UNITED STATES DEPARTMENT OF EDUCATION
WASHINGTON, D.C. 20202

In the Matter of **Docket Nos. 95-05-DA-S** [Consol.]See footnote 1[1]

Lewis M. Hall, John L. Magdiel, Carol Lee Lawhorn, Stephen E. Maloney, and Hal Turner,

Respondents.

Student Financial Assistance
Suspension and Debarment Actions

Appearances:

Robert C. Montgomery, Esq., Fruitland, Idaho, for the Respondents.

Brian P. Siegel, Esq., Office of the General Counsel, United States Department of Education, Washington, D.C., for Student Financial Assistance Programs.

Before:

Chief Judge Ernest C. Canellos

DECISION

The Respondents are the five Directors of the Student Loan Fund of Idaho (SLFI), a private, nonprofit corporation organized under the laws of Idaho. SLFI had been the designated guaranty agency for the State of Idaho in the Guaranteed Student Loan (GSL) Program, in accordance with §428(b) of the Higher Education Act of 1965, as amended (HEA); such a designation was implemented by five agreements between SLFI and the U. S. Commissioner of Education dated July 20, 1978.See footnote 2[2] The office of Student Financial Assistance Programs (SFAP), U. S. Department of Education (ED), oversees the federal student financial assistance programs authorized by the HEA including the GSL and FFEL programs.

- Procedural History -

On November 20, 1994, each board member was issued a separate Notice of Proposed Governmentwide Debarment and Suspension from Federal Nonprocurement Transactions pursuant to 34 C.F.R. § 85.312 and 34 C.F.R. § 85.411. In the notices, which are identical except for separately naming the Respondents, SFAP alleges that the Respondents "willfully failed to perform in accordance with public agreements between the Department and SLFI and have failed

to comply with directives issued by the Department" and, as such, they are subject to debarment under 34 C.F.R. § 85.305(b).See footnote 3[3] In response to the notices, on December 29, 1994, the Directors of SLFI requested hearings in both the debarment and suspension actions. The Respondents, *inter alia,* moved to join the debarment and suspension actions of all of the Directors and I consolidated these actions on March 31,1995.

On April 18, 1995, the Respondents moved that I suspend the proceedings until the issuance of a decision on an action which SLFI had filed in the United States District Court for the District of Idaho.See footnote 4[4] Although SFAP originally objected to the stay, it subsequently withdrew such opposition, and on May 2, 1995, I granted the motion. On September 14, 1995, the District Court issued orders on the substantive motions. The Respondents requested that the stay be continued; SFAP opposed; and after a conference call with the parties, I granted the stay pending an appeal of the District Court's Orders to the United States Circuit Court of Appeals for the Ninth Circuit. On December 13, 1996, the Ninth Circuit issued a Memorandum decision in which it reversed the District Court's decision relative to summary judgement and remanded the case back to the District Court for a trial on the merits. SFAP requested that the Ninth Circuit reconsider its decision which the Court denied. Subsequently, after I determined that no further postponements were appropriate, on June 25, 1997, I held an oral argument. Subsequently, the parties filed post-hearing briefs and I took the case under advisement.

-Facts and Issues -

Although the procedural history of this case has been long and circuitous, the underlying substantive issues are relatively simple and straightforward. As a background, the facts reveal that SLFI became convinced sometime prior to 1992, that because of changes Congress made to the HEA, its participation in the federal student financial assistance programs as a guaranty agency was no longer financially feasible. SLFI determined to end its status as a guarantor and, to that end, negotiated with the Northwest Education Loan Authority (NELA), the guaranty agency in the neighboring state of Washington, to transfer such responsibility to it. Part of those negotiations revolved around SLFI continuing to carry out business as a servicing agent for NELA's Idaho transactions. The two agencies reached an agreement in principal and on April 22, 1994, SLFI informed ED that it was providing the 60 days written notice of termination required under the agreements between SLFI and ED; and that, pursuant to that notice, those agreements would be terminated at the close of business on June 30, 1994. The Respondents claim that SLFI's letter was clear and showed its purpose was to cease guaranteeing any new loans but continue to service all of its existing guaranty obligations.See footnote 5[5]

