THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 19 No. 9 November 12, 2003
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DUE-DILIGENCE REVIEWS OF NON-PRIME LENDERS

Financial Institutions Acquiring Non-Prime Lenders or Their Portfolios May Inherit Their Liabilities for Violations of Consumer Protection Laws Regulating Lending. The Authors Review the Statutes and Provide a Due-Diligence Checklist to Reduce the Risk of Unknown Liabilities.

By Andrew L. Sandler, Benjamin B. Klubes, Joseph L. Barloon & Robyn C. Quattrone*

Given the explosive growth in the $200+ billion annual non-prime lending market over the last decade, non-prime lenders and their portfolios have become increasingly likely acquisition targets for financial institutions. Acquisitions of non-prime lenders or their portfolios, the establishment of typical business relationships with non-prime lenders, and even the extension of credit to non-prime lenders, however, can carry an increased risk of liability from consumer class actions and government lawsuits alleging "predatory lending." This exposure creates nameplate reputational risks as well as the potential for significant financial consequences.

This article addresses the risks inherent in acquiring or establishing any relationship with a non-prime lender and provides a guide to the due diligence process. The first part of this article describes the legal framework under which a party seeking to acquire or establish a business relationship with a non-prime lender or a non-prime lender itself may be held liable. Next, the article addresses considerations regarding the level of due diligence appropriate for different types of transactions. Finally, we present a checklist of materials and issues for a non-prime, due-diligence review.

LEGAL FRAMEWORK

Non-prime lenders, and those acquiring them or their loans or establishing a business relationship with them, operate within the legal framework set forth below that creates a variety of opportunities for government enforcement and regulatory agencies and class action lawyers.

A financial institution acquiring a non-prime lending operation may have successor liability for any violation committed by the acquiree prior to the acquisition. Further, after the acquisition, the acquirer may become directly liable for any continued conduct by the acquiree. Even the acquisition of a portfolio of loans originated by

*ANDREW L. SANDLER and BENJAMIN B. KLUBES are partners and JOSEPH L. BARLOON AND ROBYN C. QUATTRONE are associates in the Government Enforcement and Litigation Group in the Washington, DC office of Skadden, Arps, Slate, Meagher & Flom LLP. Their email addresses are, respectively, asandler@skadden.com, bklubes@skadden.com, jbarloon@skadden.com and rquattro@skadden.com.

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ANDREW L. SANDLER, BENJAMIN B. KLUBES, and ROBYN C. QUATTRONE are partners at BuckleySandler LLP, in the Washington, D.C. office.

another institution may create liability for the purchaser under federal and state laws that hold loan assignees liable for the loan originator's unlawful conduct. Finally, the establishment of a business relationship with a non-prime lender or the extension of credit to a non-prime lender can expose the company or lender to liability for the practices the lender on theories such as "aiding and abetting" and conspiracy.[1]

The relevant legal framework is as follows:

Discrimination — Two federal statutes prohibit discrimination against credit applicants.

Fair Housing Act ("FHA") — The FHA prohibits real estate lenders from discriminating against credit applicants because of race, color, religion, sex, handicap, familial status, or national origin.

Equal Credit Opportunity Act ("ECOA") — ECOA makes it unlawful for creditors to discriminate against any credit applicant on the basis of race, color, religion, national origin, sex, marital status or age. Assignees can be held liable under ECOA as well because "creditor" is defined to include "any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."[2] Unlike the FHA, ECOA also applies to non-real estate secured lending, such as personal loans, automobile financing and credit cards.

Disclosures — Numerous federal statutes impose disclosure obligations on lenders.

