Clients&FriendsMemo

Third Circuit Decides Statutory Trusts Are Covered Persons: What This Means for the Securitization Market

April 4, 2024

On March 19, 2024, the Third Circuit handed down a decision that statutory trusts used as issuing entities for securitizations are considered "covered persons" for purposes of the Consumer Financial Protection Act ("CFPA"), in the long-running case involving the Consumer Financial Protection Bureau ("CFPB") and the National Collegiate Master Student Loan Trust ("NCSLT").

This memo provides background on the underlying litigation, describes the court's analysis and identifies possible next steps in the litigation. We also discuss the implications of this decision for the securitization industry and practical steps that participants should take under consideration.

Although we provide a synopsis of the course of the litigation below, please review our previous memos on this case for more details.[1]

Background

The National Collegiate Student Loan Trusts (the "Trusts") hold more than 800,000 private student loans through 15 different Delaware statutory trusts created between 2001 and 2007, totaling approximately $12 billion. The loans originally were made to students by private banks. The Trusts provided financing for the student loans by selling notes to investors in securitization transactions. The Trusts also provided for the servicing of and collection on those student loans by engaging third-party servicers. However, the Trusts themselves are passive special purpose entities lacking employees or internal management. Instead, to operate, the Trusts relied on various interlocking trust-related agreements with multiple third-party service providers to, among other things, administer each of the Trusts, determine the relative priority of economic interests in the Trusts, and service the Trusts' loans.

The CFPB first sued and reached settlement with some of the servicers engaged in debt collection on behalf of the Trusts. According to the CFPB, the servicers had engaged in a variety of bad acts,

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[1] November 2, 2018: https://www.cadwalader.com/resources/clients-friends-memos/forward-movement-in-the-bureau-of-consumer-financial-protections-student-loan-litigation-what-this-means-for-securitization; April 1, 2021: https://www.cadwalader.com/resources/clients-friends-memos/cfpb-suit-against-student-loan-trusts-dismissed#_ftnref7; December 15, 2021: https://www.cadwalader.com/resources/clients-friends-memos/federal-court-holds-that-student-loan-trusts-are-subject-to-cfpb-enforcement-authority--what-this-means-for-consumer-securitizations-and-other-whole-loan-buyers; February 16, 2022: https://www.cadwalader.com/uploads/cfmemos/ed8d3e6964771ddb277cfec2b3c0f1a3.pdf.

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including collecting on time-barred debt, engaging in robo-signing of affidavits used in court to support debt collection lawsuits, and collecting on debts for which they either had no note to prove the debt was owed or for which they did not have a clear chain of title showing ownership of the underlying loan by the Trusts. After reaching settlement with these servicers, however, the CPFB had insufficient funds to provide full redress to harmed consumers.

Accordingly, in September 2014, the CFPB issued a civil investigative demand ("CID") to each of the Trusts for information concerning thousands of allegedly illegal student loan debt collection lawsuits used to collect on defaulted loans held by the Trusts. From there, in 2017, the law firm McCarter & English ("McCarter"), purporting to represent the Trusts, proceeded to negotiate a Proposed Consent Judgment to resolve the CFPB's investigation of the Trusts and settle the lawsuit the CFPB had commenced in the U.S. District Court of Delaware. However, multiple parties associated with the Trusts intervened in the litigation to argue against the entry of the Proposed Consent Judgment. The intervenors expressed concern that by entering the judgment, it would impermissibly impair or rewrite their respective contractual obligations as set forth in the agreements underlying the Trusts.

On May 31, 2020, the Court denied the CFPB's motion to approve the Proposed Consent Judgment, holding that McCarter lacked authority to execute it pursuant to the terms of the agreements governing the Trusts and Delaware law. Responding to a motion to dismiss brought by the Trusts and in light of the CFPB's challenges with constitutionality, on March 26, 2021, the Court dismissed the lawsuit. The CFPB filed an amended complaint on April 30, 2021 that provided additional explanation regarding why the Trusts should be considered "covered persons" for purposes of the CFPA. On December 13, 2021, the Court denied a motion to dismiss by the Trusts, ruling that the Trusts were "covered persons".