ED's reaction was swift and direct. SLFI was informed that it had no authority to engage in discussions with NELA, any agreement between those parties was a nullity, and that ED would decide who would be designated as the new guaranty agency for Idaho. Interestingly, after considering the issue, SFAP decided that, indeed, NELA was the appropriate agency to be designated the new guarantor, however, it refused to approve the continued participation of SLFI as a servicer absent a clear showing that the arrangement was cost effective for the FFEL Program. To effectuate the transfer of guaranty agency responsibility from SLFI to NELA, on May 31, 1994, SFAP directed that SLFI, "transfer its outstanding guarantees, the defaulted loan

portfolio, and all of its reserve funds and assets to NELA." Later, on September 20, 1994, SLFI was directed to cease and desist any activities involving the FFEL Program. SLFI refused to comply with these directives on two basic grounds. First, some of its assets were its separate property and should not be turned over. Second, since the rules require that lenders must approve a transfer of guarantees from one agency to another, SLFI could still have contractual liability for its guarantees even if they were transferred to NELA. Ultimately, relations between SLFI and SFAP became strained and then acrimonious, the result of which was that the lawsuits were filed and the subject actions were initiated.See footnote 6[6]

It is readily apparent that there are two separate courses of action which are being pursued contemporaneously and one of the threshold questions is how do they interact. The first one involves the substantive issue of whether SLFI is in violation of its agreements with ED and, if so, what is SLFI's resulting liability. Included therein is the question of how much of SLFI's funds and property should be characterized as federal assets and, therefore, returnable to ED or its designee. Without question, that issue is before the District Court and I have no jurisdiction to influence that resolution. The other issue involves the five Respondents in this suspension and debarment case, over which I have the exclusive authority to decide. After the Ninth Circuit had issued its decision which found, in part, that a statutory predicate to the demand for return of funds had not been met by the Secretary, I posited the following to the parties, "[T]herefore the ultimate issue, here, is whether the Respondents may be held accountable, by the imposition of a debarment action, for the failure of SLFI to return funds over which a genuine dispute exists as to what amount of the funds are owed to the Federal government." In response to my solicitation of the parties' views on my observation, SFAP argued that "the Ninth Circuit's action is irrelevant to this proceeding since it does not address the individual Respondents' failure to comply with the directives from the time they became effective until the date the Ninth Circuit issued its decision." Also, SFAP argued that "the directives issued by the Department directed SLFI and its directors to: turn over defaulted loans and outstanding guarantees to the successor agency designated by the Department; cease and desist from the use of reserve funds without prior approval of the Department; and turn over reserve funds and reserve fund assets to the Department," something they have failed to do.See footnote 7[7] As previously mentioned, the Respondents view the Ninth Circuit's action as removing all possible bases for the debarment and suspension actions.

- Discussion -

As an initial observation, and despite SFAP's protestation to the contrary, I find that the merits of the dispute between SLFI and ED relative to SFAP's directives enumerated above are inextricably interwoven with the suspension and debarment actions before me. Any other decision would defy credulity. To hold individuals personally accountable for failing to comply with directives without determining what those directives were, or whether they were a legitimate exercise of authority, would certainly not comport with due process.

SFAP's contention that SLFI was obligated to comply with the ED's directives irrespective of the appropriateness of the directive appears to be at odds with the purpose for which debarment proceedings are used. The fulcrum of SFAP's argument rests on the assumption that upon receipt of the Department's directive, the SLFI board members had no choice other than to vote to

comply with the Directive. As a factual matter, SFAP's assumption was not only unfounded, but incorrect since the Ninth Circuit determined that the directives were procedurally defective and without legal effect. According to the Ninth Circuit, "[t]here was no evidence that the Secretary had made a 'best interest' determination" as required by 20 U.S.C. 1072(g)(1). The Ninth Circuit found that the May 16, 1994 and September 20, 1994 letters to SLFI from the Department "do not satisfy the statutory condition that the Secretary determines that such return is in the best interest of the operation of the program." Given that the Ninth Circuit determined that the Secretary had not met the statutory condition providing him with the requisite authority to require SLFI to return reserve funds to SFAP, it would be anomalous to find that the SLFI board members were, nonetheless, subject to debarment simply because SLFI challenged the correctness of the Department's directive without first following it. In this respect, I find SFAP's argument, that the fact that the SLFI board members' failed to vote to comply with the Department's directives warrants each board members' debarment, unpersuasive.

