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Income Share Agreements (ISAs) for Education Financing: Understanding the Regulatory Treatment of a Rising "Loan Alternative"

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Outstanding student loan debt in the United States has steadily grown to become one of the largest categories of consumer debt, second only to residential mortgages. This growth has driven concern about a student loan "bubble," particularly in light of rising interest rates and job market volatility for new college graduates. Simultaneously, rising delinquency/default rates and the conduct of certain "bad actors" have led regulators to implement enhanced consumer protection regimes, including "student loan bills of rights" and new student loan servicing licensing requirements. These measures are intended to provide borrowers with fair and accessible pathways to loan repayment.

Against this background, educational institutions and some private entities have attempted to design financially viable student loan alternatives to meet the needs of students in an evolving economy. Income Share Agreements ("ISAs"), in which students are provided education financing in exchange for repayment of an agreed-upon percentage of income over a defined, post-graduation timeframe, are one of the most unique potential alternatives. ISAs' viability as a student loan alternative, however, may depend on whether traditional loan regulatory requirements apply to their unique structure. In particular, certain state licensing and usury laws may not necessarily leave room for the repayment flexibility inherent in ISAs. However, one option for developing a successful market in ISAs may be to ensure that ISAs are structured so they are not "loans" or other "credit" subject to certain consumer financial laws.

The issue of whether (or when) ISAs should be treated as loans or credit under federal or state consumer financial laws has not yet been resolved in the courts or addressed in detail by relevant regulators. ISAs are, however, similar to certain small business and commercial financing approaches such as merchant cash advances ("MCAs") and receivables factoring agreements under which businesses sell future or existing receivables in exchange for an up-front purchase price. To some extent, courts have opined on whether these approaches should be viewed as credit for usury, licensing, and other compliance purposes.

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Review of the treatment of MCAs and/or factoring agreements when subject to legal challenge arguably provides program structuring guidance relevant to ISA providers. In general, courts have reviewed whether a MCA or factoring agreement is a "loan" through fact-intensive, case-by-case evaluations. A key factor has been whether the initial amount extended under the agreement is an absolutely repayable obligation.[1] Where the financing party bears significant repayment risk (other than for a credit default), the product can be viewed as a true sale of receivables, rather than a loan. Courts also evaluate other indicia of a lending relationship, such that using personal credit history in underwriting, acquiring security interests, charging fees similar to typical loan fees, or representing the agreement as a loan may create risk of recharacterization as a loan.[2]

Recharacterization of ISAs could be assessed under standards similar to those that have been applied to MCAs or factoring agreements. Accordingly, structuring ISAs so that the provider has limited (or no) recourse in the event that earned salaries are lower than expected, underwriting to future employability rather than heavily toward current creditworthiness, structuring guarantees or co-signer relationships as backups to nonpayment of the contingent/salary-based repayment obligation rather than insufficient repayment of the initial extension of funds, and similar approaches would likely decrease the risk that the ISA will be treated as a loan subject to, for example, state licensing and/or usury requirements.

Since ISAs are consumer-purpose agreements (unlike MCAs and factoring agreements), the regulatory consequences of recharacterization are relatively high. In addition to the licensing and usury concerns already mentioned, compliance with several core federal consumer financial laws, including disclosure requirements under the Truth in Lending Act ("TILA") and interest rate restrictions under the Military Lending Act ("MLA") and Servicemembers Civil Relief Act ("SCRA"), would be ambiguous or difficult for ISA providers. Other requirements of federal and state law might only become formally applicable to ISAs if they were recharacterized as loans, but might be more suitable for voluntary compliance as a conservative approach to risk management. Such requirements might include, for example, anti-discrimination provisions of the Equal Credit Opportunity Act ("ECOA"), repayment restrictions under the Electronic Fund Transfer Act ("EFTA"), and consumer privacy and information security requirements under the Gramm-Leach-Bliley Act ("GLBA").

ISAs show potential as a student loan alternative. Their success in the market likely depends on providers "getting it right" in a tricky regulatory environment for products that do not cleanly slot into a well-defined and delineated asset class.

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[1] *See, e.g.*, *Transmedia Rest. Co., Inc. v. 33 E. 61st Street Rest. Corp.*, 710 N.Y.S.2d 756 (N.Y. Sup. Ct. 2000) (transaction is not a loan "unless the principal sum advanced is repayable absolutely."); *Essex Partners Ltd. v. Merch. Cash and Capital*, 2011 WL 13123326, at *5 (C.D. Cal. Aug. 1, 2011) (under California law, one of the "essential elements of usury" is "the loan and interest must be absolutely repayable by the borrower … ."); *Wiers Farm, Inc. v. Waverly Farms, Inc.*, 2011 WL 1296867, at *2 (M.D. Fla. Mar. 31, 2011) (re-characterizing transaction as secured loan because, in part, finance company did not agree to assume risk of nonpayment on all of purchased accounts).

[2] *See*, *e.g.*, *Math Magicians, Inc. v. Capital for Merch. LLC,* 2013 WL 6192559, at *3 (Cal. Ct. App. Nov. 26, 2013); *Wiers Farm, Inc.*, 2011 WL 1296867 at *2; *Nickey Gregory Co., LLC v. AgriCap, LLC*, 597 F.3d 591, 602-03 (4th Cir. 2009).