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Ability-To-Repay Enforcement Comes To Auto Finance

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In recent years, regulators and enforcement agencies have eagerly exercised their authority to prosecute what they perceive as unfair or deceptive acts and practices (UDAPs).[1] Unfortunately for the auto finance industry, these regulators and agencies show no sign of tapping the brakes on such actions. To the contrary, recent events suggest that they may be gearing up to hit the accelerator by using UDAP theories to extend ability-to-repay principles to auto finance.


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On March 29, 2017, the Massachusetts and Delaware attorneys general (the states) announced settlements with Santander Consumer USA Holdings Inc. (the company) over allegations that the company "facilitated" the origination of subprime auto finance contracts when it knew or should have known that contracting consumers likely could not repay. The company is an indirect auto finance company that purchases subprime retail installment contracts from motor vehicle dealers.

The settlements focus on consumers' ability to repay their installment contracts, which is a novel claim in the auto finance context. While Massachusetts has previously seen similar UDAP theories applied to underwriting practices and a consumer's ability to repay in the subprime mortgage context, Delaware has not seen UDAP theories applied in such scenarios. In neither state, however, had the ability-to-repay UDAP theory been applied to subprime auto finance — until now. Given Massachusetts' and Delaware's entrée in this new space, and the now-familiar refrain among industry critics that "subprime auto is the new subprime mortgage," other regulators and enforcement agencies may take this new liability theory out for a spin.

This article discusses the historical application of UDAP to underwriting in Massachusetts, the Delaware law at issue in the settlement, and potential implications for auto finance market participants elsewhere. It concludes by suggesting risk mitigation strategies that auto finance sources may want to consider going forward.

The Massachusetts and Delaware Settlements

The settlements concern retail installment contracts secured by a vehicle entered into between the dealer and consumer, which dealers then sell to the company. When acquiring these contracts, the company generally relies on application information received from the dealers when underwriting the transaction and establishing the wholesale price — the buy rate — that it will pay the dealers, which is typical in indirect auto finance. Also typical, the company prices for the risk of default, which is expected to occur in a certain percentage of transactions.

The states allege that during the period covered by the settlements, the company identified certain dealers it considered higher risk and for whom additional oversight was appropriate. As part of its dealer oversight process, the company allegedly became aware that certain dealers were inflating consumer incomes, a practice the company believed was correlated with higher early payment default rates. Consequently, the states further alleged that the company was on notice it was being induced to purchase installment contracts from those dealers it might not otherwise have purchased.

Ultimately, the states alleged that the company's actions were insufficient to address the risk that the identified, problematic dealers were placing consumers into vehicles and financing transactions those consumers could not afford. The states maintained that, upon learning of the issues, the company did not appropriately discipline the dealers by terminating the relationship with those dealers. Thus, the states alleged that the company was "reckless with respect to the unfairness" under the states' UDAP statutes. In the settlements, the states did, however, recognize the steps the company had taken to improve processes to identify and address the issues alleged to have occurred in the past.

Based on the facts as alleged, the parties entered into a settlement under each of the states' UDAP statutes, and the company paid a total of (1) $22.1 million to resolve the Massachusetts action, of which $16.3 million is to be used for remediation and paying the costs of investigation and the remaining $5.8 million is to be paid to the state; and (2) $3.9 million to resolve the Delaware action, of which $2.875 million is to be used for remediation and paying the costs of investigation and the remaining $1.025 million is to be paid to the state. In addition, under both settlements, the company agreed to certain operational changes going forward, including implementing additional underwriting and documentation requirements for dealers that appear to be inflating consumer incomes.

State AGs Apply Ability-to-Repay Principles to Auto Finance

It is generally recognized that state statutory and regulatory regimes do not expressly require prospective assignees of installment contracts to engage in an ability-to-repay analysis. That said, courts in a limited number of jurisdictions — including Massachusetts — have held that conduct resulting in a high likelihood of consumers being unable to repay their credit obligations is an unfair or otherwise actionable practice under those jurisdictions' UDAP statutes. However, much of this jurisprudence has arisen outside of auto finance.

