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Specialty Finance M&A Transactions in the Post-Credit Crisis Environment

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Key Trends Driving Specialty Finance M&A

U.S. finance companies, particularly in the mortgage, credit card, student loan and non-prime consumer lending industries, were under stress during the credit crisis, and many of these businesses went bankrupt or were sold, shut down or significantly reorganized. In many cases, the beneficiaries of this shake out were private equity and hedge funds that specialize in credit opportunities and working out distressed assets and businesses. Moving beyond the crisis, the post-credit crisis era of 2011 to 2013, with its low interest rates and relatively easy access to credit, provided a stable foundation for finance companies to recover, grow and make acquisitions.

Increase in Commercial Banks Selling Finance Company Businesses and Assets. U.S. commercial banks have become some of the most active sellers of finance company businesses and assets, particularly in the mortgage industry, in the post-credit crisis environment. A number of factors have driven this phenomenon:

- *Increased Regulation and Drive to Divest "Non-Core" Businesses and Assets.* First, bank capital requirements and the Volcker Rule have led banks to focus on their "core" businesses and to seek to shed capital intensive "non-core" businesses and assets. The 10% cap on insured deposits and the prohibition in Section 622 of the Dodd-Frank Act (111 P.L. 203, 124 Stat. 1376, 2010 Enacted H.R. 4173, 111 Enacted H.R. 4173) on acquisitions where the resulting company would have consolidated liabilities in excess of 10% of the aggregate consolidated liabilities of all financial companies has helped encourage divestitures by the largest U.S. commercial banks and has created enormous opportunities for non-bank finance companies. These non-core businesses and assets include asset management businesses, private and corporate investment banking divisions as well as mortgage, credit card and student loan businesses and assets, both distressed and performing. Banks are intensely focused on reputational risk and have been challenged by the huge flood of new regulation and the need to work through litigation generated by the credit crisis. If a business or asset is deemed non-core to a bank or finance company, it will not be worth the regulatory and reputational headaches to keep running the business and a divestiture, even at a relatively low price, will be preferred. One asset class that fared particularly well in the credit crisis was auto loans but even in that industry a good deal of consolidation has occurred with a number of private equity and hedge fund buyers showing interest.

- *Some Increased Availability of Financing.* The financing available for consumer assets strengthened in 2011 to 2013, although capital markets and bank financing for financial assets such as student loans, mortgage servicing rights ("MSRs") and non-agency mortgages remains difficult.

Challenges in the Post-Crisis Environment. The current environment for finance company M&A remains active despite several new complications.

- *Intense Competition.* Competition for attractive financial assets and businesses has become more intense, driving up prices and creating fewer opportunities for financial buyers. In the mortgage industry, there is a shrinking pool of non-prime and non-agency assets to buy because very few have been originated since 2008, and a number of the new non-bank servicers are competing for this shrinking pool. Private equity and hedge funds are willing to buy down the credit chain to acquire, for example, subprime auto lenders and student loan portfolios, in the search for yield in the current extremely low interest rate environment. In many finance businesses, such as auto loans and leases, the competition for customers has increased and auto finance companies are loosening up credit standards, lengthening payment terms and narrowing their margins in order to obtain product.
- *Regulatory Uncertainty.* There remains a good deal of uncertainty as to how state and federal consumer financial services regulation will affect finance company businesses, with many new Consumer Financial Protection Bureau ("CFPB") regulations and hot buttons and a very active group of state regulators, such as the New York State Department of Financial Services (the "NY DFS"). Regulatory scrutiny and regulatory actions remain intense and frequent. In addition, many mortgage finance companies and servicers find themselves subject to federal supervision and examination for the first time as a result of the creation of the CFPB by the Dodd-Frank Act. The latest focus by the NY DFS, the CFPB and the Federal Housing Finance Agency has been on the rapid growth and servicing practices and relationships of non-bank mortgage servicers, with actions taken or pending against many of the largest non-bank servicers. This regulatory uncertainty affects all consumer finance businesses, not just the mortgage industry, and these new concerns are starting to be reflected in the M&A 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.

Structuring the Transaction

Portfolio Sale v. Platform Sale

A threshold issue for many finance company transactions, particularly where the buyer's primary goal is to purchase a large portfolio of loans, leases or other receivables, is whether the transaction will be executed as a portfolio sale or a finance company platform sale. A finance company's "platform" includes the assets needed to operate the business, including employees, facilities and real estate, information technology and contracts. Because the finance company platform assets generally include state licenses, change of control consents and other state agency notices and approvals may be required. These approvals can create uncertainty and increase the time required to close the transaction. Many buyers are already in the finance company business and do not need the facilities, people and information technology assets that may be offered as part of a platform sale along with the loans, leases or other receivables and related rights and loan documents included as part of a loan portfolio. These buyers may only be willing to purchase the platform (other than the licenses) as a reduction to the purchase price for the portfolio or may view the platform as a very small part of a much bigger asset play. This view by buyers is more likely where the seller is a large commercial bank that either cannot offer its information technology assets in the transaction or its information technology assets represent older and less versatile solutions than buyer's existing technology.

M&A Deal or Loan Portfolio Sale? If a valuable operating platform is being sold along with loan assets, a traditional M&A structure as (stock, merger or asset purchase) will typically be used, and the purchase agreement will likely contain traditional M&A representations, covenants and indemnities. On the other hand, if only or predominantly loans or other financial assets are being sold, the parties may opt for execution of the transaction in a manner that is more typical of a capital markets trade and follow a whole loan portfolio format as described below. The decision to structure the sale using an M&A or a loan portfolio sale format may depend as much on the expertise of the deal team executing the transaction as anything else. It may also depend on whether the buyer intends to immediately finance the loans in the capital markets after the purchase, in which case a whole loan portfolio execution may be more desirable for the buyer. Finally, the valuation method being used (whole business versus loan portfolio or assets under management) may lead to a particular type of execution. For a discussion of these valuation methods, see Negotiating the Acquisition Agreement – *"Purchase Price Provisions"* below.

Advantages and disadvantages of M&A execution include the following:

- *Ability to divest of an entire business.* A seller that desires to divest an entire business line may find the M&A-style execution more favorable for avoiding trailing liabilities of the business and allowing a "clean break." If the seller divests only the portfolio of assets (and not the platform that supported the operation of those assets), it will be left with a platform (employees, office leases, etc.) that it no longer needs. The buyer will need to consider what effect its acquisition of the operating platform has on value.
- *Ability to limit indemnification remedies.* An M&A indemnity regime may allow the seller to cap certain of the buyer's indemnification remedies to a relatively low threshold, such as 10% to 20% of the purchase price, and to require a relatively high deductible, such as 1% to 3% of the purchase price, before certain of the seller's indemnity obligations kick in. This may contrast favorably for the seller with a more typical loan portfolio remedy, which is to repurchase individual loans on a loan-by-loan basis if the seller's representations are breached. The warranty repurchase is a remedy borrowed from capital markets transactions such as securitizations. The buyer may seek a warranty repurchase remedy the terms of which mirror as closely as possible the repurchase remedy imposed on the buyer in the capital markets transaction it executes to finance the loan portfolio purchase. If the seller is divesting an entire business line, it may no longer be able to service repurchased loans or may find it cost prohibitive to do so. These differing indemnity regimes have tended to infiltrate both types of deals, with warranty repurchases cropping up in M&A-style transactions and caps and deductibles cropping up in the warranty repurchase remedy of loan portfolio sales.
- *Ability to limit representations and warranties.* M&A representations tend to be more general and qualified as to materiality or a "material adverse effect" and knowledge than representations in a whole loan transaction. The spectrum of representations that can apply to financial assets ranges from the detailed and numerous representations found in capital markets/securitization transactions (e.g., 20 to 30 representations covering the financial assets being financed) to a medium number of representations in performing whole loan transactions to very limited "as is, where is" representations contained in nonperforming loan sales to what may only be a single paragraph of loan representations in an M&A transaction qualified by materiality and knowledge. Where the buyer has the ability to do extensive diligence on the loan portfolio, an "as is, where is" or more limited M&A-style execution may be possible.
- *Risk of receiving a lower purchase price for the portfolio.* A disadvantage that may come hand-in-hand with the limited recourse and limited representations points discussed above is that the buyer may pay a lower price for the portfolio. In effect, the buyer may "price in" the cost of its limited rights.

