Clients&FriendsAlert

Seeing Red Flags in Tricolor: A Colorful Lesson on Collateral Interests

September 23, 2025

Tricolor Situation Overview

Tricolor Auto Acceptance, LLC ("Tricolor"), founded in 2007, is a "buy here-pay here" ("BHPH") subprime auto finance company. This means that it is both an auto dealer and an auto finance company, offering in-house financing directly to its customers. Tricolor is also a Community Development Financial Institution ("CDFI").[1] Tricolor, which is a subsidiary of Tricolor Holdings LLC, operates over 60 dealerships, the majority of which are located in Texas and California. Subprime customers visit their locations, find a car that suits their budget and obtain financing on the spot through Tricolor.

Over the past five years, Tricolor has been among the fastest-growing auto lenders in the United States, quadrupling in size. Earlier this year it closed two term securitization transactions, the most recent of which was Tricolor Auto Receivables Trust 2025-2.[2] However, last week, Tricolor's rapid growth came to a halt when reports surfaced that warehouse lenders had uncovered alleged fraudulent activity, including double-pledging of collateral.[3] Shortly after those reports were published, Tricolor filed for Chapter 7 bankruptcy.[4]

Because Tricolor operates as both a BHPH and a CDFI, its auto loan portfolio has features that differ from those of a typical subprime auto finance company. These unique characteristics should be considered when evaluating the lessons to be learned and applying safeguards to similar transactions.

---

[1] CDFIs are financial institutions that are focused on providing credit to underbanked and unbanked populations. For more information about CDFIs, *see* https://www.cdfifund.gov/.

[2] The S&P Presale Report is available at https://www.spglobal.com/ratings/es/regulatory/article/-/view/sourceId/13500998. Tricolor has several other term ABS transactions that remain outstanding.

[3] Amelia Pollard, "Tricolor collapse sparks concern about health of US subprime auto sector," *The Financial Times*, Sept. 15, 2025, available at https://www.ft.com/content/27de0a41-4dd4-410c-92de-b30ec4672905.

[4] An independent third-party trustee has already been appointed to oversee the bankruptcy case. The Chapter 7 trustee's role will primarily be to liquidate assets to maximize value for creditors. Those assets can include claims against the debtor's prior officers and directors, as well as against creditors and other parties for actions taking place in the run-up to bankruptcy.

While the facts and circumstances of the Tricolor case are still developing, industry participants across myriad asset classes (including consumer loans, mortgage loans and esoteric assets) and types of transactions (including whole loan trades, warehouse financings and securitizations) have renewed their focus on four key areas: (i) improved due diligence, (ii) updating credit agreement provisions related to pledged assets, (iii) revisiting who maintains custody of pledged assets and ensuring better control over cash flows, and (iv) evaluating the treatment of structured finance transactions under the UCC and in bankruptcy.

Each area is addressed below, with suggestions for enhanced practices and controls, with callouts for considerations that may be specific to one asset class or transaction type as opposed to others. However, it is important to note that no set of controls can completely eliminate the risks inherent in third-party relationships, particularly the risk of fraud.

Due Diligence

Due diligence is the single most important step that banks and whole loan purchasers can take to protect themselves against fraud or mistake by originators and servicers. Because every company operates differently, there is no "one-size-fits-all" diligence protocol or checklist. The scope and focus of diligence should be tailored to the company and the asset class, including any aspects of its business model that are unusual or high-risk, giving due consideration to the regulatory landscape and the mechanics of enforcement against the specific asset type. Given Tricolor's unique business model as a BHPH and CDFI, lenders must carefully tailor the due diligence, focusing on how its customer base was likely more deeply subprime than usual and collateral risks inherent to BHPH companies.

In general, key areas for proper due diligence include all of the following:

- **Assessing the company's culture of compliance**. In addition to public record searches for consumer complaints, licensing issues, regulatory enforcement actions and lawsuits, consider on-site meetings and interviews with management, and a review of compliance policies, procedures, internal controls and related training materials to ensure alignment with regulatory requirements that includes not just current documents but considers how things may have recently been updated or changed. Particularly when the asset class involves subprime loans, review of each of these points at regular intervals (*e.g.*, every six months or annually) may be appropriate.
- **Understanding bank-fintech partnerships**. If the warehouse loans are tied into a bank-fintech partnership, enhanced due diligence is appropriate. In addition to examining the overall culture of compliance, it is recommended to review the program agreement between the bank and the fintech, paying special attention to how involved the bank is in reviewing customer-facing materials, establishing the credit policy and reviewing consumer complaints.

