How States May Regulate Income Share Agreements

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A new form of educational financing has been gaining traction in the wake of increasingly alarming reports about the amount of student debt — over $1.5 trillion in the U.S., second only to mortgage debt, and higher than credit card and auto loan debt combined. Income share agreements, or ISAs, are privately funded arrangements whereby a student agrees to pay a percentage of his or her post-graduate gross income for a fixed number of years in exchange for the school covering educational costs.

In response to growing attention to ISAs, the ISA Student Protection Act of 2019 was recently introduced as a bipartisan bill in the U.S. Senate. The act sets forth a comprehensive regulatory structure specific to ISAs and would explicitly preempt state efforts at regulating ISAs other than with their own ISA-specific laws. As further discussed in this article, absent this legislation passing, states could view ISAs through the lens of traditional loans or wage assignments and attempt to regulate them accordingly.

To avoid the inherent suspicion and misunderstanding that often comes with alternative financing programs, institutions funding, administering or offering ISAs should proactively engage state regulators to educate them early about the unique nature of ISAs and their potential to change the education funding landscape.

Overview of Income Share Agreements

ISAs are not structured as loans. Rather, they are agreements between a school and a student where, in exchange for the school providing an education and related services, the student agrees to pay a percentage of their post-graduate income for a set time period. Unlike a loan, payment is not based upon an amount owed, but on making a certain number of payments or making payments for a certain number of years. ISAs can be used as the primary source of education funding, or can be used to fill gaps left by federal financial aid. According to one ISA administrator, over 30 educational institutions offer ISAs, including universities, coding boot camps and trade schools.

As an example, the Purdue Research Foundation has an ISA program in place for Purdue University's current sophomore, junior and senior students — the "Back a Boiler-ISA Fund." Most ISAs offered by Purdue have a standard 10-year payment term, and the university offers a six-month grace period immediately after the student's graduation. Purdue bases the terms of each ISA on the individual student's choice in major combined with data demonstrating the anticipated salary of a graduate entering the workforce with that degree.[1] Payment amounts are calculated annually based upon documentation of the student's earned income and the agreed-upon percentage. Purdue caps the total amount a student would pay at twice the cost of the student's education.[2]

Monthly payments are required under Purdue's program only when the student's income exceeds a specified minimum income threshold, so students who are unemployed or underemployed do not make payments. Unlike a loan, if a student does not pay for a month, that simply means a month of nonpayment, rather than an accrual of interest that may later be capitalized once payments resume.

Accordingly, depending on the type of employment a graduate secures, the student could end up paying more or less than the original borrowed amount. Importantly, one of the key features that distinguishes an ISA from a loan is that the student can meet her obligations under the ISA regardless of the ultimate amount paid. While ISAs can vary according to the particular school's preferences, they all share the features of allowing flexibility based upon post-graduate income and the school assuming the risk of not being fully compensated for the amount of funding extended to the student.

Public and Legislative Reactions to Income Share Agreements

Because ISAs are new financing models that appear to share some characteristics with traditional student loans, and because there is not yet a regulatory regime specific to ISAs, they are being approached with caution and suspicion. For example, Democratic lawmakers, including Sen. Elizabeth Warren, D-Mass., sent letters to seven schools that currently offer ISAs expressing concern about their use and requesting more information about them.[3]

These letters were prompted as a result of comments made by Diane Auer Jones, the principal deputy under secretary at the U.S. Department of Education, indicating that the Trump administration was thinking about establishing a federal income share agreement program. At a February 2019 meeting, California's Bureau for Private Postsecondary Education struggled to determine how ISAs would fit into their current regulatory structure for education loans in light of requirements that students understand the total charges of their education prior to enrollment, and that consumer loans comply with the Truth in Lending Act's annual percentage rate disclosures.[4] Several states, including California, have proposed ISA legislation, with only one law passing in Illinois that will enable the state treasurer to enter into ISAs with student borrowers.

Prior to the most recently introduced federal legislation, two other bills were introduced in Congress geared toward ISAs.[5] In 2017, Sen. Marco Rubio, R-Fla., introduced a bill known as the "Investing in Student Success Act of 2017,"[6] which ultimately died in the Senate. The bill explicitly authorized the use of ISAs for financing post-secondary education and provided various requirements to qualify as a valid educational ISA.[7]

For example, the bill required that an ISA specify the percentage of future income to be paid; it also provided an annual limit on payment amount, a lifetime cap and other time-based limitations.[8] The bill imposed other protective measures, such as precontractual disclosure requirements and a requirement for early termination procedures.[9] The "Kids to College Act," introduced in March 2019, also contains disclosure requirements and limits on ISA payment terms.[10] The recent act provides even more robust qualification and disclosure requirements for ISAs, and clarifies their treatment under various federal consumer finance laws, such as the federal Equal Credit Opportunity Act, the Fair Credit Reporting Act and the Fair Debt Collection Practices Act.[11]

Notably, all three federal bills have included state law preemption. The most recently introduced federal legislation provides that "qualified ISAs" are valid notwithstanding state laws regarding wage assignments and expressly preempts state law pertaining to usury, credit, loans or credit or installment sales, "unless such state law expressly states that it is intended to apply to qualified ISAs."

