

The Consumer Finance Podcast: Loan Securitization Trusts as Subject to CFPB's Enforcement Authority: The Implications of a Recent Court Decision Affirming Such Authority

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Guest: Glen Trudel

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Chris Willis:

Welcome to *The Consumer Finance Podcast*. I'm Chris Willis, the Co-Leader of Troutman Pepper's consumer Financial Services Regulatory Practice. Today, we're going to be talking about a recent court decision that held that the securitization trust was a covered person for purposes of the Consumer Financial Protection Act, which we think may be a very far-reaching decision.

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Chris Willis:

So, as I said, today, we're going to be talking about a recent decision from the US Court of Appeals from the Third Circuit, which held that a securitization trust dealing with a consumer loan portfolio was a covered person under the Consumer Financial Protection Act, and therefore subject to the CFPB's jurisdiction. Joining me to talk about that is one of my partners, Glen Trudel. Glen does a lot of transactional work for our financial services clients, including transactions related to securitizations, and all kinds of portfolio sales, mergers, acquisitions, et cetera. He's a really great resource for us and for our clients who are engaging in any kind of transaction like that. So, Glen, welcome to the podcast, and thanks for being here today.

Glen Trudel:

Oh, thanks, Chris. Glad to be here.

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Chris Willis:

So Glen, let's start off by just educating the audience. They may not have seen this decision from the Third Circuit that we're interested in today. So do you mind giving the audience a little background about what the issue was before the Third Circuit? And what the court ended up deciding?

Glen Trudel:

Yes, Chris. The case is based on a CFPB enforcement action that was brought against multiple related trusts that each had securitizations based on pools of private student loan debt. The underlying enforcement action related to alleged violations relating to collection and servicing of those loans. Now, the trust themselves don't have employees or anything like that. So, it was all being done via contracts that they had entered into with servicers and various collection agencies.

The court as you mentioned, the court ultimately found that the trust qualified as covered persons under the CFPB and thereby subjecting them to the enforcement jurisdiction. That definition of covered person, as you know, relates to a person that engages in offering or providing a consumer financial product or service. So, the focus really was whether these trusts were in fact engaging in a consumer financial product or service. There were some basic points that were touched on by the court. The trust had acquired these loans in order to have an enterprise or activity relating to them. They entered into agreements with third-party servicers, to carry out activities that otherwise the trust, were going to have to provide. Without those services, the trust couldn't fulfill those obligations of servicing the loans, and the lawsuits that were brought against the underlying borrowers were done to benefit the trust.

The court also looked at the trust instruments themselves, where in a number of places, it mentioned that the purposes of the trust were to engage in ownership of these loans, the servicing of the loans and collection of these loans. Ultimately, the court said that, and held that the trust agreement's purpose indicates that the trust engages in both student loan servicing and debt collection. As such, they fall within the purview of the CFPB, because they are engaging in a known consumer financial product or service, and therefore necessarily subject to the enforcement authority.

As a result of that, the CFPB is now of the view that in these situations, they can go after not just the specific servicing company, or the debt collection entity, but also the trust sphere, while it does not have employees that are doing it themselves, they're entering into agreements for these entities to conduct activities the trust needs on their behalf. That's a significant change.

Chris Willis:

Yes, so Glen, you mentioned, it is a significant change, which I agree with as well. To what extent do you think we, as an industry, should view this decision as idiosyncratic to this one particular case? Versus appreciate it as a danger to sort of securitization trust in general, which, as you know, and as our audience knows, are incredibly common in the consumer financial services industry?

Glen Trudel:

Well, that's right. I mean, it is a Third Circuit case. So of course, as you know, it's binding within the Third Circuit, which is obviously a popular place for the site of securitization trusts, and so forth. I mean, that's one aspect of it, so it does have that effect, and creates a floor and a basis for the CFPB to go after trust, either directly or maybe if the underlying servicers or collection agents may not have the financial wherewithal to provide full redress, then they can start looking to the securitization trust as another pocket and be able to flex that enforcement authority.

