Consumer Finance Monitor (Season 3, Episode 8): Sales of Charged-off Debts: Key Issues and Practical Pointers for Sellers and Buyers to Consider

Speakers: Chris Willis and Glen Trudel

Chris Willis:

Welcome to the Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. I'm your host, Chris Willis. I'm the practice group leader of Ballard Spahr's Consumer Financial Services Litigation Group, and vice-chair of our Consumer Financial Services Group, and I'll be moderating today's program. For those of you who want even more information, don't forget about our blog, consumerfinancemonitor.com. We've hosted that blog since 2011, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those of us in the industry, so to subscribe to our blog or to get on the list for our webinars, visit us at ballardspahr.com. And if you like our podcast, let us know. Leave us a review on Apple podcasts, Google play, or wherever you get your podcasts. Today, I'm joined by my partner, Glen Trudel, from our Wilmington office, and we're going to be talking about the mechanics of debt sales and debt sale agreements. Glen, welcome to the show.

Glen Trudel:

Thanks, Chris, glad to be here.

Chris Willis:

I'm looking forward to you sharing your knowledge and expertise about this area, which is what area you have a lot of experience in. So, let's just start from the standpoint of a financial institution who's thinking about engaging in a debt sale, when it perhaps hasn't sold or charged off debt in the past, what are some of the considerations that a financial institution should be asking or taking into account in preparing for a sale of portfolio of accounts?

Glen Trudel:

Well, Chris, those considerations, that's a big topic. It really could be the subject of their own podcast, but since we'll be hitting different topics on this, I'll hit some highlights. What it really comes down to is that the better prepared the seller is, or the would be seller is, the better off they're going to be and the more smoothly the sale process is going to flow. So, it's really going to require, say it's a financial institution or a bank, to really perform their own upfront internal due diligence to make sure that their systems and their records are in shape for a sale, starting with policies and procedures. Do they have any policies and procedures related to the sale of asset? They may have sold other kinds of assets in the past that they can bring to Ballard for purposes of the portfolio or portfolios that they're thinking of selling in this instance, but do they have one for the entire sale process? And by that I mean, everything from buyer selection through documentation management, developing criteria for designation of accounts to be sold, managing the sale process itself and as important, post-sale administration requirements.

Glen Trudel:

These sorts of issues need to be thought through and determined and policies drafted, really ahead of time, so as to not unduly delay the process, and to avoid sudden issues at closing, that could delay or prevent closing, or later on in the process. In the course of doing these things, we've reviewed these sorts of policies and procedures that the clients have put together as they were looking to get back into the process of debt sales. And so, it can be in itself, can be a rather time consuming process and

really should be if they're doing the job properly. The other aspect just as important as appropriate policies and procedures, is the documentation itself of the loans that they're looking to sell.

Glen Trudel:

Documentation is really everything in the debt sales world, making sure you have it all, all the necessary documentation and in a form that ideally can be efficiently transferred because the quality of the documentation is going to directly affect the value that's ascribed to the portfolio by would-be buyers. In part, because a well-documented account is on balance, more likely to be efficiently and therefore, profitably in the eyes of a buyer collected upon by that buyer, and partly due to, as you know, the strong regulatory emphasis on appropriate documentation, that's been the calling card of the bank regulators and financial institution regulators for several years. Now, as a result of all of this inquiry and effort, the financial institution may wind up self-identifying accounts, which it won't put up for sale because of that lack of documentation, or perhaps other issues that they find with those loans. Better to find out before you go out into the market and keep them from being part of the offering.

Glen Trudel:

Another consideration, and maybe a final highlight for purposes of this question is, are the accounts secured in some fashion or are they guaranteed by a third party or third parties? If so, that's going to add another level of complexity because the financial institution is going to look to how and determine how those guarantees or securities papered, and what will the assignment process be? The financial institution will need to learn about that and really understand any special state requirements that might apply to making those transfers. For example, depending on circumstances, auto title lien transfer may need to be recorded by the state within a certain number of days after the event of the transfer, and rules can vary, for electronic only versus paper title, or depending on circumstances may require even other additional steps like a smug certification or something like that.

Glen Trudel:

Again, determining those sorts of requirements is an area where we've assisted clients and can certainly do so. And again, policies and administrative procedures will need to be worked out and in place in advance of the sale to deal with this aspect because once the sale is imminent, the buyer's going to want to move very quickly on these sorts of guarantee and security transfers.

