Clients&FriendsMemo

Forward Movement in the Bureau of Consumer Financial Protection's Student Loan Litigation: What This Means for Securitization

November 2, 2018

Introduction

In September 2017, the Bureau of Consumer Financial Protection (the "**Bureau**") brought an enforcement action against the National Collegiate Student Loan Trusts for alleged violations of consumer financial protection laws in connection with student loan debt collection practices. The action, titled *Consumer Financial Protection Bureau v. The National Collegiate Student Loan Master Trust,*[1] was brought in the United States District Court for the District of Delaware.

This litigation has important implications for the structured finance industry as a whole, as the Proposed Consent Judgment filed by the Bureau contains terms that would effectively alter the contracts affecting the underlying securitization trusts at issue. The Proposed Consent Judgment also was submitted to the District Court by the Bureau without first seeking or obtaining consent from all of the affected contractual counterparties. Securitization transactions are built upon transaction agreements that define the obligations and responsibilities of each party to the transaction. By purporting to alter and thereby effectively rewrite these agreements, the Bureau's Proposed Consent Judgment upended well-established and long-standing market expectations and thereby threatens to undermine investor confidence, destabilize the student loan securitization market, and paradoxically, restrict student access to credit by making securitizations more risky.

The parties to the transaction agreements, which were non-parties to the litigation, quickly sought to intervene in the proceedings, and Cadwalader client the Structured Finance Industry Group ("**SFIG**") submitted an *amicus curiae* brief highlighting the negative impact this litigation could have on the industry as a whole. On October 19, 2018, the Honorable Maryellen Noreika issued a Memorandum Opinion that granted the motions to intervene, on the basis that that the Proposed Consent Judgment and settlement approved by the equity holder might impermissibly alter the existing contractual obligations.

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[1] No. 1:17-cv-01323-MN (D. Del. Sept. 18 2017).

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Background

The National Collegiate Student Loan Trusts (the "**Trusts**") are a group of 15 Delaware statutory trusts that hold more than 800,000 student loans totaling $12 billion. The loans originally were made to students by private banks and were subsequently securitized. On September 18, 2017, the Bureau brought an enforcement action against the Trusts for illegal student loan debt collection lawsuits, together with a motion for approval of a Proposed Consent Judgment. Despite acknowledging that the Trusts had no employees and that the alleged violations resulted from actions taken by the Trusts' servicers and sub-servicers in the course of debt collection activities, rather than any actions taken by the Trusts themselves, the Bureau nonetheless named *only* the Trusts as defendants.

Crucially, the terms of the Proposed Consent Judgment sought to create additional contractual obligations or amend existing obligations for the parties to the securitization transaction that were not consented to and conflicted with the original terms of the agreements, including: imposing extensive audit requirements that would force these parties to bear obligations not contemplated in the original agreements and bear the costs of those compliance efforts, further impairing their contractual rights; granting the Trusts the authority to remove the administrator and appoint a successor of its own choosing; and granting the Trusts the authority to use assets already pledged to the bond holders and the transactor in the existing agreements to pay the civil penalties that the Bureau seeks to impose. The original terms of the agreements do not grant the Trusts the authority to take any of these actions. The Bureau even acknowledged as much, alleging in its original complaint that the Trusts have no employees and that all actions relating to administration of the Trusts are carried out by its servicers.[2]

Motions to intervene were filed on behalf of nearly every party to the securitization transaction, including: Ambac Assurance Corporation, which provides financial guarantee insurance with respect to securities in nine of the fifteen trusts; Transworld Systems Inc., a sub-servicer responsible for the collection of delinquent loans; the "Objecting Noteholders," a group of entities that collectively own approximately $1.4 billion in notes issued by the Trusts; GSS Data Services, Inc., the administrator that is responsible for certain administrative functions; the Pennsylvania Higher Education Assistance Agency d/b/a American Education Services ("PHEAA"), the Primary Servicer for the Trusts; Wilmington Trust Company, the owner trustee; and U.S. Bank National Association, in both its capacity as successor special servicer, where its role is to engage sub-servicers, and in its capacity as indenture trustee.

In their respective motions, each intervenor asserted that the Proposed Consent Judgment, if approved, would impermissibly impair or rewrite their respective contractual obligations, as set forth in the relevant agreements. The Objecting Noteholders also asserted that the Proposed Consent

2 *Complaint* at 4.

Judgment would transfer benefits to which they were entitled to the equity owners, and PHEAA opposed the Proposed Consent Judgment's implication that it was involved in the wrongful conduct alleged by the Bureau. Subsequent to the filing of these motions, SFIG filed an *amicus curiae* brief emphasizing the harm to the securitization industry and the overall economy that would result from approving the Proposed Consent Judgment. As SFIG observed, market participants rely on the stability of law to anticipate their liabilities and risk, and the intrusion of a government agency into previously negotiated transactions would create instability and confusion. SFIG also asserted that the Trusts were not "covered persons" within the meaning of the Consumer Financial Protection Act, and that the interest of market participants will be harmed if the Bureau is allowed to extend its litigation and enforcement powers beyond what is provided by the Act.

Opinion and Order

Citing Third Circuit precedent,[3] Judge Noreika agreed with the intervenors and emphasized that each movant had adequately described the ways in which their contractual obligations would be impaired and that their interests in the Trust Related Agreements were likely to be "modified or invalidated or otherwise impacted" if the Proposed Consent Judgment were to be approved.[4] Judge Noreika declined the Bureau's request that the Court limit the intervenors' participation in the lawsuit after specifically finding that "a later-entered consent decree may well impose obligations on the intervenors that would require their approval."[5] She stated that the Court was mindful of a Supreme Court decision holding that, "of course, a court may not enter a consent decree that imposes obligations on a party that did not consent to the decree."[6]

Finally, the Court stated that whether the Trusts properly fall under the definition of "covered person" under the Consumer Financial Protection Act might require further briefing. Proceedings are ongoing.

Key Takeaways

The District Court's decision to allow intervention in these proceedings is important, because the parties to the securitization transactions, who are likely to be the most affected, are now "at the table" and able to defend their rights. The intervening parties argued—and the Court agreed—that the Proposed Consent Judgment, if approved, would alter the carefully and highly negotiated agreements that market participants relied upon when they entered into the transactions and made their investment decisions. Such an outcome would inject uncertainty into previously agreed upon investment terms, which in turn could destabilize securitization markets by causing investors to reassess their willingness to invest. Further, this outcome would perhaps even have the unintended

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3 *Kleissler v. U.S. Forest Serv.*, 157 F.3d 964, 969 (3d Cir. 1998).

4 *Memorandum Opinion* at 7.

5 *Id.* at 12.

6 *Id.* at 11 (citing *Local No. 93, Int'l Ass'n of Firefighters, AFL-CIO C.L.C. v. City of Cleveland,* 478 U.S. 501, 529 (1986)).

consequence of making access to credit more difficult and costly to students, as the threat that a government agency may set aside or rewrite contracts will change the risk calculus for investors in these products. Finally, there is no reason to expect that this outcome would be limited to the student loan market, as robust securitization markets provide lower interest rates for mortgages, auto loans and credit cards.

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