Notwithstanding the absence of a statutory ability-to-repay requirement, it is industry practice for both bank and nonbank financial institutions to collect and review relevant consumer financial data when deciding whether to purchase a retail installment contract and the price at which they are willing to do so as part of their underwriting and pricing processes. They do so with an eye toward controlling the risk of loss, understanding that some percentage of transactions will nonetheless fail to perform as expected, to achieve an acceptable risk-adjusted return. The Massachusetts and Delaware settlements are notable because they impose an obligation to mitigate potential credit losses regardless of whether an institution believes that it will achieve an acceptable risk-adjusted return, recognizing there were additional facts that helped drive them to this result. The concern for all institutions should be that other states seek to use their UDAP authority to hold market participants liable for "unacceptable" credit losses based solely on the level of losses and no other factors that might lead the institution to conclude those losses are the result of inappropriate actions by the parties from whom installment contracts are purchased.

Ability-to-Repay Analysis in Massachusetts

Massachusetts' courts have demonstrated a willingness to apply the state's UDAP law to a consumer's ability (or inability) to repay, doing so initially in the context of residential mortgage lending. Additionally, there has been the occasional matter outside the mortgage lending context to suggest broader application of Chapter 93A.

Application to Residential Mortgage Lending

When considering whether a practice is "unfair" under Mass. Gen. Law 93A § 2 (referred to herein as 93A), Massachusetts courts have stated that the following should be considered: "(1) whether the practice ... is within at least the penumbra of some common-law, statutory or other established concept of unfairness; (2) whether it is immoral, unethical, oppressive or unscrupulous; and (3) whether it causes substantial injury to consumers (or competitors or other businessmen)."[2]

In Commonwealth v. Fremont Investment & Loan, et. al.,[3] the court analyzed the Massachusetts Predatory Home Loan Practice Act General Laws c. 183C (the act). The act prohibits making a "high-cost home mortgage loan" absent a reasonable belief at the time the loan is made that the borrower "will be able to make the scheduled payments to repay the home loan based upon a consideration of the [borrower's] current and expected income, current and expected obligations, employment status, and other financial resources other than the borrower's equity in the dwelling which secures the repayment of the loan."[4] While the Fremont court concluded the loans were not "high-cost home mortgage loans" under the act, it deemed them to be unfair and in violation of 93A because they shared a "central element of unfairness" with the act's specifically prohibited conduct; to wit, the origination of a home mortgage loan that the lender should recognize at the outset the borrower is not likely to be able to repay.

The court went on to explain "[t]hat the Legislature chose in the act to focus specifically on home loan mortgages with different terms and features from Fremont's is not dispositive; the question is whether the act may be read to establish a concept of unfairness that may apply in similar contexts."[5] It further noted that, "As stated by the single justice of the Appeals Court, the judge appropriately could and did look to Chapter 183C as an established, statutory expression of public policy that it is unfair for a lender to make a home mortgage loan secured by the borrower's principal residence in circumstances where the lender does not reasonably believe that the borrower will be able to make the scheduled payments and avoid foreclosure."[6]

In a later decision, the Supreme Court of Massachusetts explained that "[n]othing in our decision in Fremont, however, was intended to suggest that the universe of predatory home loans is limited only to those meeting the four criteria present in that case ... Rather, [the Fremont holding] was that [Chapter 93A] prohibits 'the origination of a home mortgage loan that the lender should recognize at the outset that the borrower is not likely to be able to repay.'"[7]

Beyond Mortgage Lending

Though initially applied in the residential mortgage lending context, at least one court has been willing to consider the Fremont ability-to-repay construct in the commercial loan context. In Wright v. Marjen Recovery LLC,[8] while questioning whether Chapter 93A could be applied to a commercial loan, the court nonetheless considered what the outcome might be if applied. In doing so, the court noted:

> Even if [the Fremont reasoning applied], however, Wright failed to prove Marjem Mortgage made the loan without a reasonable belief that it could be paid back ... In Fremont, the Commonwealth supplied evidence showing the mortgagee determined loan qualification based on a borrowers [sic] debt-income ratio for the introductory rate payments rather than the full rate that would be applied after two or three years, thereby allowing borrowers to qualify for loans they would be unlikely to be able to repay. Here there is no such evidence of conduct on the part of the Marjem Defendants. Wright did not show that Marjem Mortgage had information in its possession at the time which would cause a reasonable lender to believe the note could not be paid back. As a result, this court cannot find Marjem Mortgage made a predatory loan that would violate c. 93A, and must find in favor of the Marjem defendants on this claim.[9]

Though not previously addressed outside the context of residential mortgage lending, the recent settlement with the Massachusetts attorney general leaves little doubt as to their willingness to apply Chapter 93A to nonmortgage finance transactions, including indirect auto finance transactions.

As an alternative theory, it is possible that the Massachusetts attorney general could seek to claim that a failure to properly consider a consumer's ability to repay constitutes an unconscionable act, giving rise to a Chapter 93A claim outside the mortgage context.[10] While Massachusetts case law does not define what constitutes unconscionability for purposes of 93A, at least one court has undertaken to analyze unconscionability from the perspective of "substantive contractual unfairness."[11] The court in Penney v. First National Bank of Boston[12] noted that when considering whether a commercial loan agreement and subsequent repossession of the collateral is unconscionable, such an analysis must be performed on a case by case basis, "giving particular attention to whether, at the time of the execution of the agreement, the contract provision could result in unfair surprise and was oppressive to the allegedly disadvantaged party."[13]

Ability-to-Repay Analysis in Delaware

The Delaware attorney general's reliance on the state's consumer protection statute[14] in entering into its settlement with the company represents entirely new ground for Delaware; no prior application of this particular subchapter has been identified as the basis for an action by the attorney general arising out of a consumer's ability to repay. But, and as the premise of this article implies, this action appears to be another milestone in the race to UDAP-ify the auto finance market and indirect auto finance participants.

While new to the attorney general's office, civil litigants have previously relied upon ability-to-repay theories. In fact, a claim based on this theory was initially brought in civil class action litigation involving a payday lender in Delaware, though the claim was voluntarily dismissed during the course of the litigation.[15] Notwithstanding the case did not proceed under the state UDAP statute, the court analyzed the loan agreement under a substantive unconscionability standard — an analysis that must necessarily be based on a determination of whether it was unconscionable at the time the contract was made[16] — and held the payday loan contract void as unconscionable and awarded judgment to the plaintiff.

Beyond Massachusetts and Delaware

Use of Ability-to-Repay Analysis as a Basis for UDAP Claims Elsewhere

Though state attorneys general and other enforcement bodies have brought few, if any, actions under a state UDAP theory for failure to comply with a general ability-to-repay concept in the absence of a state mandated ability-to-repay analysis requirement, civil cases in a number of state and federal jurisdictions have addressed the issue. As a general matter, these cases have involved either residential mortgage lending or "high-cost" consumer loan transactions (e.g., payday and other short-term loans).[17] In each of these instances, and in the absence of an actual ability-to-repay requirement, courts have applied an unconscionability standard when analyzing potential liability.

In DeBerry v. First Government Mortgage and Investors Corp.,[18] a civil action, the D.C. Court of Appeals determined, in the context of mortgage financing, that the D.C. Consumer Protection Procedures Act (D.C's UDAP statute) prohibited unconscionable terms resulting in a consumer's likely inability to repay. It explained that the CPPA had a broad remedial purpose, and that the defendant had failed to establish that the statute was not meant to apply to real estate mortgage finance transactions.[19] It would not be particularly surprising, given the current regulatory and enforcement environment, for an attorney general or other law enforcement body to rely on such a statute in the auto finance context.