So, you've got that, just with respect to that. Then, more broadly, this could be seen as a predicate or a basis to go after non-securitization situations and transaction structures, where for example, you have a buyer of whole loans that is engaging in doing the similar thing as a trust are in terms of the actual servicing and collection, just using these various contractual agreements to get that work done, but not themselves have that be directly engaged in it. Therefore, the thought was that they would have – that gave them some insulation against having the CFPB come after them.

Chris Willis:

So, it was certainly in a time when we have a very aggressive CFPB, which I think is fair to say that we have today, probably prudent for the industry to conclude that the Third Circuit decision represents an avenue that the CFPB might use in a variety of securitizations and whole loan sales situations. Do you agree with that, Glen?

Glen Trudel:

I do. Yes. I think so.

Chris Willis:

So, with that being the case, let's talk about what the implications are. Because again, securitizations are one of the most important sort of capital financing mechanisms for consumer lending in the United States. What would the implications be of a greater exposure to the CFPB, of the entities where the loans are held? Whether it's a securitization trust or a whole loan buyer?

Glen Trudel:

Well, again, the implication is that there will be these holding entities may have additional risks that they didn't fully appreciate that they may have had before. They can call into question licensing structures. I mean, if they're liable for these sorts of things now, at least to the CFPB, does a state regulator looking at that begin to wonder whether they should be getting the same licenses that the underlying companies have been getting for their particular activities for one? It's also an additional risk, which may or may not be in the documentation, the investor documentation that was set out to the investors for existing securitizations, or for non-securitization situations for investors in the entities that are holding these accounts. Then, now

begins to become more incumbent on those entities to take some defensive measures to put themselves in a better position to avoid giving the CFPB an opening to go after them.

Chris Willis:

You mentioned licensing, Glen. I mean, if you have even a base familiarity with state licensing statutes, they require things like identification of officers and background checks on officers and things like that. I don't even know how a securitization trust would do that. Because usually, they don't have any personnel, at least as far as I know, is that right?

Glen Trudel:

Well, typically, yes. They may not have personnel. There may be some things that would have to be worked through and some things that they may not be able to do. You may have deal administrators, and maybe the licensing falls on them, because it's often that you might have a securitization, but the agreements with these underlying providers are actually entered into by a dealer administrator that is ostensibly acting on behalf of the trust to get these agreements in place. It can create some real questions.

Chris Willis:

So, leaving the licensing issue aside, though, now that the trust need to live. I mean, trust in general, need to live under the cloud of potential exposure to the CFPB, you mentioned steps they might have to take to try to protect themselves under these new change circumstances. What are the kinds of things that you think they'll do?

Glen Trudel:

Well, again, the deal administrators that I mentioned, sponsors of the trust should seek to ensure that the underlying service providers are in fact complying with the law. Adopting a stance, perhaps more similar to what we typically see with a financial institution and what it does with its third-party service providers, pursuant to the guidance that's been put out for them by many of the federal regulators. But better due diligence of the servicers, the debt collectors, and perhaps their significant sub-providers, both prior to establishing the securitization vehicle, in, I would say, periodically thereafter.

This could be established as an ongoing routine because as you can appreciate, as the securitization trusts or many are related and many come out one after another after another, but they're all somewhat related and they all have similar administration, they would be dealing with typically the same servicers. So, this could be something that's done on a regular basis across the related trust. It could be working for all of them. As is the case here, where there were multiple trusts involved in this case.

Now, there are existing vehicle's ability to do that might be affected by the current terms of their documentation. That would need to be something to look at, for existing providers to make sure that the trust documentation permits that sort of thing, then making whatever adjustments may need to be made to allow that. But beyond that, the diligence would include reviews of policies

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and procedures, establishing a rubric for reporting on complaints, or analysis of complaint threat. Again, some of this may already be established at the administrator level. But nevertheless, this is a wakeup call to make sure that these things are in place.

The vendors, employee incentive programs, notice of ongoing material changes these policies and procedures, that sort of thing. The consumer collection lawsuits should be examined to be reviewed for regulatory compliance to make sure there is an absence of the issues that were at the base of the CFPB's arguments and issues in this case. Even considering a look back at some closed cases, to see if there's any risks that are latent in those cases, might be a good idea.

