Mortgage REIT Summit 2020

April 22, 2020

<u>Supplemental Materials</u>

Panel 1. **The State of the Market for mREITs and Trends Affecting mREITs**

- REIT IPO Market Update (*Bloomberg*)

Panel 2. **Coronavirus Response from the Fed and Congress, GSE Updates and Mortgage Policy Reform**

- Legal Update: FHFA Issues Request for Input on FHLB Membership Requirements (*Mayer Brown*)
- Legal Update: Could the US Government's Financial Stability Oversight Council Subject the Residential Mortgage Market or Mortgage REITs to Supervision by the Federal Reserve's Prudential Standards? (*Mayer Brown*)

Panel 3. **Consolidation and Acquisition Activity in the Mortgage REIT Sector**

- When M&A Meets Securitization: A Deeper Dive (Part One) (*The M&A Lawyer*)
- When M&A Meets Securitization: A Deeper Dive (Part Two) (*The M&A Lawyer*)
- Top 10 Issues in M&A for Securitization Sponsors and Servicers (*Mayer Brown*)
- Answers to five sticky questions about mortgage company investments (*National Mortgage News*)

Panel 4. **SEC and Capital Markets Updates for mREITs**

- Technical Line: How to appropriately use non-GAAP measures to discuss the effects of COVID-19 (EY)
- Legal Update: Chair Clayton and Division Director Hinman Issue Public Statement on the Importance of Disclosure in the Current COVID-19 Environment (*Mayer Brown*)
- Legal Update: COVID-19: SEC Disclosures and Related Ramifications (*Mayer Brown*)
- Legal Update: SEC Issues MD&A Guidance (*Mayer Brown*)

Panel 5. **Asset-Specific Financing Developments**

- Legal Update: TALF 2020 and CLOs (*Mayer Brown*)
- Legal Update: The CARES Act and CLOs (*Mayer Brown*)
- Legal Update: COVID-19 and US Securitization Impacts (*Mayer Brown*)

2019

REIT IPO Market Update

By Brian Hirshberg, Anna Pinedo, Yelena Dunaevsky and Tom Shen

Bloomberg Law®

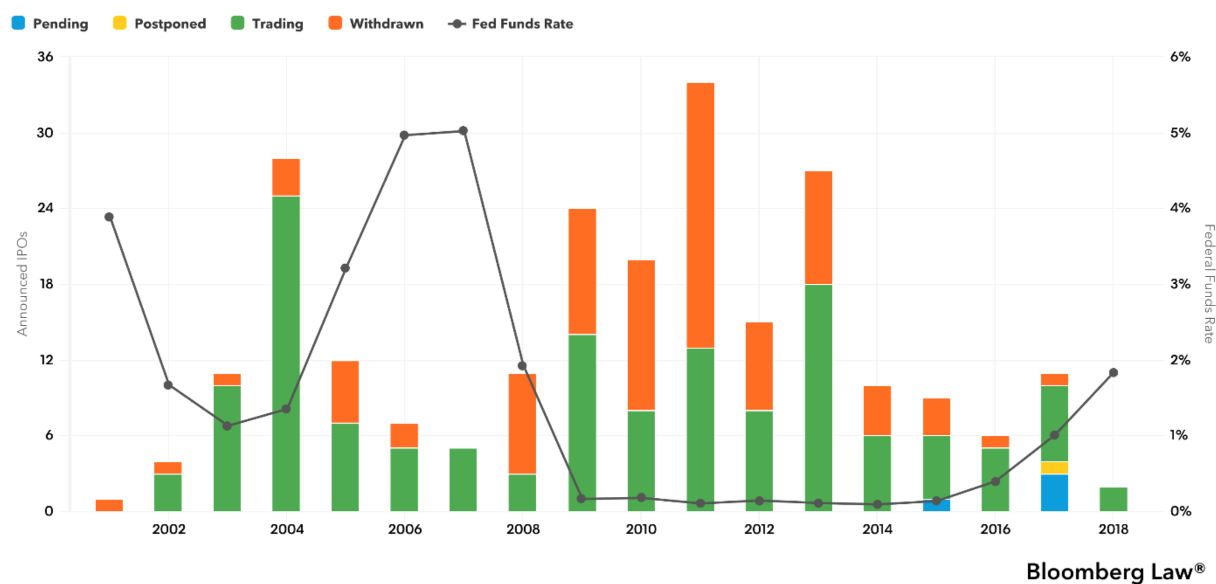
Interest Rate Hikes Subdue REIT IPO Market in 2018

By Brian Hirshberg, Anna Pinedo, Yelena Dunaevsky and Tom Shen

Real estate investment trusts ("REITs") faced a difficult capital-raising market in 2018 due to rising interest rates, a softening real estate market, economic uncertainty and resulting market volatility. In 2018, the FTSE NAREIT All REITs Index fell approximately 4.1%. During 2018, many publicly-traded REITs traded at a significant discount to their reported book values compared to private real estate vehicles, the broader equity market and fixed income market. This resulted in a significant impediment to initial public offering ("IPO") and follow-on offering activity for REITs and an acceleration of the consolidation that the REIT sector experienced in 2017.