Truth-in-Lending Act ("TILA") — TILA requires mortgage lenders to disclose finance charges and annual percentage rates to borrowers and gives borrowers three days to rescind their mortgages after closing. Loan assignees may be liable under TILA where the violation is apparent on the face of the disclosure statement.[3]

1. In a landmark ruling, a California judge ruled that plaintiffs could seek to hold Lehman Brothers liable for fraud by non-prime lender First Alliance Mortgage Company because plaintiffs' allegation that Lehman provided First Alliance with a $150 million credit facility was sufficient for the plaintiffs to have the opportunity to convince a jury that Lehman provided "substantial assistance" to First Alliance such that it could be held liable under California's aiding and abetting statute. The jury found that Lehman knowingly helped First Alliance charge excessive fees to customers with credit problems and conceal information, and ordered it to pay $5 million to First Alliance customers. The verdict may set a significant precedent holding parties liable for the acts of non-prime lenders they finance or otherwise contract with.

2. 15 U.S.C. § 1691a(e); 12 C.F.R. § 202.2(1).
3. 15 U.S.C. § 1641(a) & (e).

Standard & Poor's

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Home Ownership and Equity Protection Act ("HOEPA") — HOEPA, which amended portions of TILA, requires lenders to provide borrowers with additional disclosures, in conspicuous type size, for "high cost" loans as defined by the statute and prohibits lenders from making high-cost loans without regard to the borrower's ability to repay. Assignees of HOEPA loans are "subject to all claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage."[4]

Real Estate Settlement Procedures Act ("RESPA") — RESPA requires lenders to disclose closing costs within three days of taking an application for a real estate loan and to provide a breakdown of those costs at closing.

Unfair and Deceptive Acts — Federal and state statutes prohibit deceptive, misleading or unfair acts.

Federal Trade Commission Act ("FTC Act") — The FTC Act prohibits all "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce." The FTC Act has been used to attack a variety of non-prime lending activities, from the representations made to consumers to the collections tactics employed.

Fair Debt Collection Practices Act ("FDCPA") — The FDCPA prohibits unfair practices, such as harassment or abuse, in the collection of loans.

Common Law Fraud and Unfair and Deceptive Trade Practices Statutes — Actions alleging common law fraud or a violation of a state unfair and deceptive trade practice statute (which usually prohibits any act that tends to deceive a consumer,) typically claim that a borrower was "flipped," *i.e.*, repeatedly refinanced without economic benefit to the consumer, or that insurance or other ancillary products were "packed" onto the loan without the borrower's knowledge or consent. In addition, state attorneys general have brought numerous actions alleging that lenders have violated these state statutes by failing to make adequate disclosures to consumers and by misrepresenting loan terms to customers.

By virtue of this extensive legal framework, virtually every aspect of the lending process — from the taking of an application through servicing and foreclosure — can be the basis for a class action lawsuit or government enforcement proceeding. Accordingly, when contemplating the acquisition of a non-prime lender or portfolio, the acquirer must assess carefully the exposure it might face.

LEVELS OF DUE DILIGENCE

The appropriate level of due diligence is directly related to the nature of the transaction. The OCC has issued some general guidance with respect to any transaction with another lender. The OCC states that every due diligence effort should include a review of the non-prime lender's (i) general competence; (ii) business practices and operations; (iii) reputation; (iv) financial capacity and condition; (v) internal controls; and (vi) compliance record.[5] In addition, while acknowledging that no federal laws or regulations provide a comprehensive definition of predatory or abusive lending practices, the OCC has identified a number of "factors" that it considers to be indicative of a predatory loan. These include collateral-based lending, frequent refinancing, and "packing" of excess points, fees and charges for ancillary products, such as credit insurance. The OCC has also noted that predatory lending often involves "fraudulent, deceptive, or high-pressure sales tactics."[6]

Beyond this general review, different transactions in the non-prime environment will require different levels of due-diligence review. A merger or acquisition will, of course, require the most thorough effort because the merged entity will, in all likelihood, be responsible for the

4. 15 U.S.C. § 1641(e)(2). This section also explains if "the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine, based on the documentation required by this subchapter, the itemization of the amount financed, and other disclosure of disbursements" that the loan was a HOEPA loan, it will not be held liable.