Advantages and disadvantages of a whole loan portfolio style of execution include the following:

- *Faster execution and lower cost.* Because only financial assets are being purchased in a whole loan portfolio sale, it is typically quicker and has lower legal and other transaction costs than an M&A-style transaction.
- *Ability to quickly finance or securitize the loans.* Execution as a whole loan portfolio sale will be preferred if the buyer plans to finance or securitize the loans immediately after or simultaneous with the closing of the purchase. The buyer's goal will be to match to the greatest extent possible the representations and covenants it receives from the seller to those demanded by its underwriters and investors in the capital markets.

- *Ability to accommodate a forward flow arrangement.* The whole loan portfolio style of execution is better suited to a forward flow arrangement, which is a loan sale program that will involve multiple loan sales over a period of time. The seller may seek a forward flow sale arrangement where it has a large portfolio of financial assets for which it can obtain better value by selling in blocks over time.
- *Retention of post-closing liabilities for individual loans.* The seller may achieve higher pricing in a whole loan portfolio sale but it will retain trailing liabilities for the portfolio, typically on a loan-by-loan basis. As discussed above, the buyer in a portfolio sale typically seeks to obtain a warranty repurchase remedy to sell individuals loans back to the seller if the seller's representations relating to the loans are breached.
- *Importance of data tape.* The data tape for the portfolio of loans takes on heightened importance in a loan portfolio execution. The data tape typically is a large Excel spreadsheet that contains hundreds of line items, and it may be difficult to verify the accuracy of each and every line item, particularly for an older pool with multiple servicers and information technology systems over time. On the other hand, the buyer must have a high degree of confidence that its data is accurate if it intends to launch a capital markets deal immediately after or simultaneous with the closing.

Basic M&A Structures

If an M&A-style execution is chosen, there are three basic structures for the transaction: (1) stock purchase, (2) merger and (3) asset purchase. The choice of an M&A acquisition structure will be highly fact specific and related to how the buyer values the business being acquired and a number of other considerations discussed below. Key considerations will include the target's specific asset portfolio (including key contracts), its liability mix, tax consequences of a particular structure and the ease or difficulty of obtaining contractual and other approvals for the transaction. In the post-credit crisis environment, if an M&A-style execution is chosen, an asset sale has typically been the preferred structure for buyers of finance company businesses given that these companies often have a high degree of regulatory or litigation risk.

Stock Purchase

In a stock purchase, the buyer enters into a stock purchase agreement directly with the target's stockholders, and the stockholders receive consideration directly from the buyer. The target typically becomes a new subsidiary of the buyer. If the buyer seeks 100% of the target's stock, this structure will not be practical for a public company or a company with many stockholders, and a "back end" merger will be needed. For a target that is a public company, a tender offer may be used to purchase stock, with Section 251(h) of the Delaware General Corporation Law eliminating the need for a back-end merger vote of a Delaware target if certain conditions are met.

Advantages of a stock acquisition include the following:

- *Simpler structure and lower transaction costs.* The structure is simpler so legal and transaction costs tend to be lower.
- *Business remains intact.* The target and its business remain intact and there are fewer issues as to whether the buyer is purchasing all the assets it needs to run the business and whether a transition services or interim servicing arrangement will be needed for the buyer or the seller.
- *Fewer consents and approvals required.* Third-party and governmental consents are typically fewer and easier to obtain (although licensing will be an issue in any structure as discussed in "Impact of Licensing Issues on Structure" below).
- *Favorable tax consequences for seller.* Tax consequences to the seller are favorable because, assuming no "section 338 election," there is generally no corporate level tax in a stock sale, but only one layer of tax at the shareholder level, and usually at more favorable capital gains rates.

Disadvantages of a stock acquisition include the following:

- *Assumption of all (even unknown) liabilities.* The buyer assumes all of the target's liabilities, including unknown liabilities, subject to negotiated representations and indemnities that can mitigate this effect, or the procurement of third-party representation and warranty insurance.
- *Inability to pick and choose assets.* The buyer generally cannot pick and choose among the assets it wants to purchase.
- *Stockholders must be party to the agreement.* In a private transaction, each selling stockholder must be a direct party to the acquisition agreement as a "seller."
- *Limitations on dealing with minority stockholders.* If less than all of the shares are purchased, the buyer must deal with state corporate law issues after closing that limit how the buyer can deal with minority stockholders.

Merger

Mergers are effectuated under state law and combine all the assets and liabilities of two businesses into a single surviving corporation or other entity. Mergers are similar to a stock purchase in terms of simplicity. All assets and liabilities of the target will be transferred by operation of law. Where a target is a public company or has numerous stockholders, holders of a majority of the outstanding shares can typically cause the merger to occur regardless of a dissenting minority, thus eliminating the risk of hold-outs presented by a stock purchase structure. Although the dissenting minority stockholders will be obligated to transfer their equity to the buyer, they will have statutory appraisal rights to establish the value of their equity if they believe it is worth more than the consideration being paid by the buyer. The disadvantages of a merger are similar to those of a stock purchase.

Asset Purchase

In an asset purchase, the buyer only acquires specified assets and assumes specified liabilities from the target. The target continues to be owned by its original stockholders and does not become a subsidiary of the buyer. As a result, unless third parties release or "novate" contracts and other liabilities of the business, the target generally remains liable for the transferred liabilities with contractual rights against the buyer if the buyer fails to discharge any of these liabilities that were affirmatively assumed by the buyer (with buyers often trying to limit the liabilities they assume in an asset deal). The purchase price is paid to the target and not its stockholders.

Advantages of an asset sale include the following:

- *Flexibility to apportion assets and liabilities.* The buyer and the seller can determine exactly which assets and liabilities will be included in the transaction, and can choose to transfer all pre- and post-closing liabilities (to mimic a stock purchase), can choose an "our-watch/your-watch" approach (where the buyer does not assume pre-closing liabilities) or can choose another split. In other words, the seller can retain, and/or the buyer can avoid purchasing, some businesses or assets as desired.
- *Stockholder approval required only if "all or substantially all" assets are sold.* Stockholder approval will typically not be required unless the assets constitute "all or substantially all" of the seller's assets (although this analysis can be complex and does not work well in the context of evaluating a typical finance company's assets and operations).
- *Favorable tax consequences for buyer.* The buyer is able to obtain a "step-up" in the tax basis of the assets, which typically allows the buyer to recover the purchase price faster for tax purposes through depreciation. There are also deductions and/or reduced taxable gain on a subsequent disposition of the assets.

Disadvantages of an asset sale include the following:

- *Complexity and risk that critical assets may not be acquired.* Asset deals can be extremely complex, with a risk that desired assets could be accidentally omitted or unintended liabilities could be assumed.
- *Longer timeline and increased costs.* Title to each asset must be transferred individually, driving up legal and transaction costs, and potentially lengthening the time to close.
- *Shared asset issues may require post-closing agreements.* Assets shared between the businesses of the seller being sold and the businesses of the seller not being sold tend to present issues and require the parties to negotiate post-closing agreements (although shared asset issues can arise in stock purchases as well).
- *More extensive third-party consents required.* Third-party consents to transfer contracts, licenses and other assets are typically much more prevalent and may cause delay and/or be obtainable only for a price.

Given the liabilities associated with specialty finance businesses in the post-credit crisis environment, many buyers following an M&A-style execution may prefer an asset acquisition. However, the buyer should carefully consider the immense amount of work and cost involved in obtaining consents and structuring an asset acquisition. An asset purchase structure may be viewed as nearly impossible to effect or too expensive based on a close review of the financing contracts that typically make up a large portion of a specialty finance business.

