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

In the Matter of **Docket No. 96-23-SL**

STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE), Student Financial Assistance Proceeding
Respondent.

Appearances:

Sheldon D. Repp, Esq., and Robert S. Lavet, Esq., Office of the General Counsel, Student Loan Marketing Association, Washington, D.C., for Student Loan Marketing Association.

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

Before:

Judge Richard F. O'Hair

DECISION UPON REMAND

This case comes before me in the form of a remand from the U.S. Secretary of Education (Secretary) following my initial decision dated, September 26, 1996, in which I held the respondent, the Student Loan Marketing Association (Sallie Mae), should not be limited from participating in the Federal Family Education Loan (FFEL) program. The Secretary, in his Remand Order, requested that I examine a heretofore unexplored issue. After having done so, I adhere to my original decision.

As background, this proceeding was initiated when the U.S. Department of Education's (Department) office of Student Financial Assistance Programs (SFAP) issued a notice of intent to limit the eligibility of Sallie Mae to participate as a lender in the FFEL program. SFAP alleged that Sallie Mae's contractual arrangements with Dr. William Scholl College of Podiatric Medicine (Scholl College) violated Section 435(d)(5)(A) of the Higher Education Act of 1965, as amended (HEA). 20 U.S.C.§1085(d)(5)(A). That statutory provision prohibits lenders from offering, directly or indirectly, “points, premiums, payments, or other inducements, to any educational institution or individual in order to secure applicants” for FFEL program loans.

After a rather lengthy description and analysis of the student loan process conducted at Scholl College and the many student loan services provided by Sallie Mae pursuant to its standard loan servicing contracts with Scholl College, I concluded that Scholl College, and not Sallie Mae, was the originating lender of student loans under the FFEL program, and that Sallie Mae had not offered “points, premiums, payments, or other inducements” to Scholl College “in order to secure loan applicants.”

Sallie Mae's arrangement with Scholl College is typical of the traditional loan servicing, forward financing, and loan

sale contracts used in the industry by Sallie Mae and other banks and guaranty agencies. Pursuant to a series of formalized agreements between Sallie Mae and Scholl College, labeled ExportSS Agreements and Revolving Financing Agreements, which were originally executed in 1992 and renewed in 1995, Sallie Mae agreed to service Scholl College's FFEL program loans and to issue Scholl College a $20 million line of credit to be used for those loans at a predetermined interest rate. More specifically, Scholl College is obligated to: 1) market student loans to its students, 2) prepare, distribute, and accept student loan applications, and 3) certify the loan applications. The school sends the certified loan applications to Sallie Mae which processes the loan applications, submits them to the guaranty agency for approval, disburses the loan payments from the line of credit bank account it maintains and controls for the college, and services the loans while they are held by the college. These are functions which are customarily performed by third party servicers in the FFEL program, as the regulations specifically authorize a lender, in this case Scholl College, to "contract or otherwise delegate the performance of its functions under the Act and this part to a servicing agency or other party." 34 C.F.R. § 682.203(a); *see also* 34 C.F.R. § 668.25(a). At a specified time before a loan enters repayment status, Scholl College is obligated to sell it at a predetermined price to Sallie Mae which then assumes the collection of loan payments. At this point Sallie Mae may also solicit borrowers to consolidate or take out additional loans. During the period Scholl College holds the student loans, the school receives interest and special allowance payments from the Department and, in all respects, is treated as the lender.

In my September 26, 1996, decision I found Sallie Mae did not violate the statute because there was no evidence that Sallie Mae was the originating lender in that it does not secure student loan applications; that procedure is conducted solely by Scholl College. The Secretary, in his remand of this case, asked that I re-examine the facts of this case to determine whether I might

> characterize a party as a lender under the FFEL program based on the substance of the transactions involved and in spite of their form.

Recognizing the absence of any statutory authority to look beyond the form of a transaction and "characterize a party", in this case Sallie Mae, as a lender under the FFEL program, SFAP has cited a number of federal court decisions which it believes address situations analogous to the issue before this tribunal. These decisions authorize a government agency to look beyond the formal structure of a commercial entity, or characterize it, to determine its true substance. The rationale for permitting this characterization is that the process is necessary to ensure that, despite its form, the true nature of the entity does not conflict with overriding federal legislative policies.See footnote 1[1] In the business setting, this characterization has been frequently applied where the federal agency involved is permitted to ignore the corporate veil in situations where the incorporators have been charged with violating a federal statute or policy but are seeking immunity based upon the corporate structure they have created. A typical example is found in *Thomas v. Peacock*, 39 F.3d 493, 503 (4th Cir. 1994), *rev'd on other grounds*, 116 S.Ct. 862 (1996), in which the court held that it was appropriate to ignore the corporate identity to prevent shareholders from avoiding their financial obligations to employee benefit plans, the type of conduct Congress intended to prevent.

