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GUARANTEED STUDENT LOAN PROGRAM

Proposed Rules

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE

Office of Education

[45 CFR Part 177]

GUARANTEED STUDENT LOAN PROGRAM

Notice of Proposed Rulemaking

Notice is herby given that, pursuant to the authority contained in section 432 (a) (1) of the Higher Education Act of 1965, as amended (20 U.S.C. 1082(a) (1), the Commissioner of Education, with the approval of the Secretary of Health, Education, and Welfare, proposes to amend Part 177 of Title 45 of the Code of Federal Regulations, by amending §§ 177.44 and 177.49 and adding § 177.52, as set forth below. The purpose of these amendments is to clarify the amount of loss which will be paid by the Commissioner on default claims submitted by lenders holding loans which are insured under the Federal Insured Student Loan Program (Subpart E of 45 CFR Part 177) and to specify the responsibilities of lenders prior to filing such claims.

Under the Federal Insured Student Loan Program (FISLP), the Commissioner issues a certificate of insurance for a loan made to an eligible student by an eligible lender, insuring the loan against losses incurred by the lender because of the student's failure to repay the loan. For this purpose, an eligible lender may be a bank or other financial or credit institution, or agency or instrumentality of a State, or an institution of higher education or a vocational school, as those terms are defined in the Higher Education Act. The Act and the regulations further provide that insured loans may be transferred or assigned by an eligible lender to another eligible lender. If the student fails to repay the loan, the holder of the loan may file a claim with the Commissioner to be reimbursed for the "unpaid balance of the principal amount and interest."

(20 U.S.C. 1080(a)).

Several questions have been raised regarding how the amount of the unpaid balance of the loan should be computed in situations in which the student borrower may have claims or defenses which he could assert against the original lender or a subsequent holder of the loan. Although it has been generally understood and accepted that a promissory note made under the FISL Program is not a negotiable instrument and that a purchaser of such a note cannot become a "holder in due course," as those terms are defined by commercial law, questions have still remained concerning the proper interpretation and application of the Act and regulations. The major issues relate to: (1) Defenses which the student borrower may have concerning the origination of the loan; (2) the rights of a holder who has obtained the loan by transfer or assignment from the lender; (3) the treatment to be accorded refunds to which the student borrower has become entitled; (4) the consequences of an educational institution closing during an academic term; and (5) whether a lender which is not an educational institution but which has a special relationship to an educational institution, should be required to assume certain responsibilities or risks beyond those of other nonschool lenders.

1. *Defenses on the loan.* The FISLP Program is designed to insure lenders against the student's failure to repay the loan. It does not insure the lender, or a subsequent holder, against such legal defenses as fraud or forgery on the part of the lender or third parties in the making of the loan which would be available to the student. In addition, the Act, particularly at 20 U.S.C. 1077, and the regulations provide for a number of requirements which must be met if a loan is to be insurable. Subject to the provisions of the proposed amendment to § 177.44, the Commissioner will not guarantee a lender or a subsequent holder against a loan failing to be in compliance with these requirements.

The amendment to § 177.44 would permit a non-school lender, acting in good faith and without information to the contrary, to rely upon the certification provided by the educational institution that the student is eligible for an FISLP loan and upon the assurances and the information provided by the student to establish his eligibility. The Commissioner, in effect, would insure such a lender against such certifications and assurances being false or inaccurate. However, lenders which purchased loan notes that were originated by a school (as specified in more detail in the proposed § 177.52(c)) would not be insured against false certifications made by the school in the making of the loan. Lenders in these two situations would be expected to pursue their legal remedies against the school. The proposed regulation thus encourages a lender to make a sound professional judgment regarding the practices of a school before purchasing loans originated by the school.

