Podcast: *The Consumer Finance Podcast*
Episode: Point-of-Sale Finance Series: Auto Finance — Dealer Risk, Lien Perfection, and Compliance Essentials for Market Entrants (Crossover Episode With Moving the Metal)
Host: Jason Cover
Guests: Brooke Conkle and Chris Capurso
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Jason Cover (00:04):
Welcome to a special crossover edition of *The Consumer Finance Podcast* and our now long-running special series focused on point-of-sale finance. I'm Jason Cover, and today I'm joined by Brooke Conkle and Chris Capurso to discuss auto finance issues. Brooke and Chris, welcome aboard.

Brooke Conkle (00:19):
Thanks, Jason.

Chris Capurso (00:20):
Thanks for having us.

Jason Cover (00:21):
Quickly, before we jump into today's episode, let me remind you to visit and subscribe to our blog, troutmanfinancialservices.com, and don't forget to check out our other podcasts on troutman.com/podcasts. We have episodes that focus on trends that drive enforcement activity, digital assets, consumer financial services, and more. Make sure to subscribe to hear the latest episodes. With all that said, for those of you that have been tuning in here, I think for over a year now on point-of-sale finance, you may have found it a bit odd that we've never discussed maybe the biggest point-of-sale finance purchase that most folks make in their lives, which would be related to purchasing and financing an automobile. And there's a very good reason for that. Brooke and Chris host a separate podcast called *Moving the Metal*, and we wanted to do a podcast crossover with them today to discuss some of the issues that they talk about on a daily basis. So we're hoping that this will be somewhat enlightening for those maybe that have other types of point-of-sale products but don't have auto that have considered it, or maybe just some interesting issues that creep into auto and may also creep into your day-to-day point-of-sale finance issues. So with all that said, Chris and Brooke, let's jump into it. I think there are some structural changes that happen when someone jumps into auto finance that they might not necessarily have incorporated into their product structure for, say, home improvements or medical finances or something along those lines. Do I have that right?

Chris Capurso (01:50):
That's right, Jason. And yeah, it's, like you said, the biggest point-of-sale purchase many of us will make, unless for some reason we're buying a house point-of-sale, which would be a very interesting process, is probably the car. And yeah, there are a lot of different things. I think one of the key aspects, obviously, in the auto context, most of us have been to a dealer in some time. That is the salesperson. The structural thing that we need to consider is typically what we're going to see is retail installment sales financing. Sometimes we'll see loans, but we'll typically see retail installment sales financing where the dealer is the original creditor and they're selling that vehicle on credit, and then they're going to assign it on to a finance company that is going to service it and they're going to deal with all those things. So we've got that overlay where maybe in some of the other areas like home improvement financing or medical services financing, as you mentioned, it might be more kind of the direct loan route.

We see that in auto, but it's more prevalent to see the retail installment sales financing method. Another big thing that I think probably everybody's going to guess is the security aspect of things. And it's a huge purchase, there is a lot of money being thrown out there on credit when it comes to a car. So they're going to be secured purchases. And you have to think at the dealer level, securing a vehicle is a very different process than, say, getting a UCC-1 on maybe your home improvement financing or whatever you're going to be dealing with in other financing contexts. Vehicle securities are very heavily regulated. There's actually a carve-out from the UCC for how these things are done so that they are specifically through vehicle codes and through state DMVs and state titling laws. We've got a title for a car that's going to list the lienholder, and every state has their own different way of doing it. Some may be just purely paper, some may have a hybrid, some may be just electronic when we're talking about financial institutions. So that's another very interesting wrinkle that I'm sure folks, if you want to get into the auto finance space, that is one of those things that you really have to be thinking about is how am I going to secure my obligation?

Jason Cover (04:07):
Chris, that's a great point. I think there's some level of security interest taken in some point-of-sale, like in larger home improvement projects or solar, but I'm sure a lot of folks listening in right now don't have to consider security interest generally, repossession, and certainly not in the context of auto. And having been through some of the vehicle titling and lien statutes, it's tricky and can be time-consuming. So something definitely worth considering. Do you have a sense of why so much of the auto finance market is based in retail installment sales versus direct lending? Is it by virtue of the dealer network or some other reason?