Similarly, in In re. Bagot,[20] the court denied the defendant's motion for summary judgment under the New Jersey Consumer Fraud Act (NJCFA),[21] based in part on the existence of a genuine issue of material fact as to whether the defendant violated the NJCFA by "recommending a loan that the plaintiffs could not afford ..."[22] The court, in discussing the prohibition against "unconscionable commercial practices" under the NJCFA, noted that the term "unconscionable" must be liberally construed, and that predatory lending would be properly classified as unconscionable if proven.[23]

Though arising outside the indirect auto finance context, there is little within these decisions that might make them uniquely applicable to residential mortgage loans or unsecured consumer loans. In fact, given the broad language of the statutes and regulations relied upon to support claims that a consumer's likely inability to repay may give rise to a finding of unconscionability, and that such a finding may support a UDAP claim under state law, the regulators of other states such as D.C. and New Jersey may seek to apply ability-to-repay principles to auto finance.

What is an Indirect Auto Finance Source to Do?

To enforcement agencies revving up to pursue the auto finance industry, it seems that the ability-to-repay theory has that new car smell. Auto finance industry participants can and should take proactive steps to avoid such liability. While regulators and others may seek to hold assignees of indirect auto installment contracts liable for the actions of the automobile dealers from whom such contracts are purchased, it is important to state at the outset that automobile dealers typically are neither vendors nor affiliates of such assignees. Nevertheless, purchasers of auto installment contracts may wish to consider taking steps to identify potentially problematic dealer practices and address those practices if and when they arise. Such steps might include:

- Conduct appropriate due diligence on dealers at on-boarding and periodically throughout the relationship. This diligence may include requesting information about the dealer's financials; checking public complaint databases, such as the Better Business Bureau and Consumer

Financial Protection Bureau's complaint portal; identifying key employees in the F&I department to ensure that they are not known bad actors; researching any litigation against the dealership; and checking for negative press in public news sources that could suggest concerns.

- Include clear expectations regarding compliance in dealer agreements and other dealer guidelines, including an expectation that dealers will not engage in any act or practice that might inflate a consumer's income, minimize debt service or otherwise give a false impression of the consumer's ability to afford the vehicle under the proposed terms.

- Monitor individual dealer performance in connection with key risk indicators. Key risk indicators may include early payment defaults, the dealer's overall default rate, litigation, the frequency of inaccurate underwriting information provided, and the frequency of consumer complaints regarding the dealer (whether received by the institution or from other sources).

- Establish thresholds for further investigation and/or corrective action. This involves establishing numeric standards that define when an individual dealer performance with respect to a risk indicator may suggest a potential problem. Such thresholds could be based on the dealer's absolute performance or based on the dealer's performance relative to the portfolio.

- Take appropriate action when issues are discovered, either through monitoring or on an ad hoc basis. It is absolutely critical for an institution to take action once it has facts suggesting a potential problem. The gravamen of the states' allegations was that the company failed to take effective correction action when it allegedly had facts suggesting dealer misconduct and consumers' inability to repay. Such action might include remediation of losses suffered by the consumer and corrective action with the dealership, which may include escalation to senior dealer management, seeking the repurchase of contracts or indemnification from the dealer, the termination or clawback of other dealer incentives, and/or termination of the institution's relationship with the dealership.

Similarly, indirect auto finance sources should remain vigilant and aware of what occurs internally, and what information is known about dealers or transactions from dealers with higher loss ratios, and react appropriately. Such practices might include:

- Ensure appropriate oversight by executive management and the board of directors;

- Assign internal responsibility for monitoring activities and responding to findings;

- Ensure that internal review and auditing procedures are appropriate in scope to identify issues that may arise and could enhance the risk of loss, regulatory criticism or enforcement;

- Implement clear guidelines to allow for escalation of matters within the company as potential issues arise;

- Document policies, procedures, assessments, results and action taken as a result of any findings of inappropriate conduct both within and outside the company;

- Communicate to employees that they should raise dealer risk issues notwithstanding the potential negative sales impact it could have with the dealer; and

- Ensure that dealer and employee incentives are aligned with the company's commitment to the fair treatment of consumers and prudent risk-taking.

The recent enforcement actions by Massachusetts and Delaware are a key milestone in the evolving expectation that prudential risk controls are not just a matter of financial performance, but also a critical consumer protection issue. This expectation is migrating into auto finance and institutions should ensure that they have the compliance infrastructure to meet the challenges that it will pose.

