

Between a Rock and a Hard Place

Courthouse Doors Shut for Aggrieved Private Student Loan Borrowers

Acknowledgments

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Introduction

Until recently, there was little scrutiny of the private student loan market. Little was known about market participants and their practices, and the resulting impacts on borrowers and the overall economy. Much like the rest of the financial system, this largely unregulated and opaque market has allowed powerful financial institutions to reap enormous benefits at consumers' expense.¹ Additionally, in the student loan market, for-profit colleges have taken advantage of vulnerable student borrowers.

Charging high interest rates and penalties in alleged violation of state consumer protection laws, providing high-cost loans to borrowers who will likely be unable to repay their debts, and misrepresenting the quality of educations that they finance are just a few of the predatory practices of which private lenders and for-profit colleges have recently been accused.

The Consumer Financial Protection Bureau (CFPB or Bureau) recently released a report on the private student loan market,² which was preceded by a request for information regarding private education loans and lenders. Thousands of borrowers responded to the request, detailing a variety of grievances with their private student loan experiences.³

Borrowers' troubles are magnified by their lack of access to justice. Private student loan borrowers are often unable to seek redress for harms suffered at the hands of private lenders, loan servicers and other industry players, because contracts governing their loans dictate pre-dispute binding (or forced) arbitration. The terms require borrowers to resolve disputes with their lenders in private arbitration proceedings.

In April 2012, the Bureau launched a study on forced arbitration in contracts for consumer financial products and services as it is required to do under the Dodd-Frank Act. Following completion of the study, the Bureau can and should eliminate forced arbitration in private student loan contracts, because the lack of accountability resulting from these contract terms harms the consumer financial market and the public interest.

Financially distressed borrowers are also blocked from obtaining relief in bankruptcy proceedings. Until 2005, financially burdened borrowers of private student loans had an adequate mechanism to discharge (or cancel) their private student loan debt. But post-2005, students in deep financial despair who turn to the bankruptcy system for assistance

¹ Tiffany S. Lee, *No More Abuse: The Dodd-Frank and Consumer Financial Protection Act's "Abusive" Standard*, 14 J. Consumer and Com. L. 118, 126-127 (2011).

² Report on Private Education Loans and Private Educational Lenders, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No 111-203, 12 U.S.C. § 5602 (2010), <http://bit.ly/NVvBcz>.

³ Request for Information Regarding Private Education Loans and Private Educational Lenders, Document ID CFPB-2011-0037-0001, <http://1.usa.gov/Q7Klf0>.

are severely disadvantaged because their student loan debt cannot be extinguished unless they can demonstrate that their financial condition meets an arbitrary and undefined “undue hardship” standard. The result is that borrowers of private student loans lack a meaningful opportunity to seek relief in bankruptcy court. Congress must pass a law that would return the system to the pre-2005 bankruptcy treatment of private student loans.

Student borrowers’ predicaments with predatory student lending practices and deficient legal remedies necessitate action from both the Bureau and Congress. These changes will strengthen the rights of consumers with private student loans and restore their access to justice.

I. Private Student Loan Market in a Nutshell

Private student loans are awarded to borrowers outside the federal financial aid system and are not subsidized or insured by the federal government. Borrowers do not benefit from many of the protections and flexible repayment options that apply to federal loans, such as deferment, income-based repayment, and loan forgiveness.⁴ As a result, private student loans can be especially dangerous for borrowers who are presented with unforeseen repayment challenges.

Private student loans have the same characteristics as other forms of private unsecured consumer loans, such as credit cards.⁵ Just like credit card issuers, private student lenders consider credit score, debt-to-income ratio, and co-signor status as the primary indicators of a prospective borrower’s ability to repay.⁶

Private and federal lenders have different criteria for whether to extend credit to borrowers. For example, private lender Discover Financial Services highlights its strict current underwriting standards, with an average credit score⁷ of 740 on its portfolio and nearly 70 percent cosigned as evidence of its “disciplined” and “conservative” lending approach.⁸ Sallie Mae boasts that its 2011 originations had an average credit score of 748 and 91 percent of loans had a cosigner.⁹ These underwriting standards are in stark contrast to federal loans, which do not consider a prospective borrower’s credit score, debt-to-income ratio, or cosigner status. To qualify for a federal loan, a borrower must be 18 years old, a U.S citizen or eligible non-U.S. citizen, enrolled or admitted for enrollment at an

⁴ Private Loans: Facts and Trends, THE PROJECT ON STUDENT DEBT, July 2011, <http://bit.ly/oIxzDh>.

⁵ U.S. Private Student Loan ABS Criteria, Structured Finance, FITCH RATINGS, January 31, 2012.

⁶ SLM Private Education Loan ABS Primer, *Sallie Mae*, June 2011, at 11, <http://bit.ly/MxY8e8>.

⁷ FICO score (named for Fair, Isaac and Company) is the best-known and most widely used credit score model in the United States. FICO scores range from 300 and 850. The higher the score, the lower the predicted risk to creditors. The median FICO score is about 725. (Get Your FICO, SUZE ORMAN.COM, <http://bit.ly/pYuxfy>.)

⁸ Jackie Stewart, *Discover to Buy \$2.5B Student Loan Portfolio from Citi*, AMERICAN BANKER, Sept 2, 2011, <http://bit.ly/NAITkh>.

⁹ Primer on Private Education Loans, Sallie Mae Private Education Loans, SALLIE MAE, <http://bit.ly/Mug45E>.

eligible school, and maintain a satisfactory academic progress.¹⁰ The difference in treatment between federal government and private loans is likely related to the Department of Education's stated mission to "promote student achievement and preparation for global competitiveness by fostering educational excellence and ensuring equal access,"¹¹ whereas private lenders are motivated largely by profit.

