

Dodd-Frank: What About Leasing?

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Part Two of a Two-Part Article

Part One of this two-part article provided an overview of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, codified at 12 U.S.C. 5301), better known simply as "Dodd-Frank," which became effective on July 21, 2010. The Act is expected to have broad and deep implications for all sectors of the U.S. financial industry and marketplace, from securities to real estate to credit cards to banking, and to have long-term consequences for the equipment leasing and finance industry and for leasing counsel. This second installment discusses in detail those provisions of Dodd-Frank, among many others, which may have the most immediate and greatest impact on U.S. equipment leasing and finance companies.

Some Important Definitions

The Dodd-Frank statute includes a number of new terms and revises the meanings of various existing terms in common usage in the banking and financial industries. First, the provisions of the law make frequent reference to "bank holding companies," which are defined for purposes of Dodd-Frank as they are under the Bank Holding Company Act of 1956 (12 U.S.C. 1841) as companies that have "control over any bank or over any company that is or becomes a bank holding company."

Then a new term of art is introduced for purposes of the Act, and it is anticipated that the definition of this term will garner significant attention as the wide range of applications of Dodd-Frank continue to be worked out in coming years. A "nonbank financial company" is defined in the statute (Section 102(a)(4) of the Act) to mean a company (other than a bank holding company or certain other specialized entities) that: 1) is incorporated or organized under the laws of the United States or any State, or a country other than the United States (a "foreign" nonbank financial company), and 2) is "predominantly engaged in financial activities," even (in the case of a foreign nonbank financial company) through a branch. The statute goes on to state that "predominantly engaged in financial activities" means either: a) deriving 85% or more of its consolidated annual gross revenue from activities that are "financial in nature," or b) having consolidated assets of which 85% or more are "financial in nature." Under proposed Federal Reserve rules, this 85% test applies to either of the past two years, or it may be determined through a facts and circumstances examination.

Whether or not a company's activities are "financial in nature" is determined by further reference to the Bank Holding Company Act (12 U.S.C. 1843(k)) and to proposed Federal Reserve rules under Regulation Y (12 C.F.R. 225). Taken together, these

guidelines define activities to be "financial in nature" if they are:

- "Closely related" to banking activities, such as credit extension and debt collection, real estate appraising, asset management, credit bureau services, or check cashing and check guaranty activities.
- Determined to be "usual" in connection with the transaction of banking or other financial operations abroad, such as management consulting services, travel agency operations, or the organization, sponsorship, and management of a mutual fund.
- Defined as financial in nature by the Gramm-Leach-Bliley Act, such as insurance or annuity services provided in a principal or agent capacity, securities underwriting, or making a market in securities, or merchant banking activities used to control nonfinancial companies.

As under Regulation Y, a company may request a determination from the Federal Reserve Board as to whether an activity is "financial in nature." Given the broad definitional framework laid out in Dodd-Frank, however, it seems clear that virtually all full-time leasing and equipment finance companies are "nonbank financial companies" for purposes of the Act.

Given this underlying definition, then what is a "significant" nonbank financial company for purposes of the application of the multitude of the new and future rules and regulations under Dodd-Frank? The rules proposed by the Federal Reserve define a significant nonbank financial company as one that is: a) supervised by the Federal Reserve Board of Governors or b) had \$50 billion or more in total consolidated assets as of the end of the most recently completed fiscal year. (Similarly, the rule proposes that a "significant" bank holding company is one with \$50 billion or more in total consolidated assets.) If adopted, these rules will clearly subject many large independent and bank-owned leasing and finance companies (and their affiliates) to the broad range of rules and requirements of Dodd-Frank.

In this context, it should also be noted that under the statute a finding of "significance" is not required for the Financial Stability Oversight Council (the "Council," described in detail in Part One of this article) to make a Systemic Importance Determination with respect to any particular bank holding company or nonbank financial company. The Council is granted broad discretion in making such determinations, and imposing the rules and requirements attendant to such a determination.

In addition to the definitional framework of the Act, the following specific statutory provisions of Dodd-Frank, among many others, are expected to affect and impact the operations and business of equipment leasing and finance companies.