As a general premise, in any debarment action the burden of proof is on ED. 34 C.F.R. § 85.314(c)(2). The causes of debarment must be established by a preponderance of the evidence. 34 C.F.R. § 85.314 (c)(2). Generally, the existence of a cause for debarment does not necessarily require that the individual be debarred, rather the seriousness of the omissions and any mitigating factors must be considered in making the debarment decision. 34 C.F.R. § 85.300. Here, even assuming that SLFI violated SFAP's directives so as to make it subject to debarment, SFAP presented no direct evidence of which, if any of the Respondents made or were, otherwise, responsible for the decisions enumerated above. Of course, it is sometimes impractical for ED to uncover who is responsible for business decisions -- such decision-making processes are often not revealed. In recognition thereof, and in order to help to correctly attribute fault, the regulations provide that the "fraudulent, criminal or other seriously improper conduct of a participant may be imputed to any . . ., director, . . .who participated in, knew of, or had reason to know of the participant's conduct." 34 C.F.R. § 85.325 (b)(2). This imputation allows for the debarment of individuals for decisions they made for their principals. However, the imputation is limited to "fraudulent, criminal, or other seriously improper conduct," and not any lesser conduct. See generally, In re Marcus Katz, Docket No. 93-115-DA, U.S. Dep't of Educ. (January 18, 1994)

With that background, I will review the facts of the cases before me. The evidence of record reveals that SLFI determined to change its status as a guaranty agency which it had under agreements with ED; such change would include, at a minimum, that there would be no new guarantees after June 30, 1994. To effectuate that change, SLFI entered into an agreement with NELA that NELA would guaranty all new loans in Idaho and SLFI would turn over all the old guarantees and the "corresponding reserve funds." SLFI claims that it wished to continue in the program but in a modified manner, i.e. that it would continue to service existing guarantees because it was contractually obliged to do so and it would service NELA guarantees in Idaho. When SFAP was apprised of that situation, it refused to agree. SFAP basically decided that a designated guaranty agency had to either fulfill all program requirements of that function or remove itself completely. Therefore, NELA would be designated as the guaranty agency for Idaho, but NELA could not contract with SLFI unless NELA could show convincingly that such a set-up was cost effective. SFAP's position effectively undermined the NELA-SLFI agreement and it was abrogated. In a May 31, 1994 letter, SFAP directed SLFI "to transfer its outstanding

guarantees, the defaulted loan portfolio, and all of its reserve funds and assets to NELA." This demand was modified by a September 30, 1994 letter to provide, "This transfer must include the transfer of all legal ownership and control of SLFI's assets to NELA, including: defaulted loans; outstanding guarantees; any and all funds, in whatever form; SLFI's 'Reserve Fund'; SLFI's 'Operating Fund'; and all physical assets wholly or partially owned by SLFI."

It is interesting to note that at an initial hearing that I held by conference call, counsel for SFAP agreed that some of SLFI's funds were probably not federal funds and that SFAP was ready to negotiate over that issue. This negotiation, however, was to be accomplished only after SLFI had turned over all its funds to NELA -- if the negotiations culminated in an agreement that some of the funds were, in fact, really SLFI's, they would be returned. Since then, SFAP's position has changed somewhat -- all the funds must be returned because, although it has been given every opportunity to do so, SLFI has not presented any evidence to show that the funds are independently their own. SLFI disputes that it has not provided sufficient information establishing its entitlement to certain funds, and argues that following SFAP's directives would effectively put it out of business, something they could not recover from even if they subsequently prove that they were correct all along. Without submitting any evidence to that effect, SLFI alludes to bad faith on the part of SFAP, attributing SFAP's position to its desire to assist the administration's Direct Lending Program by discouraging its natural competitor, the FFEL program and its participants.