Impact of Licensing Issues on Structure

State licensing issues may have a significant impact on structure and speed of execution of a finance company M&A transaction. Financial buyers such as private equity and hedge funds (unlike strategic buyers) typically do not have all the state licenses needed to hold and service consumer loans or hold and operate other finance company assets or businesses. The financial buyer must anticipate a lengthy process, potentially as long as six months to a year, to obtain all these licenses. Moreover, applications for these licenses often require disclosure of personal information about principals, criminal record checks, fingerprinting and the like.

Required Licenses. Licenses and notifications or approvals that may be required include the following:

- *State Licenses to Hold Consumer Loans*. While state licenses are required for non-banks to originate or service consumer loans, some states also require licenses merely to hold consumer loans or retail installment sales contracts. For example, approximately 12-18 states require a license or registration to purchase or hold residential mortgage loans. These licensing requirements arguably apply even if the loans were originated by a licensed lender or an exempt entity and are being serviced by a licensed servicer. While many entities historically have not obtained state licenses to merely own or acquire (as contrasted with originating or servicing) mortgage and other consumer loans, over the past few years there has been a heightened awareness of state licensing and regulatory issues. Based upon the rising number of defaults and the need for significant loan modifications, holders of mortgage loans and other consumer credit receivables need to address the varied and changing state regulatory regimes in a practical and comprehensive manner. As a result, market participants typically either obtain state licenses in a subset of states (i.e., those where the statutory regime appears to include the holding of mortgage or consumer loans) or rely upon a trust or participation structure typically seen in the securitization context. Under the participation structure, the buyer would typically acquire an undivided interest in the loans while the seller would retain bare title to the loan. Under the trust structure, the loans would typically be sold to a common law or statutory trust with the trustee holding legal title to the loans.
- *Mortgage Servicing Licenses.* For mortgage transactions, every state requires mortgage servicing and/or debt collection licenses to service and make collections on mortgage loans. The government-sponsored enterprises ("GSEs"), the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Government National Mortgage

Association ("Ginnie Mae"), will also require that a new servicer be an eligible originator and servicer to originate, hold and service conforming mortgage loans.

- *Debt Collection Licenses.* For consumer loans other than mortgages, the buyer may need debt collection licenses (especially if the loans were in default at the time of the acquisition) or may need to file notifications with state regulators.
- *Change of Control Filings/Approvals.* As noted above, acquiring the seller's licenses will typically require change of control filings and approvals from the various state regulators.

Interim Servicing Arrangements. As mentioned previously, obtaining all of the necessary licenses, even if the transaction is structured as a stock purchase or a merger, can take a significant amount of time. In order to present a more attractive bid, the financial buyer may team up with an existing servicer to make its bid (as discussed below under "Joint Venture, Co-Investments and Affiliated Entity Structures - Club Deals"), may enter into an interim or long-term servicing agreement with a third-party, or may request that the seller provide an interim servicing arrangement pending the buyer's receipt of licenses. The buyer's decision to team up with an existing servicer as opposed to entering into an interim servicing arrangement pending receipt of its own servicing licenses will depend on whether the buyer's business strategy is to service assets itself or to hold assets that will be serviced by others for a fee. The seller may be willing to provide interim servicing as an accommodation with "as is, where is" servicing standards as opposed to the quite robust service level agreements currently seen for consumer loan servicing. In the mortgage industry, mortgage loan servicing agreements follow relatively established patterns. For other consumer assets, the practice is less uniform and the liability and service level standards may be hotly negotiated. Regulatory considerations for any servicing relationship should include credit reporting obligations, debt collection issues and the possible need for borrower notices of the sale or transfer of servicing. The obligations of the servicer and the time frame for performance of these obligations should be clearly established by the interim servicing agreement. The buyer and the seller should also agree on the timing and content of any borrower notices. For example, the Real Estate Settlement Procedures Act (12 USCS § 2601) and its implementing regulation, Regulation X (12 CFR 1024.1), generally requires the new and old servicer to provide notice to borrowers within a prescribed period of time regarding the transfer of servicing for their residential mortgage loans.

Joint Venture, Co-Investments and Affiliated Entity Structures

Financial buyers of consumer finance companies have increasingly utilized joint ventures, co-investment and affiliated entity structures.

Club Deals. Club deals where bidders team up to purchase a company are quite common for financial buyers in part because:

- multiple buyers can more easily finance a large acquisition; and
- a bidder can team up with a partner that is expert in an area, such as loan servicing, where it may not be expert or have the required licenses to close.

Where regulatory consents are needed or financing parties such as rating agencies and trustees must consent to transfer financial assets, bringing in a well-known player in the industry will allow the financial buyer to better compete with industry players.

A careful review of regulatory issues for these structures will be needed. For example, joint ventures involving banks and bank holding companies raise a number of potential regulatory considerations, including that the joint venture may become subject to examinations by the banking regulators and limitations on its permitted activities.

Affiliated Entity Structures. Financial and strategic buyers may also purchase a consumer finance business using multiple affiliated entities to:

- enhance their financing structure for the loan assets after closing;
- create tax efficiencies; and/or

- allocate businesses among investors with differing risk appetites or provide ancillary services for the business.

For example, a number of non-bank mortgage servicers have expanded by setting up affiliated entities to raise capital and hold assets. Typically a new real estate investment trust ("**REIT**") will raise funds by selling securities, purchasing MSRs and other servicing assets and hiring an affiliated servicing company and other affiliates to service and manage the assets. Thus, investors can choose to invest in a tax-advantaged REIT that holds the more volatile servicing assets or in the servicing entity with less volatile fee income. However, the NY DFS has recently raised concerns with the provision of ancillary services to mortgage loan servicers by its affiliates, citing the potential for conflicts of interest and self-dealing.

Antitrust Issues

A threshold issue for finance company acquisitions is whether the Hart-Scott Antitrust Improvements Act (the "**HSR Act**") (15 USCS § 1) approval process will apply to the transaction or whether an exemption such as the "ordinary course" exemption will apply.

Statutory Tests. There are two statutory tests that must be met in order for the HSR Act to apply to a transaction.

- *"Size of the Parties" Test.* Generally, the test is satisfied if there is a "person" on one side of the transaction with $151.7 million or more in annual revenues or total assets and a "person" on the other side with $15.2 million or more in annual revenues or total assets (thresholds are those in effect as of June 2014). For purposes of the HSR Act, the annual revenues and total assets of a person include the revenues and assets of parent, subsidiary and affiliated entities that are under common control.
- *"Size of the Transaction" Test.* The HSR Act applies only to any acquisition of assets and/or voting securities valued at more than $75.9 million. Transactions valued at $303.4 million or less will not be subject to the HSR Act unless the "size of the parties" test is satisfied. Transactions valued at greater than $303.4 million will be reportable without regard to the "size of parties." These same thresholds apply to an acquisition that will result in the acquirer holding 50% or more of the equity interests in a non-corporate entity, such as a limited liability company or partnership.

Exemptions. Congress recognized that strict application of the "size of the parties" and "size of the transaction" tests contained in the HSR Act would require pre-acquisition filings in many transactions that could not conceivably cause antitrust problems. Thus, the statute itself and the implementing regulations promulgated by the Federal Trade Commission (the "FTC") contain exemptions for several types of transactions that might otherwise trigger HSR Act filings. Most transactions designed to extend financing to another party, including sales of loans or receivables, ordinarily should come within the scope of one or more exemptions, and the parties therefore will not be required to comply with the statute's pre-acquisition filing and waiting period requirements.

