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Update on Litigation and Audit Risks Facing Student Loan Lenders

Presentation for
Student Loan Capital Strategies LLC
Student Loan Industry Forum

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Department of Education Review of Schools and Lenders re Prohibited Inducements and Borrower Choice

- As outgrowth of Cuomo investigation Department sent letters in fall 2007 to numerous colleges and lenders.
 - Letters request extensive information from July 1, 2005 on, among other things, financial transactions between lenders and schools.
- Department continuing program reviews of lenders practices in connection with prohibited inducements provisions of HEA.
 - Focus of reviews on compliance with rules that existed prior to July 1, 2008 changes in the regulations.
 - Lack of clarity pre-July 2008 on lenders' private loan practices as FFEL inducement issue.
 - Possible sanctions.

Office of Inspector General – Final Audit Report Re Fifth Third Bank

(January 5, 2009)

- Fifth Third held legal title as ELT to \$3 billion dollars of FFEL consolidation loans under 3 separate trust agreements with MSA Solutions, Pacific Loan Processing and Law School Financing (“Marketing Companies”).
- Consolidation loans were “made” by 3 marketing companies through a trust under which Fifth Third held legal title to loans. Student Loan Express (“SLX”), which serviced the loans and financed the marketing companies, was a party to the trust agreement with Fifth Third and the Marketing Companies.
- Marketing Companies obtained completed loan verification certificates from consolidation borrowers.

- SLX purchased consolidated loans “made” by Marketing Companies for a premium using a separate trust under which Fifth Third acted as ELT.
- Department of Education’s Office of Inspector General (“OIG”) concluded that premiums SLX paid to Marketing Companies violated prohibited inducements provision of HEA.
- Central to OIG’s decision is that challenged activities did not involve the sale of existing loans between two lenders (neither SLX nor Marketing Companies are eligible lenders in their own right), but rather according to OIG simply provided for the payment of premiums by SLX to secure loan applications.

- As legal title holder, Fifth Third is considered responsible for any violations of HEA.
- OIG recommends that Fifth Third's participation under the three ELT Agreements be terminated, and that Federal Student Assistance ("FSA") assess fine against Fifth Third and/or terminate federal reinsurance on \$3B of loans.
- OIG also concluded that Fifth Third should be required to implement written procedures to monitor entities with which it has ELT Agreements.
- OIG recommendation now with FSA which will decide what to do.

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- OIG also referred numerous other ELT Agreements involving Fifth Third to FSA for further review.
 - The other ELT Agreements involve as much as \$13B in FFEL loans and include arrangements with other marketers who sold to lenders other than SLX.

■ Implications of OIG Findings

- Ruling will discourage bank lenders from holding legal title as ELT for non-bank lenders.
- Loans affected by OIG review have already been securitized.
- Those acting as ELT's will have to increase fees to compensate for increased risk.
- It was common industry practice for non-bank lenders to purchase consolidation loans from other non-bank entities that engaged in marketing activities – all these transactions now in question.

- OIG Interpretation seems inconsistent with past approach taken by FSA.
- HEOA now specifically limits prohibited inducement provision to points, premiums, payments, et. al, offered by lenders **to institutions of higher education or any employee of an institution of higher education.**
 - Conflicts between HEOA and regulations on application of prohibited inducement provisions.
 - Under current HEOA language, it is unclear whether OIG could successfully challenge the ELT arrangements.

Private Education Loan Market – Key Legal Proceedings

■ Discriminatory Impact Claims

- Putative class action against Sallie Mae in Federal Court in Connecticut. (*Rodriguez et. al v. Sallie Mae*, filed 12/18/2007.)
- Alleges that Sallie Mae's private loan pricing has discriminatory impact on minorities.
- Challenges use of school cohort default rates as factor in loan underwriting and pricing.
- Complaint alleges that Sallie Mae “steered” plaintiffs to substandard private loans on account of their race through relationships with colleges having high minority populations and discriminatory underwriting policies.

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- Proposed class is broadly defined in complaint as all minority persons who have or have had a private loan underwritten by Sallie Mae or one of its agents.
 - Complaint alleges violations of TILA, ECOA, and 42 U.S.C. §§ 1981-1982 (civil rights).
 - Could lead to copycat suits against other lenders if successful.

■ FTC Holder Rule Claims

- Lenders who make private loans at for-profit schools have increased litigation risks under FTC Holder Rule.
- FTC Holder Rule allows student borrower to assert claims he has against for-profit school against lender as defense against repayment of loan.
 - FTC Holder claims against Keybank, Student Loan Express (“SLX”), among others, arising from Silver States Helicopter school closing. (*Kilgore, et. al v. Keybank USA, et.al*, Superior Court, California, filed May 16, 2008.)

- Complaint alleges that lenders and servicers violated California Unfair Competition Law (B&P Section 7200) by, among other things, intentionally omitting FTC Holder Rule notice from promissory notes. Complaint also alleges that defendants' aided and abetted Ponzi scheme perpetrated by school officials.
- Losses on private loans made to Silver State students led to shareholder suit against CIT, parent of SLX, alleging CIT failed to disclose risk that it will have to write off \$179 million of private loans made to Silver State students.

Shareholder Class Action Litigation Claiming Lender Misrepresentations on Private Loan Portfolios

- Class action against CIT Group (filed July 25, 2008 in federal court in NY)
 - Alleges that CIT's (owner of SLX) financial statements failed to disclose likely write off of \$129 million in private loans made to Silver States flight school that went bankrupt.

- First Marblehead Corporation Securities Litigation (amended class action complaint filed November 28, 2008 in federal court in Mass.)
 - Complaint alleges FMD made host of material misstatements and omissions re quality of private loan portfolio, including:
 - Alleged misrepresentations re level of default rates.
 - Alleged misrepresentations re credit quality of private loans.
 - Failure to disclose that back-end residual interests in securitizations were materially impaired.
 - Failure to disclose that TERI was not positioned to adequately guarantee FMD's private loans.

- Complaint also alleges sales of stock by insiders violated Section 10(b)(5).
- Sallie Mae Shareholder Litigation
 - Consolidated class actions in federal court in NY
 - Complaint alleges Sallie Mae failed to engage in proper due diligence in originating loans to subprime borrowers, and further claims:
 - Sallie Mae's loan loss provisions for subprime borrowers were inadequate.
 - Sallie Mae had more extensive losses and defaults related to non-traditional portfolio than previously disclosed.