A. The Size of the Market Is Relatively Small but Still Significant.

Private student loan debt accounts for roughly 15 percent, or \$150 billion, of the total roughly \$1 trillion outstanding U.S. student loan debt.¹² While this amount may seem like a relatively small share of the market, it has the potential to adversely impact a significant number of people. About 2.9 million students have private student loans, according to an analysis of the most recent data by The Institute for College Access and Success (TICAS).¹³

Students attending for-profit colleges use private student loans at much higher rates than students who attend conventional non-profit institutions. According to the most recent data available from the Project on Student Debt, an estimated 42 percent of for-profit college students used private loans in the 2007-2008 academic year. In contrast, 25 percent of students at private non-profit four-year schools and 14 percent of students at public four-year schools had private loans.¹⁴

B. The Market Grew Precipitously from 2000 Until the Financial Crisis in 2008. While the Market Plummeted in the Financial Crisis, It is Now Showing Signs of Growth.

As more students have enrolled in higher education in recent years, tuition costs have increased, and students have accumulated more debt.¹⁵ As Figure 1 shows, private student loan originations grew from \$6.4 billion in the 2000-2001 academic year, to \$24.3 billion in the 2007-2008 academic year. Then the market contracted as a result of the financial crisis.

¹⁰ Basic Eligibility Criteria, Federal Student Aid, An Office of the U.S. Department of Education, <http://1.usa.gov/NpVm9a>.

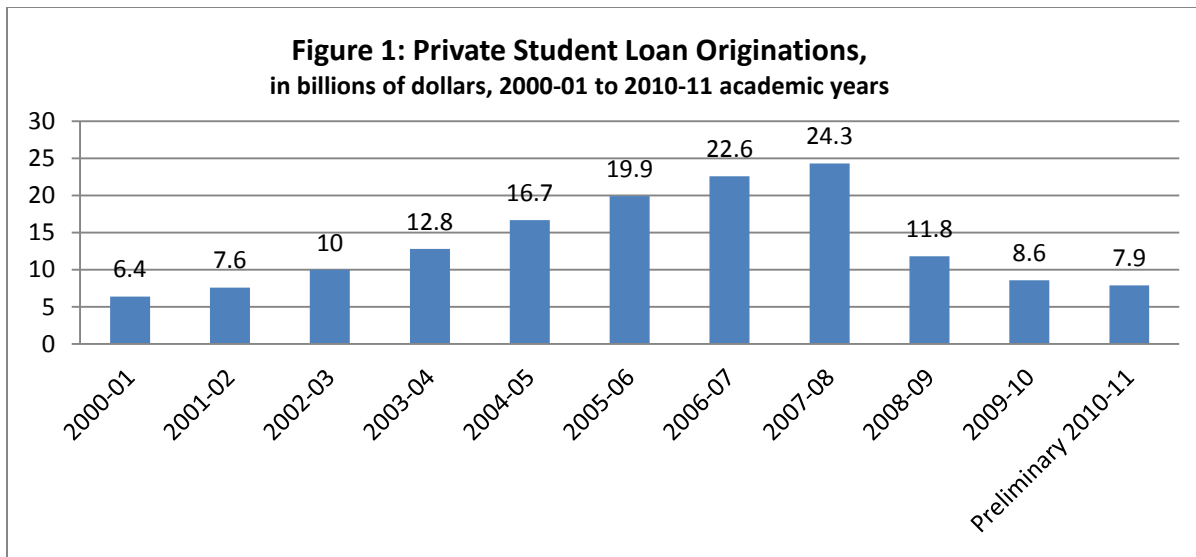
¹¹ See, e.g. U.S. Department of Education web site, <http://1.usa.gov/9zzim4>.

¹² Kevin Wack, *Geithner Hedges Bet on Durbin Student Loan Bill*, AMERICAN BANKER, Mar 28, 2011, <http://bit.ly/H1skZL>.

¹³ Janet Lorin, *Students Pay SLM 9.25% on Exploitative Loans for College*, BLOOMBERG NEWS, June 5, 2012, <http://bloom.bg/LjVnWq>.

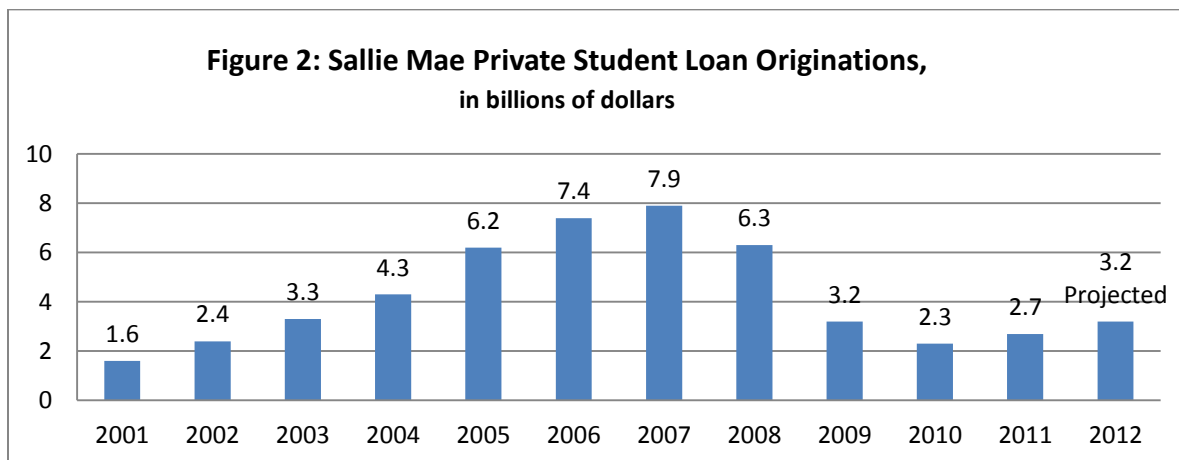
¹⁴ Private Loans: Facts and Trends, THE PROJECT ON STUDENT DEBT, July 2011, <http://bit.ly/oIxzDh>.

¹⁵ SLM Private Education Loan ABS Primer, SALLIE MAE, June 2011, at 5, <http://bit.ly/MxY8e8>.