Chris Willis:

Well, and there are a couple of things, Glen, that you mentioned there that I think are worth underlining and I'll ask you if you agree with these, but first of all, it's natural for a financial institution thinking about selling debt, to think about doing due diligence on potential buyers and making sure that the buyers have the right policies and procedures and compliance record and all that other material before selling debt to them, and I'm sure you're going to talk about that later in the podcast, but the first step really, is for the seller to do due diligence on itself to make sure not only that it presents the portfolio in a way that maximizes its value to buyers, but also may prevent regulatory problems from occurring down the line if the sale were to go through.

Glen Trudel:

Oh, absolutely. That's all part of when I was talking about the internal due diligence and we spoke about documentation, but you're absolutely right to emphasize that. Part of that is looking at, did we do the job right and putting the loan together in the first place. So that's certainly a part of it because buyers looking at it, will be asking similar sorts of questions and it really does go to avoiding problems later and having to answer to a regulator.

Chris Willis:

Yeah, because one thing's for sure, if there are problems with documentation, either from the origination side or from the servicing of an account, and the buyer then takes those accounts and begins attempting to collect them, which of course it will

do, and particularly if it uses litigation to do so, it really subjects the documentation to very extreme scrutiny from whatever lawyer is representing the consumer in the case. And so, it's a sure fire way to have weaknesses in your processes and documents exposed.

Glen Trudel:

Oh, absolutely, and it also, if the financial institution is looking to go into the market with any regularity, that will directly affect how their portfolios are perceived in the marketplace as well.

Chris Willis:

Yeah, that makes sense. Let's take the next step in the process. Once the seller has prepared itself in the manner that you've recommended for a sale of a portfolio of accounts, the seller will start to engage in the buyer selection and contracting process. When that part comes around, you're looking for buyers and contracting with buyers. What are the considerations that the financial institution ought to keep in mind at that stage of the process?

Glen Trudel:

Well, at that stage, sellers should really have documented due diligence process for the debt buyers, which is similar to what they have for service provider due diligence in general. The regulatory guidance on third party relationships can certainly be a useful guide here. Though, at least the OCC has recognized that there is some distinction between a debt buyer and a service provider. Nevertheless, I think that guidance is a very useful tool for structuring the policies about what due diligence you want to take on debt buyers. Questionnaires, obviously, should be developed and provided to the would-be buyers for completion as a start of a robust due diligence process, and as many sellers do for broker is being employed by the seller to help with the process, then they can certainly provide assistance in this regard, as well as ideas for what those upfront questionnaire should look like.

Glen Trudel:

There are a host of issues that one would examine in terms of buyer due diligence. A few basic questions would include whether there are any existing regulatory or legal actions against the debt buyer or its principles alleging compliance violations or other shady practices, or is the buyer licensed and in good standing in all states in which buys and collects upon debt, and does the buyer have appropriate and comprehensive policies and procedures that are correct and accurate and current, and do they address the buyer's compliance obligations fully, and do they provide for training and all of those sorts of things. Those are all things that you're going to want to be asking about and looking at, particularly when dealing with a buyer that a financial institution really hasn't dealt with before. Buyers will, of course, want to review the portfolio data for evaluation purposes themselves.

Glen Trudel:

One consideration in that regard is they will often ask for information which would be PII along with the overall portfolio data, as they believe that such data can assist them in better determining value. Now, sometimes this can be avoided by anonymizing the data, especially in the early going. I would certainly say that a well-written nondisclosure agreement must be in place before any confidential information would be provided to a would-be buyer or broker, and especially information that's more sensitive like PII.

Glen Trudel:

Also, they should consider the timing of permitted due diligence in the context of the execution of a debt sale agreement. Sometimes the agreements are executed by the parties, but there's an expectation of post-execution due diligence. Sometimes there's a considerable amount that remains to be done before sale is accomplished. In my experience, I think it's better for the parties to really complete their respective due diligence prior to signing a death sale agreement and then going on to close the

sale. I think it's a cleaner approach and it avoids issues about whether a party, which has signed and now has become unhappy, can exit the deal under those circumstances based on the drafting of the agreement.