In cases brought against business enterprises under the Truth in Lending Act, 15 U.S.C. § 1601, *et seq.*, courts have shown a willingness to characterize a credit enterprise or finance company (a business which ultimately holds consumer loans) as a creditor, even though the borrower entered a credit contract with a separate retail operation which subsequently transferred the loan obligation to the finance company. Most of these cases involved automobile dealerships which ostensibly extended credit to a buyer and this credit contract was later transferred to a finance company. Generally, the dealer had no intention of carrying the loan, but had previously arranged to assign it to the finance company which would then assume full responsibility as a lender. For purposes of allocating the rights and responsibilities under the Truth in Lending Act, the courts have been willing to overlook the form of the transaction and characterize the contractual relationships, treating both the dealer and the finance company as creditors.See footnote 2[2] SFAP asks that these same principles be applied here to label Sallie Mae as the true credit enterprise for the loans taken out by Scholl College students, but I refuse to make this analogy. Sallie Mae is unquestionably a lender or creditor in its arrangement with Scholl College, but it is clearly a creditor only to the school. Not only is this recognized in the forward funding documents the parties executed, but also reflected in the interest expense the college must pay to Sallie Mae and the limitation on the amount of credit which may be extended to Scholl College. The contracting out of the student loan approval function by itself is not indicative that Scholl College is not the lender. Additionally, the fact that Scholl

College holds the loans during a period in which it has very few servicing obligations and, as SFAP alleges, it “assumes no significant financial risk,” does not require a conclusion that Sallie Mae, and not Scholl College, is the lender of loans held by the latter. In fact, the services provided by Sallie Mae are those which may specifically be contracted out to a servicing agency or other party.

Courts have shown a similar willingness in the corporate setting to look behind a transaction between private parties to determine the tax consequences of a transfer of funds to a corporation. In these instances, courts will evaluate the essential characteristics, economic realities, and financial expectations in determining whether to treat this transfer as a loan to the corporation or a contribution to capital, regardless of the label the parties have given to this transaction.See footnote 3[3] SFAP argues that these cases further support its proposition that Sallie Mae should be treated as the originating lender. Once again, I disagree. SFAP relies on assertions that Scholl College posted no collateral for the line of credit other than the student loan notesSee footnote 4[4] and that Sallie Mae essentially controls the management of the loan transactions to include approval, disbursing of loan proceeds, and servicing the loan. This analysis overlooks the essential steps provided by Scholl College in competing with other lending institutions to attract potential borrowers, marketing the loans, receiving and forwarding the completed loan applications, obligating itself to Sallie Mae in the amount of the loans, suffering some risk of loss while holding the loans, and reimbursing Sallie Mae for the predetermined interest cost of the loans.

SFAP also cited several cases in the area of bank lending law in which courts were willing to ignore the fiction of a lender-borrower relationship when the lender has a contractual right to control the management of borrower.See footnote 5[5] Since Sallie Mae has not even arguably attempted to exercise any involvement in the management and operation of Scholl College, I do not believe an application of these cases is appropriate here.

In the cases cited by SFAP, the courts were faced with extraordinary situations where one of the parties was attempting somehow to avoid an obligation or gain an improper advantage by interjecting a third party into the relationship, or incorporating, or by placing unrealistic labels on certain transactions. To prevent this injustice and in furtherance of the interests of public convenience, fairness and equity, the courts were persuaded to disregard the form of a transaction and look at its substance.

After having considered SFAP's argument and supporting cases, I am unpersuaded that I should ignore the form of the transactions between Scholl College and Sallie Mae. Sallie Mae should not and cannot be characterized as the originating lender of loans to students enrolled at Scholl College. By federal statute, Sallie Mae is authorized to lend money to FFEL program lenders and originate, service, and purchase student loans. In fact, an SFAP witness admitted that if Scholl College were a bank and not a school lender, SFAP would have no complaint about its operations. There are no secret deals between Sallie Mae and Scholl College, and Scholl College had no obligation to contract with Sallie Mae. It could have chosen any number of other financial competitors which were capable of providing the same services as Sallie Mae. Regardless of which financial operation Scholl College chose to associate with, the college would still be characterized as the originating lender of the FFEL program loans it extended to its students.

