What 3rd Circ. Trust Ruling Means For Securitization Market

By **Mercedes Tunstall and Michael Gambro** (April 23, 2024)

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On March 19, the U.S. Court of Appeals for 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, in the long-running case of Consumer Financial Protection Bureau v. National Collegiate Master Student Loan Trusts.

This article provides background on the underlying litigation,[1] 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.

Background

The trusts hold more than 800,000 private student loans through 15 different Delaware statutory trusts, totaling approximately $12 billion. The trusts provided financing for student loans made by private banks by selling notes to investors in securitization transactions. The trusts are passive special-purpose entities lacking employees or internal management, and operate through various interlocking trust-related agreements with third-party service providers to manage things such as servicing and collecting on the trusts' loans.

The CFPB first sued and reached a settlement with some of the trusts' servicers engaged in debt collection. According to the CFPB, the servicers had engaged in a variety of bad acts, including collecting on time-barred debt, engaging in robosigning 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 loans by the trusts.

After reaching a settlement with these servicers, however, the CPFB had insufficient funds to provide full redress to harmed consumers.

Accordingly, in 2014, the CFPB issued a civil investigative demand to each of the trusts. From there, in 2017, a law firm purporting to represent the trusts proceeded to negotiate a proposed consent judgment to settle the lawsuit the CFPB had commenced in the U.S. District Court for the District of Delaware. However, multiple parties associated with the trusts intervened and argued against the entry of the proposed consent judgment.

In light of the CFPB's challenges with constitutionality, on March 26, 2021, the court dismissed the lawsuit, but the CFPB filed an amended complaint on April 30, 2021, explaining why the trusts should be considered "covered persons" for purposes of the CFPA and thus, the case should proceed. On Dec. 13, 2021, the court denied a motion to dismiss by the trusts, ruling that the trusts were "covered persons."

On Feb. 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 U.S. 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 appointment 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 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 on 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 also be "covered persons."

Next Steps in the Litigation

The Structured Finance Association met on March 22 to discuss the implications of the Third Circuit decision, and during that discussion, members outlined three paths forward for the litigation.

First, the trusts could petition the Third Circuit to hear the case en banc. Second, the trusts could file a petition to the U.S. Supreme Court to grant review of the case. Third, the trusts could allow the case to be remanded to the U.S. District Court for the District of Delaware to be finally litigated.

Should the third path be chosen, the CFPB would need to prove that the alleged 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 the law.

Enhanced due diligence of servicers, subservicers and debt collectors 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 procedures, and receive regular reports regarding consumer complaints being filed against or received by servicers.

Meanwhile, statutory trusts used in consumer asset securitizations should now have their own 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 so-called lookback reviews over those collection lawsuits to ensure that none of the flaws the CFPB noted in the student loan trusts 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 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 also 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, CFPB v. Manseth, the U.S. District Court for the Western 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.

Based on 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 a 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, as well as the Federal Trade Commission, have developed procedures to understand funds that 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 present case has shown a permeable membrane around consumer-facing servicers, the agencies can reach back to a trust — or really, whoever 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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[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.

[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.