:" for GSLP interest subsidy eligibility, whereby only students with family incomes below \$30,000 qualify.

<sup>11</sup> See Jenkins, *Regulation of Colleges and Universities Under the Guaranteed Student Loan Program*, 4 J.C. & U.L. 13, 15 (1976).

<sup>12</sup> Since the program's inception, the federal government has insured an estimated 18 million loans valued at nearly \$30 billion. See National Commission on Student Financial Assistance, *Guaranteed student Loans: A Background Paper 1* (1982). The volume of loans during the three years following the 1978 elimination of income eligibility guidelines equaled the total volume during the preceding 13 years. *Id.* at 24

<sup>13</sup> *Id.* at 1.

<sup>14</sup> See Jenkins, *supra* note 11, at 15.

<sup>15</sup> See *Id.* at 18.

<sup>16</sup> The following institutions are eligible to be the GSLP lenders: state and federally chartered banks, savings and loans, and credit unions; pension funds; insurance companies; state or private non-profit agencies designated by a state; the Student Loan Marketing Association (Sallie Mae); and participating educational institutions that are not solely correspondence schools and employ at least one full-time financial aid administrator. See 34 C.F.R. § 682.100 (1982). This Article focuses primarily on the problems encountered by lenders that are not educational institutions.

<sup>17</sup> *Windsor Univ. v. Secretary of Health, Educ. & Welfare*, 550 F.2d 1202, 1204-05 (9th Cir. 1977). For many, if not most, lenders there has been an expectation that the GSLP would be no more administratively burdensome than the FHA and VA loans guarantee programs. See VETERANS ADMINISTRATION, *LENDERS HANDBOOK, VA PAMPHLET 26-27* (rev. ed. 1977); FEDERAL HOME ADMINISTRATION, *LENDERS HANDBOOK* (1975).

<sup>18</sup> See *infra* notes 33-38 & accompanying text (discussion of lender incentive to participate in the GSLP).

<sup>19</sup> See *infra* notes 39-53 & accompanying text (examples of congressional measures designed to encourage lender participation).

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<sup>20</sup> From its inception until May 4, 1980, the GSLP was administered by the Office of Education of the Department of Health, Education and Welfare. Pursuant to § 601 of The Department of Education Organization Act, Pub. L. No. 96-88, tit. VI, 93 Stat. 696 (1980), the Office of Education was reorganized and the Department of Education (the Department) was created. In the process, the administration of the GSLP was transferred to the Secretary of Education. All references herein to the Department of Education include its predecessor, the Office of Education.

<sup>21</sup> See OSFA PROGRAM BOOK, *supra* note 2, at 43.

<sup>22</sup> *Id.* Actual government losses from defaults total just under 6% after adjustments are made for post-default collection efforts by the Department. *Id.* It should be noted, however, that the 6% figure does not include any adjustment upward for the cost of post-default collections.

<sup>23</sup> See U.S. GENERAL ACCOUNTING OFFICE, THE GUARANTEED STUDENT LOAN INFORMATION SYSTEM NEEDS A THOROUGH REDESIGN TO ACCOUNT FOR THE EXPENDITURE OF BILLIONS, app. II (1981). A number of causes have been cited for the high rate of default. Until recently, once lenders' default claims had been paid and the defaulted loan notes were assigned to the Department for collection, the federal government pursued only a small percentage of defaulting students. See *infra* note 132 (discussion of the Department's failure to pursue post-default collections). Without some reasonable expectation that the Department would seek repayment on such defaulted loans, it is not surprising that so many students chose not to repay their loans. NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE, *supra* note 12, at 23.

Another frequent cause of student borrowers' failure to repay guaranteed student loans lies in student dissatisfaction with their schools. The federal government in no way warrants the quality of education provided by schools participating in the GSLP. See *Rattler v. Career Academy, Inc.* No. 7501302, slip op. (9th Cir. Feb. 9, 1976), where the courts held that the Commissioner of Education satisfied his statutory duties by determining that the school had been accredited by a nationally recognized accrediting agency. The court noted that "[I]f more active policing of the method of selection of students and the curriculums adopted by ... institutions participating in the FISL program is to be required of the Commissioner, it must be by congressional legislation..." *Id.* at 3. Nevertheless, many students who have been dissatisfied with their educations have simply refused to repay their loans. See *Guaranteed Student Loan Program: Hearings Before the Permanent Subcomm. On Investigations of the Senate Comm. On Government Operations*, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 348, 353-54 (1975) (testimony of William O. Goodman of the Attorney General's Office of Texas) [hereinafter cited as *1976 Senate Hearings*].

A third cause of student defaults is that lenders have failed to exercise due diligence in the servicing and collection of loans. See *infra* notes 116-49 & accompanying text (discussion of due diligence requirements). Most often, the lender simply loses track of the borrower. As in the case of the Department's failure to pursue students *after* default, when student borrowers are not pursued by lenders the chances of default increase substantially.

A number of studies have attempted to develop a demographic profile for defaulting student borrower. See Bergen, Bergen & Miller, *Do G.P.A. and Loan Size Affect NDSL Repayments?* 13 J. C. STUDENT PERSONNEL 65 (1972); Dyl & McGann, *Discriminant Analysis of Student Loan Applications*, 7 J. STUDENT FIN. AID 35 (1977); Spencer, *Risk Measurement for Short Term Loans*, 4 J. STUDENT FIN. AID 30 (1974); see also Emmert, *National Direct Student Loan Default Rates: A Measure of Administrative Quality, or Something Else?*, suggests that, independent of efforts by the Department or individual schools and lenders, some groups of student borrowers are inherently more likely to default. For instance, one researcher describe the worst possible loan risk as "a student without a phone, unmarried, in his [last] semester, with an old car, 17 years old (or over 26, male, with a large loan, who is unemployed." Spencer, *supra* at 32. This last cause of student defaults—the inherent unreliability of some students themselves—is precisely the risk that Congress undertook in guaranteeing loans to students, who as a class are considered to be traditionally poor credit risks. See *Higher Education Act of 1965: Hearings on S. 6500 Before the SubComm. On Education of the Senate Comm. On Labor and Public Welfare*, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess. 119 (1965); Emmert, *supra* at 46. Congress and the Department have taken a number of steps, with limited success, to reduce losses arising from defaults. More rigorous post-default collection efforts have been instituted, including expansion of the corps of government collection agents, greater use of outside collection agencies, and the use of credit bureaus and Internal Revenue Service records to Track borrowers. NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE, *supra* note 12, at 24. Moreover, schools with excessively high default rates are subject to suspension or termination from the

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program. See 34 C.F.R. § 682.611 (1982). Finally, the gradual shift since 1976 from direct federal insurance under the FISLP to reinsurance through state guaranty agencies has generally resulted in lower default rates, and has at least stemmed the rapid escalation of defaults experienced in earlier years. See NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE, *supra* note 12, at 24. See generally Leonard, *Skipping Out on Alma Mater: Some Problems Involving the Collection of Federal Student Loans*, 5 COLUM. J.L. & SOC. PROBS. 317 (1980) (examinations of remedial measures to reduce default). Nevertheless, as indicated in the text, GSLP loan defaults have continued apace.