Source: Trends in Student Aid, 2011¹⁶

There are signs, however, that private student loan originations may be increasing. Sallie Mae, the largest student lender, with roughly 40 percent market share in the 2010-2011 academic year,¹⁷ has steadily increased its originations since 2010. The company expects to continue this trend in the future. As Figure 2 shows, the institution is targeting \$3.2 billion in new originations this year, up from a post-recession low of \$2.3 billion in 2010.¹⁸ While its 2012 projection is considerably less than the company's peak of \$7.9 billion in 2007, the recent increase suggests a moderate rebound in the overall market.



Source: Authors' analysis of Sallie Mae's SEC disclosures

¹⁶ Trends in Student Aid 2011, THE COLLEGE BOARD, at 10, <http://bit.ly/vA7pXb>.

¹⁷ Private Credit Industry Originations, Sallie Mae Corporation Q1 2012 Investor Presentation, at 18, <http://bit.ly/OdSB6M>.

¹⁸ Sallie Mae Corporation Form 10-K, Annual Report Pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934, For the Fiscal Year Ended December 31, 2011, at 31, <http://bit.ly/QsO6LL>.

C. For-Profit Institutional Lending Does Not Resemble the Dynamics of the Overall Private Student Loan Market.

While financial institutions dominate the private student loan market, not all private student loans are originated by them.¹⁹ For-profit colleges also contribute to the private student loan market by lending their own institutions' funds to students.

Institutional lending varies from the overall private student loan market in several critical ways. These differences are driven largely by federal law. First, the so-called 90/10 rule requires for-profit colleges to receive at least 10 percent of their revenue from non-federal sources. This rule prohibits these schools from being funded exclusively by federal tax dollars that are distributed by the Department of Education.²⁰ To comply with the rule, for-profit colleges depend on their students financing their educations with private loans. Traditionally, private loans came from banks. But when the private market collapsed in 2008, those lenders decreased their funding activities. As a result, for-profit colleges needed a new source of non-federal funding. And so, they created and expanded private lending programs within their institutions.²¹ While data on the institutional loan market is not precise, the College Board estimates that institutional loans grew from about \$500 million in the 2007-2008 academic year to about \$720 million in the 2010-2011 academic year.²²

Another critical difference between private loans issued by banks and those issued by private colleges is that loans issued by banks are expected to be profitable directly; loans issued by private colleges, however, are expected to incur substantial losses as a result of nonpayment by borrowers. For example, California-based Corinthian College recently reported to investors that it expected a default rate of more than 50 percent on its student loan portfolio.²³ Despite this astronomical rate, its executives subsequently told investors that the company planned to double its origination volume.²⁴ This lending strategy is still profitable for for-profit colleges on the whole because the federal subsidies and other revenues that are gained outweigh the expected loan losses incurred.²⁵

¹⁹ Report on Private Education Loans and Private Educational Lenders, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No 111-203, 12 U.S.C. § 5602 (2010), at 29, <http://bit.ly/NVvBcz>.

²⁰ See 20 USC 1094(a)(24); Q&A on the For-Profit College "90-10 Rule," The Project On Student Debt, February 22, 2012, <http://bit.ly/M4Ogl4>.

²¹ Deanne Loonin, *Piling It On: The Growth of Proprietary School Loans and the Consequences for Students*, NATIONAL CONSUMER LAW CENTER, January 2011, <http://bit.ly/gGGuuu>.

²² Trends in Student Aid 2011, THE COLLEGE BOARD, at 13, <http://bit.ly/vA7pXb>.

²³ Corinthian Colleges, Inc. Q2 2010 Earnings Call Transcript, at 12, transcript <http://bit.ly/MQHyRH>.

²⁴ Corinthian Colleges, Inc. Q3 2011 Earnings Call Transcript, at 14, <http://bit.ly/Qcf9e8>.

²⁵ Deanne Loonin, *Piling It On: The Growth of Proprietary School Loans and the Consequences for Students*, NATIONAL CONSUMER LAW CENTER, January 2011, <http://bit.ly/gGGuuu>.

D. There Are Signs of Distress Ahead as Delinquencies and Defaults Remain High.

Indicators of timely private student loan repayment are troubling. The weak economy has caused continually high unemployment, especially for recent graduates. Additionally, larger student loan balances have made it difficult for many borrowers to make their payments. Consequently, the market has experienced persistently high delinquencies and defaults. For example, gross defaults are approximately triple pre-recession levels and the percentage of loans in repayment that are 60 or more days delinquent are more than double, according to a report published in February by the Toronto-based credit rating agency DBRS.²⁶

Loans that were originated before the market contracted in 2008 have performed particularly poorly, likely because of the pre-recession practice of lenders providing loans to borrowers who were poor credit risks. The credit rating agency Moody's recognized in early 2010 that the high default rates for private loan securitizations reflected weak underwriting in the period just prior to the crisis.²⁷

II. Predatory Practices in the Private Student Loan Market

Private lenders have recently been accused of a wide range of abuses that have harmed borrowers. Such alleged abuses have included charging high interest and penalties on loans in violation of state consumer protection laws, providing high-cost loans to borrowers who are unable to repay, and misrepresenting the quality of educational programs that their loans finance. As a result, there has been increased litigation by current and former students, and greater scrutiny of private student lenders and for-profit colleges by policymakers and regulators.

A. Private Student Lenders Have Been Accused of Charging High Interest Rates and Penalties, in Alleged Violation of State Consumer Protection Laws.

Several borrowers have recently sued private lenders for charging borrowers high interest rates and penalties, in alleged violation of various state consumer protection laws. In one case, Angelo Bottoni alleges that when he defaulted on his private Sallie Mae loans, Sallie Mae assessed a collection penalty of 25 percent of the principal and interest. Bottoni filed suit against Sallie Mae, claiming that the 25 percent fee was not reasonable and had no relation to the actual costs that Sallie Mae incurred from his default. Bottoni has asserted several legal claims based on California's consumer protection laws, including violation of

²⁶ Kate Berry, *Shrinking Private Student Loan Market Faces New Stress*, AMERICAN BANKER, October 6, 2011, <http://bit.ly/p3BTs2>; Karen Sibayan, *DBRS Releases Private SLABS Performance Report for 4Q11*, ASSET SECURITIZATION REPORT, Feb 13, 2012, <http://bit.ly/MnuTc2>.