On February 11, 2022, the Court granted a motion for interlocutory appeal to the Third Circuit filed by the Trusts and certain intervenors in the action. The Court certified two questions for review by the Third Circuit, one involving CFPB constitutionality and the second regarding whether the Trusts were "covered persons."

Decision by the Third Circuit

The interlocutory appeal was argued on May 17, 2023 to a three-judge panel of the Third Circuit, and the decision was filed on March 19, 2024, with an opinion written by Circuit Judge Jane Richards Roth.

On the constitutional question, the Third Circuit found that even if the CFPB was found to be unconstitutional because the Director could not be removed at will by the President, that unconstitutionality did not cause actions taken by the CFPB Director to be void, because the appointment of that CFPB Director had proceeded constitutionally.

On the question regarding whether the statutory trusts are covered persons, the opinion focused specifically on language in the CFPA regarding covered persons being those entities that "engage" in consumer financial services under the CFPA. To recount, the purpose of the Trusts is to facilitate the ownership of the loans held in securitization pools. Accordingly, the Trusts have no employees and are necessarily engaged in an extremely limited set of activities, all of which occur as a result of automatic processes established by the agreements used to set up the securitization.

However, the opinion ignored the automatic process aspect of the Trusts, commenting in a footnote that while the Third Circuit recognized that there were parties with employees, such as the Administrator, who were "not subject to the supervision of the [Trusts] or the Owner Trustee" it was not necessary to ". . . address [the Administrator's role]. It is a bridge too far. All we need to determine is whether the Trusts engaged" in agreements for the servicing of the loans.

With that viewpoint in mind, the Court found that based upon legislative history, plain language and the language of the administration agreements used in the transactions, the statutory trusts are considered "covered persons" under the CFPA.

Finally, although the case was focused on statutory trusts, the Court noted that the CFPA definition of "person" explicitly includes the term "trust" and that such terminology is sufficient to encompass statutory trusts. Given the Court's focus on the plain meaning of the term trust, it is reasonable to assume that common law trusts could be "covered persons".

Next Steps in the Litigation

The Structured Finance Association (SFA) met on Friday, March 22, 2024 to discuss the implications of the Third Circuit decision, and during that discussion, they outlined three paths forward for the litigation. First, the Trusts could petition the full Third Circuit to hear the case *en banc*. Second, the Trusts could file a petition to the Supreme Court to grant review of the case. Third, the Trusts could allow the case to be remanded to the U.S. District Court of Delaware to be finally litigated. Should the third path be chosen, the CFPB would need to prove that the alleged activity occurred (which activity took place more than ten years ago), that such activity was violative of the law, and that the Trusts should be responsible for those activities.

Thoughts for the Securitization Industry Going Forward

Employing Best Practices

The CFPB has long held that it can go after securitization trusts, but has done so sparingly to date. To understand why, it is important to remember that two of the biggest reasons that the CFPB investigated and sued the Trusts in the first place is because: 1) the servicers were allegedly engaged in truly egregious collections behaviors, and 2) the servicers did not have sufficient funds to provide full consumer redress for the consumers harmed by their actions.[2]

This means that the best initial step to mitigate risks and prevent these kinds of lawsuits from being filed consistently by the CFPB (and others) is to ensure that the servicers are complying with law. Enhanced due diligence of servicers, sub-servicers and debt collectors (collectively, "Servicers") acting on behalf of trusts should be conducted at the outset and periodically throughout the course of the securitization. Warehouse lenders, sponsors and administrators should all review collections policies and procedures, require notice from Servicers if they change those policies and

[2] As evidenced by the Proposed Consent Judgment, the CFPB was looking for $3.5MM in consumer redress and another $7.8MM in disgorgement, as well as $7.8MM as a civil money penalty. The original case involving some of the servicers settled for a civil money penalty of only $1.3MM.

procedures, and receive regular reports regarding consumer complaints being filed against or received by the Servicers.

Meanwhile, statutory trusts used in consumer asset securitizations should now have themselves proper policies and procedures in place to interpret consumer financial services laws relating to servicing loans and collecting debts.