- **Considering independent reviews or consultants**. Engaging third-party specialists can provide objective insights and detect red flags that internal teams may miss. Firms are often engaged by the company to conduct targeted reviews of loan files, lender and portfolio-level due diligence, review of servicing practices, operational assessments, including IT systems and data security controls, cash flow and liquidity analysis and vendor oversight audits. Ideally, the reports from these reviews can be evaluated and the company can provide updates regarding improvements stemming from the reviews.
- **Consider engaging third parties for ongoing review**. Third-party firms may also include verification agents, valuation agents and hot backup servicing arrangements. A verification agent independently confirms the existence of each asset and the related documentation. A valuation agent provides an independent assessment of the value of the assets, ensuring true and accurate marking as opposed to inflation of value. A hot backup servicer (especially when the primary servicer is an affiliate of the originator) provides a real-time alternative to the entity closest to the assets on a day-to-day basis. In the aggregate, these protections provide operational comfort about the integrity of the assets while deterring double pledging.
- **Conduct lien searches and collateral verification**. Fraud often centers on misrepresentation of collateral, making the following steps essential: (i) lien searches to identify other secured creditors of the company who have perfected their security interests and confirm details about the pledged collateral,[5] (ii) double-pledging controls, including reconciliation of pledged assets across facilities, (iii) electronic chattel paper controls, ensuring systems meet UCC requirements for control and include complete audit trails, and (iv) review of custody practices for both physical and electronic loan files.

The Interagency Guidance on Third-Party Risk Relationships: Risk Management[6] provides further detail on due diligence procedures. Although the guidance addresses banks' reliance on third-party providers of products and services, it highlights critical areas such as (i) business strategies and goals, (ii) legal and regulatory compliance, (iii) financial condition, (iv) business experience, (v) qualifications and backgrounds of key personnel, (vi) risk management, (vii) information management and security, (viii) incident reporting, (ix) physical security, (x) reliance of subcontractors, (xi) insurance coverage, and (xii) contractual arrangements with other parties.[7]

Contract Provisions

The contracts governing asset purchases by a special purpose entity ("SPE") and the pledge of those assets to a lender, trustee or other secured party are essential to mitigating risk. These agreements

[5] Note that lien searches will not be effective to identify a secured party who has perfected its security interest solely by possession (in the case of tangible chattel paper) or control (in the case of electronic chattel paper).

[6] *See* 88 Fed. Reg. 37920 (June 9, 2023).

[7] *Id.*, at pp. 37929-37931.

generally address four core elements relating to the collateral, including (i) representations and warranties, (ii) covenants, (iii) repurchase and indemnification remedies, and (iv) audit and inspection rights.

Representations and Warranties. For common asset types, there is a well-developed and relatively market-standard set of representation and warranties. A good source for benchmark representations and warranties for various asset types is the Rule 17g-7(N) reports published by rating agencies for rated ABS.[8]

For example, a whole loan trade, warehouse financing or securitization of auto loans will typically contain the following representations or warranties, or some variation thereof, which help to establish chain of title, the creation and perfection of first-priority perfected security interests and the physical location of the collateral:

- Each receivable (i) was originated in the United States by a dealer for the retail sale of a financed vehicle in the ordinary course of such dealer's business and has been fully executed by the parties thereto and, (ii) was purchased by the seller from a dealer and was validly assigned by such dealer to the seller.
- Immediately before the sale under the purchase agreement, the seller had good title to each receivable free and clear of any lien other than permitted liens and, immediately upon the sale under the purchase agreement, the purchaser will have good title to each receivable, free and clear of any lien other than permitted liens.
- There is only one original executed copy of each receivable.
- The receivables constitute "chattel paper" (including "tangible chattel paper" and "electronic chattel paper") "accounts", "instruments" or "general intangibles" within the meaning of applicable UCC.
- Other than the security interest granted to the indenture trustee under the indenture, the issuing entity has not pledged, assigned, sold, granted a security interest in, or otherwise conveyed any of the receivables. The issuing entity has not authorized the filing of, nor is the issuing entity aware of, any financing statements against the seller, the depositor or the issuing entity that include a description of collateral covering the receivables other than the financing statements relating to the security interests granted to the depositor, the issuing entity and the indenture trustee under the basic documents or any financing statement that has been terminated. The issuing entity is not aware of any judgment or tax lien filings against the seller, the depositor or the issuing entity.