²⁷ Tim Ranzetta, *Moody's Outlook For Student Loan Securities: Expect Negative Credit Trends For Private Loans In 2010*, STUDENT LENDING ANALYTICS BLOG, January 29, 2010, <http://bit.ly/aCgVUH>.

California's Civil Code, Legal Remedies Act, Unfair Competition Law, and Fair Debt Collection Practices Act. The case is pending.²⁸

In another case recently filed, Tina Ubaldi claims that when she was late on a monthly loan payment, Sallie Mae charged her daily interest despite fixed monthly loan payments customarily having a 15-day grace period. Ubaldi asserts that Sallie Mae also assessed a late charge for nonpayment. The result, according to Ubaldi, was paying Sallie Mae "twice—in two different ways—for being late on a single loan payment." She has asserted several claims based on California's Civil Code and Unfair Competition Law. That case is also pending.²⁹

The most recently filed case that has garnered public attention was brought by Justin Kuehn against Citibank, The Student Loan Corporation, and Discover Bank. Kuehn claims that he borrowed approximately \$100,000 in private student loans from The Student Loan Corporation that were being serviced by Citibank. Kuehn asserts that he paid \$845.72 per month through an auto-debit program. He then made principal payments of \$25,000 to repay the loan faster and reduce the total amount paid. Kuehn contends that subsequently, his loan was sold to Discover, but he was informed that Citi would remain his servicer. According to Kuehn's complaint, the defendants then unilaterally changed his monthly auto-debit payment to \$539.27. The effect of this change, Kuehn argues, was to offset his previous principal payments by extending the loan's repayment term and causing thousands of dollars in additional interest that he would be forced to pay over the life of the loan.³⁰ Kuehn's case is also pending.³¹

Because these cases are pending, not all judicial determinations have been made.

B. For-Profit Colleges Have Been Scrutinized For Predatory Lending Practices, Including Providing High-Cost Loans to Borrowers Who Will Likely Be Unable to Repay Their Debts, and Misrepresenting the Quality of Educations That They Provide and Finance.

For-profit colleges' predatory lending schemes have recently drawn significant scrutiny. For example, for-profit colleges have been accused of providing loans to students, knowing there is little likelihood that borrowers will be able to repay their debts. Several colleges expect default rates on their loan portfolios to be near 50 percent. For example, the

²⁸ *Bottoni et al. v. Sallie Mae, Inc.*, Case No. 4:10-cv-03602-LB (N.D. Cal 2011). Complaint <http://bit.ly/NBinVA>; Email with Ray Gallo, plaintiff's counsel (July 17, 2012) (on file with authors).

²⁹ *Ubaldi v. SLM Corporation*, 2012 WL 465198 (N.D. Cal 2012).

³⁰ Susanna Kim, Student Loans: Law Graduate Sues Lenders for Interest 'Scheme,' ABC NEWS, May 2, 2012, <http://abcn.ws/Ku8e8Y>; *Kuehn v. Citibank, N.A., The Student Loan Corporation, and Discover Bank*, Case 1:12-cv-03287-DLC, (S.D.N.Y. 2012).

³¹ Email with Justin Kuehn (July 12, 2012) (complaint on file with authors).

Colorado-based Westwood College charged borrowers 18 percent and expected a 44 percent default rate in the 2009-2010 academic year.³²

For-profit colleges have also been accused of misrepresenting the quality of educations that they provide and finance. Students enroll in programs believing they will receive quality training to prepare them for job placement, but they often graduate with debilitating debt and degrees that fail to qualify them for the jobs they seek. Some programs have been accused of misleading students about graduation, employment, and salary statistics, and of lacking accreditations necessary for graduates to practice in their desired fields.³³

Westwood recently came under fire for making misrepresentations during its admissions process, as well as for its deceptive lending practices. Among other allegations, students complained that the for-profit college enrolled them in the college's lending program, called APEX, without their knowledge or consent.³⁴ Colorado Attorney General John Suthers sued Westwood, claiming violations of Colorado's consumer protection laws. State officials recovered \$4.5 million from the institution, \$2.5 million of which will be paid directly to students who financed their tuition with the school's lending program.³⁵

Regulators and policymakers have turned their attention to alleged bad practices by for-profit schools. For example, a bipartisan working group of 23 state attorneys general is examining many aspects of for-profit colleges, including their lending practices.³⁶ In addition, the Senate Health, Education, Labor and Pensions (HELP) Committee has conducted an exhaustive investigation of the for-profit college industry.³⁷ Its findings are expected soon.

In addition, the CFPB has begun to scrutinize for-profit lending. On April 3, 2012, the CFPB served Corinthian College with a Civil Investigative Demand, seeking to "determine whether for-profit postsecondary companies, student loan origination and servicing providers, or other unnamed persons, have engaged or are engaging in unlawful acts or

³² Institutional Loans: High Interest Rate -- Low Expected Repayment, Senator Tom Harkin For-Profit College Investigation, at 5, <http://1.usa.gov/k9H7ld>.

³³ See e.g. For-Profit Colleges: Undercover Testing Finds Colleges Encouraged Fraud and Engaged in Deceptive and Questionable Marketing Practices, Government Accountability Office Report, August 2010, <http://1.usa.gov/9TP0Tr>; See also *Rude v. Nuco Education Corp*, 2011 WL 6931516 (Ohio Ct. App. 2011).

³⁴ Press Release, Colorado Attorney General's Office, "Attorney General announces \$4.5 million settlement with Westwood College to address deceptive business practices," (March 14, 2012), <http://bit.ly/PmAT5V>; complaint at 8.

³⁵ *Id.*

³⁶ Jack Conway, "The Looming Student Debt Crisis: Providing Fairness For Struggling Students," Testimony of Kentucky Attorney General Jack Conway before the Senate Judiciary Committee/Subcommittee on Administrative Oversight and the Courts, March 20, 2012, at 7, <http://bit.ly/xwPL9H>.