- *Goods or Realty Transferred in the Ordinary Course of Business.* Section 7A(c)(1) (15 USCS § 18a) of the HSR Act exempts acquisitions of goods or realty transferred in the ordinary course of business. Although receivables may not typically be thought of as "goods or realty," the FTC staff has informally indicated that parties to acquisitions of loans or receivables may take advantage of the exemption.
- *Acquisitions of Bonds, Mortgages, Deeds of Trust or Other Obligations Which are Not Voting Securities.* In addition, there is a statutory exemption for "acquisitions of bonds, mortgages, deeds of trust, or other obligations which are not voting securities." While there is relatively little in the way of FTC precedent interpreting this latter exemption, the applicable legislative history suggests that Congress intended to remove routine financing transactions from the reach of the HSR Act. As Senator Hart explained in debates prior to enactment of the statute, Congress wished to "exempt consumer receivables and loans or other obligations, which are not voting securities, which are traditional financing arrangements and which normally are sold to banks or other financing agencies and acquired in the normal course of business."

Taken together, the two exemptions described above provide the basis for removing many loan sale and receivable financing transactions from the reach of the reporting requirements of the HSR Act.

Determining Which Transactions are in the "Ordinary Course." Section 802.1 (16 CFR 802.1) was intended to expand on the types of transactions that are considered to be "ordinary course" transactions. Certain types of transactions are clearly "in the ordinary course" and need not be reported. For example, a bank engaged in the "origination, sale and servicing of residential mortgages, automobile loans, credit card accounts and other debt instruments" asked the FTC staff whether it needed to report periodic sales of "parts of its loan portfolio to other financial institutions." The bank further informed the FTC staff that it would continue to service all loans it had originated and would continue to solicit the types of loans being sold. The FTC staff determined that the periodic sales were subject to the Rule 802.1 ordinary course of business exemption and did not need to be reported. Sales of receivables generated by retail businesses to finance institutions also fit easily into the "ordinary course" exemption.

More difficult questions arise as the details of a particular transaction become less routine. For example, a seller might enter into a transaction that involves a much larger portion of its loans or receivables than would normally be transferred in a single sale or in order to raise funds for a purpose other than to replenish working capital. A seller may have never previously sold loans or receivables, or the purchaser may be a special purpose vehicle established for that particular transaction rather than an institution that regularly purchases receivables. Obviously, there are any number of other variations that may accompany a particular transaction.

One exception to the "ordinary course" exemption found in the premerger rules is that sales of "all of the assets of an operating unit" cannot be sales in the ordinary course of business. Thus, while the sale of a part of a bank's credit card receivables is exempt as an "ordinary course" transaction, the sale of all of a bank's credit card receivables as part of a plan to abandon its consumer lending business would not be a sale in the ordinary course of the bank's business. At the same time, however, the fact that a particular transaction involves a substantial percentage of the seller's existing loans or receivables should not take the sale outside the "ordinary course" exemption when the seller intends to continue to service the portfolio that has been sold and to originate new receivables. For example, the FTC now takes the view that the sale of a portfolio of leases is not reportable and is exempt as an "ordinary course" transaction so long as the seller will remain in the leasing business.

Another important consideration is whether the seller or others in the seller's industry typically raise funds through sales of receivables. The more common the industry practice, the more likely it is that the FTC staff would consider sales to be in the ordinary course of business of a member of that industry. A seller should not be precluded from relying on the exemption simply because it has never before engaged in loan sale transactions.

Finally, the parties may wish to consider what the seller intends to do with the funds it obtains from the sale. For example, many companies sell receivables in order to replenish working capital. If a seller entered into a loan sale transaction to raise funds for an extraordinary purpose, e.g., to pursue an acquisition, the FTC staff might be more inclined to question whether the transaction itself was truly in the seller's ordinary course of business. However, given the FTC staff's policy of weighing several factors in making "ordinary course" determinations, it is unlikely that the seller's use of the proceeds of a loan sale transaction would ever alone be enough to prevent the parties from relying on the exemption.

Due Diligence and Reverse Due Diligence

The buyer's due diligence in a finance company acquisition requires extensive familiarity with the underlying financial products and services of financial institutions, including the structures, risks and regulatory issues that relate to these financial products and services. Increasingly, a seller must also engage in due diligence of the buyer, especially if the seller is a bank or finance company subject to regulation by the banking regulators or the CFPB.

Due Diligence of Loans, Loan Files and Servicing Agreements

Review of Loans, Leases and Other Receivables. The buyer typically will want to review the forms of loans, leases or other receivables that comprise the bulk of the assets being sold. Other items of interest to the buyer would typically include consumer complaint information, compliance audits, licenses, policies and procedures. Some issues to consider in reviewing loans, leases and other receivables include the following:

- *Selective Review/Sampling.* Buyers and sellers will debate over how extensive the buyer's review of actual loan files should be. Most buyers will insist on at least sampling a statistically significant number of loan files for missing documents and other potential defects. The buyer's accountants or financial advisors can assist in determining what represents a statistically significant number of files, which will depend in part on the diversity of the loan assets. Consumer law counsel should undertake at least a selective review of the basic form of loans, leases or other receivables to ensure that they comply with relevant consumer laws on both a federal and state level, as applicable. In a consumer business, it may not be practical or cost effective for legal counsel to review all the forms in every state. In this case, it should be possible for legal counsel to review a sampling of the loan forms, perhaps in the more important states for the portfolio, and provide a checklist for outside due diligence consultants to review the forms for consumer law or other regulatory compliance. For example, does the form contain the mandated Regulation Z (12 CFR 226), Truth in Lending Act (15 USCS § 1601) disclosure, and an arbitration waiver if arbitration is desired? If a mortgage is a "high cost loan," does it contain the disclosure required under the Truth in Lending Act as amended by the Home Ownership and Equity Protection Act?
- *APR Calculations and "High-Cost Mortgages" Laws.* An outside consultant may also be hired to review the lender's original calculations regarding the Annual Percentage Rate (APR) and finance charge disclosures required under the Truth in Lending Act. In addition, a review of the points and fees paid by the borrower (as set forth in the Truth in Lending Act disclosures and the HUD-1 or HUD-1A required by the Real Estate Settlement Procedures Act (12 USCS § 2601)) is often conducted to determine whether the loan exceeded the "points and fees" trigger and should have been treated as a federal or state "high-cost mortgage" laws. If the loan is a "high-cost mortgage," the buyer may be potentially liable for the acts or omissions of the originator.
- *Process to Update Forms.* Buyer's counsel should also review the seller's process for updating its forms or agreeing to changes to its forms. Any lender engaged in a nationwide lending program will need to rely upon legal counsel, trade associations and other vendors to track changes to the applicable laws and regulations and ensure that such changes are reflected in the revised loan agreements.
- *Assignability.* In an asset deal or loan portfolio sale, counsel should confirm that the loans, leases or other receivables are freely assignable by the seller as lender without notice to or consent from the borrower. In a commercial lending business where the borrowers may have more leverage to negotiate their form of lending arrangement, the loans may not be assignable by the seller as lender and consents will be required.
- *Effect of Defects on Purchase Price and Structure.* The mortgage robo-signing scandal has heighted the awareness of consumers and their attorneys and the courts to inadequate evidence of a debt. For example, it may be quite difficult to enforce a loan without a signed note. Older consumer loan and mortgage portfolios may have a host of defects and be missing key documents that will affect the value of the portfolio even if the loans are performing. If the loans are non-performing and the loan files show a high level of defects, the purchase price will be severely affected. The buyer may also seek to exclude certain types of loans if it determines that the risk of enforcing these loans is too high or servicing the loans is not cost-effective. The seller may be willing to entertain a lower price from the buyer if the buyer is willing to take on all types of loans on essentially an "as is, where is" basis.