The proposed § 177.52 states that the Commissioner will take cognizance of legal defects affecting the initial validity or insurability of a loan and, subject to § 177.44(b), will deduct from the default claim amounts attributable to such defects. This provision is intended primarily to cover intentional misrepresentations, fraud, forgery and other knowing or intentional acts undertaken in order to obtain Federal insurance for a loan which would not be eligible for such insurance. In addition to such legal defects as these, there are a number of other requirements imposed by the authorizing legislation or the regulations for the FISL Program which could give rise to defects impairing the insurability of a loan. An example of such a defect would be the lender obtaining an endorsement in contravention of section 427(a)(2) of the Act (20 U.S.C. 1077(a)(2)). Since such an endorsement would, under the terms of section 427, render the loan uninsurable, the Commissioner could not reimburse a lender on a default claim filed for a loan bearing such an endorsement. Defects such as this one may, however, be remedied, with the Commissioner's approval, if he determines that no one has been adversely affected by the defect and that it can be remedied on a timely basis.

Thus, if a lender discovers such an unauthorized endorsement and, with the agreement of the student, deletes the unauthorized endorsement from the student's promissory note prior to the student becoming delinquent in his payments and prior to the time any party (other than the lender) has relied upon the endorsement, the Commissioner will not deem the loan to have been void ab initio. Rather, the Commissioner will view the defect as having been harmless up to the time of its deletion and will ratify the insurability of the loan.

2. *Transfers and assignments of FISLP notes.* The statute (20 U.S.C. 1079(d)) and the regulations (45 CFR 177.49) provide for the transfer and assignment of FISLP notes, even though such notes are not negotiable instruments. However, in order to provide the student and the subsequent holder of the note with as much protection as possible, the regulations require that notice of such transfer or assignment be given to the student, and to the Office of Education, if the rights or responsibilities regarding any payments on such loan are affected by the transfer or assignment. (See 45 CFR 177.49(b).) The proposed amendments set forth in this Notice attempt to clarify what statements must be included in such notices of transfer and to establish the legal consequences, as they relate to default claims, of a failure to comply with the notice requirement.

It should be noted that the regulation does not necessarily require the assignee of the loan to send the notice to the student; rather it would permit the notice to be sent by either the assignor or the assignee. However, if the assignee relies on the assignor to send the notice, the assignee would bear the risk that such notice was not sent. Thus, if proper notice has not been given to the student borrower, and the student has made payments to the assignor of the note which have not been passed on to the assignee or otherwise taken into consideration in computing the amount of the unpaid balance submitted on a default claim, the Commissioner would deduct the amount of such payments from the amount of the default claim which he would pay to the assignee.

Another specific situation concerning the transfer of FISL notes that is covered by the proposed amendment occurs when the lender has obtained from the student borrower a written statement authorizing the educational institution to pay any refunds which become due to the student directly to the lender. This issue in discussed in detail below, under the next heading.

3. *Treatment of unpaid refunds.* This issue arises most often in cases in which the original lender was an educational institution, although it can arise in cases where a non-school lender has obtained an authorization to have the refund paid directly to it, rather than to the student.

The proposed amendments specify that, under certain circumstances, a refund which has become due but has not been paid will be treated as a payment by the student on the loan and that, under other circumstances, the lenders and assignees of loans will have some responsibility to attempt collection of such refunds, but as to such lenders and assignees, such refunds will not otherwise be treated as payments by the student.

An unpaid refund would be treated as a payment by the student, and would be deducted from a default claim (if it has not already been taken into consideration in determining the amount of the unpaid balance), whenever the educational institution which owes the funds to the student is the original lender and has filed the default claim. An unpaid refund would be treated, in the same manner, as a payment by the student in any case in which the loan was made by the educational institution which owes the refund to the student and was transferred to another eligible lender after the refund became due. For this purpose, the date the refund became "due" is the date on which the student's entitlement first became established (by withdrawal, by notification to the school, or by failure to attend class or submit lessons), rather than the date within which payment of the refund must be made. Thus, the assignee of the loan would bear responsibility for pursuing its own remedies against the school. This should encourage a lender which is contemplating purchasing a loan from a school lender to inquire about the status of the student or to obtain an assurance from the institution protecting it against the risk of a refund having become into existence prior to the transfer.

The responsibilities of lenders with respect to unpaid refunds in other situations would be dependent on whether the original lender had been an educational institution and, if so, whether the loan had been transferred from the original lender to another eligible holder of the loan.