Chris Capurso (04:42):
I think it is. I think... We've talked about this before. Actually, we were just saying you were one of the first guests on Moving the Metal, and we kind of discussed the retail installment sales financing versus direct loan financing, pros, cons, all those types of

things. So this is kind of a weird bookend moment. But it's a very institutionalized thing. I think it's a little bit more deregulated. You're not going to see as many dealers having to go get licenses. I mean, there are some that do have retail seller licenses, and there's certainly sales finance company licenses, but it's just a different scheme than the direct loan world. And, to your point, I think a lot of it, it's the way it's been, it's the way it's been institutionalized, this is the way things operate. But with that always comes the risks, and I'm sure Brooke is going to get into it, the idea of the holder rule and the different types of things you have to specifically deal with. Obviously, you could have to deal with the holder rule in direct loan context, but it's a little bit more limited than in sales finance where it is there and it's always omnipresent in whatever you're going to be doing.

Jason Cover (05:43):
That's a great segue, Chris. Brooke, from a litigation standpoint, considering these nationwide dealer networks, what does that look like when the relationship goes wrong between the seller, who's really a critical part of that relationship, and the finance company?

Brooke Conkle (06:00):
Yeah, Jason, you're exactly right. So in the auto context, you have a triangulation. You have the consumer, the dealer, and the auto finance company. And the dealer agreement is the backbone of the relationship between a finance company and the dealership. And specifically when dealer fraud occurs, as Chris mentioned, the FTC holder rule means that the consumer can assert against the lender every claim and defense that they have against the dealer. So a lender who bought a contract clean can suddenly find itself in the midst of defending dealer misconduct that it may or may not have known about. And, as Chris mentioned, there are UDAP claim risks arising from the F&I office. There's add-on products like gap insurance, extended warranties, credit insurance. Those are frequently the subject of consumer litigation, and through that holder rule, lenders can be pulled in as defendants even when the misconduct, whether it's alleged or whether it's real, if that misconduct was entirely the result of the dealer's action or inaction. And so in litigation, that dealer agreement and also the lender's oversight practices really become critical evidence. Did the lender have a dealer monitoring program? Did it act on red flags? These are the kinds of questions that plaintiffs' counsel ask in discovery and at trial. So state court class actions based on dealer markup, disparate impact issues are alive in several jurisdictions, and a new entrant who doesn't build a fair lending infrastructure before scaling up will face exposure really quickly, and that's one of the areas that we're always concerned about.

Jason Cover (07:45):
And Brooke, I think for the folks that have been tuning in, this is a recurring theme. I think we've called them, like, merchant or dealer shenanigans on other podcasts, but it's that same issue of that the dealership is effectively your agent brokering the deal. The point about gap insurance and other add-ons in the auto space is a good one. I think

that is probably somewhat new to folks that are financing other types of products. Maybe you're throwing other things in there, but ancillary products aren't as prevalent, I think, in at least for our other clients in this space. So all good points there. Chris, moving back to collateral titling, lien perfection, what types of things from a compliance and operational standpoint does an auto finance company need to be thinking about there? I mean, I've talked to some clients just about the UCC filings and things of that nature, and that's a lot to handle in and of itself. But it sounds like the auto finance side is even more complex.

Chris Capurso (08:37):
Right. And I'm sure the audience here... We're talking point-of-sale, obviously, this is the series, but I'm sure there are folks on or listening who may have refinance programs, and that has its own interesting titling, lien security issues. So I'll kind of get to both of them. With the point-of-sale, there is a lot of reliance on the dealer, right? They're the ones there. They're the ones as the originator of the credit, and they're also the ones with the DMV hookup, so to speak. Like, they are the ones who deal with that on a daily basis. So there's some reliance there that they are going to properly record the liens. And of course, one of the interesting things in sales finance is for auto, it appears everywhere, but if it's a good program, there's going to be typically a dealer agreement between the dealer and the finance company where they kind of outline all of these obligations that the dealer is going to have. So in there, there's going to be some kind of representation, covenant, what have you, by the dealer saying, "Hey, we are going to make sure that your lien is recorded on this." That if it's not recorded within a certain time period, there may be a chargeback or a buyback obligation where the finance company sends it back because the security is not good. It's not what the finance company would expect. So you build those types of things in, but there's a lot of reliance on the dealer.