Review of Servicing Agreements. Servicing agreements are often key assets being sold in a specialty finance M&A transaction and must be carefully vetted for consents and issues relating to assignability. A finance company seller typically has multiple servicing agreements to provide collection and administration services for its portfolio of loans, leases or receivables. These servicing agreements may be with the seller's affiliate or with third party servicers or both. Specific specialty services may be subserviced to other servicers. A loan aggregator may front the servicing obligations as a master servicer for multiple servicers that have originated the loans. The buyer's financing arrangements for the M&A transaction may require amendments to the servicing agreement to ensure that the buyer is an "eligible servicer" or that the servicing rights can be pledged to the buyer's lender.

A very active area in finance company M&A is the sale of MSRs by mortgage servicers, particularly by bank sellers, seeking relief from increased capital requirements and mark-to-market volatility, to non-bank servicers. The assets involved in these transactions are rights under the mortgage servicing agreements and thus numerous servicing agreements must be carefully reviewed for assignability, eligibility and licensing requirements for the servicer, the buyer's ability to pledge the MSR in a financing, and related issues.

Due Diligence of Financing Arrangements

Buyers and sellers will also need to diligence the seller's existing financing arrangements for assignability and plan for what can often be a complex and time-consuming consent process. The buyer will need to understand how the finance business is currently financed and determine whether it seeks to keep that financing in place.

Review When Using Buyer's Own Financing. If the buyer has its own sources of financing that it prefers to the seller's existing sources, the buyer's counsel will need to review the seller's financing facilities for prepayment restrictions or penalties.

Review When Retaining Seller's Financing Facilities. Where the buyer seeks to retain the seller's financing facilities, a complex review process must be undertaken.

- *Review in a Stock Deal.* In a stock deal if the seller has multiple securitizations, the buyer will need to understand the merger and change in control provisions contained in the securitization deal documents. In public and term securitizations, the merger provision is typically permissive and only applies to the entities in the deal – typically the deal sponsor (which may be the entity whose stock is being sold to the buyer), the depositor and the issuer trust or limited liability company. Other transaction parties, such as the rating agencies, trustees and perhaps third party credit enhancement providers, typically only get notice of the merger. In private deals and bank lending facilities, change in control covenants and events of default are much more common and will likely require direct negotiations with the lender.
- *Review in an Asset Deal.* In an asset deal, the analysis is even more complex. The buyer needs to determine exactly which assets it wants to purchase. For example, it may seek to purchase the stock of the depositors in each securitization and the seller's residual interests in the transactions, each of which will likely require their own analysis. Consents and multiple legal opinions (as to compliance with the securitization agreements and tax and UCC matters) may be required for each transaction. For the purchase of several repeat securitizations issued by the same sponsor, it may be possible to aggregate consents so that each rating agency, indenture trustee and credit enhancement provider consents for the assignment of all the deals in which it is involved. The buyer must also be sure that it meets all eligibility requirements for the sponsor, depositor or servicer roles and consider amending the transaction documents if needed. Where consents will be protracted and the parties seek to close quickly, it may be possible to structure an interim servicing arrangement whereby the seller runs the transaction on behalf of the buyer until all consents are received. Here again, the financing or securitization agreements must be reviewed to see if there is any prohibition on subservicing or outsourcing arrangements.

Data Tape Issues and Information Technology

Another area for the buyer to explore is the accuracy and reliability of the data tape for any portfolio of loans, leases or other receivables. Data tape issues are one of the most common areas of stress for a seller, especially for a seller with an older portfolio where the seller's information technology systems may represent an amalgamation of many older systems that may have grown by past acquisitions. The seller is well-advised to carefully detail any quirks of its data tape in detailed notes to the data tape. For example, if finance companies in the industry typically show delinquencies at 30, 60 and 90 days but the seller shows this information at 31, 61 and 91 days, detailed notes on the tape should be added to explain this unusual characteristic. The buyer will base its valuation to a large extent on the data tape. As a result, the seller should not launch its sales process until it has adequate assurances, which may include assistance from outside experts, that nasty surprises about the tape will not crop up later.

Information technology in general will be a detailed area for due diligence as well if the seller intends to sell systems. Large financial institutions may not be able to easily separate the systems for the business from the systems for the businesses it is retaining and thus may not include information technology assets in the sale or may require detailed IT transition services.

Litigation and Regulatory Issues

Buyers and sellers will want to carefully diligence any litigation or regulatory issues that have arisen with the other party. Even in an asset sale where all pre-closing liabilities will be retained by the seller, the buyer needs to understand what the problems have been and whether they will require changes to the operations of the business after the closing. For example, the seller may be retaining responsibility for lawsuits alleging violations of the Telephone Consumer Protection Act ("**TCPA**") (47 USCS § 227) but the buyer will need to understand how collections practices and policies regarding the use of cell phones may need to be changed in the future and whether they mesh with the buyer's own practices and policies. Pending regulatory investigations must be explored with careful consideration as the parties must refrain from revealing confidential supervisory information or waiving attorney-client privilege. In the mortgage M&A area, a large majority of recent transactions have been structured as asset sales to avoid the many liability issues surrounding mortgage origination and servicing. Significant licensing or regulatory issues may cause the buyer to seek to restructure a stock sale to an asset sale to attempt to isolate the buyer from any lingering liabilities.

An Emerging Area: The Need for Reverse Due Diligence

A new issue arising for bank and non-bank sellers that are regulated by the CFPB is what level of due diligence sellers must engage in with respect to their buyers. Non-bank servicers that are owned by private equity or hedge funds have become very common bidders. A 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. As discussed in Negotiating the Acquisition Agreement below, buyer representations and covenants relating to its pre-closing 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 (the "**OCC**") 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. See http://files.consumerfinance.gov/f/201302_cfpb_bulletin-on-servicing-transfers.pdf. CFPB Bulletin 2013-01 was replaced by CFPB Bulletin 2014-01 in August 2014. See http://files.consumerfinance.gov/f/201408_cfpb_bulletin_mortgage-servicing-transfer.pdf. 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. See http://www.occ.gov/news-issuances/congressional-testimony/2013/pub-test-2013-116-oral.pdf. 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. See http://www.occ.treas.gov/news-issuances/bulletins/2014/bulletin-2014-37.html. 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 (15 USCS § 1692), the Fair Credit Reporting Act (15 USCS § 1681), unfair or deceptive acts or practices (**UDAP**), the TCPA (47 USCS § 227) and the Servicemembers Civil Relief Act ("**SCRA**") (50 USCS Appx § 501), 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 guidance 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. See http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html. This OCC Bulletin is similar to the FRB's recent outsourcing guidance. 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 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 (October 16, 2013) (http://files.consumerfinance.gov/f/201310_cfpb_student-loan-ombudsman-annual-report.pdf). 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 NY DFS and banking regulators on MSR sales to non-bank finance companies, reverse due diligence will continue to be a hot topic.

Negotiating the Acquisition Agreement

Preparation and negotiation of the acquisition agreement in the finance company context is similar to any other M&A transaction in a highly regulated industry where the seller may have a number of litigation and governmental investigation issues and where the buyer must consider reputational risk issues. Even though many of the regulatory and reputation concerns that a large commercial bank seller confronts may be less pressing to a non-bank buyer, the more sophisticated non-bank buyers are cognizant that the CFPB and state regulators are trying to create similar supervisory regimes applicable to non-banks. Many sellers will now attempt to impose additional representations and covenants on the buyer on top of those typically seen in other industries in order to mitigate the seller's risk of retaining lingering liability for how the assets and businesses will be operated after closing. Some of the specialized provisions found in finance company M&A transactions are described in this section. These specialized provisions are more likely to be relevant in private M&A transactions but have also infiltrated public deals and Section 363 asset sale transactions to some extent, as well.

Purchase Price Provisions

Whole Business v. AUM Valuations. The pricing for specialty finance acquisitions falls into two primary categories: (1) pricing based on a valuation of the business as a whole; and (2) pricing based on the "assets under management" or "**AUM**," which are the loans, leases or other financial assets or rights comprising the bulk of the assets being sold. Some transactions share elements of both the whole business and AUM approach. The whole business valuation approach is likely to lead to an M&A platform sale execution while an AUM approach lends itself to a whole loan portfolio execution as discussed in Structuring the Transaction – "Portfolio Sale v. Platform Sale" above.