5. OCC Letter No. AL 2003-3, February 21, 2003 at 8.
6. Note that the OCC also lists "mandatory arbitration clauses" as a feature "associated with abusive lending practices." *Id.* at 8. Courts, however, have upheld mandatory arbitration clauses, provided that that terms of the agreement are not so one-sided as to render the agreement "unconscionable."

pre-acquisition conduct of the merged entities.[7] In addition, to the extent the challenged business practices continue after the acquisition, the acquirer faces direct liability for that conduct.

Where a lender's portfolio is acquired, in whole or in part, any successor liability should arise only from the acquired loan files. Here, a focused due-diligence process should be performed, emphasizing an analysis of the characteristics of the acquired portfolio.

Finally, some due diligence is required when an entity proposes to enter into a contractual or lending relationship with a non-prime lender. One example is an agreement whereby a prime lender refers to the non-prime lender credit applicants who do not meet the prime lender's credit criteria. Although a lender's liability for referring a consumer to another lender, which then engages in allegedly unlawful practices, is less well developed than in the context of an acquisition, courts or government agencies may seek to hold the prime lender liable for the referral, especially if the prime lender derives a financial benefit from the referral. For the same reasons, parties entering into business relationships with institutions that service or collect non-prime loans should conduct a due-diligence review.

DUE-DILIGENCE CHECKLIST

Each of the following "checklist" categories should be reviewed prior to any acquisition of a non-prime lender in order to comprehend, as completely as possible, an acquirer's potential liability. While no due diligence is foolproof, a careful review of each of the following categories of files should reveal the primary litigation and enforcement risks associated with the non-prime lender.

- Legal files:
  - Ongoing litigation files;
  - Government inquiries;
  - State regulatory examination summaries; and
  - Customer complaints.
- Regulatory and compliance materials:
  - Policies and procedures;
  - Training materials;
  - Internal audits; and
  - State audits.
- Marketing materials:
  - Direct mail materials and telephone scripts; and
  - Marketing material approval process.
- Underwriting and pricing guidelines;
- Employee compensation guidelines;
- Loan files;
- Broker and originator agreements;
- Servicing and collection policies and charges: and.
- Interview key personnel.

When reviewing these materials, it is important to look for patterns that may lead to future legal or regulatory problems.

Legal Files

Reviewing files maintained by the legal department may be the single most important checklist item, as only through a diligent search of these records can a potential acquirer assess its true litigation exposure. Ongoing litigation should fall into one of three categories: (i) borrower litigation — individual plaintiff or class action; (ii) government litigation; or (iii) employee litigation. Each type of litigation has its own set of risks and attendant exposures. Class actions and government suits generally carry the greatest potential for monetary and reputational exposure.

7. This article does not deal with the ways in which parties may structure an acquisition in order to avoid successor liability, but rather assumes that the acquirer has the same risks of claims as the acquisition target.

Reviewing the pleadings, relevant motions, deposition transcripts, court opinions, expert reports, and litigation summaries should enable the acquirer to understand and assess the status of the litigation, the allegations, the likelihood of success or failure, the potential exposure, and the approximate costs to end the litigation, either by trial or settlement.

It may also be helpful to meet with the attorney handling larger matters, whether in-house or outside counsel, to get a better understanding of the litigation and the strengths and weaknesses of a particular claim or defense.

In addition to ongoing litigation, legal department files must also be reviewed for sources of potential litigation. For example, would-be acquirers should review any inquiries, formal or informal, from state and federal law enforcement or regulatory agencies, as well as state regulatory examination summaries. Both sources can provide a preview of potential future litigation and enforcement exposure. Similarly, acquirers should review customer-complaint files for both substance and volume. A non-prime lender with a high volume of legitimate customer complaints is more likely to end up in litigation than a lender with a low volume of complaints or an effective complaint resolution process. A potential acquirer also should consider reviewing consumer web sites on which disgruntled consumers post complaints about particular lenders.

A broad review of litigation files, although warranted where a wholesale acquisition is contemplated, may not be necessary in a secondary-market purchase of a lender's loans because potential liability should be limited to any problems with the loans themselves. Nonetheless, a potential portfolio acquirer should review any litigation relating to the portfolio. Finally, a party seeking to establish a business relationship with a non-prime lender should review litigation files related to the business unit with which the potential relationship will be established.