The trust entity itself, should probably have policies and procedures to cover indirectly initial and ongoing due diligence efforts, and for dealing with understanding and remaining current on consumer laws, relating to that third-party function, including working with counsel, with expertise in the area, so forth. Then, I mentioned the licensing issue, they may want to look at that and see how that might apply. But I haven't seen as yet, a state regulator using this case, as a basis to just start making those sorts of examinations, or making those sorts of assertions, I should say.

Chris Willis:

Two related questions to what you just went over Glen. First off, on a going-forward basis, say when new securitizations are set up, which happens all the time, of course. What kind of changes in terms do you foresee might occur as a result of the new threat shown by this Third Circuit decision?

Glen Trudel:

Right. A few things come to mind, Chris. One, they'll want to try to clarify as much as they can, the servicer status, as independent contractors, and not as agents. Often language to that effect, but these things, you need to be – really underscore try to build that. Looking to their indemnifications. Seeking to strengthen those indemnifications in favor of the trust as it relates to these service providers, so as to be more specific about including amounts in fees paid by the trust due to services violations of law, whether it's restitution, consumer restitution, or regulatory fines, or what have you. Understanding that it's not always that someone who's getting a consent order, or getting a result of an enforcement action or a levy of a fine may not be able to exercise indemnification rights to recoup what they have to pay to a regulator.

Chris Willis:

Particularly, with regard to a penalty. Every CFPB consent order that has ever been contains a provision saying, "You cannot get indemnified for the penalty." It doesn't say anything about restitution, but it specifically says that for the civil monetary penalty.

Glen Trudel:

That's right. But you can least get the language in, and for some of these other areas, it's better that they're not there, even though you're right, that ultimately, they may not be able to. Another idea is to focus on the service providers own insurance coverages. Are they adequate? And to the financial wherewithal of the service provider? If something were to happen, are they going to be able to stand on their own? Or are they not, and therefore tempt the CFPB to look for frankly another deep pocket to go after, and so, and this is sort of particular to this case and decision. The trust agreement language itself, use the term engage in a number of places and the court looked at that and pointed to that. Minimizing the concept that the trust is formed, and the purpose of the trust is to engage in these sorts of activities would be helpful. The court would not have had that ability if that language wasn't there. But I don't know that that's a guarantee.

Chris Willis:

Sure. Well, one last question for you, Glen. You had mentioned a couple of answers ago about the potential necessity for the trust to do diligence and monitoring of the service providers that actually touched the loans, and touch the consumers who are parties to the loans. For most trusts, again, as we said before, they don't have any personnel. So, who would do this on behalf of the trust? How would it be set up for that to occur?

Glen Trudel:

Well, again, I think often these trusts have trust administrators whose job it is, if you will, to engage in either the care and feeding of the portfolio, providing reporting to the trust, management to the trustee of the trust, as to how it's performing and those sorts of things. In handling a lot of administrative tasks, they might be tasked with doing this and getting third parties to conduct the due diligence on behalf of the trust and report the results. Again, whether it's to the trustee, or the trust administrator, or the deal administrator, whatever the case may be to make sure that that's done and that the results are accepted and analyzed by the folks who are responsible for the decisions, if you will, that the trust makes and act accordingly.

Chris Willis:

I guess, just as a concluding question for the podcast, Glen, I mean, it sounds to me like you view this is a pretty significant change in the legal landscape for securitization trust, and as you said, whole loan owners too. Am I kind of characterizing that right?

Glen Trudel:

I don't know that this is the first time that there's been assertion that the CFPB can go after the trust, but I don't know that they've done it before. If so, it's been rare. It's not something that's one typically sees. But now, we've got, circuit court, saying it's flat out that the securitization trusts can be subject to the CFPB enforcement jurisdiction and authority. I think that's a wake-up call.

Chris Willis:

Yes, I do too. I'm really glad, Glen, that you've joined me for this episode today to tell our audience about how the ground may have moved underneath our feet, I think, from the securitization world. I think it is an important thing for the industry to take into account. So, thank you for being on the podcast today.

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