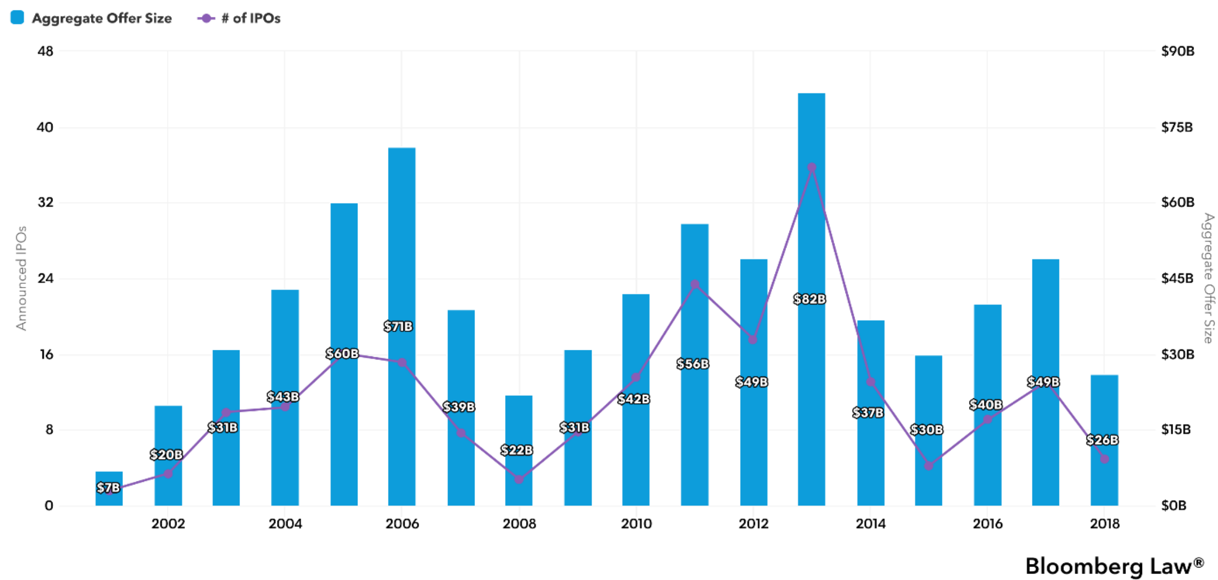
Public Markets are Underperforming

Ultra-low long-term interest rates, a limited supply of real estate and elevated property valuations have been chief contributors to strong and sustained performance in the equity REIT sector since the last recession in 2008. However, given the recent Federal Reserve interest rate hikes and the resulting higher interest rate environment, announced U.S. REIT IPOs declined from 11 in 2017 to two in 2018.



It is interesting to note a smaller percentage of REIT IPO withdrawals in the last three years compared with the withdrawal activity between 2008 and 2015. This indicates a more measured approach by issuers and underwriters, perhaps opting not to go ahead with an IPO at all, instead of filing for an IPO and then withdrawing. As discussed below, many REITs may be opting to raise capital privately, grow in scale and defer accessing the public markets for IPOs.

Worldwide, the number of REIT IPOs decreased by 47% from 49 REIT IPOs in 2017 to 26 REIT IPOs in 2018. This past year, 2018, was the worst year in a decade when measured by amount of funds raised, and one of the worst measured by number of IPOs. Notwithstanding these recent worldwide REIT IPO market challenges and the decline in the number of offerings, the median REIT IPO offering size increased approximately 42% from $108 million during 2015 and 2016 to $153 million during 2017 and 2018, as the market remained receptive to larger offering sizes for attractive property portfolios.



Private Markets are Stepping In

As a result of the difficult IPO market, late stage private capital raises for privately-held companies became the preferred method of financing for many new companies, including REITs, in 2018. Privately-held REITs, after considering their liquidity options, have more often turned to late stage private placements as an alternative to IPOs. Late stage private placements with institutional investors, cross-over investors and strategic investors eliminate a number of the issues associated with an IPO and often provide more capital to the REIT than an earlier stage financing. Privately-held REITs can also set up or sponsor liquidity programs for their early investors, employees and consultants to address concerns resulting from the lack of a public trading market.

Uptick in REIT M&A Transactions

Notwithstanding the slowdown in the REIT IPO market, the value of REIT M&A transactions increased substantially in 2018, with significant M&A activity. While the number of deals in 2017 and 2018 decreased slightly from the high of 475 deals in 2014, the total transaction value of REIT M&A transactions was $81 billion during 2018 compared to $67 billion during 2017. Most of the M&A activity was driven by the persistent undervaluing of REIT properties by the public market, which resulted in natural consolidation and going-private transactions. The acquisition of GGP Inc., a shopping mall REIT, by Brookfield Property Partners LP for a total transaction value of $27.1 billion represented the largest REIT M&A transaction in 2018.