If the original lender was not an educational institution, the holder of the loan at the time of the student's default would be responsible for making a diligent effort to collect the refund from the school. If the student had previously signed an authorization to have the school pay the refund directly to the lender, this would mean that any assignee of the loan would be responsible for obtaining an assignment of the authorization and seeking to collect on it from the school. If the student had not signed such an authorization prior to becoming delinquent on the loan, the diligence required of the holder of the loan would include a diligent effort to obtain an assignment from the student of his right to the refund and, if successful, a diligent effort to collect the refund from the school. A lender which exercised such diligence, but was nonetheless unable to collect the refund, would be reimbursed by the Commissioner for the full unpaid balance of the loan. The Commissioner, under section 430(d) of the Act (20 U.S.C. 1080(b)), is subrogated to the rights of a lender to whom he has paid a default claim and he would then exercise these rights to seek collection of the refund. If, however, a lender failed to exercise the diligence called for in this regard, the Commissioner would deduct from the default claim any amounts included therein which represented the refund which was due. In that event, the lender would be expected to pursue whatever remedies it might have against the student, the school or a prior holder of the loan.

If the original lender was an educational institution, and the loan had not been transferred to another lender (or, if transferred, has been repurchased by the original lender), an unpaid refund due from such institution would, as noted above, be considered a payment by the student and would be deducted from the default claim filed by such institution.

If the original lender was an educational institution and the loan has been transferred, so that another lender is holding the loan at the time of the student's default, an unpaid refund which became due prior to the transfer would, as noted above, be treated as a payment by the student and deducted from the claim filed by the holder. In addition, any payments which the student made to the school after the transfer which the subsequent holder authorized to be made or knowingly permitted to be made would be deducted from the holder's default claim, even if the school has not transmitted such payments to the holder. In this instance, the holder would be expected to pursue any remedies it had against the school. (Similarly, as discussed above, if the student had not been given proper notice of the transfer, or if such notice were given belatedly, any payments made to the school by the student prior to or in the absence of such notice, would be deducted from the holder's default claim and the holder would be expected to pursue its remedies against the school.) With respect to unpaid refunds which become due after the transfer, the holder would be required to exercise the same diligence in attempting to collect the refund from the school that is required of non-school lenders generally (see discussion above). Such diligence includes obtaining an assignment of any authorization which the student has signed to have his refund paid to the lender or, if no such authorization had been signed previously by the student, a diligent effort to obtain from the student an assignment of his own right to the payment of the refund. As discussed above, if the holder exercised such diligence but was not able to collect the refund from the school, it would be reimbursed on a default claim for the full amount of the unpaid balance of the loan and the Commissioner would assume responsibility or collecting the refund from the school.

4. *Consequences of a school terminating its teaching activities.* If a loan has been made by an educational institution and if the institution for any reason has terminated its teaching activities during the academic period for which the loan was made, with the result that the student is unable to obtain the academic services for which he enrolled, the Commissioner will not reimburse the institution, or any subsequent holder of the loan, for the full amount of the unpaid balance of the loan. Since the loan was made solely and specifically to enable the student to enroll in school, the school's termination of its teaching activities would result in a failure of consideration on the student's enrollment agreement with the school, thereby giving rise to a defense which is good on the loan not only against the school, but also against a subsequent holder of the loan. A lender purchasing loans which have been made by a school lender must, therefore, bear responsibility for making a reasonable, professional judgment that the institution has the resources and administrative capability to provide the services for which the student obtained the loan.

Should this situation arise, the institution, or the subsequent holder of the loan upon learning of the school's closing, would be required to submit a "default" claim promptly to the Commissioner. The holder of the loan would be required not to make any attempt to collect payments from the student and not to hold the loan during the normal grace period available to the student before he becomes obligated to begin payments. The holder of the loan would be reimbursed on its default claim on a pro rata basis for the services which the student received prior to the school's termination. That is to say, the amount which the holder would be reimbursed would bear the same ratio to the total amount of the student's loan as the amount of the services provided to the student would bear to the total amount of services which would have been provided to him had the school not closed.