Overlapping of Consumer and Commercial Finance

Continuing a trend that is already underway, many of the regulatory and compliance requirements of Dodd-Frank are expected further to blur the historical (and, as reflected

in many provisions of the U.C.C. and other strictures, the legal distinction between consumer and commercial financial transactions. This trend has accelerated over the past several years through various enforcement actions of the Federal Trade Commission, through various fraud cases and related litigation (particularly in equipment leasing) attacking the use of customary contractual terms, and through court interpretations of various consumer protection statutes as applied to small-business enterprises.

In particular, the newly created Consumer Financial Protection Bureau (the "Bureau," described in detail in Part One of this article) is granted broad authority over anyone offering or providing a "consumer financial product or service" or any service provider affiliate thereof (a "covered person" under the statute). If a leasing company offers products to both individuals and small businesses, it is likely to fall under the authority and regulations of the Bureau. For example, depending upon future interpretations of the statute but following the current trend to its reasonable next interpretive level, an individual lease guarantor or the owner of a sole proprietorship lessee may be construed as the offeree of a consumer financial product. The line between the two will continue to be blurred, and the Bureau will likely acquire more, not less, authority over small-business financial activities as the details of Dodd-Frank implementation are worked out through regulation and litigation.

The new Bureau is also given broad authority over any "covered person" whom it has reasonable cause to determine is engaging or has engaged in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services. This may include the ability to require reports and conduct periodic examinations of such covered persons. The Bureau is required to coordinate this supervisory authority with prudential regulators and state bank regulators to minimize the burden on non-depository institutions, but there is significant potential for overlap between Bureau authority and other state and federal regulatory authority. In particular, it is reasonable to expect some overlap between the Bureau's "consumer" authority and other enforcement activities concerning small-business financing and related activities; this overlap is already beginning to show between the enforcement actions of the FTC and other regulatory agencies in the leasing sector. Additional layers of reporting and compliance requirements may be anticipated as further sections of Dodd-Frank are implemented.

Finally, under the Bureau's authority a "financial product or service" specifically includes extending or brokering leases of personal or real property that are the functional equivalent of purchase finance arrangements, if such leases are on a non-operating basis, have an initial term of at least 90 days, and, in the case of leases "involving" real property, the transaction at inception is intended to result in ownership of the leased property being transferred to the lessee. Given the current blurring of the distinction between consumer and small commercial transactions, will "consumer financial products or services" be restricted by the Bureau to products "for use by consumers primarily for personal, family, or household purposes," as such language is used in the U.C.C. and many state statutes (and many equipment leases)? It is anticipated that the blurring trend will continue apace under Dodd-Frank, and many heretofore "commercial" transactions

and their lessors will become subject to new and broader regulation under the authority of the Bureau.

New Data Collection Requirements

As just one example of the effect of the new Bureau's expanded authority under Dodd-Frank, the Act amends the Equal Credit Opportunity Act ("ECOA," codified at 15 U.S.C. 1691) to require that every financial institution must, for every credit application for a women-owned, minority-owned, or small business, inquire whether the business is in fact a women-owned, minority-owned, or small business (regardless of how the application is taken, whether in writing, by phone, online, or otherwise) and must maintain a record of the applicant's responses that is separate from the application and accompanying credit information. For this purpose, "financial institution" means any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in any financial activity.

In addition, "where feasible," no loan underwriter or other officer or employee involved in the credit decision shall have access to any of the new information collected. If the financial institution determines that a loan underwriter "should" have access to this information, it must provide notice to the applicant that: a) the underwriter has access to such information, and b) the financial institution may not discriminate on the basis of such information.

Specific information that must be collected under this provision of the amended ECOA statute includes:

- The number of the application and the date received.
- The type of and purpose of the loan or credit application.
- The credit limit applied for and the amount or credit limit approved.
- The type of action taken and the date taken.
- The census tract of the applicant's principal place of business.
- The gross annual revenue of the business in its last fiscal year.
- The race, sex, and ethnicity of the principal owners of the business.
- Any additional data the Bureau may request.

All of this newly required information must be maintained in accordance with the Bureau's regulations and must be submitted annually to the Bureau. An applicant for credit may refuse to provide any of the requested information, but the financial institution must still request it (and presumably must document its request). Information must be retained for a minimum of three years, and it must be made available to "any member of the public" in a form required by the Bureau. Records of this information may not include the name, specific address, telephone number, e-mail address, or other personally identifiable information concerning any individual who is the applicant or is "connected with" the applicant.

This new data collection requirement is currently pending implementing regulations; but

whatever form such regulations take, it is anticipated that this requirement will represent a significant compliance and administrative burden for virtually every equipment leasing and finance company.