Chris Willis:

Speaking of the agreement, Glen, you have drafted and negotiated and reviewed lots of debt sale agreements. And so, I'm really curious for you to share your experience in this regard as to what are some of the pain points or issues or thorny and difficult problems that come up in negotiating and drafting agreements for the sale of portfolios of debt.

Glen Trudel:

Sure thing, I'll touch on some topics and though there are others, and of course, every deal is somewhat different, I'll touch on a number of them. One area is, what will the circumstances be when repurchase or one or more of the accounts can be required, and time limits for doing so. Now, these would be repo situations that's either due to the seller's subsequent request to pull an account back or buyer acting as a right under the agreement based on these provisions. A lot of them are fairly standard that you'll see particularly among the more sophisticated buyers, but sometimes the circumstances could be a matter of some discussion, and particularly, as well, with time limits. How long a seller will have, for example, to put an account back, if they discover something is amiss.

Glen Trudel:

Now again, that's another example where the timing can be a direct result of the perceived quality of the documentation, and the ability of the buyer to be able to examine the files that they've been provided either pre- or post-sale. So again, a good documentation may allow a shorter time horizon for a seller to be able to put back an account, but also in that regard, it is usually beneficial for the seller to not allow a buyer to put back except within a certain time period and make that repurchase be the sole remedy for a buyer in putting that back. Another area might be the scope of post-sale due diligence and audit rights. Buyers generally accept those provisions, at least in concept, as sellers have been asking for them for some time, particularly in response to regulatory guidance, such as the OCC's bulletin, 2014-37, but we still get issues over the extent of fourth party access.

Glen Trudel:

The providers that the buyer uses to collect on the loans that they purchase, that can be very important if the debt buyer is outsourcing its own servicing functions or collection functions, and many do so very heavily. They may not always have the level of access themselves that the seller may want, so that they can look at them and they can examine what they're doing after having sold a portfolio. So, you know what to do? In some cases I've seen a couple of things. One being, a limitation to the significant contractors by function as a possible middle ground, in terms of the ability of the seller to have direct access and the buyer to be cooperating in achieving that access, because they're the ones who are in privity with those fourth party providers, but something that I always insist upon is that the buyer agree to be responsible for basically anything and everything that their fourth party service providers may do or fail to do, again as a fail-safe. And of course, that's as strong as the insurance policy and the financial wherewithal of your buyer, and obviously, that's a consideration when you're looking to sell a portfolio to that buyer.

Glen Trudel:

Another issue would be the ability of the debt buyer to resell the debt, and I've seen this vary from zero ability to resell the debt to ability to do so within a certain number of months or even years, post-sale, sometimes with a standstill period of time where they can't do it, and then a period of time when they could, but sellers ought to be advised that this will go directly to the valuation of the portfolio. If you are selling a portfolio and you're not allowing the buyer any ability to resell the debt, they are likely to give the portfolio a lower valuation than when they have some or more flexibility to resell the portfolio or the accounts in the portfolio after a period of time.

Glen Trudel:

One last point would be assignment controls. Basically, when, if ever can the buyer assign the agreement? This is more of an issue for forward flow agreements, where the agreement is contemplating a series of sales, as opposed to a single portfolio sale agreement. Now, this may be a requirement if the buyer has rights to resell the portfolio, but the scope of prerequisites in terms of what a new buyer, or the assignee, must agree to as part of the assignment can be a point of discussion. For example, what degree of access will the financial institution have, the entity that's originally selling the portfolio, with respect to this new assignee, and how is oversight exercised over that new assignee, and by whom? To what extent will this be the responsibility of the original buyer? They should be picking up that responsibility since they're profiting from the resale, but again, that's only as good as your confidence in that buyer. And so, having the ability to look at what they're doing and have some control over that is usually a useful thing to have for the original seller of the portfolio.

Glen Trudel:

And on that as well, often the buyer is getting financing for the purchase of these portfolios. What if your buyer defaults on their financing and their secured lender takes the collateral? And then what controls apply to them? That frequently is an overlooked issue and we try to seek to get the buyer to require their finance partner to agree to assignment of the agreement, in such circumstances, if possible, where the buyer would be charged with getting their financing partner to agree that if they're taking over the loans in the collateral, exercising a security interest in the collateral, that they're also going to be taking assignment of this agreement. You can't always get that, but it is something to try to deal with that issue because again, as I said, sometimes that issue is not picked up.