The proposed bill similarly preempts existing state licensing and registration laws as well as any laws imposing an "ability-to-repay" requirement, unless passed after the act and specific to qualified ISAs.[12] Given the language in the proposed legislation, states will still have the ability to investigate ISAs for violations of their respective unfair and deceptive acts and practices laws.

Likely State Response to Income Share Agreements

Pending the passage of federal legislation, we should expect that states will step into the void and attempt to bring ISAs within their regulatory purview. Although they differ significantly from loans, they have several characteristics that will drive concerns that, without traditional credit-related consumer protections, such as disclosure requirements and rate caps, borrowers may be at risk.

For example, because ISAs are designed such that graduates earning higher incomes can end up paying more than the cost of their education, those borrowers effectively pay an amount that could be construed as interest. Moreover, because certain borrowers may pay more than others, and because ISAs are often tailored to a student's particular degree and its income potential, others have voiced criticisms akin to fair lending concerns.[13] Finally, there is the overarching worry that borrowers are committing to a complicated financial product that they may not completely understand, and for which tax implications and impact to credit history are currently undetermined.

Consequently, states could view ISAs as an effort to circumvent state regulation, as they have done with other forms of alternative financing. For example, in a 2015 case involving the Colorado attorney general and the Uniform Consumer Credit Code administrator, the Colorado Supreme Court determined that litigation finance agreements qualify as "loans" for purposes of Colorado's UCCC.[14]

Litigation finance agreements are similar to ISAs because, in both, a participant receives a sum of money in exchange for a future interest in income — proceeds from a successful lawsuit in the case of a litigation finance agreement, and a portion of future earnings in the case of an ISA. Neither agreement imposes an unqualified obligation to repay the original tendered amount. In Oasis Legal Finance Group LLC v. Coffman, the litigation finance companies argued that, given the lack of an absolute obligation to repay, their agreements should be characterized as asset purchases rather than loans, and thus, should fall outside the provisions of the UCCC.[15]

The court ultimately disagreed and found that litigation finance agreements were loans under the UCCC.[16] It rested its conclusion on (1) the broad concept of debt as an obligation to repay; and (2) an explicit rejection of the argument that "a loan exists only where the borrower has an unconditional repayment obligation."[17] Other UCCC jurisdictions have similarly found alternative finance arrangements to fall within the UCCC.[18] While it is important to note that there are other decisions holding that a loan must include an unconditional repayment obligation,[19] and that no jurisdiction has specifically addressed whether ISAs are loans, states are likely to initially approach ISAs as creating an obligation to repay similar to a loan.

Additionally, some states' consumer credit laws prohibit lenders from taking assignment of earnings as payment for a debt, specifically stating that "a sale of unpaid earnings made in consideration of the payment of money to or for the account of the seller of the earnings is deemed to be a loan to him secured by an assignment of earnings."[20] An ISA does not involve a wage assignment — the ISA provider does not obtain the right to collect earnings directly from an employer.

Payments under an ISA are calculated based upon a student's projected income, but the students make the payments themselves, and, as noted earlier, they do not have to make up for months where payment cannot be made. Nevertheless, the principle underlying these prohibitions — that a person should not be required to promise unpaid earnings to meet an obligation to repay a debt — could also cause states to question the propriety of ISAs and to bring them into existing regulatory regimes.

Finally, the ongoing rift between states and the federal government on regulation of federal student loan servicers may cause states to claim the ISA regulatory battlefield early. In recent years, the U.S. Department of Education has aggressively thwarted attempts at state regulation of federal student loan servicers, including not permitting servicers to share borrower documents with states investigating loan servicers for consumer protection violations.[21]

In response, states have cited to the federal government's apparent lack of oversight over student loan servicers as reason for the states to maintain regulation of these servicers at the state level, and have begun passing their own laws to license and regulate student loan servicers.[22] Consequently, any effort to preempt state regulation of ISAs is likely to be met with some distrust, and rather than take time to pass their own legislation addressing ISAs, states may look to their existing consumer finance laws to initiate investigation and regulation.

ISAs Provide Benefit and Merit Their Own Regulatory Framework

ISAs have significant potential to alter dynamics that have led to the student debt crisis. Because ISAs shift the risk of nonpayment back to the school, schools have an increased incentive to ensure that graduates are gainfully employed. Much of the current student debt load is attributable to questionable practices in the career college industry, such as encouraging students to take out federal loans with promises of better jobs and higher incomes, only to underdeliver on those promises and not bear the risk of default on those loans.[23]

ISAs could, consequently, equalize the for-profit college sector and weed out poor performers and bad actors without the expense of regulatory enforcement and unnecessary consumer losses. Additionally, ISAs provide an alternative for students who may not otherwise be able to avail themselves of traditional federal education funding.