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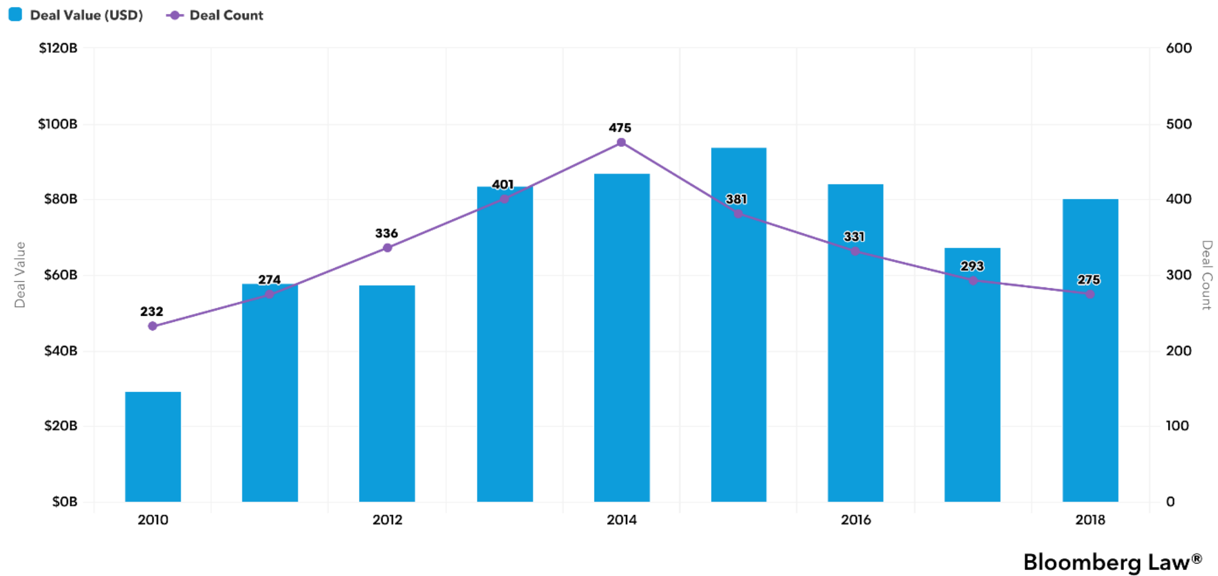
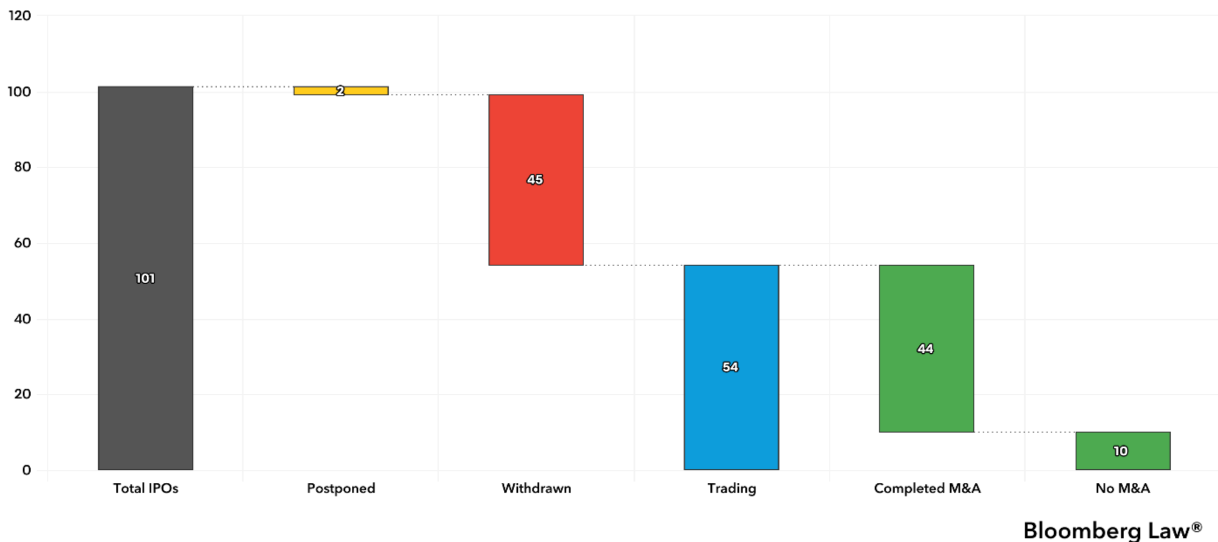


How do REITs Use IPO Funds?

We analyzed the stated use of proceeds in REIT IPO prospectuses. M&A financing was cited as the principal intended use of proceeds, outside of general corporate purposes.



Over 80% of currently trading REIT IPO issuers that identified M&A as one of the stated uses in their use of proceeds did indeed successfully complete an M&A transaction of one million USD or more after going public. Again, it is interesting to note the high percentage of withdrawn IPOs.

Despite the high rate of IPO withdrawals, out of 76 withdrawn REIT IPOs (all U.S. IPOs, not just the ones listing M&A in their use of proceeds), only seven became targets of an M&A deal. That might not be enough to conclude that an M&A exit by would-be REIT IPO issuers is a popular alternative to an IPO.

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Regulation A is a REIT Magnet

In lieu of the traditional REIT IPO, Regulation A offerings have become an increasingly important capital-raising tool for REITs. Regulation A is an exemption from registration for public offerings with two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period. For the three years from effectiveness of the amendments to Regulation A in 2015 through September 30, 2018, 257 offerings were qualified and nearly $1.3 billion was raised in Regulation A offerings. Real estate and REIT offerings account for the largest percentage of these transactions.