Chris Willis:

Speaking of responsibility, it's probably tempting for a financial institution selling debt to think that its involvement with the accounts ends at the time that they are conveyed to the buyer. In other words, they're not mine anymore, so I don't have to fool with them anymore, but as a matter of fact, there are a variety of situations in which the buyer may want, or even need access to further information about the accounts after a sale to respond to disputes or validation requests, to handle litigation, to perhaps respond to a regulatory inquiry, would be some of the examples. With respect to these post-sale requests for information by the buyer, how are those usually structured in debt sale agreements and what are some of the principle issues that are encountered in negotiating between sellers and buyers on this point?

Glen Trudel:

Sure. This post-sale obligation on the part of the seller can be a real chore for sellers and the operation folks in financial institutions typically really balk at this because often they haven't provided for it, and that goes back to my first comments about, be prepared for the whole process before you get into the process, but while it can be a chore, it's an absolute necessity in the eyes of the regulators. Particularly, since about 2013, 2014, when the OCC came out with its debt sales regulations and guidance, and the industry as a whole was put under a lot of regulatory scrutiny as it has been ever since. This is part of it, the idea about making sure that the buyers are getting adequate documentation in order to enforce their debts.

Glen Trudel:

Now in the past, some sellers would try to be a little bit slick about it. They would charge sometimes fairly exorbitant fees as a disincentive for buyers to come back to the seller for information or documentation or other assistance. It became almost a profit center. The regulators have really essentially prohibited this sort of practice and generally frown on charging any more than a de minimis amount, if any. So this is not going to be a profit center for the seller in any way, but again, this goes back to my original proposition that having well-documented loan files and an efficient system for the transfer of those documents to the buyer on or soon after the closing, can really greatly reduce the frequency of these requests on the backend, so that, again, it's worth the investment.

Glen Trudel:

In terms of, typically in these requirements, there's some sort of turnaround time that a buyer will seek to get from the seller for these requests because the buyers are looking to file a case or respond to discovery, or what have you, so they have time

commitments, and they have time parameters. The turnaround times and requests really should be short enough for the buyer to be able to use the documents and to respond to disputes and validation requests and that sort of thing in a timely way, but it's also going to be long enough that the seller can comfortably hit the deadline, keeping in mind that often many requests will come in at once from a buyer, which can often happen, particularly as they get to the end of the time that either they can bring a lawsuit to enforce the debts or when they feel they're coming to the end of when the financial institution seller is required to respond to their requests.

Glen Trudel:

Now, and that raises another point where the obligation to provide documentation on the part of the financial institution selling the portfolio doesn't necessarily need to go on forever, but depending on the size and nature of the portfolio, after a period of perhaps a few years or the end of the statute of limitations on the accounts, if that's easily spotted or is uniform or the end of the sellers standard record retention period for those documents, the seller's obligation should to assist, it might be reduced to more of a reasonable effort to try to accommodate sort of standards, so they're never completely off the hook, but they recognize that at a certain point, the documentation may not be available to the same extent that it was at the time of sale.

Glen Trudel:

Finally, sellers should monitor the requests from buyers that they're getting from these portfolios, really as a self-check to detect any larger issues or problems with portfolio documentation that may be lurking on the seller side. This can help them improve their own compliance profile with respect to these loans and cut down on back requests after with respect to sales or subsequent portfolios, and it gives them a chance to fix the issue going forward, which is always a great thing to be able to show a regulator if the regulator says, "Well, you're missing this documentation on your portfolio." "Well, we've identified that and we're taking steps to fix it or we have fixed it," is a great response for a regulator who may raise a question down the road.

Chris Willis:

Glen, you've given us a really excellent overview of the debt sale process, and now everybody listening to this knows exactly who they need to call if they want to engage in a debt sale transaction. So, thank you very much for being on the podcast today and thank you to our listeners for tuning in and downloading today's episode. Be sure to visit our website at ballardspahr.com, where you can subscribe to the show in Apple podcasts, Google Play, Spotify, or your favorite podcast platform. Don't forget to check out our blog, consumerfinancemonitor.com for daily insights about the financial services industry. If you have any questions or suggestions for the show, please email us at podcast@ballardspahr.com, and as always, stay tuned for a great new episode every Thursday. Thank you all for listening.