Under these circumstances, the Commissioner would be subrogated to any rights which the holder of the note might have had, under applicable law, to receive payments from the student. The Commissioner will determine whether the student has any obligation, based on the facts and the applicable law, to make repayment on the loan. If it is determined that the student does have such obligation, the Commissioner will, after the expiration of the grace period, seek to collect such payments.

5. *Lenders having special relationships with schools.* It is apparent that there are circumstances in which a lender, although not an educational institution, could have established a relationship with an educational institution which might result in the lender not exercising the independent judgment and responsibility in making loans which would otherwise be expected of a non-school lender. Such circumstances include cases in which the lender and the institution have mutual financial interests and cases in which the lender has delegated its normal loan-making activities to the school.

The purposes of the program, particularly the interests of the students and the Federal Government appear to be best served in such circumstances if the lenders are required to assume responsibilities or bear risks beyond those of other non-school lenders.

Section 177.52(c) of the proposed amendments would define certain relationships between a lender and a school which would result in the loans made by the lender being treated as if they were made by a school and transferred to the lender. Thus, lenders with such relationships, unlike other non-school lenders, would bear the risk that a refund had become due prior to the disbursement of the loan; would bear the risk that payments had been made to the school by the student in the absence of adequate information about his repayment responsibilities, would have to make a diligent effort to collect an unpaid refund from the school, and would bear some risk in the case the institution terminated its teaching activities prior to the conclusion of the academic period for which a loan was made.

The relationships giving rise to such additional responsibilities would be (i) a school owning a majority of the voting stock of the lender; (ii) the lender having common ownership or management with one or more institutions and a majority of the loans made under the FISL Program by the lender are to the students at such institution; and (iii) the lender has delegated to a school substantially all of the loan-making functions and responsibilities which a non-school lender would ordinarily exercise.

Subdivision (iii) of this provision is not to be construed as authorizing or encouraging lenders to adopt the practice of delegating a lender's normal responsibilities to an educational institution. Rather, such a practice is discouraged and its use could raise serious questions regarding the lender's exercise of the requisite care and diligence in making loans. This provision is merely intended to establish that any lender which engages in such a practice will be held to assume additional risks.

Public comment. All interested parties are invited to submit written comments, suggestions or objections regarding these proposed amendments to the regulations to the Associate Commissioner, Office of Guaranteed Student Loans, Room 4051, Regional Office Building #3, Seventh and D Streets, SW., Washington, D.C. 20202. All relevant material received on or before April 24, 1975, will be considered. (Such response to this notice will be available for public inspection on Mondays through Fridays between 8:30 a.m. and 4:30 p.m.)

(Catalog of Federal Domestic Assistance No. 13.460: Guaranteed Student Loan Program)

Dated: March 3, 1975.

T. H. BELL,
U.S. Commissioner of Education.

Approved: March 18, 1975.

CASPAR W. WEINBERGER,
Secretary of Health, Education, and Welfare.

Part 177 of Title 45 of the Code of Federal Regulations is amended as follows:

§ 177.42 [Amended]

1. Section 177.42 is amended by deleting paragraph (d) and by redesignating paragraph (e) as paragraph (d).

2. Section 177.44 is amended by designating the undesignated paragraph as paragraph (a) and by adding a new paragraph (b) to read as follows:

§ 177.44 Eligibility for insured loans.

* * * * *

(b) In making a loan under this part, a lender which is not an institution of higher education or a vocational school, acting in good faith and in the absence of information to the contrary, may rely upon the certifications provided by an institution and upon the assurances and other information provided by a student pursuant to paragraph (a) of this section. A lender which, by transfer or assignment pursuant to § 177.49 of this part, obtains possession of a loan which has been made by an educational institution may, acting in good faith and in the absence of information to the contrary, rely upon the assurances and information provided by a student to such institution pursuant to paragraph (a) of this section, but such transferee or assignee shall not be entitled to rely upon the certifications provided by an educational institution pursuant to paragraph (a) of this section in the making of the loan. In making a loan under this part, a lender which is not an educational institution, but for which the conditions set forth in paragraph (c) of § 177.52 exist, acting in good faith and in the absence of information to the contrary, may rely upon the assurances and information provided by a student pursuant to paragraph (a) of this section, but shall not be entitled to rely upon the certifications of the educational institution provided thereunder.