<sup>24</sup> Under the statutory formula for calculating the level of special allowances, the rate of special allowance for a three-month period is determined by subtracting 3.5% from the average of the rate of 91-day Treasury Bills auctioned during the preceding three-month period, rounding to the nearest one eighth of one percent and dividing the resulting percent by four. 20 U.S.C. § 1087-1(b)(2) (1976); 34 C.F.R. § 682.301(c)(1982).

<sup>25</sup> See NATIONAL COMMISSION ON STUDENT FINANCIAL ASSISTANCE; *supra* note 12, at 23.

<sup>26</sup> *Id.* OSFA PROGRAM BOOK, *supra* note 2, at 37.

<sup>27</sup> WASHINGTON OFFICE OF THE COLLEGE BOARD, THE GUARANTEED STUDENT LOAN PROGRAM: OPTIONS FOR CONTROLLING FEDERAL COSTS WHILE PRESERVING NEEDED CREDIT FOR COLLECT 1 (May 1981).

<sup>28</sup> 606 F.2d 65 (5<sup>th</sup> Cir. 1979).

<sup>29</sup> *Id.* at 67 n.2.

<sup>30</sup> *Student Assistance Amendments of 1981: Hearing on S. 11087 Before the Subcomm. On Education, Arts and Humanities of the Senate Comm. On Labor and Human Resources*, 97 Cong., 1<sup>st</sup> Sess. 237 (1981) (testimony of Edward A. Fox, President, Student Loan Marketing Association) [hereinafter cited as *1981 Senate Hearings*]. See *infra* note 41 & accompanying text (explanation of nature of purpose of Sallie Mae).

<sup>31</sup> Since fiscal year 1978, increases in the volume of GSLP loan commitments by the Department have averaged about 58% a year. See OSFA PROGRAM BOOK, *supra* note 2, at 38. Increases in lender sales of GSLP notes, on the other hand, have averaged almost 70%. See STUDENT LOAN MARKETING ASSOCIATION, 1981 ANNUAL REPORT 32 (1982).

<sup>32</sup> *1981 Senate Hearings*, *supra* note 30, at 240.

<sup>33</sup> See 20 U.S.C. § 1080(a) (1976 & Supp. V 1981).

<sup>34</sup> See *id.* § 1078 (a)(3).

<sup>35</sup> See *id.* § 1077(b); Jenkins, *supra* note 11, at 14.

<sup>36</sup> See *supra* note 24 (explanation of special allowances); Jenkins, *supra* note 11, at 14.

<sup>37</sup> Cole, *Why Student Loans Are Beginning to Look More Attractive to Lenders*, 70 BANKING 84 (1978); GORDON & ERRECART, A SURVEY OF LENDERS IN THE GUARANTEED STUDENT LOAN PROGRAM 107-08 (Dec. 1975) (available from United States Department of Education, National Institute of Education, Educational Resources Information Center (ERIC)).

<sup>38</sup> Cole, *supra* note 37, at 93; GORDON & ERRECART, *supra* note 37, at 108.

<sup>39</sup> LYBRAND, ROSS BROS & MONTGOMERY, SURVEY OF LENDER PRACTICES RELATING TO THE GUARANTEED STUDENT LOAN PROGRAM 6 (1970).

<sup>40</sup> See 20 U.S.C. § 1087-2 (1976 & Supp. V. 1981).

<sup>41</sup> Under the Loan Purchase Program, Sallie Mae offers to buy student loans outright from GSLP lending institutions. Through the Warehousing Advance Program, begun in October 1973, a lender can borrow against such loans, using all or part of its student loan portfolio or other eligible securities as collateral. The lender can receive a cash advance of up to 100% of the face value of the pledged collateral. Proceeds from a warehousing advance, however, must be reinvested in student loans. See *id.* § 1087-2(d); Smith, *Why Students Can Still Get Loans*, 4 Am. Educ. 6 (1978); STUDENT LOAN MARKETING ASSOCIATION, 1981 ANNUAL REPORT, *supra* note 31, at 4.

<sup>42</sup> See *supra* note 24 (explanation of how the rate of special allowances is computed).

<sup>43</sup> Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 536, 95 Stat. 357, 455-56 (codified at 20 U.S.C. § 1087-1 (1976 & Supp. V 1981)).

<sup>44</sup> Education Amendments of 1980, Pub. L. No. 96-374, § 422, 94 Stat. 1367 (codified as amended at 20 U.S.C. § 1080(a) (1976 & Supp. V 1981)). Even prior to enactment of the Education Amendments of 1980, the Department had an obligation under former § 1080(a) to promptly pay default claims, but that obligation was often ignored. As the Senate Committee on Labor and Human Resources noted in 1980, “[t]he Committee is informed that, in some cases, payments to insured beneficiaries under [20 U.S.C. § 1080(a)]... have been withheld for indefinite periods without any determination of wrongdoing or lack of

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due diligence on the part of the insured beneficiaries. The Committee believes that such actions discouraged vital participation by lending institutions and are contrary to the express directives of the Act.” S. Rep. No. 733, 96<sup>th</sup> Cong., 2d Sess. 42 (1980).

<sup>45</sup> Lenders have been encouraged to make partial periodic disbursements of loans as funds are needed for students’ educations, rather than lump sum disbursements, in order to minimize government exposure in cases where students withdraw from school. *See* 34 C.F.R. § 682.302(c) (1982).

<sup>46</sup> 20 U.S.C. § 1078(a)(8) (1976 & Supp. V 1981); S. Rep. No. 733, 96<sup>th</sup> Cong., 2d Sess. 35 (1980).

<sup>47</sup> 20 U.S.C. § 1082(a)(2) (1976 & Supp. V 1981).

<sup>48</sup> *Id.* § 1078(i).

<sup>49</sup> *Id.* § 1078(f)(1)(A), (3)(A).

<sup>50</sup> *Id.* § 1078(f)(1)(C), (3)(C).

<sup>51</sup> *Id.* § 1078(f)(1)(D), (3)(D).

<sup>52</sup> Instead the determination of financial need is made by states, educational institutions, or private organizations under contract with the Department. *Id.* § 1090(a).

<sup>53</sup> As the Senate Budget Committee noted when rejecting a proposal to eliminate the in-school interest subsidy, “[t]he Committee firmly believes, based on testimony from lenders and others, that elimination of the in-school interest subsidy would result in a precipitous and progressive drop in lender participation.” S. Rep. No. 97-139, 97<sup>th</sup> Cong., 1<sup>st</sup> Sess. 894 (1981); *see also* WASHINGTON OFFICE OF THE COLLEGE BOARD, *supra* note 27, at 2.

<sup>54</sup> The regulations promulgated by the Department and its predecessor, the Office of Education, are incorporated by reference into the Contract of Insurance executed by each lender and the government. *See* 34 C.F.R. § 682.503(a)(2) (1982).

