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Investing in Consumer Financial Services Companies or Consumer Loans and Receivables: The Importance of Due Diligence

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Consumer Finance
MONTHLY BREAKFAST BRIEFING

Agenda

- Introduction to Regulatory Diligence
  - What are regulatory diligences and why are they conducted?
- Diligence Scoping (including Case Studies)
  - What should you review and where should you focus?
- Achieving Efficiency
  - How can you manage cost while still identifying material risks?
- Effective Use of Diligence Findings
  - How can you mitigate or otherwise address identified risks?

INTRODUCTION TO REGULATORY DILIGENCE

Introduction — What is a Regulatory Diligence?

- Flexible concept
- Generally:

  Any review of a counterparty to a transaction that seeks to understand that counterparty's ability to comply, and actual compliance with, applicable law and regulatory expectations governing conduct in a particular industry

- Supplements general corporate and legal diligence

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Introduction — Why Conduct a Regulatory Diligence?

- Understanding and mitigating risks
- Structuring transactions (including future transactions) efficiently with respect to regulatory risks and requirements
- Adhering to regulatory expectations
    - Safety and soundness expectations of banking regulators
    - Vendor management expectations of banking and consumer finance regulators
- Developing required transaction disclosures (*e.g.*, in a securitization)

Introduction — Understanding Risks: Types of Risk

- Your legal and regulatory risk
- Asset impairment/unenforceability risk
- Counterparty risk
- Regulatory oversight risk
- Reputation risk

DILIGENCE SCOPING

Diligence Scoping — Factors

- Asset class
- Counterparty’s role in offering product/service
- Counterparty’s size and age
- Regulators (yours and the counterparty’s)
- Nature and size of the transaction
- Your risk appetite and particular concerns

Diligence Scoping — Asset class

- Credit vs. other financial product/service (e.g., payment card/system, insurance, advisory services)
- Target customer (individual vs. business)
- Product Purpose (consumer vs. business; specially-regulated purposes such as student loans; purchase-money loans)
- Security interest (mortgage/auto/unsecured; lien priority)
- Open- vs. Closed-end
- Government loan programs (FHA, VA, RHS, Dept. of Education)
- Other (unregulated industries, promotional products, etc.)

Diligence Scoping — Holder Notice

- Consider whether the asst class at issue is subject to the “Holder Notice” under FTC Rules.
- Applies to certain purchase money loans and credit sales

> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

Diligence Scoping — Counterparty's Role

- General Roles
  - Creditor/Servicer
  - Broker
  - Service Provider
  - Secondary Market Aggregator
  - Retailer/Dealer
- Core Business Lines
  - How does the counterparty make its money?
  - What is the counterparty's value proposition to customers?

Diligence Scoping — Counterparty's Size and Age

- Regulatory expectations regarding compliance management permit tailoring of CMS to nature and scope of a company's business
- In general, expect smaller, younger companies to have less-developed and less-formal compliance functions
- Accordingly:
  - For a larger, mature company, review scope might include more written policies and monitoring/audit materials;
  - For a smaller, less-mature company, alternative sources of information may have to be developed and/or focus may be on ability of Legal and Compliance functions to adapt and grow

Diligence Scoping — Regulators (Yours and the Counterparty's)

- Regulatory expectations and regulatory/enforcement priorities can affect risk just as express legal requirements can
- Consider regulatory, enforcement, and supervisory exposure
    - Does the counterparty's business have touchpoints with federal banking regulators?
    - Will your involvement with the counterparty expose you or the counterparty to regulation, enforcement, supervision by a new regulator (*e.g.*, because you may need to obtain licenses to hold a new asset class)

Diligence Scoping — Nature and Size of the Transaction

- The structure of the transaction can affect legal risks, as well as regulatory expectations
- Considerations:
  - Assignee liability
  - Aiding and abetting liability
  - Controlling interests
  - Vendor management requirements
  - Securitization due diligence requirements
- The size of the transaction may also help determine a reasonable diligence scope/depth

Diligence Scoping — Your Risk Appetite and Particular Concerns

- Considerations:
  - What is your risk appetite?
  - Are particular products or practices absolute deal killers?
  - Are you willing to take on a “work in progress?”
  - Have you faced liability or hassle from prior investments?
  - Do you have contractual obligations affecting your exposure to risk?

Diligence Scoping — Case Studies—Case 1

- Case 1: Purchase of receivables from a mature consumer marketplace lending platform that operates in partnership with a bank lender
  - Heavy focus on:
    - Compliance management system
    - Structure of bank partnership agreements (true lender and *Madden* risk)
    - Residual licensing analysis (servicing, brokerage, etc.)
    - Internal monitoring and audit findings
    - Regulatory investigations and litigation
  - Additional consideration to licenses necessary to purchase receivables and/or structures for mitigating license exposure

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Diligence Scoping — Case Studies—Case 1 (cont.)