³⁷ Senator Tom Harkin For-Profit College Investigation, <http://1.usa.gov/k9H7ld>.

practices relating to the advertising, marketing, or origination of private student loans.”³⁸ On May 18, 2012, the CFPB served ITT Educational Services with a similar demand.³⁹

III. Shut Out from Justice: Borrowers Are Denied Reasonable Access to Legal Remedies

Many students victimized by flawed student loan industry practices turn to the legal system seeking to recover for their losses. However, they find that the legal system suffers from shortcomings of its own. The web of predatory terms and conditions in loan promissory notes includes severe restrictions on access to the court system, particularly predispute binding (or forced) arbitration clauses. These clauses require students to resolve disputes with lenders in private arbitration instead of in open court. Further, financially distressed students who turn to bankruptcy court for relief are blocked by a law that makes it virtually impossible for them to cancel their student loan debt. The result is that borrowers are left without adequate redress.

A. Forced Arbitration Exacerbates Abusive Practices.

Private arbitration lacks critical benefits of the public court system. It is typically a one-sided endeavor where businesses, in this case, banks and institutional lenders, set the rules to govern the arbitration, select the organization that administers the arbitration, and may dictate the location of the arbitration. A typical arbitrator charges hourly fees and there are often other service charges, including fees to initiate the proceedings. There is minuscule opportunity to appeal an unfavorable arbitration decision. Arbitrators are not required to apply state consumer protection or even federal lending laws. Further, arbitration offers little transparency. Even if the issues in a dispute relate to conduct that could impact the public interest, a matter forced into arbitration will likely remain hidden from the public.

The National Consumer Law Center, which calls arbitration clauses “hallmarks of predatory loans,”⁴⁰ reviewed the note terms of 28 private student loans issued between 2001 and 2006,⁴¹ and found that 61 percent of the loans required arbitration.⁴² The number of private loan notes with arbitration requirements likely has increased since these findings,

³⁸ Corinthian Colleges, Inc. Form 10-Q, Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the Quarterly Period Ended March 31, 2012, at 18, <http://bit.ly/OcusU4>.

³⁹ ITT Educational Services, Inc. Form 8-K, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, Filed May 22, 2012, at 18, <http://bit.ly/LveXjl>.

⁴⁰ Deanne Loonin and Alys Cohen, Paying the Price: The High Cost of Private Student Loans and the Dangers for Student Borrowers, NATIONAL CONSUMER LAW CENTER, March 2008, at 4, <http://bit.ly/MwRoIa>.

⁴¹ Loonin and Cohen, at 4.

⁴² *Id.*

paralleling the overall trend of increasing use of arbitration clauses in consumer contracts.⁴³

The terms for loans with forced arbitration clauses often prohibit students from joining together collectively in class actions.⁴⁴ Class actions can provide an efficient method to resolve similar consumer claims in one proceeding. Bars on class actions, on the other hand, make lawsuits cost-prohibitive, particularly for small-dollar claims, which most consumers could not pursue individually. Consequently, the bans on class actions suppress claims and effectively deprive consumers of their statutory protections. Courts around the country had held that these types of class action bans violated state laws because the terms were “unconscionable” or egregiously unfair to consumers. But the U.S. Supreme Court disagreed. In 2011, the Court issued its opinion in *AT&T Mobility v. Concepcion*,⁴⁵ broadly interpreting the Federal Arbitration Act, the federal statute governing arbitration, to block states from prohibiting class action bans inserted within forced arbitration clauses.

While many corporations had already begun to insert class action bans in their consumer and employment contracts, the *Concepcion* decision amounted to a virtual endorsement of their use. As a result, the practice has become more widespread. Businesses that issue contracts with their consumer products and services have been successful in using class action bans to suppress consumer claims and avoid the need to defend against allegations of misconduct, which in turn allows them to resist fixes to harmful practices.⁴⁶ Corporations in the private student lending industry have joined in the use of this practice.

*Loan Payment Calculation Methods are Questioned, but Concepcion May Limit Borrowers’
Access to Remedies.*

In 2006, law school graduate Joshua Fensterstock sought to consolidate his loan by borrowing from financing company Education Finance Partners (EFP), and the loan was serviced by Affiliated Computer Services (ACS).⁴⁷ Fensterstock alleged that the companies were applying an improper method to determine how much of a loan payment to apply to the loan principal, rather than to interest.⁴⁸ The lenders would apply payments differently depending on the date they were received, regardless of whether they were received

⁴³ See, e.g. Zachary Zima, et al. *Forced Arbitration: Unfair and Everywhere*, PUBLIC CITIZEN, Sept. 14, 2009, <http://bit.ly/IMCsCr>.

⁴⁴ See, *Kilgore v. KeyBank, Nat. Ass'n*, 673 F.3d 947 (9th Cir. 2012).

⁴⁵ *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011).

⁴⁶ Christine Hines, et al. *Justice Denied, One Year Later: The Harms to Consumers from the Supreme Court’s Concepcion Decision Are Plainly Evident*, PUBLIC CITIZEN, April 2012, <http://bit.ly/JcxLlw>.

⁴⁷ *Fensterstock v. Education Finance Partners and Affiliated Computer Services*, 618 F.Supp.2d 276 (2009) rev. by *Affiliated Computer Services, Inc. v. Fensterstock*, 131 S.Ct. 2989 (June 13, 2011). See also, Mark Hamblett, *Federal Court Bars Arbitration Over Student Loan Terms, Decision by New York federal court paves the way for a possible class action*, NEW YORK LAW JOURNAL, March 30, 2009, <http://bit.ly/NJX4Dt>.