<sup>55</sup> *See* 31 Fed. Reg. 6109 (1966).

<sup>56</sup> *See* 45 C.F.R. §§ 177.1-51 (1973) (originally promulgated in 1970 in 35 Fed. Reg. 16,888 (1970)).

<sup>57</sup> *See* 45 C.F.R. §§ 177.100-.713 (1979) (currently 34 C.F.R. §§ 682.100-.713 (1982); 44 Fed. Reg. 53,868 (1979)).

<sup>58</sup> *See e.g., infra* notes 67-149 & accompanying text for discussion of illegal inducements and due diligence in the collection of loans.

<sup>59</sup> OFFICE OF EDUCATION, U.S. DEP’T OF HEALTH, EDUCATION AND WELFARE, FEDERAL INSURED STUDENT LOAN PROGRAM MANUAL FOR LENDERS (1972) *as amended* (1976) [hereinafter cited as *MANUAL FOR LENDERS*].

<sup>60</sup> Other than the *MANUAL FOR LENDERS*, the Department officials have two sources of guidance in applying program requirements. The first is the *REGIONAL CLAIMS PROCEDURES* manual, prepared for use by the Department regional claims personnel. U.S. DEP’T OF HEALTH, EDUCATION AND WELFARE, *REGIONAL CLAIMS PROCEDURES*) rev. 4<sup>th</sup> ed.) [hereinafter cited as *REGIONAL CLAIMS PROCEDURES*]. The second is a compilation of opinions issued by the Department’s Office of General Counsel and located in the Bureau of Student Financial Assistance [hereinafter cited as *Off. Gen. Counsel Opinions*]. Neither of these sources is generally available to lenders, but both are helpful in explaining ambiguities in the regulations and the *MANUAL FOR LENDERS*, and in showing how program requirements have actually been applied.

<sup>61</sup> The *MANUAL FOR LENDERS* has never been published in the Federal Register; consequently, it has no legal effect apart from its restatement of the statute and regulations. *Sky, Rulemaking in the Office of Education*, 26 AD. L. REV. 129, 131 n.11 (1974); *see* General Education Provisions Act. Pub. L. No. 91-230, § 431, 84 Stat. 169 (1970) (codified at 20 U.S.C. § 1232 (1976)).

<sup>62</sup> Moreover, even within the context of lenders’ insurance contracts, the *MANUAL FOR LENDERS* is not binding because, unlike the regulations, the requirements of the manual are not incorporated by reference into the insurance contracts. *See* *MANUAL FOR LENDERS supra* note 59, ¶ 1.3.1 & apps. A.12-.13 (rev. ed. 1976) (sample insurance contracts). Nevertheless, the *MANUAL FOR LENDERS* is sometimes useful in interpreting ambiguous provisions in the Act and the regulations.

<sup>63</sup> For instance, the 1972 edition of the *MANUAL FOR LENDERS* states that “if a borrower’s institution loses its eligibility, he enters the grace period at that point.” *MANUAL FOR LENDERS, supra* note 59, at VII-1 (1972). In a 1975 memorandum, however, the Department’s Office of General Counsel concluded that the above-quoted statement from the *MANUAL FOR LENDERS* was not supported by any provision in the Act or regulations. *See* Memorandum from Office of General Counsel to Associate Commissioner

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Kenneth A. Kohl, Off. Gen. Counsel Opinions (August 27, 1975). The cited provision was deleted from the 1976 edition of the MANUAL.

<sup>64</sup> See *American Bank v. United States*, 633 F.2d 543 (Ct. Cl. 1980); *Federal Deposit Ins. Corp. v. United States*, 527 F. Supp. 942 (D.C.W. Va. 1981); *American Sav. v. Bell*, No. 79-1834, (D.D.C. Dec 17, 1980) (summary judgment denied).

<sup>65</sup> See *infra* notes 113-15 & accompanying txt.

<sup>66</sup> Grounds for denial arise, for example, where the disbursement date falls before the commitment date, the claim is in hold status, there is an absence of evidence of collection activity prior to claim submission, or the lender was not an eligible lender at the time it became the holder of the loan. See REGIONAL CLAIMS PROCEDURES, *supra* note 60, at 110-25 (rev. 4<sup>th</sup> ed. 1979).

<sup>67</sup> 45 C.F.R. § 177.6(e)(1)(1973). The current language of the regulation is found at 34 C.F.R. § 682.205 (1982). This regulation applies to both the FISLP and to the state guaranty agency program.

<sup>68</sup> 45 C.F.R. § 177.6 (e)(2) (1973).

<sup>69</sup> See *id.* (“In no event may the costs of making a loan under this part (except those specifically provided for in this section) be passed on (in the form of higher tuition charges or otherwise) to the borrower.”) see also *De Jesus Chavez v. LTV Aerospace Corp.*, 412 F. Supp. 4 (N.D. Tex. 1976) (FISLP regulations are designed to protect the students from excessive charges).

<sup>70</sup> The Department’s application of the illegal inducements regulation is being challenged in several pending cases. See *United States v. Medsa Co.*, No. 81-F1695 (D. Colo. Filed Sept. 23, 1981); *American Sav. v. Bell*, No. 79-1834 (D.D.C. Dec 17, 1980) (Summary judgment denied); *LTV Educ. Sys., Inc. v. Bell* No. 3-80-0125R (N.D. Tex. filed Jan. 28, 1980) (filed Mar. 29, 1979 as No. 79-0905 in D.D.C. transferred to N.D. Tex. Jan. 24, 1980).

<sup>71</sup> See *e.g.*, *United States v. Brown*, 333 U.S. 18, (1948) (penal regulations are to be narrowly construed). Under a narrow construction of the pre-1979 regulation, the prohibition would be limited strictly to payments of “points, premiums or additional interest of any kind,” which have very specific, technical meanings in a banking context. See 45 C.F.R. § 177.6(e)(1) (1973). Under the 1979 regulation, the prohibition is broadly worded to include “points, premium, payments, or additional interest of any kind ... paid or otherwise extended.” 45 C.F.R. § 177.205(a)(1) (1979). While the later version of the regulations is clearly more all-inclusive, any attempt to apply an equally inclusive interpretation of the pre-1979 regulation, without adequate notice having been given to lenders, not only would be contrary to traditional rules of construction, but also would raise due process problems. Indeed, any prohibited conduct must be sufficiently defined for a reasonable person to understand and to conform his or her conduct accordingly. *F.T.C. v. Atlantic Richfield Co.*, 567 F.2d 96 (D.C. Cir. 1977). Thus, it is arguable that any denial of default claims for inducements that are not expressly prohibited by the regulations would be unconstitutional.

<sup>72</sup> See *American Sav. v. Bell*, No. 79-1834, (D.D.C. Dec. 17, 1980) (summary judgment denied); *LTV Educ. Sys., Inc. v. Bell*, No. 3-80-0125R (N.D. Tex. filed Jan. 28, 1980) (filed Mar. 29, 1979 as No. 79-0905 in D.D.C., transferred to N.D. Tex. Jan. 25, 1980).