Another Alternative: Forward Sale Arrangements

REITs also increasingly opted to use forward sale arrangements in order to raise capital in 2018 due to uncertainty relating to increased market volatility. Forward sales allow REITs to sell their shares in the future at a specified price, less a discount, by entering into a forward sale agreement with a forward purchaser as part of the REIT's follow-on offering. The forward purchaser borrows shares from the market in order to allow the affiliated underwriter to sell the REIT's shares in the follow-on offering. The number of REIT forward sale issuances increased substantially in 2018. During 2018, there were nine REIT forward sale issuances, which raised an aggregate of approximately $5.2 billion with a median forward term of 12 months.

REIT Sector Performance

Despite the difficult market conditions, the best performing REIT sectors in 2018 were freestanding retail REITs and manufactured home REITs (13.9% and 11.4%, respectively), primarily due to their low valuations at the start of the year. The Diversified REIT category was the most active from 2002 to 2018, logging in 236 priced IPOs and raising $53.2 billion. The next most active REIT sector was the office property sector, which produced 81 IPOs and raised a total of $30.2 billion.

Commercial real estate markets broadly maintained momentum through the end of 2018, as net absorption continued at a high level across major property types. In particular, demand exceeded supply growth for office, retail and apartment markets. With respect to REIT sector performance, the number of REIT IPOs in the warehouse/industrial sector continued to increase primarily due to the continued expansion of e-commerce, limited supply of properties and rising rents.

Warehouse/Industrial REITs

There was only one warehouse/industrial REIT IPO in 2015 and there were three in 2016, but the number went up to 7 in 2017 before dipping down to two in 2018. The 2017 uptick may be explained by the fact that the e-commerce industry (including Amazon) continues to require additional warehouse and industrial space to satisfy increasing customer demand. This trend may result in another uptick in warehouse/industrial REIT IPOs in 2019. Industrial REITs include data center and distribution center REITs that are experiencing similar growth due to the expanding e-commerce sector.

Shopping Center REITs

Conversely, the number of shopping center REIT IPOs declined in 2018 with only four IPOs completed during 2017 and one in 2018.

Healthcare REITs

Healthcare REITs have also experienced a similar downward trend with only one IPO completed in 2017 and no IPOs in 2018 compared to three IPOs in 2015 and two in 2016. However, the already public healthcare REITs delivered a strong total return (7.58%) in 2018, suggesting a potentially positive outlook into 2019. The uncertainty of future U.S. healthcare regulatory policy has likely contributed to the overall downward trend in that REIT sector.

Mortgage REITs

Mortgage REIT IPOs continued their five-year slump in 2018. Between 2014 and 2018 there were only one or two mortgage REIT IPOs per year, a decline from between three and seven IPOs per year between 2009 and 2013 (with the exception of 2010, which did not produce an IPO). Unfortunately, U.S. regulatory constraints have limited the ability of mortgage REITs to expand into new mortgage-related asset classes. Mortgage REITs rely on the Section 3(c)(5)(C) exemption and related interpretations in order to be excluded from the definition of "investment company" under the

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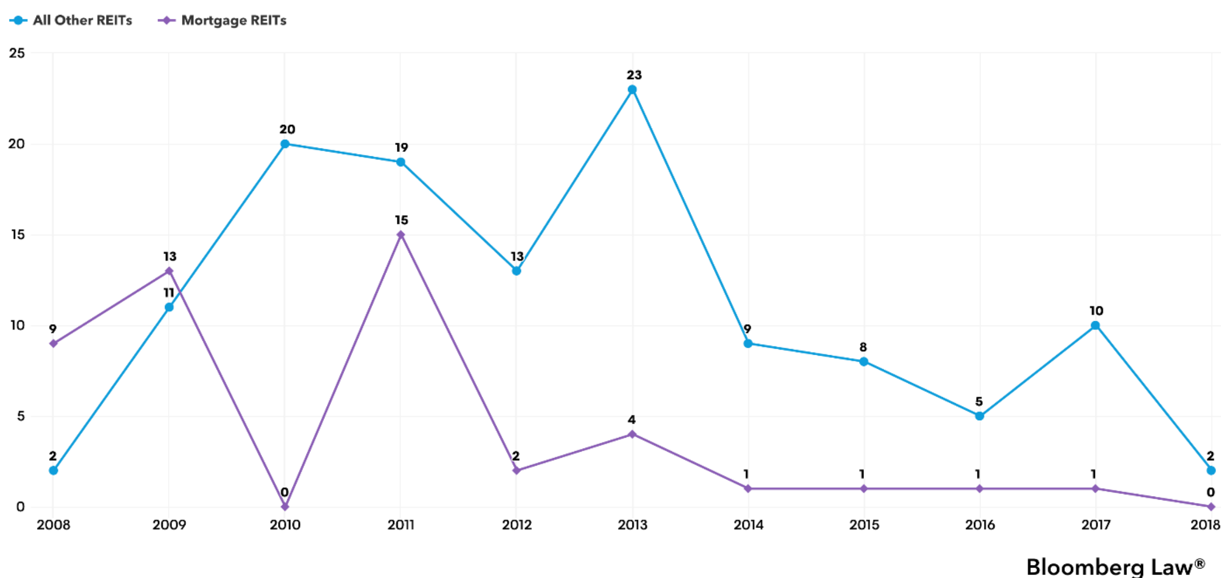
Investment Company Act of 1940 ("1940 Act"). To qualify for the Section 3(c)(5)(C) exemption, a mortgage REIT must comply with strict asset tests, including having at least 55% of its assets consist of mortgages.

