

Debt Sales 101 Mini-Series (Episode 5): Closing the Deal: Key Contracting and Transaction Issues

Speakers: Joseph Schuster and Chris Eastman

Chris Eastman:

Welcome back to our mini series on debt sale. I'm Chris Eastman from Franklin Ross Strategies. I'm here again with my colleague and friend, Joseph Schuster, a partner with Ballard Spahr's Financial Services Practice. Today, we're onto our fifth episode focusing on contracting and closing the debt sale. If you haven't had a chance to listen to the first four episodes, there's great content walking you through all things debt sale up until this point in the process. Now, I'm excited about this episode, Joseph, because this is where debt sales can really generate great additional value for both parties. And it's also where there's a lot of risk management to consider from both sides. You mentioned some of the key considerations at a high level in our last episode. Why don't you kick off this conversation by walking us through the key legal considerations you think about when advising a client on the debt sale contract?

Joseph Schuster:

Thank you, Chris. And I'm very excited about this episode as well. And as Chris mentioned, my name is Joseph Schuster, and I'm a partner in the Consumer Financial Services Group at Ballard Spahr. Chris, you mentioned that the contract and the commercial point here is really where these debt sales are providing value. I'm excited for this episode too, because this is also where I think legal provides a lot of value as well in these deals. When I think about the contractual terms, and we have a library of different kind of contracts that we'll use depending on the parties that are involved, whether it's a FinTech type transaction that you have a bank, an entity that has the receivables and the debt buyer, if it's just straight from the originator to a debt buyer. There's a number of different considerations that you have with the contract terms.

I'm going to say that the terms high level have or accomplished two main things, but maybe three. I'll give three. Number one, they're transferring the assets, and it's documenting the commercial aspects of the bid. We've said, "We're going to buy this amount at this price. We're going to transfer you those assets." That is all covered in the contract, obviously. The second one, and this is again why I think that the outside counsel can really add value, is the allocation of the regulatory and legal risk. And we'll get into the reps and warranties, the indemnifications, all of those types of things that we run into there. And then the third piece, why I moved from two to three is that this is also an artifact for regulators. So there are specific terms that regulators expect to see in contracts when debt is being sold. And we know what those are, and we can talk through different ways to do them.

It's not necessarily creating new obligations on the seller or on the buyer from a practical perspective, but they are things that regulators are expecting to see, especially because I think that regulators are no longer looking at debt sales as a way that you can just remove your liability. Debt sales are now more of an ongoing management of risk type of activity. And so that does need to be something that's considered in these contracts. Any thoughts on that framework, Chris, before I jump into some of the specific areas?

Chris Eastman:

No, I think you're getting into an important fact there, Joseph, which is that debt sales are really a long-term relationship. It's not just a transaction at a moment in time. And you need to think about it as such as you're contracting.

Joseph Schuster:

Right. There are two types. You're going to tell me, Chris, there's a lot more. I know. I'm going to simplify the world into two types of transactions. You have a one-time sale where I have some debt that I'm going to sell, and I'm going to do it one time and that's it. Or you have forward flow agreements. And there are variations within each of them. There's never just a one-time sale. Maybe if somebody's getting out of the business, sure. But you could do a one-time sale now, six, 12 months later,

you do another one-time sale. Or the forward flow agreement is, and this is where in that initial contract, you're putting together everything that's going to govern all of those subsequent transactions that the forward flow arrangements where you're transferring debt every month, every quarter, whatever that time period is.

Those additional debt sales will have their own contract, but that will be an abbreviated contract and reference the terms in the initial contract. But with that, let's jump into some of the substance of the contracts that we generally talk about and modify and the provisions that really carry a lot of heft and importance. The first area is with respect to reps and warranties. Here is really where the seller is repping what they are selling, what they will not sell. And this is a big consideration for the buyer that they are excluded accounts. We will buy all the debt that's been charged off, whatever the case is, but we're going to exclude ... The most common and obvious exclusion is an account that's been created through fraud. That's not a valid account to sell. That term valid account is something that gets used in these contracts a fair amount.

That's the fundamental piece of this is what we're going to sell, this is what we're not going to sell, and the buyer wants to see that. The buyer also wants to see the chain of title. How did it get that the seller has these accounts? In some instances, if they're the originator, that's easy. In other instances, being able to explain what that chain of title is is important. The accuracy of the data that's been provided. At this point, and you'll touch on this a little bit later, Chris, the contract may have been provided along with the data file that the buyers are looking at to bid on on these items. They're going to want a rep that what was in that data file is actually what is going to be sold because they've used that data file to come up with their pricing. That's an extremely important piece.