Regulatory and Compliance Materials

A review of the target's policies and procedures is vital to understanding a potential acquisition target because certain types of policies could subject the company to lending abuse allegations. For example, a policy that permits loan officers to charge points to borrowers refinancing a loan within a few months or a year of their previous refinance could subject the company to allegations of loan "flipping," *i.e.* repeatedly refinancing without economic benefit to the borrower. More generally, company policies should be reviewed to ensure that they reflect the relevant legal framework.

Acquirers also should closely review training materials to assess how new employees are trained and whether existing employees are consistently kept abreast of legal developments and changes to company policies. If possible, acquirers should try to understand how the company ensures that employees are being trained as policy dictates and are implementing those lessons in their daily interactions with customers.

Finally, many non-prime lenders conduct internal audits and are regularly audited by state examiners. Reviewing audit files can inform an acquirer about the problems, if any, that have arisen and how the lender has responded.

Parties contemplating a transaction other than a merger or acquisition, e.g. loan acquisition, also should review these policies and procedures so that they can determine, when reviewing the loans to be purchased, whether the loan files are consistent with the lender's stated policies and procedures.

Marketing Materials

Another source of potential exposure to litigation is a company's marketing materials. Borrowers may claim they were misled by a company's marketing paraphernalia, and government regulators may allege that misleading marketing materials violate a variety of federal and state statutes.

For example, non-prime lenders often disseminate pamphlets emphasizing the benefits of debt consolidation, usually including a chart comparing a theoretical borrower's current monthly payments with the lower monthly payment that would be available under a consolidated loan. These charts often contain footnotes and disclaimers explaining in very technical language the various assumptions associated with the comparative chart, some of which may be wholly unrealistic or difficult to comprehend. Because deceptive or misleading materials are a source of litigation exposure, a lender should review the marketing materials to ensure that they comply with legal and regulatory requirements.

In addition to reviewing the marketing materials, the acquirer should make sure it understands the process the target undertakes before disseminating materials publicly. For example, the acquirer should determine if a lawyer reviews each marketing piece to ensure that it complies with the company's various disclosure obligations. If this routine step is not built into the process, an even more meticulous review of marketing materials would be warranted.

Finally, with regard to direct mail advertising, acquirers should ensure that offers are directed to the general public in a non-discriminatory fashion, *i.e.*, that different racial and ethnic groups are not receiving different types of offers that may be deemed discriminatory. Suits may allege "reverse redlining," or the targeting of low-income minorities for disparate treatment.

Review of this material may not be necessary outside of the merger or acquisition context.

Underwriting and Pricing Materials

A non-prime lender's underwriting guidelines and pricing sheets are key to understanding the lender's business practices and risks. A careful review of these materials is necessary to ensure that their application does not expose the lender to charges of discrimination or unfair and deceptive practices under federal and state law.

Many nonprime lenders use a pricing matrix which links a borrower's rate and points to his credit risk, as determined by a variety of objective factors, such as income level, debt-to-income ratio, and credit score. Because individual borrowers' situations vary, lenders generally are willing to make certain exceptions to the pricing matrix. In order to avoid charges that such exceptions are applied in a discriminatory fashion, acquirers should ensure that exceptions are well-defined, in writing, and are applied uniformly to all borrowers meeting the stated requirements.

As with regulatory and compliance materials, it may be worthwhile to review this material in order to determine whether the lender's loans comply with its policies. In addition, an acquirer may wish to determine whether pricing materials, such as broker rate sheets, are reviewed by a lender's legal or compliance department before they are utilized.

Employee Compensation

The way in which employees, especially customer service representative and loan officer-level employees, are compensated, can motivate them to act in ways that could expose the lender to a lawsuit. Employees that are highly compensated for credit insurance sales, for example, may have the incentive not to disclose the optional nature of the coverage and instead to "pack" such coverage onto the loans of unsuspecting borrowers. Similarly, employees that have strict loan quotas to meet in order to receive a sizable bonus or to protect their jobs may be less motivated to make the necessary disclosures to potential borrowers.

