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Reverse Due Diligence — A New Trend In Financial M&A

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As discussed in our prior article, "A Primer on Structuring Specialty Finance M&A Deals," Law360, Sept. 9, 2014, regulatory uncertainty has both driven deal flow for specialty finance businesses and portfolios and made consummation of those transactions more challenging. This regulatory uncertainty affects all consumer finance businesses, not just the mortgage industry, and these new concerns are starting to be reflected in the merger and acquisition transaction process and the negotiation of acquisition agreements. Some of the tactics of the immediate post-credit crisis period — selling assets and businesses quickly for a discounted price with no strings attached — are now less likely to pass muster based upon regulatory expectations.

Reverse Due Diligence an Emerging Trend

A new issue arising for bank and non-bank sellers that are regulated by the Consumer Financial Protection Bureau is what level of due diligence sellers must engage in with respect to their buyers. Nonbank servicers that are owned by private equity or hedge funds have become very common bidders. A regulated seller should be concerned with the regulatory and litigation history of its bidders as well as their licensing status, including whether a prospective bidder has taken aggressive positions relating to compliance matters. These compliance issues can impact a bidder's ability to close a transaction and may present potential liability for the seller.

Buyer representations and covenants relating to its preclosing and post-closing conduct have become much more common and assist the seller in completing its due diligence of the buyer. The Office of the Comptroller of the Currency and the CFPB have made it clear that a seller cannot just walk away from a consumer loan portfolio without some assurances that the portfolio will be handled properly after the closing.

Some of the new regulatory pronouncements in this fast-developing area are described below. Even if the seller is not directly regulated by the OCC or the CFPB, it should consider whether the seller or buyer may be swept within the CFPB's supervision in the future and whether the seller should diligence the buyer as if the CFPB's rules and guidance applied.

CFPB Mortgage Servicing Regulations

In 2013, the CFPB adopted new mortgage servicing regulations, including CFPB Bulletin 2013-01, regarding transfers of mortgage servicing. CFPB Bulletin 2013-01 was replaced by CFPB Bulletin 2014-01 in August 2014. These CFPB bulletins and CFPB mortgage servicing regulations effective in January 2014 impose affirmative obligations on transferors of servicing to mitigate servicing disruptions when loans are transferred, and provide that examiners will consider the steps taken by the transferor servicer to minimize disruptions, including the identification of loss mitigation in process.

In addition, the mortgage regulations require servicers to maintain policies and procedures that are reasonably designed to achieve the objectives of facilitating the transfer of information during mortgage servicing transfers. These policies and procedures would typically provide for the timely transfer of all information and documents in the possession or control of the old servicer in a form and manner that ensures the accuracy of the information transferred and enables the new servicer to comply with its obligations to the owner of the loans.

On the other hand, the new servicer should also have policies and procedures to identify necessary documents and information that may not have been transferred and to obtain those documents from the old servicer. In CFPB Bulletin 2014-01, the CFPB states that it intends to require servicers engaged in significant servicing transfers to submit informational plans to the CFPB describing how they will manage related risks to consumers.

We understand that the CFPB is actively reviewing servicing transfer plans and related documents and the servicer's policies and procedures as part of its examination process. Part of this review is intended to determine whether consumers (rather than the institution) were harmed or disadvantaged by the servicing transfer (e.g., required to resubmit information to the new servicer).

The CFPB expects that the transferor servicer will confirm that the transferee servicer has received all of the mortgage loan information and that loss mitigation in process will be honored. The old servicer may want to obtain assurances from a transferee servicer that all existing loss mitigation arrangements and those in process have been honored by the new servicer.

OCC Guidance for National Banks and Federal Savings Associations

In addition, in 2013 the OCC issued best practices for national banks and federal savings associations involved in consumer debt sales. The OCC formalized these best practices in August 2014 with its OCC Bulletin 2014-37 (the "OCC bulletin") that applies to all OCC-supervised banks. This OCC bulletin requires national banks to have risk management policies in place and take a number of steps prior to selling any debts to a third party, and are intended to limit the bank's operational, compliance, reputational and strategic risks. These steps would include establishing initial and ongoing due diligence of third-party debt buyers to help control and limit legal and reputation risk, and establishing minimum criteria for approving debt buyers (licensing review, experience in the business, recent lawsuits or regulatory actions, insurance, use of outsourced collectors, onsite visits, etc.).

In addition, the OCC bulletin requires ongoing oversight and monitoring of the debt buyer by the national bank, including reviewing annual financial statements of the buyer and any significant changes in processes, operations or personnel and monitoring the volume and type of consumer complaints, as well as applicable remediation.