⁴⁸ *Fensterstock*, 618 F.Supp.2d 276, at 277-278.

before the due date.⁴⁹ Fensterstock described the practice as a hidden penalty on the loan, and filed a class action against EFP and ACS on behalf of himself and other students whose loans were receiving similar treatment. He asserted claims of breach of contract and fraud against both companies,⁵⁰ and deceptive advertising against EFP, which had marketed and issued the loan to him.⁵¹

The promissory note drafted by EFP contained an arbitration clause and prohibited class actions. In March 2009, the federal district court in New York found that the class action ban was “unconscionable” and unenforceable. Among other factors, the trial court found that the unfair terms were presented on a “take it or leave it” basis and that students had no opportunity to negotiate the terms.⁵²

The trial court denied the lenders’ motion to compel individual arbitration, seemingly clearing the way for the borrowers’ claims to move forward in court. The lenders appealed, but the U.S. Court of Appeals for the Second Circuit affirmed the lower court’s decision in July 2010.⁵³ The lenders then asked the U.S. Supreme Court to hear the case. In April 2011, before the Court acted on Fensterstock’s case, it issued its *Concepcion* decision. Nearly two months later, the Supreme Court vacated the Second Circuit’s decision in light of *Concepcion*.⁵⁴

After the Supreme Court’s decision, the Second Circuit directed the trial court to decide other issues that could determine whether the case would go to arbitration, including whether ACS, which did not sign the promissory note, could legally enforce the arbitration clause.⁵⁵ The case is pending, but *Concepcion* will likely impact the students’ ability to seek to hold the lenders accountable for potentially bad practices.

“Poster Child for Financial Reform” Unable to Seek Justice Against Lender.

In 2010, before the passage of the Dodd-Frank Act, the San Francisco Chronicle referred to Matthew Kilgore as a “poster child for financial reform.”⁵⁶ Kilgore is a former student of a for-profit school, and was the lead plaintiff in what turned out to be a landmark California case following the *Concepcion* ruling. The case provides a vivid example of how arbitration clauses that ban class actions deprive consumers of their ability to enforce their rights under critical consumer protection laws.

⁴⁹ *Fensterstock*, 618 F.Supp.2d 276.

⁵⁰ *Id.*

⁵¹ *Id.* at 278.

⁵² *Id.* at 279.

⁵³ *Fensterstock v. Education Finance Partners*, 611 F.3d 124 (2nd Cir. 2010), vacated sub nom. *Affiliated Computer Servs., Inc. v. Fensterstock*, 131 S. Ct. 2989 (2011)

⁵⁴ *Affiliated Computer Services, Inc. v. Fensterstock*, 131 S.Ct. 2989 (Mem) (2011).

⁵⁵ *Fensterstock v. Education Finance Partners*, 426 Fed.Appx. 14 (2011).

⁵⁶ San Francisco Chronicle, *Would-be pilots stuck in debt after firm closes*, May 12, 2010, <http://bit.ly/M0EKBS>.

Kilgore was enrolled at Silver State Helicopters LLC, a national aviation school, which went bankrupt and abruptly closed in 2008.⁵⁷ Kilgore and other students were unable to complete their programs and each one was left with thousands of dollars in student loans from KeyBank, and with no course certificate or employable skills. Kilgore had noticed red flags while attending, such as helicopters disappearing from the school's fleet and unexpected departures of instructors, but he determined that leaving the school would be difficult.⁵⁸ According to the contract terms, if he had left the school before the course ended he would have been subject to penalties up to \$15,000.⁵⁹

On behalf of himself and other students, Kilgore brought a class action against KeyBank, seeking an injunction to prevent the bank from enforcing the borrowers' loan contracts and from reporting non-payment of loans to credit agencies.⁶⁰ KeyBank, whose loan terms included a forced arbitration clause and class action ban, moved to compel individual arbitration. Kilgore resisted on the ground that California law prohibited arbitration for claims seeking public injunctive relief. Under this principle of California law, a plaintiff may act as a private attorney general to stop "future deceptive practices on behalf of the general public."⁶¹ Ultimately, however, the U.S. Court of Appeals for the Ninth Circuit, citing *Concepcion*, held that California's public injunction exception was preempted by the Federal Arbitration Act.⁶² The court acknowledged that its decision to enforce the arbitration clause may "reduce the effectiveness of state laws."⁶³ Indeed, the California law, which could have stopped an alleged predatory practice, was rendered ineffective.

For-Profit Colleges Are Able to Hide Their Bad Practices Behind Veil of Forced Arbitration and Class Action Bans.

Many for-profit colleges, including some that have been accused of engaging in deceptive practices to lure students to enroll in their courses and take on burdensome loans, also include terms in their contracts to force individuals into private arbitration. In recent report filings to the Securities and Exchange Commission, Corinthian Colleges Inc., an operator of numerous for-profit schools, alluded to its use of forced arbitration and class

⁵⁷ Steve Friess, *Helicopter School Closes, Leaving Students in Lurch*, NEW YORK TIMES, Feb. 13, 2008, <http://nyti.ms/MwIQbR>.

⁵⁸ San Francisco Chronicle, <http://bit.ly/M0EKBS>.

⁵⁹ *Id.*

⁶⁰ *Kilgore v. Keybank*, Nat. Ass'n, C 08-2958 TEH, 2009 WL 1975271 (N.D. Cal. July 8, 2009) rev'd, *Kilgore v. KeyBank*, Nat. Ass'n, 673 F.3d 947 (9th Cir. 2012).

⁶¹ *Kilgore v. KeyBank*, Nat. Ass'n, 673 F.3d 947, at 959 (9th Cir. 2012). Also, discussed in Hines, *Justice Denied, One Year Later: The Harms to Consumers from the Supreme Court's Concepcion Decision Are Plainly Evident*, PUBLIC CITIZEN, April 2012, <http://bit.ly/JcxLlw>.

⁶² *Kilgore*, at 960.

⁶³ *Id.*

action bans in its recount of pending cases filed by former students.⁶⁴ The school noted its practice of routing potential class actions into individual arbitration, in accordance with provisions in its student enrollment contracts.⁶⁵ That is, each student's case was or could be forced out of court and into arbitration on an individual basis despite the similarity in the students' claims against the school.