In August 2011, the SEC issued a concept release questioning the exempt status of mortgage REITs under Section 3(c)(5)(C) of the 1940 Act. The concept release did not propose any new rules but rather informed the market that the SEC was in the process of reviewing various interpretations of the 1940 Act exemption as it pertains to mortgage REITs. Due to the resulting regulatory uncertainty, the concept release generated significant negative reaction and a perception that mortgage REITs may be materially hindered or limited in the manner in which they have historically conducted their businesses. As a result, the mortgage REIT IPO market deteriorated significantly following 2011, as illustrated by the below graph. The SEC did not follow the issuance of the concept release with any specific guidance until the publication of the Great Ajax Funding LLC No-Action Letter in early 2018.

In that No-Action Letter, the Staff of the Securities and Exchange Commission ("SEC") indicated that a particular mortgage REIT's assets, sources of income, historical development, and public representations may evidence that the mortgage REIT is primarily engaged in the real estate finance business and, therefore, should be able to rely on the Section 3(c)(5)(C) exemption. Hopefully, mortgage REITs obtain confirmation from the SEC Staff regarding new mortgage-related asset classes in order to provide industry certainty and potentially reverse the prolonged mortgage REIT slump. Relatedly, legislation expanding the current Section 3(c)(5)(C) exemption to include all risk-sharing transactions, including credit risk transfer securities, was released by the House Committee on Financial Services for discussion in 2018 without any further development. This legislation is expected to be reintroduced in the current session of Congress.



Non-Listed REITs

Despite the stock market volatility experienced in 2018, non-listed REITs had an encouraging year with strong fundraising as investors sought to increase their investment exposure to alternative assets. Non-listed REITs register with the SEC but their securities do not trade on a national securities exchange. Prior to 2018, financing in the non-listed REIT sector had been on a downward trajectory since the sector's peak in 2013. Importantly, the entrance of Blackstone into the non-listed REIT market in 2018 gave the sector a significant increase in liquidity and credibility. Additionally, the final repeal of the Department of Labor's fiduciary rule during 2018 removed a regulatory hurdle to investment in non-listed REITs.

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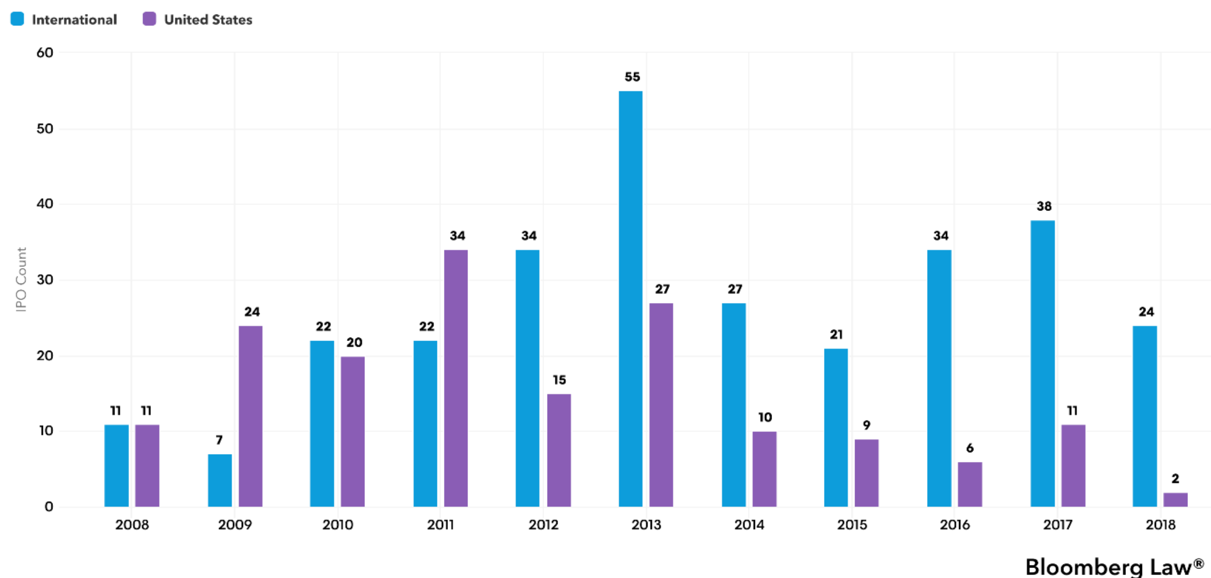
Future REIT Performance in Light of New Tax Law

In the United States, the 2017 Tax Cuts and Jobs Act introduced several new measures affecting REIT taxation. One of the central features of the tax bill is a new 20% tax deduction on pass-through income. This deduction applies to businesses that operate as pass-through entities, including REITs, allowing REIT shareholders to benefit from the deduction. The tax bill is expected to indirectly benefit certain REIT sectors by generally increasing corporate profits and providing a stimulative impact on the U.S. economy resulting in an increased demand for REIT properties. Rising property demand is expected to lead to higher property prices enabling equity REITs to raise rents on higher quality tenants. Cyclical REIT sectors, such as hotel, industrial and office REITs, are expected to derive more indirect benefits from the U.S. tax reform than are less cyclical sectors, such as healthcare.