For example, in 2018, Colorado Mountain College, or CMC, initiated its Fund Sueños so Deferred Action for Childhood Arrivals students who cannot qualify for federal financial aid are still able to obtain education funding. The financing is channeled through donations to a charitable foundation rather than a private investment fund, but the principle is the same. Money paid back by the participating students will go back to Fund Sueños to be used to provide assistance to new students. CMC reports that about 15 students participated in the first year of Fund Sueños and that more students are signed up to participate next year.[24]

It is important to note that ISA administrators and schools welcome regulation tailored to ISAs. Last month, 18 organizations sent a letter to congressional leadership requesting legislation that would develop a regulatory regime for ISAs, including defining what they are, constructing a disclosure framework, setting minimum income thresholds, and identifying a federal regulator.[25]

In addition to advocating for an ISA-specific regulatory framework, those offering or funding ISAs should proactively engage state regulators to head off uninformed assumptions about

ISAs. Alternative finance arrangements are routinely met with skepticism, and making the effort to educate regulators early on about how ISAs work and their benefits is critical to ensuring that ISAs are viewed as an innovative education financing tool, rather than an attempt at circumventing state consumer finance regulation.

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[1] However, students are not obligated to pursue a particular type of employment after graduation in order to repay the ISA.

[2] Additionally, the student can choose to prepay her ISA by paying an amount equal to the payment cap less any monthly payments already made.

[3] Senator Warren, Reps. Pressley and Porter Investigate Reports that Education Department Seeks to Develop Income Share Agreements in Risky New Student Debt Experiments, https://www.warren.senate.gov/newsroom/press-releases, June 4, 2019.

[4] https://www.bppe.ca.gov/about_us/meetings/index.shtml (February 13, 2019)

[5] Investing in Student Success Act, S. 268, 115th Cong. (2017); Kids to College Act, H.R. 1810, 116th Cong. (2019).

[6] Investing in Student Success Act, S. 268, 115th Cong. (2017).

[7] Id.

[8] Id.

[9] Id.

[10] Kids to College Act, H.R. 1810, 116th Cong. (2019).

[11] The bill also provides that Qualified ISAs are not credit as contemplated by the Truth in Lending Act.

[12] ISA Student Protection Act of 2019, S. 2114, 116th Cong. (2019).

[13] See, e.g., “What’s Scarier Than Student Loans? Welcome to the World of Subprime Children,” The New York Times, May 11,2019

[14] Oasis Legal Fin. Grp. v. Coffman et al., 361 P.3d 400 (Colo. 2015).

[15] Id. at 405.

[16] Id. at 410.

[17] Id. at 408-10. Importantly, the court also noted as significant that the transactions at issue involved an obligation to repay that increased with time. ISAs, in contrast, do not have this feature. As noted earlier, if a student cannot make payments under an ISA due to unemployment or a drop in income, the payment period does not extend, and there is no mechanism for the ISA provider to recoup those deficiencies later.

[18] See, e.g., Income Tax Buyers, Inc. v. Hamm, 1992 WL 12092431 (S.C.C.P.) (unpublished opinion) (finding that transactions in which customers were given cash subtracted from their tax refund in exchange for a right to receive the full amount of the refund were consumer loans); Decision Point, Inc. v. Reece & Nichols Realtors, Inc., 144 P.3d 706 (2006) (finding consumer loans where advances were made to real estate agents by a cash advance company in exchange for the assignment and a percentage of projected commissions owed to them by a real estate company).

[19] See, e.g., Lynx Strategies LLC v. Ferreria, 957 N.Y.S.2d 636 (Sup. Ct.N.Y. Cty. July 6, 2010) (advancing funding for lawsuit contingent on proceeds arising from settlement or judgement was not a loan under New York usury laws); Kelly, Grossman & Flanagan, LLP v. Quick Cash, Inc., 950 N.Y.S.2 723 (Sup.Ct.Suffolk Cty. March 29, 2012) (litigation finance arrangement where defendants always had risk of nonrecourse was not a loan).

[20] See, e.g., § 5-3-206(2), C.R.S. (2019); Ind. Code § 24-4.5-3-403(2)(2019); S.C. Code Ann. § 37-3-403 (2019); Iowa Code § 537.3305 (2019).

[21] See https://www.ed.gov/content/federal-preemption-and-state-regulation-department-educations-federal-student-loan-programs-and-federal-student-loan-servicers

[22] See https://portal.ct.gov/AG/Press-Releases/2019-Press-Releases/AG-TONG-21-STATES-OPPOSE-DEVOS-ATTEMPT-TO-UNDERMINE-INVESTIGATIONS-INTO-STUDENT-LOAN-INDUSTRY

[23] See, e.g., “Why This For-Profit College Will Cancel $500 Million of Student Loans,” Forbes, January 7, 2019, https://www.forbes.com/sites/zackfriedman/2019/01/07/student-loan-forgiveness-for-profit/#1721890667ee

[24] “CMC’s financial aid helps Dreamers get through college faster,” PostIndependent, July 3, 2019

[25] https://www.christenseninstitute.org/blog/a-joint-letter-to-congress-unlocking-innovation-in-the-income-share-agreement-market/