Managing Compliance Risks For Income Share Agreements

By **Austin Brown and Darren Welch** (July 17, 2019, 2:43 PM EDT)

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Educational income share agreements, which tie a student's loan repayment obligations to his or her future earnings, have risen in popularity over the past several years as an alternative to student loans. ISAs have also recently been the subject of significant attention and scrutiny, in large part due to an announcement in April by the United States Department of Education that it will experiment with federal support for ISAs.

This article describes the relevant features of ISAs, certain consumer compliance risks that may be associated with ISA contracts, and strategies to mitigate such risks.

Characteristics and Potential Benefits of ISAs

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ISAs link the value of a student's education to his or her earnings after graduation. In a typical ISA contract, the school or an investor pays a student's tuition for one or more semesters, in exchange for the student's agreement to later pay a defined percentage of income during a set term.

In several respects, student loans and ISAs are similar: students have an obligation to make monthly payments following graduation (subject to certain exceptions), the total amount paid by the student may exceed the amount borrowed, and the lender or investor faces the risk that the student will not make payments, depending in part on their employment success.

However, ISAs differ from student loans in several fundamental respects, many of which affect whether consumer compliance statutes and regulations — such as the Equal Credit Opportunity Act/Regulation B and the prohibitions against unfair, deceptive and abusive acts or practices — apply.

There are several potential benefits of ISAs. As an initial matter, given that for many, the purpose of a college education is to provide the necessary education for employment, tying payment obligations to future earnings is logically connected to that purpose. Moreover, ISAs may make it easier than a traditional loan for students to accept lower paying jobs, including those in the public sector or social services fields. And ISAs have the potential to expand access to educational financing among students who may not have easy access to traditional student loans, such as students with no credit history or co-signer and foreign students.

But ISAs differ from traditional student loans in several respects, many of which have contributed to the recent scrutiny of such contracts. In particular, unlike student loans, in a typical ISA contract:

- The monthly and total payment amounts are unknown until the student enters the workforce.

- If the student never enters the workforce (despite trying to do so) or never earns income above a threshold amount, he or she could end up owing nothing.

- The percentage of the student's income that must be paid on a monthly basis is determined based on anticipated future earnings, in consideration of factors such as the student's major or field of study.

- Prepaying the obligation may not result in lower total payments; if a student seeks to pay the obligation early, he or she may be required to pay the maximum amount set forth in the contract.

These differences between student loans and ISAs highlight a number of questions about the legal status of ISAs and whether consumer compliance laws even apply to ISAs. For example, do ISAs constitute "credit" subject to the ECOA? And how do prohibitions against unfair or deceptive acts or practices apply and who can enforce them against ISA issuers or servicers? Each of these questions is addressed below.

Are ISAs "Credit"?

A key issue relating to ISAs is whether they constitute "credit" under the ECOA, and thus whether the notice and anti-discrimination provisions in the statute apply. The ECOA defines "credit," in relevant part, as the "right granted by a creditor to a debtor to defer payment of debt … or to purchase property or services and defer payment therefor."[1]

ISA providers and servicers have argued that the ECOA does not apply to ISA contracts because the obligations do not constitute a "debt" (a term that happens to not be defined in the statute). Instead, they argue that the contracts are conditional, nonrecourse obligations — i.e., conditioned upon the student obtaining employment income above a certain amount — which have not consistently been viewed as "debts."

Whether the ECOA applies to ISAs is an important question. For example, some have argued that by tying the payment obligation to the student's major and the school that the student attends, ISAs may subject minority students to higher income percentages and longer terms than other students. On the other hand, proponents of ISAs have argued that ISAs have the net benefit of expanding access to educational financing, including for those with impaired credit and students from foreign countries.

Courts have not decided the question of whether ISAs constitute credit under the ECOA. Accordingly, any definitive answer will have to be provided by court decisions, legislation or regulations at some point in the future. In the meantime, however, ISA providers and servicers (and their legal counsel) are well-served to be thinking about how, if at all, ISA contracts may adversely affect minority groups, and to take appropriate steps to mitigate such impact.