Another area then that they look at is what were the collections activities prior to this sale? Has there been a legal strategy? Have you been complying with applicable law? Now that's one where maybe here's where I'll flip over to the reps that the seller will give.

The compliance with applicable law, there are so many different ways to interpret all of these different state laws that it is difficult to do. This is something that generally is better covered during the diligence phase, and then have a rep in there that the seller obtains from the buyer, that the buyer is representing that they were able to conduct all of the due diligence that they wanted, and all of the materials that they requested were provided. If there isn't something, and if that rep is difficult for the buyer, the seller should be asking them, "What would you like to see before this?" And be providing it so that that rep is something that the buyer can provide to the seller. Another thing that does come into play in some, but not others with respect to a rep and warranty that the seller will obtain from the buyer is limitations or prohibitions on certain practices.

Maybe it's that we don't want you to collect on members of the military if you find out, collect on bankrupt accounts. There could be certain things or not credit report for a period of time. There can be certain areas where... And you have to be careful here. The seller should not direct how the buyer collects on the accounts, but if there are certain activities that the seller wants to prohibit or restrict, that I don't think touches as much on the collection activity that the buyer's going to have. I have a lot more though, Chris, and I know that you and I have talked about some of these provisions in particular. So I don't know if you want to just briefly touch on that one with respect to that record warranty and how that can affect the economics of this deal too, because I know that that is a consideration of ours.

Chris Eastman:

So anytime, Joseph, if you're restricting collection activity contractually, that's going to significantly impact the commercial value. And there's a number of ways and areas I've seen this done, and I know we've talked about these, but some areas that have ended up getting highlighted in my experience have been credit bureau reporting, the ability to do legal collections, any types of accounts that can't be collected on, as I think you briefly mentioned there. Those all can vastly impact the pricing of accounts and the commercial outcome going along with the contract. So you're absolutely right there.

Joseph Schuster:

Thanks, Chris. Continuing on with these terms in the commercial agreement, I'm going to move to the indemnification. This is a very important one because it's important for both the buyer and the seller. The buyer wants to have that indemnification if what they are buying doesn't turn out to be what they think that they're buying. The seller, they'll want some certainty too. They don't want to be nicked and dined for everything that's happening. So we generally use the concept of a basket and a cap in our commercial contracts. The basket is really how much risk or what has had to happen before the indemnification

occurs. We'll generally do it as it can be done as a straight dollar amount or a percent of the transaction. You'll generally see something from 1% to 5% that you have to have claims of at least that level before you bring indemnification claims and then you can bring the amount in excess of that basket.

Cap as well. Having it be unlimited doesn't generally work. Having it be for the value of the transaction, that is something that you can generally have as a cap. And again, these change based on the types of deals that you're doing, if it's a one-time transaction versus if it's a forward flow, those types of things. The other piece that's very important with this is the buyback or the put back and the repurchase mechanics that happen in these agreements as well. So there will be instances where the seller will need to or want to buy back certain accounts, how they can effectuate that. There's a putback. If the buyer obtained accounts that they should not have obtained or that were subsequently determined that they are problematic, what accounts can they put back as well? And what are the mechanics, pricing, economics? How does all of that work? That's an important piece.

The audit and inspection rights. This is one that is important. It's very important where you have the forward flow agreements. It's also important in the one-time transactions, though it'll be a limited provision. And the reason that's important is, again, because this is something in that third category of what I was talking about of what you expect to see. This is an artifact for regulators as much as it is a substantive provision that gets used by the seller and the buyer. Data transfers and cutoff times are important. You'll many times have a seller that is doing activity on accounts right up until the time that is cut off and those accounts are being sold. Sometimes that's not the case, but a lot of times that is. And so the accounts that are in that are out, how the pricing works, that'll all be moving right up until that cutoff point.

And so how you do that data transfer is going to be very important. How you consider that cutoff point, how you and when you have the mechanics for the compensation that comes in, all of those types of things as well. And we touched on the restrictions on collections activity. There's a number of all kinds of additional areas that you'll have; privacy, data protection, all of those things as well. I don't want to get into those too much. Those affect a lot of different things. But, Chris, given these high level pieces on the commercial side, maybe you could talk a little bit about the process as well. And after we put together this contract, how does it get presented, and at what point of the process does that happen?

Chris Eastman:

That's a great question, Joseph. And there's a couple of ways that can occur. I would say most often when the data file is cut and the accounts are provided for the bid, and that goes out to the various buyers that are going to bid on the file, I often think of it as a best practice to include the sales contract at that point so the bidders can start reviewing it and the buyers can come back with any red lines or any key items that they want to negotiate in the contract with their bid. And that really lets the seller think about both in concert, not just the bid price, but also any key terms which may impact the commercial or the risk side of the deal, and you want to consider those together as opposed to separately. So that's my best practice when thinking about it.