<sup>73</sup> In at least two pending cases, lenders are challenging the Department’s broad interpretation of the regulation. In *United States v. Medsa Co.*, No. 81-F1695 (D. Colo. Filed Sept. 23, 1981), a parent company owned both banking and consulting subsidiaries. Student loans from the banking subsidiary were tied to schools’ use of the consulting firm subsidiary. The issue now being litigated is whether school payments to the consulting firm fall within the prohibition against the payment of “point, premiums or additional interest.”

<sup>74</sup> See *supra* note 70.

<sup>75</sup> *LTV Educ. Sys., Inc. v. Bell*, No. 3-80-0125R (N.D. Tex. Filed Jan. 28, 1980).

<sup>76</sup> See *e.g.*, *American Sav. v. Bell*, No. 79-1834 (D.D.C. Dec 17, 1980) (summary judgment denied) (discussed *supra* note 73).

<sup>77</sup> FISLP loan notes are probably not negotiable instruments because (1) they are not made payable to order or to bearer, and (2) the notes are subject to the terms of the lender’s Contract of Insurance with the Department, including the FISLP regulations which are incorporated into the contract. Therefore, enforcement of the notes is subject to terms not appearing on the notes. See U.C.C. § 3-104(1) (1978); see also 41 Fed. Reg. 4497, 4499 (1976).

<sup>78</sup> See *infra* notes 81 & 83.

<sup>79</sup> U.C.C. § 3-306 (1978).

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<sup>80</sup> See 1975 Senate Hearings, *supra* note 23, at 518-19.

<sup>81</sup> In *American Sav. v. Bell*, No. 79-1834 (D.D.C. Dec. 17, 1980) (summary judgment denied), the government alleged that the originating lenders had accepted illegal inducements from a school either in the form of higher interest paid on advances made by the lender to the school, or brokerage services supplied by the school in finding a secondary market purchaser for the loans, or both. See *supra* note 73.

<sup>82</sup> See 34 C.F.R. § 682.205(f) (1982).

<sup>83</sup> IN the case of the secondary market purchaser described *supra* in note 81, the lender's default claims were denied, and because one of the two originating lenders had gone into liquidation soon after the transaction, the purchasing lender was left with virtually no remedy other than pursuing its claim against the government.

<sup>84</sup> Letter from Caspar W. Weinberger, Secretary of HEW, to John Hill, Attorney General of Texas (April 21, 1975), reprinted in 1975 Senate Hearings, *supra* note 23, at 338-40 [hereinafter cited as Weinberger Letter].

<sup>85</sup> In connection with alternative sanctions, secretary Weinberger noted that "section 177.6(e) does not provide an explicit remedy for a violation. One consequence, of course, might be the limitation, suspension or termination of the lender's participation in the program. In addition, however, the Department has attempted to fashion a remedy [involving lender refunds to students] which presumes that the school has increased its charges to students as a result of discounting activities." Weinberger Letter, *supra* note 84; see also 45 C.F.R. § 177.50 (1973), and 45 C.F.R. §§ 177.71-78 (1975) (procedures for limitations, suspension, or termination of a lender's participation.)

<sup>86</sup> See 34 C.F.R. § 682.702 (1982).

<sup>87</sup> In late 1976 a case arose involving approximately \$900,000 in FISLP loans with respect to which the original lender had received illegal payments from the student borrowers' schools. Reaffirming Secretary Weinberger's position, the Department's Office of General Counsel concluded that insurance on the loans was not affected by the illegal payments: "In short, the *current* regulation does not provide that a violation of § 177.6(e) vitiates the insurance ... The Department has previously announced a policy of not withdrawing insurance on such loans. For these reasons there would appear to be little, if any, authority to deny claims filed by the original lender." Memorandum from the Office of General Counsel to William H. Taft IV, General Counsel, "Crocker National Bank," Off. Gen. Counsel Opinions at 3 (Nov. 24, 1976) (emphasis in original).

<sup>88</sup> 20 U.S.C. § 1232 (1976 & Supp. V. 1981) [hereinafter cited as GEPA]. The GSLP is not directly governed by the rulemaking procedures of the Administrative Procedure Act (APA) because it falls within the exception provided in 5 U.S.C. § 553(a)(2) (1976) for matters relating to "public property, loans, grants, benefits, or contracts." (Emphasis added.) See Bonfield, *Public Participation in Federal Rulemaking Relating to Public Property, Loans, Grants, Benefits or Contracts*, 118 U. Pa. L. Rev. 540 (1970). In 1971, however, the agency by administrative action elected to comply with the APA notice and comment requirements. See 36 Fed. Reg. 2532 (1971).

Amendments to GEPA since 1974 have imposed rulemaking requirements considerably more stringent than the APA. See *Sky*, *supra* note 61, at 131. See also *infra* note 89 & accompanying text (explanation of GEPA rulemaking requirements).

<sup>89</sup> 20 U.S.C. § 1232(a)(1), (b)(1) (1976 & Supp. V 1981) (emphasis added). The rulemaking requirements of the GEPA are broader in scope than the requirements of the APA, principally because the APA expressly excludes "interpretive rules [and] general statements of policy" from rulemaking requirements. *Id.* § 553(b) (1977). This exclusion has been construed as applying to agency clarifications of existing regulations and policies having no significant impact upon any segment of the public. *In re Worksite Inspection*, 481 F.Supp491 (D. Me. 1979). By contrast, interpretive rules that (1) have significant effects on private interests, (2) narrowly constrict the discretion of agency officials by largely determining the issue addressed, and (3) have substantive effect, must be promulgated according to APA rulemaking requirements. *Batterton v. Marshall*, 648 F.2d 694, 701 (D.C. Cir. 1980); *Guardian Fed. Sav. & Loan v. FSLIC*, 589 F.2d 658 (D.C. Cir. 1978); see also *Morton v. Ruiz*, 415 U.S. 199 (1974); *Chamber of Commerce v. D.S.H.A.*, 636 F.2d 464 (D.C. Cir. 1980) (both cases held that substantive changes in rule interpretation are not valid unless published as required by APA and agency rules). The GEPA dispenses with the necessity of meeting these three criteria by including all "interpretations...of general applicability" within the scope of rulemaking requirements, *without exception*.

<sup>90</sup> See *Sky*, *supra* note 61, at 131 (discussion of effect of GEPA publication requirement).

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<sup>91</sup> In fact, even under the APA, the department's change of sanctions would probably have met the three-pronged criteria for distinguishing substantive rules from mere clarifications, discussed *supra* note 89, thereby requiring notice and comment independent of GEPA. Clearly the new policy, whereby compliance with the regulation is imposed as a condition of insurance, has an impact on private interest, because the validity of lender's default claims choice is affected. Regional officials' discretion is grossly restricted, because they are given no choice in determining the validity of claims where violations have occurred. Also, the new rules is substantive in nature because it affects the vested rights of lenders to insurance benefits. Thus, notwithstanding the requirements of the GEPA, the Department should have promulgated the new interpretation of the illegal inducements regulation pursuant to the notice and comment requirements of the APA, 5 U.S.C. § 553(b) (c) (1976).