Non-U.S. REIT Market

While the United States remains the largest listed real estate market in the world, the listed real estate market is increasingly becoming a global phenomenon. The growth is being driven primarily by the appeal and success of the U.S. REIT approach to real estate investment. More than 35 countries have adopted the U.S.-based REIT approach to real estate investment, and interest rate trends are now more favorable to international REITs than to U.S. REITs. As a result, the number of REIT IPOs consummated outside of the United States has been growing. Comparing all announced international REIT IPOs to U.S. REIT IPOs, it is interesting to note the tide turning sharply in favor of international deals in 2011. Beginning in 2012, the international REIT IPO market has completely overwhelmed the continuously declining U.S. REIT IPO market, a trend that is likely to continue for the foreseeable future.



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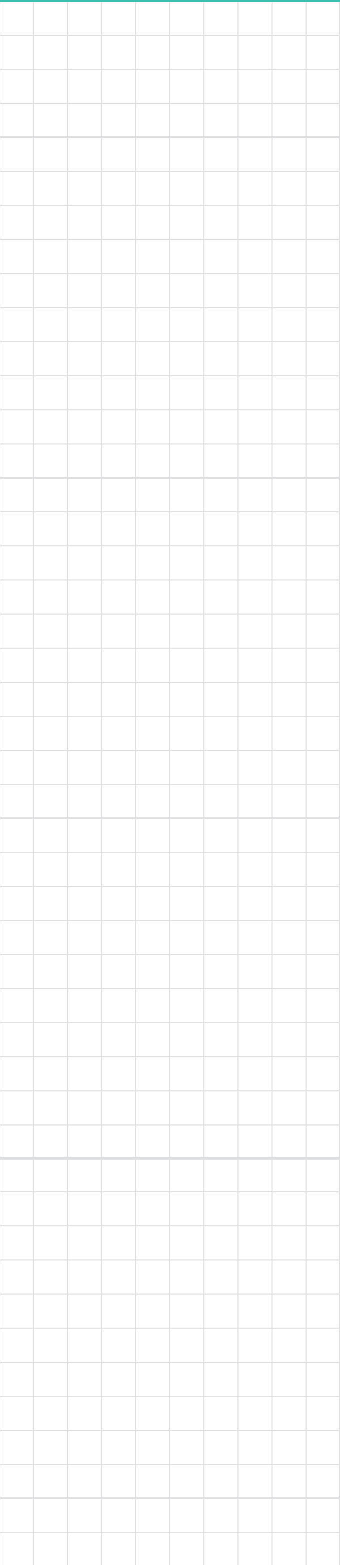

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February 28
2020

FHFA Issues Request for Input on FHLB Membership Requirements

Authors

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On February 24, 2020, the Federal Housing Finance Agency ("FHFA") issued a Request for Input ("RFI") on the eligibility requirements for membership in a Federal Home Loan Bank ("FHLB" or "FHLBank").[1] Significantly, the RFI does not provide for the restoration of FHLB membership for captive insurers or foreclose restoration at a later date. Rather, the RFI contains an even-handed summary of the recent controversy involving the eligibility requirements and poses open-ended questions that do not indicate what changes, if any, may be made to the eligibility requirements. Comments on the RFI must be submitted by June 23, 2020.

Background

The FHLB Act restricts membership in the FHLB System to US-based insured depository institutions, community development financial institutions ("CDFIs") and insurance companies that make home mortgage loans.[2] For many years, the FHFA and its predecessors interpreted this restriction as effectively authorizing membership to any regulated insurance company domiciled in the United States, including captive insurance companies owned by real estate investment trusts and other entities that would not qualify for FHLB membership on their own.[3]

Beginning in 2010, however, the FHFA began to reassess participation in the FHLB System by captive insurance companies that are controlled by ineligible parent companies.[4] Underlying the agency's concern was the fear that ineligible companies were forming captive insurers solely to acquire FHLB System membership in order to access below-market funding through advances from FHLBs.[5] This reassessment culminated in a 2016 rulemaking in which the FHFA defined "insurance company" to exclude licensed insurance companies whose primary business is underwriting insurance for affiliates.[6] As a result of this regulatory change, a number of captive insurance companies lost their FHLB System membership in 2017 or will lose it by February 2021.[7]

Industry Concerns

Many in the housing finance industry, including the regional FHLBs, expressed concerns with and opposition to the FHFA's restriction on insurance company participation in the FHLB System.[8] By excluding captive insurers, the FHFA reduced both the number of members sharing in the FHLBs' obligations and the financial resources available to the FHLBs' housing mission. Until the RFI, however, FHFA had been unwilling to reconsider its action against the captive insurers.[9]

Request for Input

The RFI covers three primary topics. The first topic is a restatement of the FHLB eligibility requirements that summarizes in one place the relevant legal authority, prudential concerns and application process. While this may be of interest to those looking for trends in interpretation or emphasis, almost all of the content is existing blackletter law.