It actually gets even fuzzier when you're talking refinance because at that point, you've already had this back and forth between a finance company and a dealer trying to figure out that whole thing. Now we have a finance company who is already a lienholder on the title, and then you've got a refinancing party who wants to replace that lien. But there's already a title out there. So there are a lot of different processes, and we see this get messed up a lot because it is more squishy. It's not... As I mentioned, the dealer has those hookups. Sometimes the finance companies don't necessarily know exactly what's going on with that title. And nowadays, I mean, it's hopefully getting a little bit better with electronic titling where everything's kind of in a central database. Back in the days of pure paper title, where it's like, "Where is this thing? Who's holding it?" all those types of things, it gets even more confusing for the refinance company. But trying to figure out, "Okay, I'm refinancing this obligation, I want my lien, but has the prior lien been entirely paid off so that the prior finance company, bank, what have you, will actually transfer or just relinquish their obligation, relinquish their security interest, and then have that transferred over to the new refinancing entity?" We see all sorts of issues with this in the refinance space.

So it's one of those things where, obviously the actual machinations of the securing process are complicated. Having to go through the DMV, they try to make it as easy as possible, but it's a 50-state patchwork because those are state law-based. So you've got to consider if you're somebody running a program 50 states on the point of sale side, okay, we've got to understand how every state does this. And then on the refinance side, you've got that overlaid with, "How are we dealing with prior finance companies, prior creditors, things like that, to try to actually get a clean lien over to us on this title?" So it's a complicated process and one of those things, as you alluded to earlier, something that you don't typically see in the other kinds of sales finance arenas. You're not going to see somebody transferring a home improvement or those types of things. We're not dealing with that with the DMV, right?

Jason Cover (12:00):
Right.

Chris Capurso (12:00):
So it's just a very different process.

Jason Cover (12:02):
So Brooke, I didn't listen to Chris, I didn't adopt a good dealer monitoring program, I don't have good dealership agreements, I didn't dot my I's and cross my T's as to 50-state electronic titling laws, and things go wrong. Is it just a perfection issue and I'm last in line in priority, or do I have a more material litigation risk once these things go awry?

Brooke Conkle (12:24):
Oh man. When things go awry, they absolutely can go awry. And really where we see it first and foremost is repossession. So even when a lender has a valid perfected lien, self-help repossession still has to comply with state-specific breach of the peace standards. So even when everything is going absolutely the way that it's supposed to, but the consumer defaults, you've still got potential risk even when the lien is perfected. When it's not, oh mama. That can really generate some affirmative claims against the lender when getting the collateral piece doesn't quite go right. And then the other area where we see it really is bankruptcy. If a lender's lien is not properly perfected, then a bankruptcy trustee can avoid the lien under the strong-arm powers in the Bankruptcy Code. And then the lender, exactly what you don't want to have happen, the lender becomes an unsecured creditor on what it thought was a secured loan. We've all seen it happen, it's not a happy surprise. So getting that piece correct is really important, not just for avoiding claims when it comes to repossession, but when it comes to generating affirmative claims against the lender, you want to make sure you have that lien perfection piece in place.

Jason Cover (13:43):
Brooke, that makes perfect sense. I had a former life as a bankruptcy attorney, and there is certainly nothing worse than being a general unsecured creditor, particularly in

a consumer bankruptcy. It's bad enough in commercial bankruptcies, but cents on the dollar to say the least. Chris and Brooke, I think a lot of our clients in the point-of-sale finance space are fintech companies that really pride themselves on instant approvals, instant quotes, pre-qualifications, things of that nature. Is that something that's transferable to the auto finance space? Are there inherent issues with that when you have someone at the dealership asking for financing?