<sup>92</sup> See *supra* text accompanying notes 85-86.

<sup>93</sup> See Notice of Proposed Rulemaking, 43 Fed. Reg. 14,376 (1978); Publication of Final Regulations with Comments and Responses, 44 Fed. Reg. 53,866, 53,922 (1979).

<sup>94</sup> See *supra* notes 89 & 91 (discussion of notice standards under the APA).

<sup>95</sup> 20 U.S.C. § 1082(a)(2) (1976 & Supp. V 1981). Lenders are not subject, therefore, to the requirement that government contract claims be filed in the United States Court of Claims. See 28 U.S.C. § 1491 (1976 & Supp. V 1981).

It should also be noted that the decision whether to seek judicial review of administrative action pursuant to the court's jurisdiction under the APA or to file a claim for breach of contract, or both, may have important strategic consequences. Under the APA, the lender's burden of showing arbitrary and capricious administrative action is considerably more onerous and the court's scope of review narrower than under a contract claims where the standard of proof is by a preponderance of the evidence and the scope of review is *de novo*. See *infra* notes 169-78 & accompanying text.

<sup>96</sup> See, e.g., *Acheson v. Falstaff Brewing Corp.*, 523 F.2d 1327, 1330 (9<sup>th</sup> Cir. 1975); *Northwest Acceptance Corp. v. Heinicke Instruments Co.*, 441 F.2d 887 (5<sup>th</sup> Cir. 1971); *Philips Elec. & Pharmaceutical Indus. Corp. v. Leavens*, 421 F.2d 39 (3d Cir. 1970) (cases held that when interpreting a contract, the interpretation that the parties to the contract give to it should be given great weight).

<sup>97</sup> See e.g., *Howard v. Federal Crop Ins. Corp.*, 540 F.2d 695 (4<sup>th</sup> Cir. 1976) (federal crop insurance contracts construed against the federal agency that prepared them).

<sup>98</sup> The contract between each lender and the Department provides that "within such limits as may be set by him, the Commissioner shall insure all loans made by the lenders which are eligible for such insurance under such Acts and Regulations, issued thereunder, which Acts and Regulations, *as they may from time to time be amended*, are made a part of this contract." MANUAL FOR LENDERS, *supra* note 59, at appendixes A.12-13 (rev. ed. 1976) (emphasis added). In order for amendments to be incorporated into the contract, however, they must be adopted in accordance with appropriate rulemaking procedures. See *supra* notes, 88-91 & accompanying text.

<sup>99</sup> At least one lender has based a claim on this contractual theory. See *American Sav. v. Bell*, NO. 79-1834 (D.D.C. Dec. 17, 1980) (summary judgment denied).

<sup>100</sup> See *supra* note 69 & accompanying text.

<sup>101</sup> See Weinberger Letter, *supra* note 84 & accompanying text.

<sup>102</sup> See *supra* notes 1-3, 16-18, 39-53 & accompanying text.

<sup>103</sup> See *supra* note 70.

<sup>104</sup> Higher Education Act of 1965, *supra* note 1, § 430(a) *as amended by* Education Amendments of 1980, Pub.L. No. 96-374, § 422, 94 Stat. 1367 (codified at 20 U.S.C. §1080(e) (1976 & Supp. V 1981)). The original version of § 430(a) did not include the due diligence investigation requirement. It should also be noted that the statute does not expressly require lenders to exercise due diligence in the *servicing* of student loans. Because due diligence in collection often depends upon adequate servicing of a loan, however, the Department has required due diligence in the servicing of student loans, implying such a requirement from the due diligence in collection requirement.

<sup>105</sup> 20 U.S.C. § 1080(d) (1976 & Supp. V 1981).

<sup>106</sup> As the United States Court of Claims stated: "A major reason for this requirement is to protect the financial integrity of the program by minimizing the potential governmental liability under it. Lender practices that diminish the enforceability of the promissory notes increase the governments' losses as insurer by limiting its ability to collect from the defaulting students." *American Bank v. United States*, 633 F.2d 543, 547 (Ct. Cl. 1980).

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<sup>107</sup> A somewhat separate due diligence requirement, often included under the rubric of due diligence in collection, is the requirement under 34 C.F.R. § 686.516(e)(1) (1982) that default claims be filed within 90 days of the final demand letter. Although the timely filing of default claims is technically a separate requirement from due diligence, courts have treated the timely filing requirement as part of the overall duty to exercise due diligence in collection. *See, e.g., American Bank*, 633 F.2d at 549. For a discussion of the policy underlying the due diligence in collection requirement, *see infra* note 132.

<sup>108</sup> *See, supra* note 5 (description of state guaranty agencies).

<sup>109</sup> 20 U.S.C. § 1085(i) (1976); 34 C.F.R. § 682.200 (1982).

<sup>110</sup> 34 C.F.R. § 682.40(c)(3) (1982); *see also* 20 U.S.C. § 1078(c)(2)(A) (1976).

<sup>111</sup> The Department has rejected proposals that would have required guaranty agencies to adopt FISLP standards for due diligence. 44 Fed. Reg. 53,868 (1979).

<sup>112</sup> *See, supra* note 5.

<sup>113</sup> The only specific due diligence requirement was that final demand letters be sent not less than 30 nor more than 60 days before claims were filed with the Department. 45 C.F.R. § 177.48(a)(3) (1973). This provision is discussed in detail *infra* notes 135-37 & accompanying text.

<sup>114</sup> 45 C.F.R. § 177.48(b) (1973). Typical collection procedures among financial institutions include telephone calls and written correspondence of increasing forcefulness requesting and finally demanding payment. There is no consistent practice among financial institutions, however, regarding the number or frequency of such requests or demands before a borrower is placed in default.

<sup>115</sup> *See* MANUAL FOR LENDERS, *supra* note 59, at ¶ II.4 (rev. ed. 1976). The 1972 MANUAL FOR LENDERS listed typically acceptable collection procedures for educational institutions, insurance companies, and pension funds. MANUAL FOR LENDERS, *supra* note 59, exhibit II-4 (1972). There was no indication prior to 1975, however, that such procedures were applicable or even desirable for the commercial lenders constituting the majority of lenders in the program. The Department tacitly acknowledged the inadequacy of the regulations in 1979, when the collection measures suggested in the 1976 MANUAL FOR LENDERS were incorporated in large part into the 1979 regulations as mandatory requirements. 45 C.F.R. §§ 177.509-511 (1979). This occurred only after repeated requests by lenders to the Department to provide concrete, consolidated due diligence standards.

<sup>116</sup> One reason that timeliness is often an issue is that delays in either collection efforts or claims filing are most easily spotted by the Department's claims personnel from documentation submitted with default claims. *See* REGIONAL CLAIMS PROCEDURES, *supra* note 60, at 41-43 (rev. 4<sup>th</sup> ed. 1979) (description of claims review procedures for due diligence).