The second topic is background and commentary by the FHFA on the issue of who should have access to FHLB advances. The background discussion discloses that the FHLBs have had difficulty implementing the eligibility requirements. It states that "on several recent occasions FHLBanks have improperly applied regulatory provisions on membership eligibility when assessing applications, resulting in a number of erroneous membership approvals." Additionally, the RFI states that some nonbanks have tried to use for-profit and other non-depository CDFIs and special purpose insured banks as "conduits" for obtaining FHLB advances. While these attempts apparently were unsuccessful because the applicants failed other eligibility requirements, their disclosure indicates that FHFA is uncomfortable with the literal language of the eligibility requirements. This discomfort, and the potential for such a nonbank applicant to structure its conduit to satisfy the other eligibility requirements, may be the genesis of the RFI.

Further, the commentary in the RFI emphasizes the residential housing focus of FHLB membership, which it implies may be at odds with the business plans of some nonbanks that have tried to create conduits to FHLB advances. However, FHFA also recognizes in the RFI that the administration's 2019 Housing Reform Plan encouraged the expansion of access to FHLB advances.

Based on this balanced treatment, it is not surprising that the third topic of the RFI is a series of open-ended questions asking what FHFA should do about the FHLB eligibility requirements. We have attached the questions at the end of this Legal Update as Appendix A. The questions emphasize the need for a solution to be consistent with the FHLB Act's focus on housing finance and principles of safety and soundness but do not otherwise reveal FHFA's intended direction. For example, there are questions premised on the FHFA banning

arrangements through which a nonbank uses a conduit to access FHLB advances, and there are other questions that ask for suggestions regarding prudential measures that FHFA or FHLBs could take to manage the risks associated with nonbank access to FHLB advances. More broadly, the questions seem torn between adopting a uniform, easily administered approach and a nuanced approach that effectively distinguishes among different categories of applicants.

Takeaways

It remains to be seen if the RFI is a prelude to a loosening or tightening of the FHLB eligibility requirements. For example, one trade group already is on the record as recommending that independent mortgage banks be given access to FHLB advances, but others see potential resistance to that idea within FHFA.[10]

We expect there will be many industry comments that point out the harm caused by the FHFA's tightening of the insurance company membership requirements and emphasize the housing policy goals that would be served by a more liberal and literal interpretation of the eligibility requirements in the underlying statute. This could lead to the FHFA issuing a formal notice of proposed rulemaking that would be subject to a further public comment period. However, it is an election year, and the combination of lengthy comment periods, the ongoing judicial challenge to the constitutionality of FHFA's structure[11] and the risk of a permanent roadblock through the Congressional Review Act[12] may delay any meaningful changes until after least the second half of 2021.

Appendix A: RFI Questions

1. ***General.*** FHFA seeks to develop requirements to address questions regarding membership eligibility on a consistent basis, guided by the twin objectives of ensuring that the FHLB System remains safe and sound and able to provide liquidity for housing finance through the housing and business cycle and ensuring that all members have an appropriate nexus to the housing finance and community development mission of the FHLBanks.
   a. In addition to the statutory requirements of the FHLBank Act, what are the most important general principles and factors FHFA should consider in achieving those objectives?
   b. Are there classes or types of institution not currently eligible for FHLBank membership under FHFA's current regulation whose eligibility would simultaneously further both of those objectives and, if so, how? In particular:
      1. What would be the safety and soundness risks, if any, to the FHLBanks or the FHLB System of making such institutions eligible for membership? What impacts, if any,

would allowing such institutions to be members have on the FHLB System's cost of funds and ability to provide low-cost liquidity to current members?

2. How, specifically, would membership of such institutions further the housing finance and community development mission of the FHLBanks?
3. Would allowing such institutions to be members further FHFA's duty to ensure that the operations and activities of the FHLBanks foster liquid, efficient, competitive and resilient national housing finance markets? How would doing so affect competition among existing participants in housing finance markets? How would doing so improve the FHLB System's resiliency through the cycle? Please be specific.

2. ***Financial condition requirement.*** As described above, the provisions of the current regulation implementing the "financial condition" eligibility requirement establish different standards of review for different types of eligible entities.
   a. In general, what financial factors should FHFA consider for the types of entities eligible for membership, and how many years of financial statements and other data is sufficient for a FHLBank to make a sound assessment of an applicant's financial condition?
   b. Would there be benefits to establishing financial condition review requirements that are substantially similar for all applicants, regardless of whether they are organized as an insured depository institution, insurance company or CDFI? What would such requirements comprise, and would such changes entail risks to the FHLB System's safety and soundness and the FHLBanks' ability to provide liquidity to members through the cycle?

3. ***Use of conduit arrangements by ineligible entities.***
   a. Should FHFA amend its regulations to bar from FHLBank membership particular types of otherwise-eligible entities that are most susceptible to being used as conduit vehicles by institutions that are not themselves eligible for membership? Which types of currently eligible entities are most susceptible to such use?
   b. How should FHFA balance the legitimate housing finance activities of those types of entities against the risks that they could be misused as funding conduits by ineligible entities to create another form of *de facto* membership?
   c. Should FHFA amend its regulations to impose conditions on membership approvals pertaining to those entities that are susceptible to being used as conduits that do not apply to other types of members?

d. Irrespective of membership requirements, should FHFA limit conduit activity by FHLBank members through other means, such as by restricting the amount of advances a FHLBank may have outstanding to a single member (for example, to a percentage of the member's total assets) or limiting the extent to which affiliates may pledge collateral to secure a member's advances? If so, what should those limitations be? Should FHFA impose any such limitations on all FHLBank members as a prudential measure, irrespective of any concerns about conduit activity?