Chris Capurso (14:20):
I think it can be, and it's a very kind of funny statement when you think about speed and how fast a transaction can go through. Understandably, buying a car at a dealership is not at the top of the list. And a lot of it is because there are a lot of regulatory things that they have to deal with. Car sales have a lot going on with them. I mean, it's the second-biggest purchase a lot of us are going to make behind a house. And the process for buying a house is even worse. So it's like varying degrees of how friction-filled the process is. What I think a lot of folks, especially now with, obviously technology is getting much better, there are programs out there where you can get that pre-qualification financing where you could go into the dealership and have something ready on the financing side or... I mean, I did that for my last car purchase. Went into the F&I room where you discuss the financing offers that you're eligible for, received a bunch of them, and I was like, "Those don't align with this nice offer I got here on my app." They were like, "You're right, they don't. Do you want to use that?" And I'm like, "Yes, of course I do." And that was very frictionless for me. I got on the app and just filled out my information, got an offer, here we go, and I was able to present that. So from the financing standpoint, that was very easy. Trying to get the car was different because that was... Dating it a little bit, it was about four-and-a-half years ago when inventory was very low. I had to drive about three hours to go get my car and then had to sit there and go through the car-buying process. But the financing part wasn't too bad.

So I would say there are ways that it can align with that point-of-sale speed idea, but there are also just the realities of vehicle buying. And obviously, there are those out there who offer, say, online vehicle buying, things like that, but there's still friction in that process too. There are certain... And some of it's the byproduct of the way the state laws are. Pre-COVID, it was very antiquated with how you were going to sign vehicle transaction papers. Some states have modernized since then, especially... We were all there for COVID where you couldn't actually go anywhere and trying to figure out how you're going to sign some of these documents that require wet signatures under the law and things like that. Again, got to go back to the original point. I think the financing can be speed, it's just the nature of the beast with vehicle transactions is that there's probably going to be some friction.

Jason Cover (16:34):
I'll keep my mouth shut and have no comment on the pleasantness of purchasing and/or financing a car, but wholeheartedly agree with you on all of that, Chris. Brooke, I think

something I always think of as being an issue in auto finance is underwriting and origination. And I think you saw the New York AG's office, in conjunction with the CFPB, file an action a few years ago. Are there current events in underwriting activity that we should be aware of when entering the auto space?

Brooke Conkle (17:03):
Yeah. And as you mentioned, there are some topics that, no matter who is holding the White House, that are certain essentially evergreen issues for loan origination and underwriting. And the first is ECOA adverse action cases. They're a consistent source of litigation for lenders. And there are issues that the plaintiffs' class action bar watches really closely. So an incorrect or missing adverse action notice can be the hook for a broader class action claim alleging systemic fair lending issues. So that's one thing that we consistently look for. But additionally, there are almost always claims of yo-yo financing. So it's the dealer calls the customer back to renegotiate terms after the customer has already driven the car home. That's not a good place for anybody. Chris, I'm assuming the dealer did not call you back. That's why we had a happy financing.

Chris Capurso (17:59):
That's right. That's why the memories are still great.

Brooke Conkle (18:01):
That's right. That's right. Everything went the way that it should. So courts have allowed both UDAP and TILA claims, Truth in Lending Act claims, against dealers. And as we've mentioned, that chestnut, the Holder Rule, it can still come back to assignee lenders. So those are issues we continue to look for. And Jason, just as you mentioned, the states continue to be active in this area. While we have seen federal regulators retreat from the areas, there are very active state attorneys general who are really looking to enter the auto finance area for enforcement actions and are looking at things. The agenda that we heard from the federal regulators in the prior administration, those talking points are being repeated by folks who are now in state attorneys general offices. Junk fees, add-ons, service member claims, all of those are consistently going to be an issue for lenders in the auto finance space. So it's really important to document your underwriting criteria and apply them consistently for dealers and for lenders. And in litigation, oftentimes it's tough to defend cases where a lender's written policy and its actual practice really show two different things. That's tough. That's tough. So that divergence is exactly what is going to be the target for an enterprising plaintiffs' lawyer.

Jason Cover (19:26):
Brooke, those are all great points. And just to throw one more thing out from the regulatory side of things, since you mentioned adverse action, I think it's... There's always kind of that inherent question of who's giving adverse action even, right, when you have a creditor who's immediately selling it to a sales finance company and the sales finance company's the one giving the green light. So there's always been a lot of back and forth and commentary about who should or shouldn't provide adverse action in

those circumstances. So always something to pick around in that sense. With all that said, guys, for our folks out there who maybe aren't in the auto finance area, have a great existing point-of-sale platform, are thinking about dabbling, do you have any parting words of advice or parting thoughts that they should consider before starting up and taking that first auto application?