The main thrust of SFAP's theory of the case is that the Respondents are fiduciaries, and their failure to comply with SFAP's directions breached their fiduciary duty -- debarment is appropriate for this dereliction. On the other hand, the Respondents point out that, regardless of the type of duty they owe ED, under state law, they are held to the standard of a fiduciary and have a duty to safeguard the corpus of their nonprofit corporation. Put in perspective, SFAP asserts that the Respondents owe it a duty to immediately comply with its directives, including those dealing with the turning over of all of SLFI's assets to a third party with whom SLFI has no enforceable agreement, with an unsecured promise that if SLFI were able to establish that some of the assets were their own, they would be returned (by NELA). Contrariwise, the Respondents argue inferentially that complying with SFAP's directions would violate their fiduciary duties as enumerated above. According to the Respondents, their only solution to this conundrum of conflicting duties, was to refer this and all other associated issues to a court of proper jurisdiction and await its decision. This they point out they have done, therefore, they should not be subject to debarment. The Respondents argue further that SFAP's property interests are secure and protected since its records were reviewed by ED's Inspector General (IG) and the record indicates the IG found no failings therein, and the District Court was sufficiently satisfied of that fact so as to deny ED's request for the posting of a bond pending the Court's decision. As was mentioned earlier, all questions regarding who owns SLFI's property is solely within the jurisdiction of the District Court. The only relevance of those questions to these debarment and suspension actions is to recognize that there is clearly a dispute on that issue, and how the fact that there is such a dispute may have an impact upon my decision as to the Respondents' culpability in debarment.

The debarment of an individual has serious consequences -- that individual is precluded from participating in any way in a covered transaction under the nonprocurement programs of any

Federal agency, and is not eligible to receive any financial or nonfinancial assistance or benefits from any Federal agency. 34 C.F.R. § 85.100. However, it is the policy of the Federal Government to conduct business only with responsible persons, and debarment and suspension actions are appropriate means of implementing this policy. 34 C.F.R. § 85.115. In conjunction therewith, debarment and suspension actions may only be utilized to protect the public interest and may not be used for purposes of punishment. 34 C.F.R. § 85.115 (b). As to the basic issue of these proceedings, i.e. whether the Respondents' actions were sufficiently egregious under the circumstances so as to support debarment: my review of the evidence reveals that the answer is clearly "no." Therefore, I find that SFAP has failed to meet its burden of establishing that the five Respondents should be debarred.

On the basis of the foregoing, it is hereby ORDERED that the debarment and suspension actions are DISMISSED.

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Ernest C. Canellos
Deciding Debarment and Suspension Official

Dated: August 21, 1997

SERVICE

A copy of the attached decision was sent to the following:

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Footnote: 1 *[1]The following cases have been consolidated herein: Docket Nos. 95-6-DA, 95-7-DA-S, 95-8-DA, 95-9-DA-S, 95-10-DA, 95-11-DA-S, 95-12-DA, and 95-13-DA-S, and 95-14-DA.*

Footnote: 2 *[2]The authority of the U.S. Commissioner of Education currently resides in the Secretary of Education. The GSL program is currently called the Federal Family Education Loan (FFEL) program.*

Footnote: 3 [3]*34 C.F.R. § 85.305* ***Causes for Debarment*** *provides, in part:*

Debarment may be imposed . . . for:

. . .

(b) Violation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program, such as:

(1) A willful failure to perform in accordance with the terms of one or more public agreements or transactions;

Footnote: 4 [4]*On March 28, 1995, SLFI filed a Motion for a Writ of Mandamus. Contemporaneously, the District Court was considering ED's Motion for Summary Judgement and Judgement on the Pleadings on the same issues.*

Footnote: 5 [5]*The April 22, 1994 letter provides, "Please accept this letter as the 60 day written notice of termination required in out agreements. We will guaranty no additional loans under your program after June 30, 1994."*

Footnote: 6 [6]*In addition, on February 20, 1996, SFAP initiated an action to terminate the agreements between SLFI and ED under which SLFI acted as a guaranty agency, and impose an emergency action. I was the hearing official and, on May 21, 1996, I dismissed both actions as moot.*

Footnote: 7 [7]*Although SFAP insists that such a "best interest" determination had been previously made, on March 7, 1997, the Assistant Secretary for Postsecondary Education issued a letter addressed to the Chief Executive of SLFI, which states, "This letter constitutes our determination that the return of federal funds by the Student Loan Fund of Idaho (SLFI) is in the best interest of the Federal Family Education Loan (FFEL) Program. This determination is being made pursuant to the authority given to the Secretary of Education by statute. 20 U.S.C. § 1072(g)(1)."*