<sup>117</sup> *See* 44 Fed. Reg. 53,915 (1979). Repayment should begin between 9 and 12 months after a borrower ceases to be at least a half-time student. In the case of a correspondence student, the 9- to 12-month grace period begins either 60 days after the student fails to submit an assignment or after the stated normal time for completion of the course. 34 C.F.R. § 682.507(a) (1982). Under the 1980 amendments to the Higher Education Act, the 9- to 12-month grace period was shortened to 6 months for new loans. *See* 20 U.S.C. § 1077(a)(2)(B) (Supp. V 1981).

<sup>118</sup> Under 20 U.S.C. § 1077(a)(1)(B) (Supp. V 1981), students are also required to report changes in enrollment status to lenders, but this provision is virtually unenforceable once a loan is disbursed. *See infra* note 130 & accompanying text for a discussion of school responsibilities to report changes in enrollment status to lenders.

<sup>119</sup> 34 C.F.R. § 682.612 (1982).

<sup>120</sup> *See* MANUAL FOR LENDERS, *supra* note 59, at appendix A.15 (rev. ed. 1976).

<sup>121</sup> *See* Memorandum from Theodore Sky, Acting Assistant General Counsel for Education, to Dr. Terrel H. Bell, Commissioner of Education, "Eligibility under Guaranteed Student Loan Program on proposed loans to students at McCarrie Schools," Off. Gen. Counsel Opinions (Jan. 13, 1976); *see also* U.S. GENERAL ACCOUNTING OFFICE, IMPROVEMENTS NEEDED IN ADMINISTRATION OF THE GUARANTEED STUDENT LOAN PROGRAM 12 (1973).

<sup>122</sup> *See* Letter from Carl H. Harper, Regional Attorney to Dr. Cecil L. Yarbrough, Office of Education, "Request for Legal Opinion on Commerce Union Bank and American Training Services," Off. Gen. Counsel Opinions at 7 (Feb. 23, 1876).

<sup>123</sup> 45 C.F.R. § 177.510(b) (1979); *see* same language in current version, 34 C.F.R. § 682.510 (1982).

<sup>124</sup> This issue is currently being litigated in *American Sav. v. Bell*, No. 79-1834 (D.D.C. Dec. 17, 1980) (summary judgment denied).

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<sup>125</sup> See generally U.S. GENERAL ACCOUNTING OFFICE, IMPROVEMENTS NEEDED IN ADMINISTRATION OF THE GUARANTEED STUDENT LOAN PROGRAM (1973).

<sup>126</sup> Before a rule of general applicability can become effective, it must be published in the Federal Register. See *supra* notes 88-90 & accompanying text for a more detailed discussion.

<sup>127</sup> See 45 C.F.R. § 177.510 (1979).

<sup>128</sup> See *supra* notes 54 & 98 (discussion of regulations as part of the insurance contracts).

<sup>129</sup> Cf. *supra* notes 95-98 & accompanying text (contract analysis of the Department policy changes).

<sup>130</sup> See *supra* notes 118-22 & accompanying text. The Department considered revising the arrangement for reporting student status by having schools report directly to lenders within 60 days after any change in a student's enrollment status. 43 Fed. Reg. 14,384, 14,418, (1978) (proposed Apr. 5, 1978). The Department expressly rejected that duty, however, on the grounds that such additional reporting requirements would be unduly burdensome to schools, and that reporting student status to the Department via Student Confirmation Reports was adequate. See 44 Fed. Reg. 53,867 (1979).

<sup>131</sup> See 1981 Senate Hearings, *supra* note 30, at 239-40 (testimony of Edward A. Fox, President of the Student Loan Marketing Association).

<sup>132</sup> The policies underlying the timely filing requirement are different from the policies served by the other due diligence requirements discussed in the text. The filing deadline is intended to ensure that the government receives a fresh claim upon which to pursue the defaulting student borrower, *American Bank v. United States*, 633 F.2d at 549, and to avoid paying an unnecessary amount of interest or special allowances while the claim is held by the lender. See 44 Fed. Reg. 53,915 (1979).

Until 1978, however, relatively few defaulting student borrowers were pursued for collection by the Department. See generally U.S. GENERAL ACCOUNTING OFFICE, COLLECTION EFFORTS NOT KEEPING PACE WITH GROWING NUMBER OF DEFAULTED STUDENT LOANS (1977). The General Accounting Office found that \$287 million in default claims paid by the Department through September 1976, only \$25 million had ever been collected from the student borrowers. *Id.* at 7. In particular, the GAO observed that "[a]s of October 1976, only about 1,150 of more than 280,000 defaulted student loans acquired by [the Department]...had been referred to Gao or the Department of Justice for consideration of possible legal action." *Id.* at 16. Defaulting student borrowers risked only four chances in a thousand of having legal action considered against them. Thus, the government itself ignored the policy underlying the default claim filing deadline; students were rarely pursued while the claims were "fresh."

<sup>133</sup> Prior to September, 1979, the regulation read in pertinent part: "The Commissioner will honor claims for reimbursement ...only if...a written demand for payment has been made on the borrower and any endorser on a defaulted note not less than 30 days nor more than 60 days prior to the filing of the claims for loss." 45 C.F.R. § 177.48(a)(3) (1973). By contrast, 45 C.F.R. § 177.516(e)(1) (1979) states clearly that a lender "must file a default claim with the Commissioner within 90 days after the loan has been determined to be in default."

<sup>134</sup> The clearest evidence of the agency's interpretation of the regulation lies in its own REGIONAL CLAIMS PROCEDURES manuals. The 1977 through 1979 editions of that manual establish guidelines for claims approval or denial by the Department's claims personnel. Despite the fact that these claims manuals provide detailed checklists of grounds for claims denial, no provision appears for denying claims based on any filing deadline in 45 C.F.R. § 177.48(a)(3) (1973). See, e.g., REGIONAL CLAIMS PROCEDURES, *supra* note 60 at 7-14 (rev. 3d ed. 1977). In fact, the 1977 manual provides a model Claim Review Sheet where *expedited* payment is recommended, even though the claim was filed long after the deadline. *Id.* at 17.

<sup>135</sup> The 1972 MANUAL FOR LENDERS is silent with regard to the deadline for filing claims. Its only reference to 45 C.F.R. § 177.48(a)(3) concerns the final demand letter rather than any deadline for filing claims. See MANUAL FOR LENDERS, *supra* note 59, ¶ IV-10 (1972). The 1976 MANUAL FOR LENDERS also focuses on the final demand for payment, indicating that the demand letter must be sent not less than 30 nor more than 60 days prior to filing a claim. Moreover, the 1976 MANUAL goes on to state in non-mandatory terms that the lender *may* file a default claim after 30 days. See MANUAL FOR LENDERS, *supra* note 59, ¶ V.4.4.2 (rev. ed. 1976).

<sup>136</sup> See 44 Fed. Reg. 53,915 (1979) (lender comments regarding 90-day filing period).