[8] *See, e.g.*, S&P Global Ratings 17g-7(N) Benchmark and Disclosure Reports, available at https://www.spglobal.com/ratings/en/regulatory/17g7reports.

- The custodian has in its possession or with other third-party vendors all original copies of the receivable files and other documents that constitute or evidence the receivables. The receivable files and other documents that constitute or evidence the receivables do not have any marks or notations indicating that they have been pledged, assigned or otherwise conveyed to any person other than the depositor. All financing statements filed or to be filed against the issuing entity in favor of the indenture trustee in connection herewith describing the receivables contain a statement to the following effect: "A purchase of or security interest in any collateral described in this financing statement will violate the rights of the indenture trustee."

Similar representation and warranty packages that are tailored to the particular asset type are also included in whole loan trades, warehouse financings and securitizations of other consumer, mortgage and esoteric assets.

Covenants. In addition to representations and warranties, transaction documents typically include affirmative (positive) and negative covenants that apply throughout the life of the transaction. Each key or material representation is generally paired with a corresponding covenant, ensuring that the stated condition remains true throughout the life of the transaction (*e.g.*, a representation confirming perfection would be paired with a covenant requiring maintenance of perfection).

Special Purpose Covenants. In addition to the standard set of affirmative and negative covenants, financial transactions may also include special purpose covenants which are designed to keep a subsidiary legally separate from its parent. The covenants include things the company must do (*e.g.*, maintaining separate books and records, holding itself out as a separate entity and maintaining adequate capital) as well as things the company must not do (*e.g.*, commingling of assets, guaranteeing the debt of others, or dissolving without the consent of an independent manager). The covenants in the aggregate are a conglomerate of bankruptcy case law which ward against the special purpose entity being consolidated into the estate of its parent such that there is legal isolation between the assets of the company and the creditors of its parent.

Indemnities, Repurchases and Other Remedies. When a representation, warranty or covenant is breached, the affected party typically has notice and cure rights and, if uncured, specified remedies (*e.g.*, indemnification, repurchase or substitution of affected assets, servicing transfer, or declaration of an event of default). Note that the representation, warranty and covenants described above, as well as the corresponding remedies for their breach, are generally well suited to deal with the occasional breach with respect to a modest portion of the asset pool. The protections are less reliable in the case of fraud or pervasive breach, particularly where the originator or servicer is in financial distress or is otherwise unable or unwilling to satisfy its repurchase and indemnification obligations.

Note that indemnification and repurchase obligations are unsecured corporate credit obligations of the seller or servicer. If the seller or servicer is in bankruptcy, indemnity/repurchase claims are subject to the automatic stay (and will generally be treated as unsecured claims in any bankruptcy case).

However, an important exception to the automatic stay arises in the warehouse finance context with respect to mortgage loans. The bankruptcy safe harbor protects certain participants in certain financial contracts backed by mortgage loans. In the repo context, the Bankruptcy Code permits creditors/repo buyers to terminate the financial contract, accelerate the related debt and liquidate the related assets notwithstanding the bankruptcy of the repo seller and the automatic stay.[9] Such actions may not be stayed or otherwise avoided by any other provision of the Bankruptcy Code.[10] It is critical to engage skilled legal counsel to structure transactions to take full advantage of the bankruptcy safe harbor to the extent the related asset and deal participants are eligible for such protection.

Audit and Inspection Rights. Robust audit rights are a primary control for validating collateral quality, confirming continuing perfection and priority, and detecting emerging operational or fraud risks. In addition to baseline access and inspection rights, parties should push for more frequent, risk-calibrated audits—particularly in the first 12-18 months of a new counterparty relationship or upon performance drift. Key elements to address are (i) broader scope and access, including unannounced visits, (ii) increased frequency and triggers, and (iii) clear logistics and cost-sharing arrangements.

Custody of Assets

Not all warehouse lending facilities or term ABS deals utilize a third-party custodian. In some cases, rating agencies, investors and lenders may permit a well-established or highly-rated seller/servicer to act as custodian of the securitized assets. In the mortgage loan repo context, however, it is market-standard to engage a third-party custodian at the start of the transaction. The triparty custodial arrangement requires a check-in process for the contents of the mortgage file, the delivery of an exception report with respect to any missing items in each mortgage file, and a checkout process for certain discrete reasons including servicing of the loan and the review of such files by potential takeout investors. These arrangements often require any released mortgage files (including the negotiable instruments evidencing the obligation to pay) to be returned well within the date the UCC would deem the lender's perfection by possession to be terminated.[11] The use of the third-party custodian is another critical lender protection in the mortgage repo market that should be maintained.