Alternatives to Credit Ratings

Under Dodd-Frank, nationally recognized statistical rating organizations ("NRSROs") will henceforth be required to register with the SEC. New governance, compliance, and reporting requirements will apply to NRSROs; and investors will now have a private right of action against credit rating agencies under securities laws, similar to rights against accounting firms and securities analysts. All federal agencies must (within one year) review their regulations to identify uses of credit ratings, and after review each agency must replace any regulatory reference to credit ratings with an "alternative standard" of creditworthiness. Proposed agency rulemakings are currently underway to determine such alternative standards of creditworthiness. It is anticipated that these changes, in addition to their dramatic impact on credit and financial markets in general, will represent significant potential disruption in the way leasing companies conduct (and pay for) credit reviews and analyses.

Retention of Securitization Credit Risk

Under Dodd-Frank, securitizers of asset-backed securities will be required to retain not less than 5% of the credit risk for any asset that is transferred, sold, or conveyed by them through the issuance of an asset-backed security. The amount of such retention may be less than 5%, but only if certain specified higher underwriting standards are met for the offering. For purposes of this provision, "securitizer" means an issuer or a person who organizes and initiates a transaction by selling or transferring assets, presumably including an originating lessor or other creditor with respect to the underlying obligations. The statute defines "asset-backed security" as a fixed-income or other security collateralized by any type of self-liquidating financial asset, including a loan, a lease, or a secured or unsecured receivable. There are carve-outs under the statute for certain classes of assets (*e.g.*, qualified residential mortgages), but these are not likely to pertain to assets comprising equipment lease rentals or receivables.

So-called "skin in the game" rules under this provision of Dodd-Frank were proposed jointly in March 2011 by the SEC, FDIC, and Federal Reserve, and they contain exemptions for securitizations of certain qualifying commercial loans. To qualify as an exempt securitization, the borrower on the included obligations must, during its two most recently completed fiscal years and the two-year period after the closing of the loan (based on reasonable projections), according to GAAP, have all of the following:

- A total liabilities ratio of 50% or less.
- A leverage ratio of 3.0 or less.
- A debt service coverage ratio of 1.5 or greater.

In addition, the loan payments must be based on straight-line amortization of principal

and interest that fully amortize the debt over a term that does not exceed five years from the closing date of the loan; and loan documents must require payments no less frequently than quarterly over a term that does not exceed five years. It is therefore anticipated that these rules, in their final form, will very likely not provide for exemptions of many commercial equipment rental and receivables securitizations; and it is expected that any final "skin in the game" rules will have a substantial effect on the availability and cost of securitization conduits and similar vehicles for equipment leasing companies.

Conclusion

There are myriad additional rules, requirements, and regulations under Dodd-Frank that are likely to affect the equipment leasing and finance industry, and this article has touched only on those that appear to be the most dramatic. As with the Sarbanes-Oxley Act before it, there will be significant cost burdens on leasing companies and their affiliates resulting from Dodd-Frank and related regulations. These include costs of mandatory reporting under rules from the new Office of Financial Research (described in Part One of this article) and the Bureau; costs of creating and retaining records to meet future audit and compliance requirements; costs of legal counsel, accountants, and other experts for advice on compliance and applicability of regulations; increased costs associated with new rules for credit agency reports and securitization requirements; and many others, including many that are not yet known. Overall, compliance with new regulations under Dodd-Frank is likely to make compliance with Sarbanes-Oxley seem like a mere nuisance.

The stated objective of the Act is to identify entities and activities that represent "systemic risk" to the overall U.S. financial system and to act proactively and preemptively to prevent another financial crisis from occurring. In reality, however, it is very likely that Dodd-Frank will create dozens of interlocking and overlapping agencies, rules, and regulations that will:

- Be heavily influenced by months or years of lobbying and special pleading.
- Require substantial resources for compliance and reporting.
- Create market uncertainty for many years, or at least until hundreds (perhaps thousands) of new regulations are worked out and promulgated; new regulations are interpreted, enforced, and then challenged; and courts determine the final shape of the regulatory landscape, which may or may not resemble anything we anticipate today.

Thus, it will be incumbent upon leasing and finance companies and their counsel to remain abreast of these developments as they occur, to participate in industry activities intended to influence the direction and scope of new regulations, and to anticipate major changes in the way we have traditionally done business in leasing.

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