I've also seen it where you take the bids and then do the contract after, but that can lead to surprises in terms of negotiated items or maybe risk profiles that you're not comfortable with as a seller and you don't want to backtrack at that point.

Joseph Schuster:

That makes a lot of sense. It's very helpful. Thank you. Now, I went through a bunch of the things where the legal folks are providing value in these contracts. Do you want to touch on some of the critical topics that you have in managing risk when you're looking at these items from a commercial perspective and if you want to add any legal things that you run into as well, what those are and how you consider those different concepts?

Chris Eastman:

Absolutely, Joseph. Thanks. This is really where the contracting and the commercial comes together. And so a lot of these are intertwined. And you were talking about the data file being cut and ongoing activity. This is an area where there's a lot of commercial impact depending upon how the deal is structured and contracted. And one key commercial driver is the concept of a lockbox provision. And this occurs when the seller sends out a file for buyers to bid on, customers may continue to make

payments on those accounts. A lockbox provision in the contract entitles the buyer to all the payments made after the date in which the file is pulled together. So the alternative here would be to recut the file at a later date with the winning bidder to price the final file and then have the money collected during that period stay with the seller.

So the buyer is going to price those each differently and price in the expected value of payments coming over, but that's an interesting dynamic on how you think about the contract. And sellers and buyers both generally have a preference on what strategy they prefer. So I've worked with several sellers to ensure this point is contracted to maximize the value to them. You mentioned buybacks. That's also a critical point to include in the contract commercially as well. And one thing I'll highlight is one of the largest areas where I've seen items put back from buyers to sellers is deceased accounts. So buyers oftentimes will scrub all of the accounts that come in, and sellers are not always scrubbing their portfolio for deceased accounts. And so buyers will find these, they'll want to put them back and unwind the sale of those accounts generally at the purchase price.

So one thing sellers can do to get out in front of that is potentially scrub the accounts upfront before putting them into the file to ensure that you don't have to work through that at the end of the process. But I'll also highlight that there's accounts that sellers want to make sure that they can buy back the accounts that may be moving into a dispute process at the last minute or accounts that pay in full and no longer have a balance to sell. Usually there's an acceptable period you'll want to negotiate for these buybacks, and allowing too much time can give the seller a long-term tale of commercial risks that they'll want to manage too.

The last thing I'll highlight real quick is the ongoing operational support, which you'll want to provide as a seller to maximize the value for the buyer. Several items to consider here, which could and should increase the value of the debt you're selling, include everything from willingness to do ongoing payment processing, forwarding checks and such. You could offer to retain servicing of certain accounts to support payments on those, and then also supporting the affidavits and providing witnesses for the buyer, communicating upfront your ability and willingness to support operational processes, and the period of time over which you'll support that can increase the sales price and then simplify contracting because you've communicated that upfront and the buyer has an understanding of that going into the bid process.

Joseph Schuster:

That's a really great point. Well, a number of them, Chris. I'd say a couple of things there that you touched on there on board is the earlier that the seller is looking at all of these different items really makes this whole process go easier. You know what you're selling, you know the chain of title, you know what's been done on those accounts, you know regulatory risks, and you can account for all those things when you're putting together this commercial agreement. And I think that's important from that early due diligence, before you've interacted with bidders, putting together this contract that addresses all those things that you've done, that makes the process go very smooth. And it goes to that point that you've finished with of what you're doing post sale as well, because you will know from the debt what activities you're able to do and how you're going to do that.

I think it's a great transition that will lead into our next episode. So unless you have anything else, I'll close this out and summarize it.

Chris Eastman:

Joseph, I think this was a fantastic episode, which really covered the contracting process. And I'm excited now to talk about post-close activities.

Joseph Schuster:

Yeah, I am as well. So I think today, hopefully what you get from this episode is the importance of that well-drafted debt purchase and sale agreement, that it doesn't just manage the downside risk, though it does do that, but that it actively supports the commercial goals of both parties, as Chris was talking about. From a legal structure, regulatory expectation, you can have those and align them with business realities. And when you do all that, debt sales, as Chris was talking about, really can become repeatable, scalable transactions rather than that one-off event. So with that, we'll close it out here. And in our next episode, we're going to talk about what happens after the close. We've gone through diligence, do we have a contract that's signed? There's still more to come and one more episode that will address all of that. So thank you.