- Bank partner issues
  - Bank partner program structure is critical to determining whether loans are validly originated (true creditor issue) and remain valid through the various transfers involved in marketplace lending (*Madden* issue).
  - True creditor
    - Not unique to marketplace lending. Prior case law has developed in connection with credit card programs and payday lending, and courts are beginning to apply true creditor standards to marketplace lending.
    - Courts have applied a number of legal standards to analyze "true creditor" issues.
    - Standards include reviews of: (i) the named lender; (ii) certain "non-ministerial" functions; (iii) the totality of the circumstances; and (iv) the predominant economic interest.

Diligence Scoping — Case Studies—Case 1 (cont.)

- *Madden*
  - Class of claims arising from Second Circuit decision in *Madden v. Midland Funding*
    - Facts—A non-bank debt buyer charged interest on a defaulted credit card account at rates permissible at origination only because the original creditor was a bank.
    - Holding—The non-bank could not rely on preemption arguments available to the bank that permitted charging interest in excess of state law limitations.
  - Serious questions as to the breadth of the ruling and whether the defendant raised the right arguments at trial to avoid waiving defenses
  - While cited by other courts, not adopted outside of 2nd Circuit.

Diligence Scoping — Case Studies—Case 1 (cont.)

- *Colorado v. Avant/Marlette*
  - Avant and Marlette are licensed as supervised lenders in Colorado to service supervised loans originated by their bank partners.
  - During examination, Administrator of Colorado Credit Code concluded that serviced loans had interest rates and certain fees above amounts permitted by Colorado law and choice-of-law provision also violated applicable law.
  - Avant and Marlette refused to reduce interest rates and fees as requested.
  - Lawsuit was filed by Administrator against Avant and Marlette and bank partners unsuccessfully tried to intervene and move to federal court.
  - Lawsuit further alleges that banks are not true lenders and seeks reimbursement for consumers plus penalties from Avant/Marlette.

Diligence Scoping — Case Studies—Case 1 (cont.)

- *Colorado v. Avant/Marlette (cont.)*
  - On November 30, 2018, Administrator filed an amended complaint listing as defendants a number of trusts and their trustees (Wilmington Trust and WSFS) who had alleged purchased or accepted assignment of loans.
  - Amended complaints indicates that trustee is not being named in its individual capacity but solely as trustee for the trusts.
  - Inclusions of trusts and trustees raises a number of concerns for secondary market participants (including trustees, investors and financing sources).
  - Trustees filed motions to dismiss on January 30, 2019.

Diligence Scoping — Case Studies—Case 2

- Case 2: Acquisition of debt collector with small, recently-launched credit program
  - Heavy focus on:
    - Compliance management system
    - FDCPA
    - Licensing, including change of control requirements based on transaction structure
  - Limited coverage of credit program
    - Not crucial to counterparty value to continue program
    - Consideration given to post-transaction compliance review

Diligence Scoping — Case Studies—Case 2 (cont.)

- Issues for equity investments
  - Licensing and change of control requirements
    - Triggers
    - Control persons
    - Closing conditions
  - Repurchase risk
  - Agency risk
  - Regulatory constraints on board oversight and control

ACHIEVING EFFICIENCY

Achieving Efficiency — Leveraging Counterparty’s Analysis

- Basic approach—If a counterparty’s CMS is strong and/or the counterparty makes regular use of quality outside counsel/compliance consultants, internal analysis and monitoring/audit documents provide a wealth of information.
  - Review CMS and assess use of counsel/consultants
  - Focus more heavily on monitoring, audits, complaint trends, and litigation

Achieving Efficiency — Multi-stage Reviews

- Limit cost by addressing most crucial issues upfront, while leaving general compliance reviews later (even after the transaction in some cases)
- May be preferable for:
  - Asset classes in which there are clear “deal killer” issues
  - Multi-stage bid processes
  - Full acquisitions of mature companies, where robust monitoring, audit, complaint tracking, etc. can identify material issues and other “clean-up” reviews can occur post-signing

EFFECTIVE USE OF DILIGENCE FINDINGS

Using Diligence Findings — Transaction Structure

- Use diligence findings to adjust the structure of the transaction to limit risk
  - Financings vs. acquisition of counterparty's portfolio
  - Acquiring participation interests vs. whole loans
  - Use of trust structures to minimize licensing risk
  - Establishing a state-licensed SPV or otherwise obtaining licenses
  - Stock vs. asset acquisitions