---

[9] *See* 11 U.S.C. §§ 362(b)(7), 559.

[10] *Id.* § 559.

[11] Twenty days for instruments perfected by possession. UCC §9-312(g). Note that there is not a parallel permission for a secured party in possession or control of chattel paper to relinquish it to the debtor for servicing; therefore, secured parties in possession or control of chattel paper will rely on filing perfection during any such release for servicing.

The use of a third-party custodian provides several important benefits, including (i) supporting and evidencing perfection (by possession or control, as applicable), (ii) preventing double-pledging and loss of collateral, and (iii) operationalizing clear release/return mechanics. This is particularly critical for transactions secured by tangible chattel paper, electronic chattel paper, instruments, and/or mortgage notes, where perfection by possession or control has priority over perfection by UCC filing alone.

It is important to remember that the use of third-party custodian does not eliminate all collateral-related risks, particularly the risk of fraud. Indeed, a third-party custody agreement will typically provide that the custodian makes no representations as to the validity, legality, perfection, priority, enforceability, recordability, ownership, title, sufficiency, due authorization or genuineness of any of the documents contained in any receivable file or of any of the contracts.

Control of Cash Flow

One other important lender protection found in the warehouse financing space is the control of cash flow. This is typically achieved through a triparty servicing arrangement, where the servicer acknowledges that the financed assets are now subject to the security interest of the warehouse lender and agrees to service such assets on behalf of the lender and other secured parties particularly upon the occurrence of an event of default under the related credit agreement. Under this arrangement, all income generated by the assets is swept by the servicer into a controlled account after receipt and identification by the servicer. This construct minimizes the risk of "leakage", meaning cash flowing outside the priority of payments in the credit arrangement (which is often called a waterfall). The involvement of the third-party servicer also wards against the risk of double-pledging, since the servicer's acknowledgment and cash sweep mechanics make it clear that the income belongs to that particular lender, making it difficult for the borrower to double-pledge the assets to any other lender.

The Tricolor Bankruptcy Proceeding, and Risks and Protections for the Lenders

Chapter 7 Bankruptcy. Tricolor's Chapter 7 petition will result in a liquidation of the business. It is highly unusual for a case of this size and scope to file for a Chapter 7 liquidation. Typically, large companies will file for protection under Chapter 11 of the Bankruptcy Code, which permits reorganization and typically keeps the current directors and officers in place to run the company during the bankruptcy.

Secured Creditor Claims in Bankruptcy. Under section 506 of the Bankruptcy Code, secured creditors are granted an allowed secured claim equal to the value of the collateral. The secured creditor may also have an unsecured deficiency claim equal to the amount of the claim that is in excess of the value of the collateral, to the extent that the collateral is worth less than the amount of the claim.

To determine the value of the collateral and the security of a claim, the Bankruptcy Code authorizes debtors (and trustees) to value the collateral.[12] If the value of the collateral exceeds the claim amount, then the secured creditor may be entitled to receive unmatured interest or any fees or charges that otherwise would have been payable to that creditor.[13] If the value of the collateral is less than the claim amount, then secured creditors are entitled to receive an unsecured claim for any shortfall in value. Unsecured claims generally receive less than secured claims in bankruptcy cases.

However, the Bankruptcy Code affords secured creditors protections during the pendency of Tricolor's Chapter 7 case. Under section 363(e), secured creditors are also entitled to adequate protection of "any interest in property used, sold, or leased . . . by the trustee." Adequate protection protects secured creditors from a diminution in the value of their collateral during the bankruptcy—thus protecting secured creditors' property rights during the pendency of the case. Adequate protection generally includes periodic cash payments to the secured creditor and the grant of replacement liens to compensate for any diminution in value of the collateral.[14]

Risks for Secured Creditors in Bankruptcy. Given the allegations concerning Tricolor's prepetition conduct and the precipitous decline of its business over the summer, a trustee may be incentivized to pursue litigation claims to maximize value for the estate, including:

- Fraudulent Transfer Claims: The trustee may pursue claims for fraudulent transfer. There are two types of fraudulent transfer claims available to trustees for recovery. In most jurisdictions, there is a four-year look-back period to potentially unwind prepetition transactions.
    - First, under constructive fraud, the trustee may recover transfers made for less than fair consideration at a time when the debtor was insolvent. The trustee may pursue such actions to avoid payments to creditors, or to unwind certain aspects of the overall transaction (such as the liens securing any debts). However, the trustee may not recover from creditors that received the value for satisfaction of a prebankruptcy debt, provided that such creditors have acted in good faith and lacked knowledge of the voidability of the challenged transfer.[15]
    - Second, and potentially relevant here, the trustee may recover payments or transfers that were made with the intent to hinder, delay, or defraud creditors. This is known as "actual fraudulent transfers." Defenses to actual fraudulent transfer claims include the lack of "badges of fraud" evidencing intent to defraud creditors.