With respect to existing securitization trusts holding consumer assets, we recommend that, to the extent possible or permitted under deal documentation, sponsors of securitizations should commence due diligence on Servicers to understand what risks may be present from their activities. To the extent securitization trusts have significant collection lawsuits being filed on their behalf by their Servicers, and, again, to the extent possible or permitted under deal documentation, securitization sponsors should endeavor to have Servicers cease filing new collections lawsuits and begin "look-back" reviews over those collection lawsuits to ensure that none of the flaws the CFPB noted in the NCSLT case exist, starting with the cases that are pending and then proceeding into lawsuits that have already been concluded.

Improving Deal Documentation

From a documentation perspective, we set forth below some suggested contractual modifications to help mitigate risk and allocate potential liability. It is important to know, however, that these strategies will not eliminate the risk of a CFPB investigation or lawsuit.

Nevertheless, the following should be considered for improving deal documentation, in light of this decision, and, of course, as may be appropriate for each transaction:

- Indemnity sections should be evaluated and strengthened to provide clear allocation of not just liability, but also responsibility for Servicer bad acts, such as by specifically covering civil money penalties, consumer redress, disgorgement remedies and other regulatory fines;
- Because the Third Circuit opinion focused in on the meaning of "engage" in both the CFPA and in the deal documents to determine whether the Trusts were covered persons, it might be helpful to avoid using the term "engage" to describe any activity undertaken by a statutory trust;
- Include a provision indicating that the Servicers are independent contractors for the statutory trust, and stating that the Servicers are not agents of the trust;
- Include provisions that allow for increased compliance oversight of Servicers by securitization sponsors and/or deal administrators and that allow securitization sponsors and deal administrators to replace Servicers if such oversight reveals practices that violate consumer protection laws or regulations; and
- Risk factors in offering documents should be updated to better reflect potential liability concerns.

We also recommend that deal parties have greater insight into the agreements signed with Servicers. Such agreements should include increased compliance requirements and reporting to deal parties, as discussed above. But, also, deal parties should evaluate typical Servicer insurance policies and limits, and require coverage that would be more likely to fully cover potential consumer

redress amounts. Servicers may not be able to afford such increased insurance costs and may have trouble acquiring such insurance, in which case, deal parties should consider covering such additional costs and perhaps even obtaining such higher insurance limits and coverage on behalf of the Servicer.

On Providing Substantial Assistance

When statutory trusts are deemed to be covered parties, the potential liability for all parties interacting with those trusts immediately increases under the CFPA, due to Section 1036(a)(3) which provides that any person that "knowingly or recklessly provide[s] substantial assistance to a covered person [that engages in unfair, deceptive or abusive acts or practices] shall be deemed to be in violation . . . to the same extent as the person to whom such assistance is provided." In a case from 2023, the Western District of the U.S. District of New York observed, "Although relatively few cases have precisely delineated the elements of substantial assistance under the CFPA, courts have required (1) a primary violation of the CFPA; (2) the defendant's knowledge or reckless disregard of the primary violation; and (3) the defendant's substantial assistance in the primary violation." CFPB v. Manseth, 2023 WL 5400235.

Based upon CFPB precedent and case law, "substantial assistance" can mean providing a covered person anything from office space to payment processing services, as well as lending to that covered person. To this end, warehouse lenders, sponsors, underwriters and administrators should all take care to understand how they may be providing "substantial assistance" to the statutory trust and prioritize actions that allow them to know if Servicers are engaged in unfair, deceptive or abusive acts or practices in violation of the CFPA, and to have a means to address such acts or practices.

Additional Considerations on Servicers

Consumer protection agencies like the CFPB, but also the Federal Trade Commission, have developed procedures to understand funds companies do or do not have available for consumer redress and penalties. These procedures help to prevent companies being investigated from trying to jump into bankruptcy, and usually, the agencies want to avoid bankrupting the company. But, now that the NCSLT case has shown a permeable membrane around the consumer-facing Servicer, the agencies can reach back to the trust (or really, whomever has deep pockets). So, on the one hand, the CFPB could skip past the Servicer once establishing liability and reach beyond them, as a matter of course. Or, on the other hand, deal parties should be aware that Servicers could immediately go into bankruptcy and force everyone else to deal with liability and payment.

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