3. Paragraph 177.49(b) is revised, to read as follows:

§ 177.49 Transfer of insured loan.

* * * * *

(b) The Commissioner shall be notified of any assignment of a note insured under this subpart if the right to receive interest payments has also been assigned. The borrower shall be notified of the assignment of any note insured under this subpart if the assignment results in his being required to make installment payments or direct other matters connected with the loan to another party. Such notice to the borrower shall contain a clear statement of all of the borrower's rights and obligations, both as to the assignor and the assignee, including a statement regarding the consequences of any payments made to the assignor, or any prior holder of the loan, subsequent to receipt of the notice and, if applicable, the effect of the assignment on any authorization previously signed by the borrower with respect to payment of refunds due under § 177.63 of this part.

4. A new § 177.52 is added, to read as follows:

§ 177.52 Determination of amount of loss on default claims.

The amount of loss to be paid on claims filed pursuant to § 177.48, for loans for which the application for insurance commitment was received by the U.S. Office of Education prior to July 1, 1972 or between August 19, 1972 and February 28, 1973 (or, with respect to claims based on the borrower's death or total and permanent disability, for loans made prior to December 15, 1968), shall be equal to the unpaid balance of the principal amount of such loan other than any interest or any other charges which may have been added to, and become part of, the principal amount of the loan. For loans for which such applications were received between July 1 and August 18, 1972 or after February 28, 1973 (and, with respect to claims based on the borrower's death or total and permanent disability, for loans made on or after December 15, 1968), the amount of the loss to be paid on claims filed pursuant to § 177.48 shall be equal to the unpaid balance of the principal and interest. In determining what amount of such balance is unpaid, the Commissioner shall take cognizance of legal defects affecting the initial validity or insurability of the loan which arise under the Act, the regulations set forth in this part, or applicable State law. Subject to the provisions of § 177.44(b) of this part, the Commissioner shall deduct from the claim any amounts included therein which are attributable to legal defects deriving from fraud, forgery or intentional misrepresentations on the part of the borrower, the educational institution or the lender or deriving from non-compliance with the statutory conditions and elements set forth in sections 425 and 427 of the Act. In determining whether deductions should be made which are attributable to other defects, the Commissioner shall consider whether there is any evidence of an intention to mislead or defraud and whether the lender, in making the loan, failed to exercise care and diligence commensurate with prudent business practices. In addition, the Commissioner will determine the amount of the unpaid balance in accordance with the following rules:

(a) *Loans made by lenders which are not educational institutions.* If the loan for which a claim has been filed was originally made by on eligible lender which was not an institution of higher education or a vocational school, the unpaid balance shall be the amount of the loan, minus any payments which have been properly made to the holder of the loan by the borrower or on the borrower's behalf. If, however, the lender has obtained the borrower's authorization to have the educational institution in which the borrower is enrolled pay directly to the lender any refund from the institution to which the borrower becomes entitled, the lender must make a diligent effort to collect such refund prior to filing the claim; if the lender fails to make

such efforts, the Commissioner will deduct from the claim any amount included therein which is attributable to such refund. If the claim has been filed by an eligible lender which did not make the loan, but has obtained it by transfer or assignment, the transferee or assignee shall not be entitled to any payment under this section greater than that to which the transferor or assignor would be entitled under this section. In particular, the Commissioner shall deduct from the claim any amounts included therein which are attributable to payments made by the borrower to a prior holder of the loan prior to, or in the absence of, proper notice of the transfer or assignment to the borrower in accordance with § 177.49(b) of this part. If the loan for which a claim has been filed was made by an eligible lender which is not an educational institution, but for which the conditions set forth in paragraph (c) of this section exist, the Commissioner will determine the amount of the loss on such claim in accordance with the rules set forth in paragraph (b) (2) of this section.