Students in several cases claimed that school representatives misrepresented facts about the quality of education, transferability of credits, and costs of attendance. Nevertheless, the company declared that "the complaints are contractually required to be resolved in individual arbitrations between the named students and the company, and the company has moved, or will move to compel these cases to arbitration."⁶⁶ The inability of these borrowers to enforce important consumer protections in court further demonstrates the consequences of forced arbitration on consumers and the student loan market.

B. The 2005 Bankruptcy Law Denies Student Borrowers Redress.

To further increase their leverage over student borrowers, private lenders secured more protections for themselves in the bankruptcy code. While bankruptcy should be treated as a last resort, it is an organized system to allow individuals to escape untenable financial predicaments. Federal and private student loans, along with child support, alimony, taxes, and criminal fines, are among the few types of debts that generally cannot be discharged, or canceled in bankruptcy.⁶⁷ Most other types of debts, including those relating to other credit products, are dischargeable in either a Chapter 7 liquidation process or Chapter 13 debt adjustment plan.⁶⁸

Prior to 1976, all student loan debt was treated the same as credit cards or any other type of unsecured debt, and was dischargeable in bankruptcy. However, a series of subsequent changes to the bankruptcy laws made it nearly impossible to discharge federal loans. In 2005, as part of a comprehensive rewrite of the Bankruptcy Code that made it more difficult for consumers to file personal bankruptcy, Congress added most private student loans in the non-dischargeability category.⁶⁹ During the years that the bankruptcy bill was

⁶⁴ Corinthian Colleges, Inc. Form 10-Q, Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, For the Quarterly Period Ended March 31, 2012, at 15-16, <http://bit.ly/QcusU4>.

⁶⁵ *Id.* at 16.

⁶⁶ *Id.*

⁶⁷ *See*, Administrative Office of the U.S. Courts, Discharge in Bankruptcy, <http://1.usa.gov/MUI6s2>.

⁶⁸ *The Student Loan "Debt Bomb": America's Next Mortgage-Style Economic Crisis?* A Report Prepared for the National Association of Consumer Bankruptcy Attorneys (NACBA), at 7, <http://bit.ly/zrc0X7>.

⁶⁹ Bankruptcy Abuse Prevention and Consumer Protection Act, P. L. 109-8 (Oct. 17, 2005).

under discussion, there was little examination of whether such a fundamental change in policy was necessary.⁷⁰

The 2005 bankruptcy law gave private loans a similar bankruptcy shield as exists for federal loans even though federal loans provide borrowers substantially more protections. Federal loan terms include provisions designed to facilitate fairness in the system, such as fixed interest rates; flexible repayment plans; and relief in times of unemployment, death, or disability; and deferment programs.⁷¹ Private loans need just as much if not more protections for borrowers because the loans carry the harshest terms.⁷²

These statutory changes to the dischargeability of federal and private student loans in bankruptcy were made despite the absence of empirical evidence that student borrowers were abusing the bankruptcy system.⁷³ Deanne Loonin, an attorney and director of a student loan borrower program at the National Consumer Law Center, aptly noted, “People who borrow to pay for education are trying to improve their financial situations, not ruin them.”⁷⁴

Further, the Bankruptcy Code already safeguards against potentially abusive behavior by individuals who might seek to take advantage of its protections. For example, debt for money obtained by false pretenses or fraud is not dischargeable.⁷⁵ “Thus, where a debtor obtains a student loan intending to seek a discharge prior to or shortly after completing his education and the creditor justifiably relied on the representation of the debtor that repayment would be forthcoming,” that student loan could not be canceled.⁷⁶

To seek cancellation of student loan debt, the 2005 bankruptcy law allows a debtor to show “undue hardship.”⁷⁷ The standard, which is undefined in the statute, has made it virtually impossible for a debtor to discharge student loans in bankruptcy.⁷⁸

⁷⁰ Deanne Loonin, *Responses to Questions for the Record*, at 2. Hearing on the Looming Student Debt Crisis: Providing Fairness for Struggling Students, <http://bit.ly/SPhOJA>.

⁷¹ Lauren Asher, “*An Undue Hardship? Discharging Educational Debt in Bankruptcy*,” Testimony Before the House Committee on the Judiciary Subcommittee on Commercial and Administrative Law Oversight Hearing: Sept. 23, 2009, <http://1.usa.gov/NuQ62N>.

⁷² *See Id.*

⁷³ Rafael I. Pardo and Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Educational Debt*, 74 U. Cin. L. Rev. 405, 426 (Winter 2005), <http://bit.ly/MrkZnS>.

⁷⁴ Deanne Loonin, “*The Looming Student Debt Crisis: Providing Fairness for Struggling Students*,” Testimony before the U.S. Senate Judiciary Subcommittee on Administrative Oversight and the Courts, at 8, March 20, 2012, <http://bit.ly/Lq24fj>.

⁷⁵ Bankruptcy Code, Section 523(a)(2).

⁷⁶ Pardo and Lacey, at 430.

⁷⁷ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

⁷⁸ Richard Fossey and Robert C. Cloud, *From the Cone of Uncertainty to the Dirty Side of the Storm: A Proposal to Provide Student-Loan Debtors Who Attend For-Profit Colleges With Reasonable Access to Bankruptcy Court*, 2011 WL 6026133, at 11 (Nov. 24, 2011).

To determine whether “undue hardship” exists for borrowers so as to allow cancellation of student loans, most bankruptcy courts rely on the so-called Brunner test, based on the 1987 case *Brunner v. New York State Higher Education Services Corp.*⁷⁹ Indebted borrowers must prove that: (1) they cannot maintain a minimal standard of living for themselves and their dependents if forced to repay their student loans; (2) that their poor financial condition is likely to persist for a significant portion of the repayment period of their student loans; and (3) that they made good-faith efforts to repay their loans.

This vague standard has led to varied interpretations by courts considering these cases, but the effect has been the same. According to a report prepared for the National Association of Consumer Bankruptcy Attorneys often it is only “borrowers very close to the poverty level with little or no hope for improvement (who) are considered eligible.”⁸⁰

Further, to seek a discharge, a student-borrower must initiate legal proceedings against the creditor, incurring substantial costs in addition to his or her existing financial burdens.⁸¹

Private Lending Practices at For-Profit Schools Necessitate More Consumer Protection in U.S. Bankruptcy System.

