http://www.financialinstitutionlawblog.com/

SHEPPARD MULLIN
SHEPPARD MULLIN RICHTER & HAMPTON LLP

Financial Institution Law BLOG
Up-to-date Information on Financial Institutions

March 2, 2010 | Posted By

PREEMPTION NOT DEAD: SERVICERS OF STUDENT LOANS ACHIEVE SIGNIFICANT VICTORY IN NINTH CIRCUIT PREEMPTION CASE

In *Chae v. SLM Corporation*, No. 08-56154 (9th Cir. January 25, 2010), the U.S. Court of Appeals for the Ninth Circuit held that the federal Higher Education Act (the "HEA") preempts student borrowers' ("Plaintiffs") claims that Sallie Mae, Inc.'s ("Sallie Mae") interest rates, late fees, and payment schedules violate California law.

Plaintiffs in this action took out Stafford, Supplemental, and Consolidated Loans from various lenders between 1993 and 2006, and Sallie Mae was the loan servicer for each of these loans. As a third-party servicer, Sallie Mae carried out administrative and servicing functions relating to the loans, including issuing billing statements, collecting and processing payments, assessing and collecting late fees, and giving notice to borrowers as required by the Federal Family Education Loan Program (the "FFELP") regulations. Plaintiffs specifically challenged three practices used by Sallie Mae in servicing student loans: (1) Sallie Mae's use of "simple daily interest" method of calculating interest instead of the "installment method" which is required by their loan contracts; (2) Sallie Mae's practice of assessing late fees – mainly, when permitted by a borrowers' promissory note, Sallie Mae charges a late fee of up to six percent of each installment remitted more than 15 days after it is due and Plaintiffs argue that California law prohibits the charging of late fees where there is also a simple daily interest charge; and (3) Sallie Mae's method of setting the first repayment date on a Consolidation or PLUS loan within 60 days after disbursement and charging interest during that period of up to 60 days – Plaintiffs allege that this amounts to deceptively increasing the cost and life span of the loan. Essentially, Plaintiffs argued that Sallie Mae's loan-servicing practices violate California business, contract, and consumer-protection law.

The Ninth Circuit began its analysis by reviewing the purpose of the HEA. The HEA was passed "to keep the college door open to all students of ability, regardless of socioeconomic background." *Rowe v. Educ. Credit Mgmt. Corp.*, 559 F.3d 1028, 1030 (9th Cir. 2009). To uphold this goal, Congress established the FFELP, which is a system of loan guarantees meant to encourage lenders to loan money to students and their parents on favorable terms. *See* 20 U.S.C. §§ 1071-1087-4; *Rowe*, 559 F.3d at 1030. Further, the Secretary of the Department of Education (DOE) is authorized to "prescribe such regulations as may be necessary to carry out the purposes" of the FFELP. 20 U.S.C. § 1082(a)(1).

The Supremacy Clause of the Constitution provides that federal law "shall be the supreme Law of the Land."

U.S. Const. art. VI, cl. 2. Further, the United States Supreme Court has recognized that "state laws that conflict with federal law are 'without effect.' " *Altria Group, Inc. v. Good*, 129 S. Ct. 538, 543 (2008) (quoting *Maryland v. Louisia*na, 451 U.S. 725, 746 (1981)). In this case, the court found that two types of federal preemption – "express" and "conflict" – act to block the class claims brought by Plaintiffs.

Under express preemption, Congress may indicate its intent to displace state law through express language. *Altria Group*, 129 S. Ct. at 543. The court found that Congress enacted several express preemption provisions applicable to the FFELP participants. One such provision, 20 U.S.C. § 1098g, titled "Exemption from State Disclosure Requirements," states that "loans made, insured, or guaranteed pursuant to a program authorized by Title IV of the Higher Education Act . . . shall not be subject to any disclosure requirements of any State law." Because the FFELP falls within Title IV of the HEA, the court found that it is subject to this express preemption provision. Accordingly, the court held that two of Plaintiffs' claims – (1) using billing methods to trick borrowers into thinking the installment method is being used and (2) improper disclosure regarding the method of setting repayment date – which fall under the Unfair Competition Law, are precluded by express preemption.

As for conflict preemption, a state law, whether arising from statute or common law, is preempted if it creates an "obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 373 (2000) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)). As previously stated, the main purpose of the FFELP is "to encourage states and nonprofit private institutions and organizations to establish adequate loan insurance programs for students in eligible institutions." 20 U.S.C. § 1071(a)(1)(A). Thus, the court found that in order to accomplish the goal of encouraging such lending, Congress intended the core aspects of the FFELP to be uniform, establishing a set of rules that would apply across the board. Accordingly, the court reasoned that the only way for the loan program to remain viable is to ensure its stability. Additionally, the court explained that if the law were to allow Plaintiffs' California state law claims, this would in effect promote similar claims being asserted in each of the other states and thus "impair and threaten the efficacy of the federal lending effort for students." Therefore, the court stated that Plaintiffs' second claim, that California law prohibits imposition of a late fee when daily simple interest is used, creates an obstacle to the uniform regulatory system that permits late fees.

The court concluded its opinion by stating the following: "In conclusion, the Plaintiffs' allegations that Sallie Mae makes fraudulent misrepresentations in its billing statements and coupon books are expressly preempted by the HEA, and conflict preemption prohibits the Plaintiffs from bringing their remaining claims because, if successful, they would create an obstacle to the achievement of congressional purposes. Having carefully considered the FFELP and the purposes of Congress in the HEA, we conclude, beyond any doubt, that subjecting the federal regulatory standards to the potentially conflicting standards of fifty states on contract and consumer protection principles would stand as a severe obstacle to the effective promotion of

the funding of student loans. Such an obstacle, which we consider hostile to the purposes of Congress in this program, must bow to the overriding principles of conflict preemption and federal law supremacy."

This ruling in favor of Sallie Mae, the nation's largest servicer of student loans, is beneficial to third-party servicers and lenders in the Ninth Circuit that service their own loans, as it provides a shield from state law claims. This case stands to show that despite the political climate, preemption is not dead. Additionally, in student lending industries, the economic efficiencies that are provided and applied across the 50 states still exist.

For further information, please contact Allison Berkley at (213) 617-5521.