In reaching this conclusion, SFAP's argument to the contrary, one cannot ignore the many contractual arrangements between the two parties which clearly label Sallie Mae as the lender to Scholl College and Scholl College as the borrower from Sallie Mae and the lender to its students, and these contracts clearly set out the specific responsibilities of each party. Following Sallie Mae's performance of its student loan processing, submission to the guaranty agency, and servicing arrangements, Scholl College becomes the holder of all student loans consummated pursuant to these agreements and it remains as such until the student loans enter the repayment stage and are sold to Sallie Mae. Sallie Mae does not consider itself to be the creditor of those student loans, in either a book keeping sense or as assets, until it purchases the loans at prescribed times. During the interim, Scholl College holds these loans and accepts all risks of loss, regardless of how insignificant they may be. More importantly, the Department also considers Scholl College to be the lender/creditor/holder of those loans. Consistent with this, the Department assigned Scholl College a lender identification number and appropriately has made regular payments to it for interest and special allowances. Additionally, in 1992 SFAP performed a program review of Scholl College's FFEL program and found it to be satisfactorily administered. One more persuasive argument for my holding that Scholl College, not Sallie Mae, is the student lender is that if I find that Sallie Mae is the lender and if I find that Sallie Mae should be limited from entering such loan arrangements in the future, SFAP has indicated it does not intend to void any existing loans held by Scholl

College. SFAP states it only wants to terminate the existing practice as it applies to future transaction between Sallie Mae and all school lenders. This means SFAP would continue to treat Scholl College as the lender while at the same time condemning any future extension of the current arrangements. I cannot condone such an inconsistent treatment of the loan process as it exists between the two parties. This leads me to conclude that Sallie Mae's rights and obligations under its forward financing and loan servicing agreements with Scholl College should not be viewed as a fiction which negates Scholl College's role as the lender of its students' FFEL program loans. Accordingly, the Department may not characterize Sallie Mae as the originating lender under the FFEL program, and thus it is unnecessary for me to further address whether Sallie Mae's conduct violates the provisions of Section 435(d)(5)(A) of the Higher Education Act.See footnote 6[6]

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Judge Richard F. O'Hair

Dated: July 18, 1997

SERVICE

A copy of the attached initial decision was sent by certified mail, return receipt requested to the following:

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Footnote: 1 [1] *Town of Brookline v. Gorsuch, 667 F.2d 215, 221 (1st Cir. 1982); Capital Telephone Co. v. FCC, 498 F.2d 734, 738 (D.C. Cir. 1974); H.P. Lambert Co. v. Secretary of Treasury, 354 F.2d 819, 822 (1st Cir. 1965).*

Footnote: 2 [2] *See Ford Motor Credit Co. v. Cenance, 452 U.S. 155, 101 S.Ct. 2239 (1981); Eustace v. Cooper Agency, Inc., 741 F.2d 294, 299 (10th Cir. 1994); Joseph v. Norman's Health Club, Inc., 532 F.2d 86, 91 (8th Cir. 1976); Kriger v. European Health Spa, Inc. of Milwaukee, Wis., 363 F.Supp. 334 (E.D. Wis. 1973).*

Footnote: 3 [3] *Saviano v. C.I.R., 765 F.2d 643 (7th Cir. 1985); Gibson Products Co. v. United States, 637 F.2d 1041 (5th Cir. 1981); Slappey Drive Industrial Park v. United States, 561 F.2d 572 (5th Cir. 1977).*

Footnote: 4 [4] *Sallie Mae disagreed with this observation and explained that Scholl College's obligations under their Forward Financing Commitment Agreement and the associated promissory note are general obligations of the college which generate a much broader obligation than SFAP suggests.*

Footnote: 5 [5] *In re K Town, 171 Bankr. 313 (Bk Ct., N.D. Ill. 1994); NCNB National Bank of North Carolina v. Tiller,*

814 F.2d 931, 936 (4th Cir. 1987).

Footnote: 6 [6] *Inasmuch as I have found that it is inappropriate for this tribunal to characterize Sallie Mae as an originating lender under the FFEL program, it is unnecessary for me to address the tangential question of whether to do so would constitute improper rulemaking through adjudication.*