[12] 11 U.S.C. § 506(a)(1).

[13] *Id.* § 506(b).

[14] 11 U.S.C. § 361.

[15] 11 U.S.C. § 550.

- Notably, non-debtors are typically protected from fraudulent transfer arguments with respect to settlement payments to financial institutions in connection with a securities contract.[16] The Bankruptcy Code also prevents the avoidance of any transfer made "in connection with a repurchase agreement" prior to the filing of a bankruptcy.[17] Moreover, if the creditors are parties to certain safe harbored contracts (such as repurchase agreements), then certain actions taken to accelerate, liquidate, or terminate a repurchase agreement may not be avoided under the avoidance provisions of the Bankruptcy Code as noted above.[18]

- Preference Claims: Section 547 of the Bankruptcy Code also authorizes the trustee to avoid any payments made to creditor within 90 days of the bankruptcy filing, if such payment enables the creditor to recover more than it would if the case were in Chapter 7 or the payment had not been made. As a general rule, a prepetition transfer to a fully secured creditor will not be considered preferential, because the creditor would be paid in full in a hypothetical Chapter 7 liquidation.[19]

  - Lien Avoidance: The trustee may also avoid any unperfected liens under section 544 of the Bankruptcy Code. Specifically, section 544(a) grants a bankruptcy trustee the powers of a hypothetical judgment lien creditor. The trustee may avoid any unperfected lien if, under applicable non-bankruptcy law, a hypothetical judgment lien creditor could have obtained a superior lien on any collateral subject to that unperfected lien.

Creditors therefore may potentially become targets of the Chapter 7 trustee in its efforts to claw back value into the estate.

Conclusion

The Tricolor case has led to renewed focus on due diligence, credit agreement provisions related to pledged assets, the custody of pledged assets, control over cash flows, and the treatment of structured finance transactions under the UCC and in bankruptcy. Although the risk of fraud or mistakes cannot be fully eliminated, robust due diligence (upfront and ongoing), well-tailored contract provisions and suitable asset custody and cash flow controls can reduce the probability of loss and mitigate any losses that do occur.

---

[16] 11 U.S.C. § 546(e).

[17] 11 U.S.C. § 546(f).

[18] *Id.* § 559.

[19] *See Official Comm. of Unsecured Creditors of 360Networks (USA) Inc. v. AAF-McQuay, Inc. (In re 360Networks (USA) Inc.),* 327 B.R. 187, 190 (Bankr. S.D.N.Y. 2005).

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Cheryl D. Barnes	+1 202 862 2340	cheryl.barnes@cwt.com
Kathryn M. Borgeson	+1 202 862 2384	kathryn.borgeson@cwt.com
Sophie K. Cuthbertson	+1 202 862 2341	sophie.cuthbertson@cwt.com
Christopher J. Dickson	+1 704 348 5277	christopher.dickson@cwt.com
Stuart N. Goldstein	+1 704 348 5258	stuart.goldstein@cwt.com
Chris Horn	+1 212 504 6961	chris.horn@cwt.com
Christopher M. McDermott	+1 704 348 5184	chris.mcdermott@cwt.com
Douglas Mintz	+1 202 862 2420	douglas.mintz@cwt.com
Andrea Nixon	+1 212 504 6223	andrea.nixon@cwt.com
Lisa J. Pauquette	+1 212 504 6298	lisa.pauquette@cwt.com
Mercedes Tunstall	+1 212 504 6223	mercedes.tunstall@cwt.com
Tom J. Curtin	+1 212 504 6063	thomas.curtin@cwt.com
Hunter A. White	+1 202 862 2341	hunter.white@cwt.com
James Thomas McDonnell	+1 212 504 5590	james.mcdonnell@cwt.com
Alexander Strom	+1 212 504 6735	alexander.strom@cwt.com