- *When to Choose a "Whole Business" Valuation.* Where a business is thriving and purchasing the entire operation, including hiring substantially all the employees, is attractive to the buyer, a "whole business" valuation may make sense. The buyer may also be more likely to desire the simplicity of a stock acquisition or merger as opposed to an asset acquisition, and may be willing to assume all the liabilities of the business without cherry picking assets and liabilities.
- *When to Choose an AUM Valuation.* As discussed above under "Structuring the Transaction — "Portfolio Sale v. Platform Sale," if the buyer of a specialty finance business perceives the business as risky, the buyer will more likely structure the deal as a loan portfolio transaction or as an asset acquisition and refuse to assume specified or unknown liabilities. A typical valuation formula for a loan portfolio or an asset acquisition would be some percentage, e.g., 105% or 95%, depending on the perceived risk of the financial assets, of the outstanding principal balance of the portfolio of loans, leases or other assets. Similarly, in the acquisition of a servicing business, if the servicer receives a 100 basis point fee in the servicing agreements being assumed, the buyer may offer a price equal to the 100 basis points (or 95 basis points again based on the perceived risk of the servicing rights) times the outstanding principal balance of the loans, leases or other assets being serviced. As discussed above under Structuring the Transaction — "Portfolio Sale v. Platform Sale," the asset acquisition may become a loan portfolio purchase that is much more similar to a whole loan purchase or a securitization than a traditional M&A deal. The buyer may close the transaction in

multiple closings for tranches of assets as consents to transfer become available, using a structure that is more akin to a whole loan flow purchase or a securitization.

- *Combination Type Valuations.* Specialty finance acquisitions may combine aspects of both types of valuation methods. For example, a financial buyer like a private equity firm or hedge fund may need the origination and servicing platform to run the target business as well as the financial assets of the business. A financial buyer may initially value the business on a portfolio basis and then add a premium for the whole business and assume various employee, IT and other assets and liabilities, such as litigation tied to the business that may be more effectively handled by the owner of that business after closing. In a distressed situation, a financial buyer may insist on buying the portfolio at a portfolio valuation price and essentially purchase the platform for "free" or even value the platform as a subtraction to the purchase price.
- *Effect of Valuation Method.* As discussed above under Structuring the Transaction — "Portfolio Sale v. Platform Sale," the decision to value a whole business versus a portfolio will generally affect all the deal terms, including the representations, covenants and of course the purchase price mechanics. For example, a portfolio-based valuation will lead to more extensive representations as to the financial assets being purchased and the financing agreements with customers and lenders related to the financial assets. Operations-based representations, such as, for example, those relating to real property and real property leases, employees and employee benefits or environmental issues of the business, will be less important. Some representations, such as those relating to the financial assets themselves and information technology, will likely be relevant to a finance company business regardless of the valuation method. Similarly, covenants between signing and closing will vary depending on whether the focus is the entire business or the portfolio alone.

Earnouts. Earnouts are sometimes used in the finance company M&A context, particularly where the buyer and seller are attempting to resolve their differing views on valuation or expected income or losses after closing. In finance businesses, such as commercial lending or leasing businesses, where borrowers may have the option to not renew their financing agreements with the lender, the buyer may seek a purchase price adjustment if the AUM decline within a specific time period after closing or provide for earnout payments if the AUM maintain their level or grow over a specific time period. Some transactions may include a more traditional earnout based on the purchased business' cumulative net income from loan origination after closing based on a set of net income targets. These earnouts present the same issues commonly presented by earnouts, such as what controls the seller will retain over the buyer's operation of the business to ensure that the seller's ability to earn the earnout payment is not destroyed.

Closing Date and Post-Closing Purchase Price Adjustments

Closing and post-closing adjustments will vary depending on the type of business being purchased and the valuation method used in calculating the purchase price.

Whole Business Valuations and Working Capital or Net Assets Adjustments. If the purchase price is based on a valuation of a whole business, the purchase price may include a traditional adjustment for changes in the working capital (current assets less current liabilities) or the net assets (total assets less total liabilities) of the business from the last audited balance sheet prepared prior to closing or the balance sheet on which the valuation for the initial offer was prepared. A typical mechanism would value the working capital or net assets as of the specified balance sheet date and base a preliminary purchase price on that amount. The parties would then calculate an estimated closing date purchase price based on an estimated working capital or net assets amount a few days or the last month end date prior to closing. After closing, a final closing date balance sheet would be prepared and a true up payment made by either the seller or buyer based on the difference between the estimated and final working capital or net assets.

A number of complex issues can arise even with this basic working capital or net assets adjustment mechanism. It is essential to be extremely precise with accounting principles. The definition of working capital or net assets should be drafted to exactly match the line items on the balance sheet of the target or its business. A common mistake of negotiators is to assume that working capital "as defined under generally accepted accounting principles" will suffice. GAAP is a broad and flexible concept that involves judgment calls and, unless the GAAP rules applied to the purchase price calculation are precisely defined, may lead to disputes after closing. A helpful solution is to attach a schedule of "accounting principles" to the acquisition agreement. A classic example would be to specify how loss reserves will be established in a manner that is consistent with past practices. Without this accounting principle in place, the seller could slow down its booking of loss reserves to improve working capital, or the buyer could claim that seller's past practices are not best practices under GAAP and attempt to lower working capital. Other issues may arise if the business being sold is in a subsidiary and the parent seller has not pushed down a full set of GAAP accounting principles to the subsidiary level. The post-closing adjustment must be drafted to allow an "apples to apples" comparison based on the seller's specific accounting principles and should result in a mechanical true up only and not a means of renegotiating the purchase price.

AUM Valuation and Adjustments Tied to Portfolio Fluctuations. Where a portfolio valuation method is used, the purchase price will be tied to the fluctuations in the portfolio. Thus, if the purchase price is 105% of the aggregate outstanding principal balance of the loans in the portfolio, the price will go up or down based on the size of the portfolio. The parties may prefer a closing date such as a month end or week end date so that back office systems personnel can freeze the portfolio as of a "cut-off date" that can be calculated precisely. For a healthy business, new loan originations may equal or exceed the loans being paid down so the purchase price will likely go up. In a distressed situation, the portfolio typically will decline as loans pay down or are written off. More complicated mechanics may include an audit of the loan portfolio to ensure that the loan amounts are correct and are being properly serviced. The deal negotiators will need an intimate familiarity with how the loan portfolio performs, and any financing or securitization agreements related to the portfolio, to negotiate the purchase price provisions effectively. Classic areas for dispute may be inadequate or overly generous loan reserves or changes in the collection strategies or advancing practices by the seller or buyer. The seller's compliance with its financing or securitization agreements can also affect the portfolio valuation.

Consent-Based Price Adjustments. Another purchase price variation seen in finance company transactions arises from consent-based price adjustments. Where the primary assets of the business are financing or customer agreements and multiple consents are needed to transfer ownership, the buyer may only be willing to close on assets for which consents have been received. In this case, each contract is assigned a price and the buyer closes and pays for that contract only when consent is obtained.

The negotiation and drafting of the purchase price for a finance company acquisition can be quite complex and requires a deep understanding of the finance business being sold. Once the valuation and purchase price mechanics are set, the rest of the transaction terms should support the valuation and pricing methodology.

Representations and Warranties

Buyers in specialty finance M&A transactions will typically customize traditional M&A representations as appropriate so that they specifically address the issues, several of which are discussed in more detail in Due Diligence and Reverse Due Diligence above, that are unique to an M&A transaction in the specialty finance industry. Moreover, specialty finance company buyers will often request that the seller make detailed representations as to the loans, leases or other financial assets being purchased and the servicing and securitization or other financing transactions related to the business. These additional representations allow the buyer to obtain information regarding, and assess the risks associated with, the financial assets that the buyer is proposing to acquire.