The OCC bulletin further provides that the contract should specify the debt buyer's obligation to comply

with the various consumer laws and standards, such as the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, unfair or deceptive or abusive acts or practices, the Telephone Consumer Protection Act and the Servicemembers Civil Relief Act, the bank's ability to conduct ongoing, at least annual, field visits, each party's obligations regarding confidential consumer information, and a limit on the volume of accounts the debt buyer can litigate.

The OCC emphasizes that debt sellers should ensure that their buyers have accurate and complete information necessary to enable them to pursue collections in compliance with applicable law and consumer protections, which may include requiring debt sellers to engage in "data scrubs" and sampling to ensure that account data are complete and accurate before transfer to buyers.

Finally, the OCC bulletin identifies certain types of debt that are not appropriate for sale (e.g., debt that is settled or in the process of settlement, debt of deceased account holders, and debt of borrowers that have sought or are seeking bankruptcy protection) as well as debt that should not be sold because it poses greater compliance and reputational risk (e.g., SCRA accounts and accounts close to the statute of limitations).

OCC Outsourcing Guidance

Finally, the seller may need to address OCC Bulletin 2013-29: Third-party relationship regarding outsourcing and third-party vendors. The OCC outsourcing bulletin is similar to the Federal Reserve Board's recent outsourcing guidance. In addition, the CFPB has also issued guidance regarding its expectations for banks and nonbanks to oversee third-party service providers.

While the outsourcing guidance may not typically apply in a sale context, where a transaction contemplates future loan sales on a flow basis or a subservicing agreement for certain assets not transferred, this guidance should be considered. Covenants addressing third-party risk management issues (audit, compliance, indemnity, etc.) may be needed for the seller.

While the OCC guidance only applies to national banks and federal savings associations, the CFPB mortgage servicing guidance and regulations are applicable to all residential mortgage servicers. It is also possible that the CFPB could extend some of these servicing requirements to other types of loans in the future. For example, the CFPB has publicly noted that recent changes to mortgage servicing practices may shed some insight on possible approaches to remedy student loan servicing concerns. Annual Report of the CFPB Student Loan Ombudsman (Oct. 16, 2013).

The OCC bulletin is generally applicable to national banks, which includes most of the largest issuers of credit cards. However, the CFPB has also expressed some similar concerns about these types of practices and clearly views its UDAAP provisions as applicable to first- and third-party debt collection. Given the recent focus by the New York State Department of Financial Services and banking regulators on mortgage servicing rights (MSRs) sales to nonbank finance companies, reverse due diligence will continue to be a hot topic for both mortgage and other consumer loan sales.

Buyer Representations

Given the current regulatory environment, sellers are much more likely to seek representations and covenants from the buyer.

- ***Privacy and Data Security.*** The seller may seek assurances that the buyer has and will handle nonpublic personal information of borrowers in accordance with the Gramm-Leach-Bliley Act and other applicable laws both before and after the closing, particularly if any consumer information is disclosed during the buyer's due diligence. Because of the potential impact on businesses and their customer relationships, privacy and data security are increasingly important considerations in transactions involving consumers and nonpublic personal information. Note that the seller may be inclined to not include any nonpublic personal information on the preclosing data tapes so this covenant would only apply to the buyer's review of loan files prior to the closing and servicing activities after closing.

- ***Licenses, Registration and Insurance.*** The seller should also seek assurances that the buyer has all licenses, registration and insurance that it needs to originate, own, service and collect on the loans or leases being purchased and to fund any open-end lines of credit.

- ***Loss Mitigation.*** The seller may also seek assurances (and may be required by its own regulators to seek assurances) that the buyer has the employee, technology and compliance resources to allow it to continue any loss mitigation programs relating to the loans or leases being purchased. Proper continuation of loss mitigation arrangements is a huge concern for regulators with respect to subprime and other legacy mortgage loans. Furthermore, the Home Affordable Modification Program and other loss mitigation programs may require written assurances from the buyer regarding existing and in-process loan modifications.

- ***Loan File Due Diligence.*** Depending on the seller's leverage, it may seek assurances from the buyer that the buyer has been able to conduct loan and loan file due diligence as it deems appropriate and that the buyer is aware that the loan files are incomplete and that no representations are being made as to the collectability of the loans or leases. Any contractual provisions regarding the incompleteness or inaccuracy of the loan files may serve as a "red flag" to the seller's or buyer's regulators and raise questions about the ability to properly service the loans. For example, OCC guidance and regulatory actions would generally preclude issuers from selling delinquent accounts without the records needed to collect them properly.

Conclusion

Specialty finance M&A transactions remain active in the current environment despite (and in part because of) a rapidly changing regulatory regime. Buyers and sellers should keep informed of changing practices in these M&A transactions and proactively address current hot-button issues. M&A transaction parties will need extensive familiarity with the underlying financial products and services of finance companies, including the structures, risks and regulatory issues that relate to these financial products and services. However, there are still many opportunities for motivated buyers and sellers to grow and restructure in the current environment.

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