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[1] While this article is limited to discussion of ability to repay and the use of state Unfair and Deceptive Acts and Practices statutes, the Dodd-Frank Wall Street Reform and Consumer Protection Act grants the Consumer Financial Protection Bureau and state Attorneys General the ability to pursue claims under the additional "abusive" prong within the Act's Unfair, Deceptive and Abusive Acts and Practices standard set forth at 12 U.S.C. § 5531.

[2] Commonwealth v. Fremont Inv. & Loan, 2008 WL 517279, at *8 (Mass. Super. Feb. 26, 2008), modified in part sub nom. Com. v. Fremont Inv. & Loan, 2008 WL 1913940 (Mass. Super. Mar. 31, 2008).

[3] 452 Mass. 733 (2008).

[4] Fremont, 452 Mass. 733 (2008) (citing General Laws c. 183C).

[5] Fremont, 452 Mass. at 749.

[6] Id.

[7] Drakopoulos v. U.S. Bank Nat. Ass'n., 465 Mass. 775, 785–787 (2013), quoting Frappier v. Countrywide Home Loans Inc., 645 F.3d 51, 56 (1st Cir. 2011); see also, In re: Morgan Stanley & Co. Incorporated, Civil Action No. 10-2538 (June 24, 2010) [http://www.mass.gov/ago/docs/press/2010/2010-06-24-ms-settlement-attachment3.pdf].

[8] 2014 WL 4274528, at *7 (D.Mass. Aug. 27, 2014).

[9] Wright, 2014 WL 4274528, at *7.

[10] 940 Code Mass . Regs. § 3.16 ("[A]n act or practice is in violation of M.G.L. c. 93A § 2 if: (1) It is oppressive or otherwise unconscionable in any respect ...").

[11] Zapatha v. Dairy Mart Inc., 381 Mass. 284 (1980).

[12] 385 Mass. 715 (1982).

[13] Id. at 721, citing Zapatha, supra.

[14] See, 6 Del. Code § 2511, et seq.

[15] See, James v. National Finance LLC, 132 A.3d 799 (2016).

[16] Id. at 814, citing, Lecates v. Hertrich Pontiac Buick Co., 515 A.2d 163, 173 (Del. Super. 1986).

[17] See, e.g., Harris v. Option One Mortg. Corp., 261 F.R.D. 98, (Dist. S.C. 2009) (Applying the South Carolina Unfair Trade Practices Act in residential mortgage loan context); In re. Bagot, 2012 WL 734178 (Bkrtcy. D. N.J. 2012) (Applying the New Jersey Consumer Fraud Act in residential mortgage loan context); In re. Moore, 470 B.R. 390 (Bkrtcy. S.D. W.V. 2012) (applying the West Virginia Consumer Credit and Protection Act in residential mortgage loan context); Johnson v. Advance America, 596 F.Supp.2d 292 (Dist. S.C. 2008) (applying South Carolina Unfair Trade Practices Act in payday loan context); O'Donovan v. CashCall Inc., 278 F.R.D. 479 (N.D. Cal. 2011) (applying California UDAP statute in high cost unsecured consumer loan context).

[18] 743 A.2d 699 (D.C. 1999)

[19] Id.

[20] 2012 WL 1207220 (D. N.J. Bankr. 2012).

[21] N.J. Stat. Ann. § 56:8-1 et seq.

[22] 2012 WL 734178, at *8.

[23] Id. at *4, citing Associates Home Equity Services Inc. v. Troup, 778 A.2d 559, 543 (N.J. Super. App. Div. 2001); Gonzalez v. Wilshire Credit Corp., 25 A.3d 1103, 1118 – 1119 (N.J. 2011). The court went on to note that predatory lending includes "'a mismatch between the needs and capacity of the borrower ... In essence, the loan does not fit the borrower, either because the borrower's underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood that the borrower has the capacity to repay the loan.'" Id. citing Troup, 778 A.2d at 536 -537.