Loans or Leases. Regardless of whether a buyer is proposing to acquire an entire origination and/or servicing platform or just specific financial assets, it should consider negotiating with the seller for representations that cover the loan or lease portfolio, including any related servicing agreements and the underlying loans or leases being acquired. In this regard, the buyer should request that the seller provide:

- a current loan or lease schedule that sets forth the information required under, and is prepared in accordance with, the servicing agreements with respect to the financial assets that are part of the transaction; and

- an electronic data tape that sets forth detailed information regarding each loan or lease and any security that the buyer is acquiring, including the unpaid principal balance of each loan, interest terms, payment terms and any modifications.

Often times, if there is a period of time between signing the acquisition agreement and closing, the seller will deliver to the buyer monthly updated loan schedules and data tapes in order to provide the buyer with the most current information regarding the loan portfolio that it is acquiring. The buyer may request that the seller represent that the information contained in each of these loan schedules, or at least specific data fields in the loan schedules and data tapes, is true and correct as of the date that each schedule and data tape is delivered.

Servicer Advances. Similarly, the buyer should consider requesting from the seller a schedule delivered prior to closing (or a series of updated schedules if there is a period of time between signing and closing) that sets forth any advances made by the seller as servicer as of the date of the schedule. Note that servicer advances are most relevant in mortgage securitization or other mortgage financing transactions and are much less common for other asset classes, such as auto loans, credit cards and student loans. If the buyer is acquiring advances as part of the transaction, this schedule will allow the buyer to closely proximate the amount of money needed to acquire these assets. In addition, in order to assess the quality and collectability of these advances, a buyer should propose that the seller represent that these advances have been made in accordance with the relevant servicing agreements and the seller's advances policy and that they are unencumbered, valid and subsisting amounts owed to the seller.

Servicing Agreements and Underlying Servicing Rights. Because the relevant servicing agreements and the underlying servicing rights are critical to many finance company acquisitions, sellers will often provide representations specifically related to the quality of these documents. To ensure that it acquires these servicing agreements (and all rights under these agreements) unencumbered, the buyer will typically request the seller to represent that it owns the entire right, title and interest in the servicing agreements and that it is not in default under these agreements. In addition to other more general representations regarding the quality of the servicing agreements (e.g., each servicing agreement is in full force and effect, etc.), because the servicing rights underlying the servicing agreements are so valuable, the buyer will also normally require the seller to represent that it has the sole right to act as servicer under the servicing agreements and that the transfer of the servicing rights will grant to the buyer all of the seller's servicing rights under these agreements free and clear at closing.

Quality of Servicing. Finance company buyers also typically request certain representations regarding the quality of servicing related to the underlying financial assets in a transaction. Normally a seller who also acted as servicer for the loans or leases in the transaction will be required to represent and warrant that servicing has been performed in compliance with the applicable loan documents, servicing agreements and law.

Compliance with Law. Given the current regulatory environment, the seller may also be concerned with what it needs to disclose under the typical "compliance with law" representation. The seller's counsel may encourage the seller to disclose anything that could possibly have gone or go wrong from a legal compliance point of view on the seller's disclosure schedules despite the fact that none of those issues are likely to be material. The buyer may seek several compliance with law representations that separately address multiple layers of legal compliance under several statutes. This proliferation of legal compliance representations will likely lower the level of materiality for a breach of representations by the seller, again forcing the seller to disclose any conceivable compliance issue. Disclosure issues can be aggravated where there are emerging views on "best practices" for compliance by finance companies, as is the case with CFPB regulation. Both the buyer and the seller need sophisticated regulatory counsel to navigate these issues. The question of whether the seller can update the disclosure schedules between signing and closing also becomes trickier when legal compliance standards are rapidly changing.

Buyer Representations. Another product of the current regulatory environment is that the seller is 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 (15 USCS § 6801) 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 pre-closing 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.
- *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. As discussed in "An Emerging Area: The Need for Reverse Due Diligence" above, 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.

Covenants

The majority of the key covenants in the acquisition agreement cover the period between signing and closing, but certain covenants remain in effect after the closing. As with representations and warranties, covenants will also vary depending on whether the buyer is acquiring the entire business or just a portfolio.

Conduct of the Business between Signing and Closing. As with most M&A transactions, one of the most important covenants made by the seller in a specialty finance M&A transaction concerns the operation of the acquired business during the period between signing and closing. The seller generally agrees to conduct its business operations in the ordinary course and to maintain the assets of the business to provide the buyer with comfort that the business and assets it is proposing to acquire remain materially unchanged between signing and closing.

Transfer of Servicing. In addition to the customary covenants present in most M&A deals, in specialty finance M&A transactions, because the transfer of an origination and/or servicing platform and any related securitization or other financing agreements can be such a complicated and technical process, the buyer and seller often agree to cooperate with each other to work to effectuate the transfer of servicing. This covenant will generally set forth the transfer procedures and require the parties to develop a more comprehensive set of transfer instructions in order to ensure that all rights and obligations are properly transferred under the operative securitization or other financing documents.

Consents. The parties can also covenant to work together to obtain the necessary consents needed under the servicing agreements, which is a complicated process that typically requires the active involvement of both parties.

Governmental Inquiries. Moreover, given the increased scrutiny that governmental agencies now give to finance company transactions and the increase in litigation affecting finance company participants, the parties will also typically agree to cooperate with each other to handle any governmental inquiries regarding the proposed transaction and current litigation affecting the financial assets being transferred. These covenants will also typically require the parties to work together following the closing to take any action to complete the transfer to the extent the action was not (and should have been) taken prior to closing.

Deficiencies in Loan Files. Depending on the relative bargaining power of the buyer in a finance company M&A transaction, it can also require the seller to covenant that it will address the deficiencies in its loan files between signing and closing. Because loan origination and servicing activities are so paper intensive and the loan portfolios are so voluminous, platform operators often fail to fully comply with the regulatory requirements regarding the contents of each of its loan files. To ensure that it does not assume any liability with respect to deficient loan files post-closing and to ensure that it can enforce the debt and has received clean title to any underlying security, the buyer can require the seller to clean up its files and to cure any deficiencies before closing. Who bears the cost of these clean-up activities is a negotiated point between the buyer and the seller.

Post-Closing Covenants. Covenants that carry over post-closing were relatively minimal in finance company M&A transactions in the past but have become much more extensive in the wake of the post credit-crisis regulatory environment. Other covenants that may apply to sellers and buyers after closing include:

- delivery of loan files, including from third party storage facilities;
- procedures to notify credit reporting agencies of the loan sale;
- procedures to terminate or transfer agreements with third party subservicers, collection agents and other vendors;
- procedures to properly transfer servicing on loans undergoing loss mitigation;
- procedures to handle any ancillary products, such as credit or other insurance related to the loans or leases;
- procedures to transfer ordinary course collections litigation that will follow the loans or leases to the buyer; and
- if the seller is providing interim servicing to the buyer, a detailed conversion plan to ensure that the servicing transition occurs in an orderly fashion.

Interim Subservicing Agreement. If the parties are unable to obtain all necessary consents and/or satisfy all necessary requirements to transfer the servicing business under the servicing agreement prior to closing, the parties will often enter into an interim subservicing arrangement where the seller will continue to service the receivables acquired by the buyer until the buyer is fully qualified to do so, including as required under any securitization or other financing agreements. In these circumstances, the parties will negotiate an interim subservicing agreement prior to closing, which will remain in effect for a relatively short period of time post-closing.

Indemnities

The indemnification provisions in an acquisition agreement involving finance company assets are not particularly different from non-finance company deals.