Individuals who borrowed to attend for-profit institutions have the highest student-loan default rates, and suffer disproportionately from bankruptcy law provisions that make it extremely difficult to discharge student loans in bankruptcy.⁸²

Between 2005 and 2008, third-party lenders increasingly began offering student loans to finance courses at for-profit schools. For example, “Sallie Mae reported that its “non-traditional” loan portfolio grew from \$3.7 billion at the end of 2006 to \$5.1 billion at the end of 2008...”⁸³ When these loans began to fail, the lenders left the market, and many schools initiated their own financing programs with similar credit products.

The bankruptcy law particularly harms students who were led to believe that these for-profit programs would help them secure jobs and careers. In many bankruptcy courts, the educational value, or lack thereof, that the borrower received from the loan is not a factor in considering whether to cancel the loans.⁸⁴

⁷⁹ *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987). See also, Richard Fossey and Robert C. Cloud, 2011 WL 6026133, at 11.

⁸⁰ *The Student Loan “Debt Bomb”: America’s Next Mortgage-Style Economic Crisis?* A Report Prepared for the National Association of Consumer Bankruptcy Attorneys (NACBA), Feb. 7, 2012, bit.ly/zrc0X7.

⁸¹ Testimony of Rafael I. Pardo, ABI Members Testify on Discharging Student loan Debt in Bankruptcy, 28-NOV AM. BANKR. INST. J. 10, (Nov. 2009).

⁸² Richard Fossey and Robert C. Cloud, 2011 WL 6026133, at 13.

⁸³ Asher testimony, FN 10, at 7.

⁸⁴ Richard Fossey and Robert C. Cloud, 2011 WL 6026133, at 11.

Even worse, there are numerous accounts of for-profit schools that lose accreditation and close down while students are in the midst of finishing their programs, but the private loans don't go away.⁸⁵ Students remain saddled with the "expensive and often unaffordable loans, which cannot be discharged in bankruptcy," said Illinois Attorney General Lisa Madigan, in hearing testimony before a U.S. Senate subcommittee examining private student loan practices. In January 2012, Madigan's office sued for-profit Westwood College "for engaging in deceptive practices that saddled Illinois students with up to \$80,000 in debt for degrees that failed to qualify them for careers in criminal justice."⁸⁶

Madigan, noting the lack of protections for students with private loans compared to those with federal loans, joins other state attorneys general investigating the private lending and underwriting practices of for-profit schools.⁸⁷

IV. Policy Recommendations: The CFPB and Congress Can Restore Consumers' Access to Justice

Section 1028 of the Dodd-Frank Act authorizes the CFPB to employ a remedy that could help generate fairness and accountability in the student loan industry. The Bureau is tasked with completing a study on the use of forced arbitration in contracts for student loans, and all other consumer financial products and services. After completing the study, the Bureau may eliminate or limit forced arbitration in contracts under its jurisdiction if it finds that such restrictions on forced arbitration are in the public interest and for the protection of consumers. The Bureau launched the study in April 2012, indicating that the prompt initiation of the project appears to indicate that it is an important issue for the agency's leadership.⁸⁸

The evidence is clear that forced arbitration is a hindrance to student borrowers in the aggressive and unforgiving private loan market. Accordingly, the CFPB should prohibit the use of forced arbitration clauses in private student loan contracts. Because the inherent unfairness of forced arbitration exists for the resolution of all other types of disputes regarding consumers, the CFPB should avail itself of its authority to ban these clauses in contracts for all consumer financial products and services.

⁸⁵ See, *Kilgore v. Keybank*. See also, Testimony of Kentucky Attorney General Jack Conway, before the Senate Judiciary Committee, Subcomm. on Admin. Oversight and the Courts, March 20, 2012, <http://bit.ly/PZrQtU>.

⁸⁶ Madigan testimony, at 3, bit.ly/NU2E48.

⁸⁷ Jack Conway, "The Looming Student Debt Crisis: Providing Fairness For Struggling Students," Testimony of Kentucky Attorney General Jack Conway before the Senate Judiciary Committee/Subcommittee on Administrative Oversight and the Courts, March 20, 2012, at 7. <http://bit.ly/xwPL9H>.

⁸⁸ Scope, Methods, and Data Sources for Conducting Study of Pre-Dispute Arbitration Agreements, 77 FED. REG. 25148, April 27, 2012, <http://1.usa.gov/SKb27Y>.

Two bills are pending in Congress that could restore a critical protection for student borrowers that the 2005 bankruptcy law had eliminated. The Fairness for Struggling Students Act of 2011 (S. 1102) and the Private Student Loan Bankruptcy Fairness Act of 2011 (H.R. 2028) would amend the federal bankruptcy code to allow qualified educational loans to be discharged in bankruptcy. The bills would again treat private student loans the same as other types of unsecured credit and assure reasonable access to justice in difficult circumstances for consumer borrowers. Consumer advocates support passage of these bills and they are not alone.

Private lender Sallie Mae has voiced support for a change in the law “that would allow federal and private student loans to be dischargeable in bankruptcy.”⁸⁹ Sallie Mae would back cancellation of loans for those who have made a good-faith effort to repay their student loans over a five-to-seven year period and still experience financial difficulty.⁹⁰

Some industry representatives argue that removing the exemption for dischargeability of student loans could open the bankruptcy system to abuse. However, experts have countered with the fact that most consumers are not prone to misuse the bankruptcy system. Bankruptcy “comes with many costs and consequences, including damaged credit that lasts for years”⁹¹ and is not easily abused. Congress should restore the rights of consumers with private student loans and grant those suffering from financial hardship access to much-needed relief.

⁸⁹ Janet Lorin, *Durbin Urges Private Student Loans Be Discharged In Bankruptcy*, BLOOMBERG, March 20, 2012, <http://bloom.bg/GCCVLN>.

⁹⁰ *Id.*

⁹¹ NACBA report, at 8, <http://bit.ly/zrc0X7>.