(b) *Loans made by educational institutions.* (1) If the loan for which a claim has been filed was originally made by an eligible institution of higher education or vocational school, and the claim has been filed by such lender, the Commissioner shall deduct from the claim any amounts included therein which are attributable to either (i) a refund which the institution is obligated to make pursuant to § 177.63 of this part; or (ii) any portion of the program of study which the student was unable to complete due to the institutions' termination of its teaching activities during the period of time for which the student obtained a loan under this part. If the situation described in paragraph (b) (1) (ii) of this section arises, the lender shall not make any effort to collect on the loan from the student, shall not hold the loan during the grace period provided for in § 177.46(d) of this part, and shall promptly file a claim pursuant to § 177.48. The Commissioner shall reimburse the lender in an amount which bears the same ratio to the total amount of the loan as the amount of the educational services which the student received before the institution terminated its teaching activities bears to the total services which he would have received, during the period for which the loan was obtained, had the institution not terminated its teaching activities. The Commissioner will then determine whether, after the grace period has expired, the student is obligated to make any repayments on the loan and, if so, in what amount.

(2) If the loan for which a claim has been filed was originally made by an eligible institution of higher education or vocational school, but the claim has been filed by another eligible lender which obtained the note by transfer or assignment, the Commissioner shall deduct from the claim any amounts included therein which are attributable to (i) a refund which the institution became obligated to make, pursuant to § 177.63 of this part, prior to the transfer or assignment; or (ii) any payments made to the institution (or any other prior holder of the loan) which the lender filing the claim authorized to be made or knowingly permitted to be made, or which were made prior to or in the absence of a proper notice of the transfer or assignment having been sent to the student in accordance with § 177.49(b) of this part; or (iii) any portion of the program of study which the student was unable to complete due to the institution's termination of its teaching activities during the period of time for which the student obtained a loan under this part. The Commissioner will not deduct from the claim an amount which would be attributable to a refund which the institution became obligated to make after the date of the transfer or assignment, if the lender, prior to filing the claim, has made a diligent effort to obtain an assignment from the student of the right to receive such refund and, if the lender received such assignment from the student, has made a diligent effort to collect such refund from the institution. If, however, the student, prior to the transfer or assignment of the loan by the institution, had signed an authorization for the institution to apply the refund to the unpaid balance of the loan, the transferee or assignee will be held responsible for obtaining an assignment of such authorization and for making a diligent effort, prior to filing a claim, to collect such refund from the institution; if the lender fails to make such effort, the Commissioner will deduct from the claim any amount included therein which is attributable to a refund which the institution is obligated to make. If a lender holding a loan that was made by an educational institution has knowledge that the institution has terminated its teaching activities during the period of time for which the student obtained a loan under this part, the lender shall not make any effort to collect on the loan from the student, shall not hold the loan during the grace period provided for in § 177.46(d) of this part, and shall promptly file a claim pursuant to § 177.48; the lender will be reimbursed an amount which bears the same ratio to the total amount of the loan as the amount of the educational services which the student received before the institution terminated its teaching activities bears to the total services which he would have received, during the period for which the loan was obtained, had the institution not terminated its teaching activities. The Commissioner will then determine whether, after the grace period has expired, the student is obligated to make any repayments on the loan, and, if so, in what amount.

(c) *Loans made by lenders having special relationships with educational institutions.* For purposes of this section, a loan which has been made by a lender which is not an educational institution shall be treated, in accordance with paragraph (b) (2) of this section, as if it were a loan made by an educational institution and transferred to the lender on the date of the initial disbursement of the loan, in any case in which the lender: (i) has a majority of its voting stock held by an educational institution; or (ii) has common ownership or management with one or more educational institutions and more than 50 percent of the loans made under this part by the lender have been made to students at such institution; or (iii) has delegated to an educational institution substantially all of the functions and responsibilities normally performed by a lender prior to making a loan, such an interviewing the applicant for the loan, explaining the applicant's responsibilities under the loan, obtaining completion of necessary forms, obtaining necessary documentation, and (subject to § 177.48 (b) of this part) verifying that the student is eligible for the loan.

(20 U.S.C. 1080, 1082(a) (1))

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