

Our Mistake in Lending Club

This article is authored by Michael Shearn of Compound Money Fund, LP.

We always believe it is useful to expose a bad investment process even if we have a good outcome. We ended up passing on online peer to peer lender Lending Club because we believed the business model was too difficult to predict but liked the CEO who passed most of the filters we use to determine who to partner with. If you read the financial press you know the CEO of Lending Club was kicked out of the company because he was aware that some employees falsified records about a product to be sold to a customer and he refused to fire them. The initial issue was relatively a small one, but CEO Renaud Laplanche was also not forthright with his board, which led to distrust. In other words, he demonstrated bad character. Even though we avoided investing in Lending Club (a great outcome) CEO Laplanche passed most of our leadership filters (exposing a bad process). Having identified a flaw in our process, we think it is important to conduct a post-mortem to better understand how we might filter such individuals out in the future.

To judge character, we usually need to wait until we have an example of a CEO acting in the best interests of all stakeholders, when it is not easy to do so. In other words, we would like them to do the right thing even if they have an incentive to act otherwise. We call this a moment of integrity, because it tells us we can trust the CEO.

Often, we are simply looking for differences between behavior and action. On this score, Laplanche appeared to have guided the company fairly well over many years. However, although he had navigated tough circumstances earlier at Lending Club, he was not under the same pressure as he was this year when Lending Club needed securitizations to encourage investors to make additional loans. Our take is that as the business environment changed and the stock price dropped, Laplanche felt that he needed to make those deals happen, and rather than make a principled decision, he made a short-term expedient decision.

Our key question is what could we have seen in his prior behavior to help us predict this action? One of the main reasons we had so much confidence in Laplanche is that he believed in transparency and would provide a lot of information about the loans they were making. We assumed someone that was so transparent in one part of the business would also be transparent in others. The problem is we allowed this to bias our view and should have instead refrained from making a judgment on Laplanche's character because we had not yet seen him face a true moment of integrity. As this story has developed, it seems Laplanche valued growth above everything else and did anything he could to achieve it.

The lesson is we will add a filter that our leaders must have survived much higher pain thresholds in the future and they must have made the right choices. For a capital allocator, this would include walking away from a deal after a lot of time and investment as we have seen the CEO of Brookfield Asset Management, Bruce Flatt, do multiple times. For someone like Laplanche, it would mean tabling a securitization, firing the unethical employees, and being upfront with his board, even though the company sorely needed to attract additional investors to buy its loans in order to sustain growth.