Using Diligence Findings — Pre- and Post-Closing Conditions

- Use diligence findings to modify counterparty conduct across its business
  - Pre-closing conditions
    - “Must have” items with clear solutions (*e.g.*, obtaining required licenses, correcting contract and/or disclosure problems, etc.);
  - Post-closing conditions
    - Conducting additional compliance reviews in areas in which there is risk of an issue, but no immediately-apparent violations (*e.g.*, marketing)
    - Ongoing implementation of compliance management enhancement (e.g., adhering to training, monitoring, and auditing schedules)

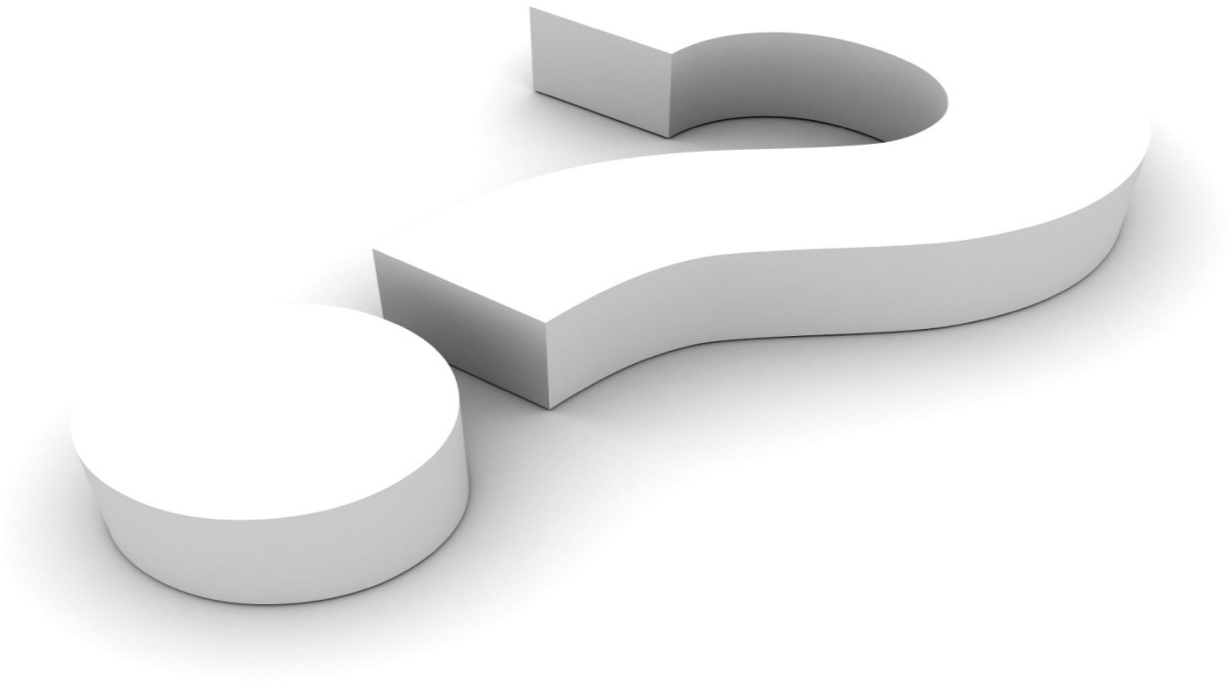
Using Diligence Findings — Transaction Documentation

- Align transaction documents with closing conditions
  - Licensing-related eligibility criteria for loan purchases supplementing a licensing pre-closing condition
  - Making conditions actionable: Adding R&Ws, compliance side letters, etc. that align with continuing obligations in post-closing conditions
- Additional compliance-related eligibility criteria applicable only to your loan purchases and/or financing
  - May be appropriate if an issue is ambiguous, but you have a lower risk tolerance for purchased/financed assets than the counterparty has for other assets
- Ensure documents include appropriate representations, warranties, and remedies

Using Diligence Findings — Refresher/Bring-Down Diligences

- Additional, frequently limited-scope, reviews based on prior diligence findings or conducted periodically
- Prior diligence findings
  - Significant CMS build-out→ review for implementation and use additional monitoring, auditing, complaint trends, etc. to further refine analysis of risk
  - Ambiguous legal issues, including issues subject to legislative or regulatory guidance developments→ review for reaction by counterparty to developments
- Periodic reviews not triggered by particular findings may be appropriate in some cases (*e.g.*, vendor management)

QUESTIONS?



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