Loan Files

While it would be impracticable to review every loan file at a given company, in the acquisition context it is worth the effort to review a sample of files selected from both central underwriting and branch locations. A loan-file review is essential to determining whether the lender implements its policies and procedures and follows relevant legal requirements. Files should be reviewed to ensure that they contain all required documents, including RESPA documents, HUD-1s, Notes, and appraisal information. In addition, documents should be checked for legitimate signatures and compliance with underwriting criteria.

Reviewing loan files is a critical element of due diligence by acquirers of loan portfolios. If it is not possible to review every loan, the purchaser should collect as much data as possible to ensure that the loans do not raise any red flags. Specifically, the reviewer should determine whether the files exhibit any of the characteristics of predatory loans, as described above.

Broker and Originator Agreements

When non-prime lenders contract with mortgage brokers, a due diligence review should include a review of those agreements to ensure that:

- the broker agrees to abide by the lender's lending policies and to comply with all relevant laws and regulations;
- the broker has no compensation incentives that might induce it to treat borrowers unfairly;

- the lender is indemnified in the event of a breach of the agreement by the broker;
- the lender can exit the agreement in the event of a breach; and
- the lender can access the broker's records to ensure compliance via an audit.[8]

A third party also might take steps to determine what due diligence the lender engages in before affiliating with a broker and whether the lender monitors customer complaints against brokers.

Servicing and Collecting

Due diligence reviews are also necessary where a party seeks to acquire or establish a business relationship with a third-party institution that services or collects non-prime loans.

Litigation, customer complaint, and state regulator complaint files should be reviewed in order to gain an understanding of the types of complaints that have been filed against the servicer/collector. The files should be assessed for a determination of whether any similar complaints could be addressed to the acquiror or party seeking to establish a business relationship with the servicer/collector as a result of the contemplated transaction or relationship.

Regulatory and compliance materials should also be reviewed to ensure that the servicer/collector complies with relevant law, such as FDCPA and the FTC Act, discussed above.

Employee compensation-related materials also should be reviewed. Where, for example, collections employees are compensated for the number of loans they collect, they arguably may have an incentive to disregard FDCPA mandates and open the institution to enhanced scrutiny and enforcement proceedings.

Three additional types of materials should be reviewed when contemplating an acquisition or business relationship with a servicer/collector. First, agreements between the servicer/collector and those institutions whose loans they service/collect should be reviewed so that the nature of the relationship — and any possible resulting liability — are fully understood. Second, materials related to fees charged to borrowers for late payments and other infractions should be reviewed to ensure that excessive fees were not imposed, which may subject the institution to government or consumer complaints. Third, materials related to the imposition of force-placed insurance should be reviewed to determine whether such insurance was improperly placed, inappropriate late fees were charged to customers, or customer complaints regarding such insurance were not dealt with properly.

Interview Key Personnel

Finally, in addition to reviewing documents, interviews should be conducted with key personnel, including the General Counsel, CEO, COO, and CFO, about their views of the company and its operations and compliance with relevant law. When permitted, interviews with lower-ranking employees can assist an acquirer in determining whether the lender's practices are consistent with its policies and procedures as understood by upper-level management.

CONCLUSION

Due diligence review is important in any acquisition or in the establishment of any business relationship. In an acquisition or business relationship relating to non-prime lending, that due diligence assumes even greater importance given the focus on "predatory lending" activities by government regulatory and enforcement agencies and class action lawyers. Although no due diligence process can guarantee protection for an acquirer, a careful due diligence review as described in this article can significantly reduce the risk of unknown liabilities arising after the acquisition or establishment of the business relationship with the non-prime lender and allow all parties to make more informed decisions prior to consummation of the acquisition or business relationship. ■

8. OCC Letter No. AL 2003-3, February 21, 2003, at 8-9.