<sup>137</sup> See 45 C.F.R. § 177.516(e)(1) (1979). Lenders have commented that even 90 days is often an insufficient amount of time in which to process and file claims. 44 Fed. Reg. 53,915 (1979).

<sup>138</sup> Bulletin to Regional Directors, No. R-83 (1979).

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<sup>139</sup> See, e.g., *American Bank v. United States*, 633 F.2d 543, 549 (Ct. Cl. 1980); *Federal Deposit Ins. Corp v. United States*, 527 F. Supp. 942 (D.C.W. Va. 1981); *Bell & Howell Educ. Group., Inc. v. Secretary of Educ.*, No. 81-C-531 (N.D. Ill. Filed Sept. 4, 1981).

<sup>140</sup> 633 F.2d 543, 548-50 (Ct. Cl. 1980).

<sup>141</sup> *Id.* at 549.

<sup>142</sup> See Plaintiff's Motion for Summary Judgment at 25, *American Bank*, 633 F.2d 543. Defendant's Cross-Motion for Summary Judgment and Opposition to Plaintiff's Motion for Summary Judgment at 21-24, *id.* Plaintiff's Opposition to Defendant's Cross-Motion for Summary Judgment and Reply to Defendant's Opposition to Plaintiff's Motion for Summary Judgment at 12-14, *id.*

<sup>143</sup> See *id.*; *American Bank*, 633 F.2d at 548-50.

<sup>144</sup> See *supra* notes 88-91 & accompanying text for a detailed discussion of GEPA and APA requirements.

<sup>145</sup> See *supra* note 71 (discussion of due process requirements).

<sup>146</sup> See *supra* notes 88-91 (discussion of GEPA requirements). A shift in the interpretation of a regulation as being directory in nature on the one hand, to an interpretation of the regulation as being mandatory on the other, requires notice to those affected by the regulations. Cf. *Briscoe v. Kusper*, 435 F.2d 1056 (7<sup>th</sup> Cir. 1971) (candidate's due process rights violated when the City Board of Elections changed rules governing signatures without notifying candidates).

<sup>147</sup> IN a case involving a publication requirement under the Economic Opportunity Act, similar to that under GEPA, implementation of a new but unpublished policy was barred despite actual notice of the policy change. See *Local 2677, Am. Fed'n of Gov't Employees v. Phillips*, 358 F. Supp. 60, 81-82 (D.D.C. 1973); cf. *Gardiner v. Tarr*, 341 F. Supp. 422,433-35 (D.D.C. 1972) (policy change implemented by internal directives sent by Selective Service System to regional offices held to have no force and effect in view of failure to publish directives in Federal Register).

<sup>148</sup> *American Bank v. United States*, 633 F.2d 543 (Ct. Cl. 1980); *American Sav. v. Bell*. No. 79-1834 (D.D.C. Dec. 17, 1980) (summary judgment denied).

<sup>149</sup> 20 U.S.C. § 1080(a) (1976 & Supp. V 1981); *MANUAL FOR LENDERS*, *supra* note 59, ¶ V.8.3.1. (rev. ed. 1976).

<sup>150</sup> See *supra* notes 39-53 & accompanying text.

<sup>151</sup> See *supra* note 23.

<sup>152</sup> See generally *Student Loan Defaults: Oversight Hearing Before the Subcomm. on Postsecondary Education of the House Comm. On Education and Labor*, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1977) (hearings on causes and cures for student defaults).

<sup>153</sup> See generally WASHINGTON OFFICE OF THE COLLEGE BOARD, *supra* note 27.

<sup>154</sup> See *supra* notes 30-32 & accompanying text.

<sup>155</sup> See *supra* note 5.

<sup>156</sup> See U.S. GENERAL ACCOUNTING OFFICE, THE GUARANTEED STUDENT LOAN PROGRAM NEEDS A THOROUGH REDESIGN TO ACCOUNT FOR THE EXPENDITURE OF BILLIONS 8-11 (1981).

<sup>157</sup> See 34 C.F.R. § 682.406 (1982).

<sup>158</sup> Omnibus Budget Reconciliation Act of 1981, Pub. L. No. 97-35, § 537(c)(2), 95 Stat. 357, 456 (1981) (codified at 20 U.S.C. § 1078(c)(8) (Supp. V 1981)).

<sup>159</sup> IN many ways, the limited opportunities for recovery explain the paucity of case law in this area. Those cases that have been litigated generally involve a large number of individual claims with aggregate values in excess of \$100,000.

<sup>160</sup> See generally Omnibus Budget Reconciliation Act of 1981, tit. V, Pub. L. No. 97-35, § 516.95 Stat. 446-47 (1981) (appropriations for higher education).

<sup>161</sup> *1975 Senate Hearings*, *supra* note 23, at 537.

<sup>162</sup> See *Lindus v. Northern Ins. Co.*, 103 Ariz. 160, 438, P.2d 311 (1968); *Campbell v. Allstate Ins. Co.*, 60 Cal. 2d 303, 384 P.2d 155, 32 Cal. Rptr. 827 (1963); *State Farm Mut. Ins. Co. v. Johnson*, 320 A.2d 345 (Del. 1974); *Leach v. Farmer's Auto. Interinsurance Exch.*, 70 Idaho 156, 213 P.2d 920 (1950); *Harleysville Ins. Co. v. Rosenbaum*, 30 Md. App. 74, 351 A.2d 197 (1976); *Wendel v. Swanberg*, 384 Mich. 468, 186 N.W.2d 348 (1971); *Reliance Inc. Co. v. St. Paul Ins. Cos.*, 307 Minn. 338, 239 N.W.2d 922 (1976); *Aetna Life Ins. Co. v. Walley*, 174 Miss. 365, 164 So. 16 (1935); *Cooper v. Government Employees Ins. Co.*, 51 N.J. 86, 237 A.2d 870 (1968); *Great Am. Ins. Co. v. C.G. Tate Constr. Co.*, 46 N.C. App. 427, 265 S.E.2d 467 (1980); *Nationwide Mut. Ins. Co. v. Motorists Mut. Ins. Co.*, 116 Ohio App. 22,

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186 N.E.2d 208 (1961); Fox v. National Sav. Ins. Co., 424 P.2d 19 (Okla. 1967); Lusch v. Aetna Casualty & Surety Co., 272 Or. 593, 538 P.2d 902 (1975); Brakeman v. Potomac Ins. Co., 472 Pa. 66, 371 A.2d 193 (1977); Picering v. American Employees Ins. Co., 10 R.I. 143, 282 A.2d 584 (1971); Squires v. National Grange Mut. Ins. Co., 274 S.C. 58, 145 S.E.2d 673 (1965); Nationwide Mut. Ins. Co. v. Gentry, 202 Va. 338, 117 S.E.2d 76 (1960).

<sup>163</sup> See, e.g., Brown v. Security Fire & Indem. Co., 244 F. Supp. 299 (W.D. Va. 1965). IN the cases cited *supra* note 162, the courts have generally required that the insurer show actual prejudice to its right under the insurance contract, rather than simply showing some speculative or remote possibility of prejudice.