Buyer Indemnities. Given the extensive liability that can be associated with financial assets in today's market, however, buyers in a finance company M&A transaction may insist on an asset sale structure with clear language in the indemnification provisions that provides that all pre-closing liabilities remain with the seller without regard to time limits or caps. Although less common in a stock deal, the buyer may also insist that the seller indemnify it for particular pre-closing liabilities in a stock deal. This "our watch, your watch" approach is not uncommon in non-finance company M&A transactions, but it is likely more standard in consumer finance company M&A transactions. Given the current regulatory environment, the buyer may seek broad indemnification for certain identified pre-closing liabilities, such as liabilities relating to litigation (other than any ordinary course collections proceedings that the buyer will assume), breach of the loan documents to the extent arising prior to the closing and any violations of law prior to the closing.

Seller Indemnities. The seller will seek to clarify that the buyer is solely responsible for how it operates the business after closing, even if the buyer is continuing practices of the seller prior to closing. In other words, the buyer needs to assess the seller's operations, servicing and legal compliance and make any changes it deems necessary after closing in light of a fast evolving regulatory environment. Depending on its leverage, the seller may seek to carve out known deficiencies in its operations or compliance regime that it has disclosed to the buyer in reasonable detail. The seller will seek indemnification for the buyer's operation of the business after the closing and the liabilities the buyer is assuming. The seller may also seek an indemnity for the buyer's misuse of any power of attorney granted by the seller, which is essentially protection against post-closing robo-signing claims based on the buyer's collections activities.

Two-Way Indemnities. Both the seller and the buyer may seek an indemnity for the other parties' failure to properly adjust or remove tradelines by credit reporting agencies, based on the heightened scrutiny regulators have placed on how lenders interact with credit reporting agencies.

Consent Issues

As previously discussed in Due Diligence and Reverse Due Diligence above, M&A transactions involving financial assets, in particular, subprime assets and loans and servicing rights that are subject to securitization and other financing arrangements, require the consent of numerous third parties. The consents required to transfer these financial assets, regardless of whether a buyer is proposing to acquire an entire loan origination and/or servicing business or just certain financial assets, is often driven by the transaction structure. Generally, if the transaction is structured as an asset sale, which would trigger the various assignment provisions in the operative servicing agreements, the consent process is more time-consuming and complicated because the transaction will entail a complicated third-party consent process. If the transaction is structured as a merger or a sale of stock (or, in some instances, as a sale of substantially all of the seller's servicing platform assets), however, the transfer process is generally less complicated and time-consuming because the third-party consent provisions may not be triggered (although there are other requirements that the parties must satisfy before closing).

Consent Issues in an Asset Sale. If a buyer and a seller structure a finance company M&A transaction as an asset sale, nearly all of the operative servicing agreements involved will contain an assignment provision that sets forth extensive requirements that must be satisfied prior to the transfer/assignment. Because servicing is such a critical component of any financial asset financing, third-party stakeholders in the financing will want to confirm that a proposed M&A transaction involving the transfer of servicing to a new servicer will not weaken the performance of the financing. In nearly every instance, therefore, various third party deliveries will typically need to be obtained prior to closing.

- *Rating Agencies.* Some of the more important third parties in a securitization or other financing that the buyer and seller will need to work with during the transaction process are the rating agencies. Under the operative servicing agreements, the identified rating agencies will have to confirm prior to transfer that the proposed transaction will not result in a reduction of credit ratings, which requires the parties to obtain a "no downgrade" letter from each of these agencies prior to closing. Similarly, servicing agreements in the mortgage context will often require that the new servicer be Fannie Mae- and/or Freddie Mac-approved and that each of Fannie Mae and Freddie Mac provide written consent to the transfer. The buyer may need to complete the relatively complicated and time consuming Fannie Mae and/or Freddie Mac qualification process prior to servicing the assets. Obtaining written consent from the GSEs can also be time-consuming, and this process, along with the qualification process (if applicable), should be initiated as soon as practicable in the deal timeline.
- *Master Servicer, Trustee, Trust Administrator, Depositor.* Generally, prior written consent of the master servicer, trustee, trust administrator, depositor, purchaser and owner (in each case, as applicable) is also required under servicing agreements prior to a transfer of servicing. Although time-consuming, obtaining these third-party consents is typically not problematic, except in cases where security holder consent is required.

- *Security Holders.* Some servicing agreements will expressly require the consent of security holders (typically, the noteholders of loan-backed securities) holding a certain percentage (often a majority or 66%) of the outstanding securities prior to the transfer of servicing. In addition, even though trustees may have discretionary powers under servicing agreements as to whether security holder consent should be obtained prior to a servicing transfer, trustees will be more likely to seek security holder consent following the credit crisis in an attempt to insulate the process from potential liability. Soliciting security holder consent is generally undesirable for a buyer and a seller in a M&A transaction because of the inherent difficulty of attempting to obtain consent from a wide pool of public security holders. The time and expense required to properly stage a security holder consent and the potential unpredictability of the results makes it a very onerous process. As such, the parties should work with the trustee as soon as possible in the transaction process to determine whether security holder consent is needed (if it is not expressly required under the servicing agreements). Trustees will typically take into account the experience and creditworthiness of the proposed servicer and the extensiveness of other security holder projections, such as rating agency confirmation and master servicer consent, when determining whether security holder consent is needed. Understanding what a trustee needs to consent to a servicing transfer without obtaining security holder consent in the early stages of the transaction can save the parties considerable transaction costs.
- *Bond Insurer.* In addition, if a bond insurer or other credit enhancement provider guaranteed or "wrapped" the loan-backed securities (as was more typical prior to the credit crisis), the servicing agreements will likely require the prior written consent of the bond insurer to transfer servicing, which may be highly negotiated and depend heavily on the experience, creditworthiness and servicer rating of the proposed servicer. Many bond insurers or other credit enhancement providers also charge material consent fees for providing consents of this nature.

Consent Issues in a Merger or Stock Sale. If a buyer and a seller structure a finance company M&A transaction as a merger or a stock sale (or, in some instances, as a sale of substantially all of the servicer's assets), the transfer process can be less difficult because the transfer provisions in servicing agreements are generally more relaxed in the case of a merger or stock sale. Typically, under these transaction structures, third party consents are not needed, but the buyer/proposed servicer must satisfy several regulatory and financial requirements. For example, in a mortgage transaction the buyer must generally be Fannie Mae, Freddie Mac and/or HUD approved and its deposits must be FDIC-insured. In addition, the buyer may be required to satisfy certain financial thresholds (e.g., have a GAAP net worth of at least $25 million) and the proposed transfer cannot result in a reduction of credit ratings (i.e., a "no downgrade" letter must be obtained from the relevant rating agencies). Given the complex language of servicing agreements and ambiguities that may arise, each relevant agreement should be carefully analyzed by the parties to ensure that the transfer process outlined in the agreements is correctly interpreted.

Approval of State and/or Federal Mortgage Regulators. Finally, because of the heightened scrutiny that governmental authorities have placed on the finance company market, a finance company M&A transaction may require the approval of state and/or federal mortgage regulators. These regulators may want to confirm that a buyer in a finance company M&A transaction will adequately manage the financial assets that it is proposing to acquire. These regulatory concerns will lead to detailed pre- and post-closing covenants of the types described in "Covenants" above.

Amendments to Servicing Agreements. In addition to the often lengthy and complicated consent process, the proposed transfer of a finance company platform or certain of its assets (in particular, servicing rights) also generally requires that each of the operative servicing agreements be amended in order to effect the proposed transaction. This process is typically document intensive involving numerous parties, which can essentially require a mini-closing for each of the amendments. This process normally involves a negotiation with the trustee and depositor that are parties to the relevant servicing agreement with respect to the language of the amendment, obtaining a "no downgrade" letter from each of the relevant rating agencies (the rating agencies typically provide one "no downgrade" letter that covers the consent to the amendment and the transfer of servicing rights), obtaining legal opinions with respect to the authorization of the amendment and tax matters and obtaining miscellaneous third-party consents (e.g., consent from a collection agent if a collection agent agreement is in place).

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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