For example, use of future earnings potential associated with a particular major to set the terms of ISA contracts could potentially be criticized as resulting in discriminatory outcomes for minority students, inasmuch as such students disproportionately pursue certain majors.

We note that the Consumer Financial Protection Bureau and others have criticized as potentially discriminatory the use of the "cohort default rate" (or the historical default rate of students from specific schools) in pricing and underwriting models, which suggests that consideration of the student's major in setting the terms of ISA contracts could likewise be subject to fair lending scrutiny by regulators.[2] In addition, the CFPB recently announced that student loan originations are a "new focus area[] for fair lending examinations or investigations."[3]

Despite this fair lending scrutiny, recent developments make clear that regulators and others are not altogether opposed to the setting of terms based in part on a student's major.

For example, in 2017, the CFPB issued a "no-action" letter to Upstart Network Inc., which used an underwriting system that considered, among other things, the school that the applicant attended and the degree obtained.[4] Also, in a recent settlement of a case alleging that Facebook engaged in discriminatory marketing, the settlement terms generally allowed for the platform to use "profession and field of study" as a factor in identifying credit advertising recipients, although it specifically disallowed use of "school" for that purpose.[5]

ISA issuers and servicers should take steps to determine the impact on minority groups of setting terms based on the student's major and balance such impacts against the business justifications (such as the predictive power that comes from considering the student's major) and potential benefits to consumers. Such an analysis could be relevant even if ISAs are not subject to the ECOA, because regulators and others may challenge whether it is "fair" to make students pay different amounts based on their major.

Unfair, Deceptive or Abusive Acts or Practices

Regardless of whether they are considered "credit" products, ISAs are likely subject to laws prohibiting unfair and deceptive acts or practices, including Section 5 of the Federal Trade Commission Act, which is enforced by the FTC. In addition, state UDAAP laws are enforced by state regulators and, unlike the FTC act, typically allow for private lawsuits by consumers.

Also, if ISAs are ultimately determined to constitute extensions of credit, issuers would be subject to the broader prohibition against "unfair, deceptive, or abusive acts and practices" under the Consumer Financial Protection Act, which is enforced against nondepository institutions by the CFPB.[6]

Steps to Mitigate Risk

In addition to the considerations described above, certain steps could mitigate potential ECOA and UDAAP risks relating to ISAs. These include:

- Providing prominent disclosure of aspects of ISAs that vary from traditional student loans, including:
    - Factors that determine the potential payment amount, including the fact that the total payment amount may substantially exceed the amount paid by the ISA issuer to the school;
    - That terms and conditions vary depending on the school attended and degree obtained;
    - Conditions that give rise to extension of the term of the ISA, such as deferments based on lack of employment or income below a specified amount; and
    - Whether and how information may be reported to credit bureau reporting agencies.
- Advising consumers of the potential availability of traditional student loan options as an alternative to ISAs;

- Providing early termination options that do not require payment of the maximum amount due under the contract; and

- To mitigate discrimination concerns, monitoring fair lending impact and documenting a strong business justification for the use of factors such as the student's major in setting terms and conditions, as well as why alternatives that may have less discriminatory impact would not adequately serve these business needs.

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[1] 15 U.S.C. § 1691a(d).

[2] Fair Lending Report of the Consumer Financial Protection Bureau, December 2012.

[3] Fair Lending Report of the Bureau of Consumer Financial Protection, 84 Fed. Reg. 32,420 (July 8, 2019).

[4] CFPB Announces First No-Action Letter to Upstart Network, Sept. 14, 2017.

[5] National Fair Housing Alliance, et al. v. Facebook, Inc., No. 18-cv-02689-JGK (S.D.N.Y. Mar. 18, 2019), Settlement Agreement and Release, Exhibit A.

[6] 12 U.S.C. §§ 5531, 5536(a)(1)(B).

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