Chris Capurso (20:15):
Yeah. I mean, on the point-of-sale side, the thing I keep coming back to is the dealer side of things. And obviously, in really any kind of point-of-sale, there's always that idea of oversight of what the dealers are doing, what are they saying, those types of things. And it's valid, you have to have dealer monitoring, dealer compliance, all those types of things, the dealer agreements. But in auto, it is such a large transaction and there is so much that can be said and so many things that can be done. I mean, a great example, and this is something we've been covering on our podcast almost incessantly since they came out, is in March, the FTC came out and said price advertising in the auto finance area is not what we want it to be. There's a lot of UDAP going on. So what we need is a total price disclosure that has everything except for government fees in it. There are a lot of fees in an auto transaction. Fees that are permitted, such as document fees and things like that, but the FTC takes the position, oh, those need to be advertised as total sales price. And now that is starting to trickle down to the states where some states are even altering their current law and interpretations to align with what the FTC has just said.

And you may be saying, "Okay, that's dealer advertising." Well, Holder Rule, if those state actions, for example, have, say, a private right of action in there, then all of a sudden you as the buyer of the paper are right there for something the dealer may have advertised that you may have absolutely no idea that they did. They may have put that out there in an online ad, in some message board. It could be anywhere on the internet. Trying to figure out the different kinds of advertising avenues that a dealer has used and trying to police all those things is very difficult. And with the Holder Rule and with liability the way it is, you could theoretically be on the hook for that. So I think one of the most important things is to know who you're doing business with. And this is the same for any industry. I mean, Jason, you and I know from the solar industry, the same idea where if you're dealing with a bad dealer, a bad installer, or things like that, there could be problems for you down the road. It's the exact same thing in auto finance. You want to have your due diligence on who you're buying the paper from because that risk is real, as Brooke has mentioned several times throughout this. And you could just take care of so many headaches up front if you just know the people you're doing business with and have already determined, okay, this is somebody who I want to be doing business with, they have a culture of compliance, and we don't expect these types of issues to be coming up, rather than fast-forward three months, you've been taking a bunch of contracts from them and lo and behold, they're one of the prime people that the FTC or a state AG is looking at for these types of claims.

Brooke Conkle (22:54):
Yeah, Jason, I'm going to echo almost all of what Chris has said. And just as Chris said, the relationships in auto finance are so important. It's always important to have a good relationship with your customer. When you add a dealer to that mix, then suddenly you have demands coming from the customer, coming from the dealer, it's going back to the auto finance company. A lender has a seat at the table at the transaction at the point-of-sale, even though the lender is not in the room at the time that the transaction goes final. So recognizing that risk, sort of evaluating risk when it comes to auto finance is so difficult because it can be very challenging to figure out what is actually going on at the dealer level. And then that risk can come back to you through the Holder Rule. We've said it once, we'll say it again, trying to figure out how much risk you're willing to take on because of the exposure that is part and parcel of the Holder Rule, that can be a tough calculation. And then, just as Chris said, making sure that you have a very buttoned-up compliance plan ready to go when you make that transition into auto lending because it is so complex, it is not something that you can retrofit. You start accepting retail installment sales contracts, everything has to be ready to go with that compliance program already, rather than just, "Let's take a couple, let's see how we do." Unfortunately, that is not going to work in this space.

Jason Cover (24:25):
At the risk of sounding like a broken record to folks who've been tuning in, we've talked a lot about merchant risk in various shapes and formats. It sounds to me from listening to you both that people in the auto industry may be even more familiar with this long-standing risk because it's been around so long, whereas I think some of our clients in the contractor or general merchant space, it's only become an issue more recently or they've only become accustomed to it more recently. So it sounds like if there was one piece of advice, it's that you really need to have that buttoned up before you move into auto if you don't have it buttoned up now.

Brooke and Chris, this has been absolutely fantastic and thank you for joining us. And thank you to the audience for listening to today's episode. Another plug for Brooke and Chris, if you're interested in auto finance, please subscribe to the *Moving the Metal* Podcast and visit our other blogs, the troutmanfinancialservices.com blog, and subscribe so you can get the latest updates. Please also make sure to subscribe to this podcast via Apple Podcasts, Google Play, Stitcher, or whatever platform you use. We look forward to seeing you next time. Thank you so much.