<sup>164</sup> See 44 Fed. Reg. 52,916 (1979).

<sup>165</sup> REGIONAL CLAIMS PROCEDURES, *supra* note 60, at 41 (rev. ed. 1979).

<sup>166</sup> The regulation in question, 34 C.R. § 682.517(g) (1982), reads as follows:

Circumstances under which defects in claims may be cured or excused:

- (1) The Commissioner may permit a lender to cure certain defects in a specified manner as a condition for payment of a default claim.
- (2) The Commissioner may excuse certain defects –
  - (i) If the holder submitting the default claim satisfies the Commissioner that *the defect did not contribute to default or prejudice the Commissioner's attempt to collect on the loan from the borrower, o*
  - (ii) If the defect arose while the holder submitting the default claim was holding the loan but the Commissioner had previously found that the holder had procedures in effect sufficient ensure that such a defect would not normally arise.
- (3) The Commissioner may also excuse certain defects if the Commissioner is satisfied that –
  - (i) The defect arose while the loan was held by another lender.
  - (ii) The assignment of the loan was an arm's length transaction.
  - (iii) The present holder did not know of the defect at the time of the assignment; and
  - (iv)(A) The present holder could not have become aware of the defect through an examination of the loan documents, or:
    - (B) The present holder had relied on a finding by the Commissioner that the lender holding the loan when the defect arose had procedures in effect sufficient to ensure that such a defect would not normally arise. (Emphasis added).

<sup>167</sup> A separate problem arises as to whether a *particular* Department official has authority to waive or allow the curing or excuse of defects. Section 177.517(g) gives express authority only to the Commissioner of Education, and whether any official below the Commissioner's level has such authority depends on whether the authority has been delegated. The two reported decisions that have addressed this issue concluded, largely on the basis of affidavits from agency officials, that no official below the Associate Commissioner level has the authority to waive regulatory requirements. See *American Band*, 633 F.2d at 552; Hicks v. Califano, 450 F. Supp. 278, 284 (N.D. Ga. 1977) *aff'd sub nom.* Hicks v. Harris, 606 F.2d 65, 69 (5<sup>th</sup> Cir. 1979).

This conclusion appears to be correct at least with regard to regional offices of the Department, which comprise the agency's "front line" for claims processing. Section 403(c)(1) of the GEPA, 20 U.S.C. § 1221c(c)(2) (1976 & Supp. V 1981), prohibits any delegation of authority to regional officers not in effect as of June 1, 1973 without express approval from Congress. Prior to that date, no delegation of waiver authority had been made to regional offices. See Memorandum from the Office of General Counsel to T.H.Bell, Commissioner, Off. Gen. Counsel Opinions (May 14, 1975).

<sup>168</sup> As discussed earlier, the number of lenders participating in the program has been steadily decreasing. See *supra* note 32 & accompanying text.

<sup>169</sup> See e.g., Basic Media, Ltd. v. FCC, 599 F.2d 830 (D.C. Cir. 1977).

<sup>170</sup> The procedures for administrative adjudication of claims against the Department are not provided by the GEPA. See H.R. REP. NO. 1137, 95<sup>th</sup> Cong., 2d Sess. 141, *reprinted in* 1978 U.S. CODE & AD. NEWS 4971, 5111 (GEPA administrative appeals provisions inapplicable to GSLP). The agency's decision to pay or deny a default claim under the FISLP is accomplished by informal adjudication, and need not comply with the formal adjudicatory procedures of the Administrative Procedure Act. See 5 U.S.C. §§ 556-557 (1976). Similarly, the refusal to excuse or allow the curing of a defect constitutes only an informal adjudication. Within the context of informal adjudication, the Department is limited to the grounds originally stated for such a refusal. *Camp v. Pitts*, 411 U.S. 138, 143 (1973). If no grounds are given, the

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reviewing court must obtain the necessary reasons for the Department's refusal by means of testimony from agency officials who made the decision. *Id.*; *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 419-20 (1971); *see generally* K. DAVIS, *ADMINISTRATIVE LAW TREATISE* § 29.01-6 (Supp. 1982).

It should be noted, however, that where the claim of arbitrary and capricious administrative action is coupled with a cause of action for breach of contract, the agency is not limited in the defenses or counterclaims it may raise to the *contract* claim. See 20 U.S.C. § 1082(a)(2) (1976 & Supp. V 1981). Likewise, the reviewing court is not limited in the scope of its review of the contract claim, and must conduct a *de novo* review of the evidence on the issues of whether defects in a claim were material, or whether the agency had established a course-of-dealing by virtue of other claims where defects were waived. See K. DAVIS, *supra*, § 29.09 (1982 Supp.).

<sup>171</sup> See 45 C.F.R. § 177.517 (g)(2) (1979).

<sup>172</sup> Under the APA, 5 U.S.C. § 706(2)(E) (1977), the substantial evidence test applies only to formal adjudications. The courts have increasingly recognized, however, that in reviewing informal agency proceedings, the differences between the substantial evidence and arbitrary and capricious standards is largely semantic. *Aircraft Owners & Pilots Ass'n v. FAA*, 600 F.2d 965, 971-72 n.28 (D.C. Cir. 1979); *Pacific Legal Foundation v. Dep't of Trans.*, 593 F.2d 1338, 1343 n.35 (D.C. Cir. 1979), and cases cited therein. AS Judge Friendly noted in *Associated Indus., Inc. v. United States Dep't of Labor*, 487 F.2d 342 (2d Cir. 1973), "in the class of cases in which the ground for challenging the agency action is the inadequacy of its evidentiary bias, it is difficult to imagine a decision having no substantial evidence to support it which is not arbitrary," or a decision stuck down as arbitrary which is in fact supported by "substantial evidence." *Id.* at 349 (quoting Scalia & Goodman, *Procedural Aspects of the Consumer Product Safety Act*, 20 U.C.L.A. L. REV. 899, 935 n.138 (1973)).

<sup>173</sup> See, e.g., *United States Health Club, Inc. v. Major*, 182 F. Supp. 759 (D.N.J. 1960), *rev'd on other grounds*, 292 F.2d 665 (3d Cir. 1961), *cert denied*, 368 U.S. 896 (1961).

<sup>174</sup> *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 477 (1951).

<sup>175</sup> In other words, only slight evidence of prejudice is required, even if the bulk of evidence shows that prejudice to the government did not occur. *Associated Indus., Inc. v. United States Dep't of Labor*, 487 F.2d at 349.

<sup>176</sup> For instance, the lender in *American Bank* was unsuccessful with a similar argument when it claimed that the government suffered no prejudice from the last filing of default claims, because the students had defaulted. 633 F.2d at 549-50.

<sup>177</sup> See *supra* notes 67-103 & accompanying text.

<sup>178</sup> In this regard, the compilation of Off. Gen. Counsel Opinions, *supra* note 60, is a helpful source of information regarding the Department's past treatment of similar claims.