4. ***Unsupervised members and affiliates.***
   a. What are the principal risks to the FHLBanks from doing business with members that are not subject to supervision by a prudential safety and soundness regulator, and are those risks materially greater than those associated with doing business with members subject to such oversight?
   b. If FHFA were to allow conduit arrangements, what would be the principal risks to the FHLBanks in cases where the affiliate to which the FHLBank funding is being passed by the conduit member is not subject to supervision by a prudential safety and soundness regulator?
   c. To the extent there are added risks arising from either scenario, what measures could FHFA or the FHLBanks take (for example, enhanced collateral discounts, capital requirements or other counterparty risk management practices) that would best mitigate those risks? Would such measures be sufficient? Please be as specific as possible.
   d. What would be the added risks and costs, if any, to the FHLBanks and the FHLB System, including with respect to the cost of funds, in the event of a default or failure of a member and/or parent institution for which a bankruptcy or similar proceeding would be the resolution regime (as opposed, for example, to an FDIC resolution for an insured depository institution)?

5. ***Nexus to FHLBanks' public policy mission.***
   a. Is the current membership regulation sufficient to ensure that the activities of FHLBank members have a sufficient nexus to the public policy mission of the FHLBanks? If not, what changes should be made?
   b. Should FHFA require FHLBank members to demonstrate an ongoing commitment to housing finance in order to remain eligible for membership? If so, how should that commitment be measured and monitored?
   c. If FHFA were to permit conduit arrangements, should it limit such arrangements to members whose parent company is actively and substantially engaged in activities that

are consistent with the housing finance and community development mission of the FHLBanks? If so, what criteria should be employed, and how could compliance with such criteria be monitored and enforced?

d. Would the use of FHLBank advances to finance the purchase of mortgage-backed securities by the conduit entity or its parent, as was the case with mortgage REITs that created captive insurance companies, be consistent with the mission of the FHLBanks, particularly if the mortgage-backed securities have been issued or guaranteed by Fannie Mae or Freddie Mac?

6. ***Rebuttable presumption approach of regulation.*** As discussed above, an applicant's failure to meet the specific standards by which compliance with a membership eligibility requirement is determined may, in some cases (specifically, with respect to the "subject to inspection and regulation," "financial condition," "character of management" and "home financing policy" requirements), raise a mere presumption of non-compliance that the applicant may rebut by meeting additional criteria. The intent behind this approach is to facilitate the processing of membership applications by the FHLBanks by allowing them to exercise a degree of judgment in assessing the unique facts that may be presented by some applicants. Because those additional criteria allow the FHLBanks considerably more discretion than do the primary standards, however, they also are more subject to misinterpretation and misapplication, particularly when the FHLBanks are considering cases of first impression.

   Would the safety and soundness of the FHLBanks be enhanced if FHFA were to establish new standards that provided less discretion to the FHLBanks and all of which must be met for an applicant to be admitted to membership? If so, what should those standards be? Please explain in detail.

7. ***Other issues and concerns.*** Are there any issues not explicitly discussed above that relate to FHLBank membership and need clarification?

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[1] FHFA, Federal Home Loan Bank Membership: Request for Input (Feb. 24, 2020), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-RFI-on-FHLBank-Membership.aspx.

[2] 12 U.S.C. § 1424(a)(1).

[3] *See* 81 Fed. Reg. 3245, 3254 (Jan. 20, 2016).

[4] 75 Fed. Reg. 81,145 (proposed Dec. 27, 2010).

[5] 81 Fed. Reg. at 3254-58. FHLB advances are a low-cost wholesale source of funding for FHLB members because FHLBs fund their operations through the issuance of consolidated obligations that are exempted government securities that benefit from an implicit federal government guarantee. Additionally, FHLBs and their consolidated obligations are not subject to state or federal income taxes.

[6] 81 Fed. Reg. at 3264.

[7] 81 Fed. Reg. at 3269; Tim Zawacki, Handful of mREITs left to enjoy ‘extreme competitive advantage’ of FHLB funding, SNL (Mar. 29, 2017).

[8] *E.g.,* FHLB Cincinnati, 2015 Annual Report: A Message to Our Members (Apr. 2016).

[9] See our earlier Legal Update on a 2018 bill that would have partially reversed the FHFA’s action. That bill stalled in committee and was not enacted.

[10] MBA, The Rising Role of the Independent Mortgage Bank 10 (Feb. 2019); Christopher Whalen, “Will FHFA create a level playing field for nonbanks,” *National Mortgage News* (Feb. 7, 2020).

[11] Laurence Platt, “High Court CFPB Review May Determine Fate Of FHFA Too,” *Law360* (Oct. 28, 2019) https://www.mayerbrown.com/en/perspectives-events/publications/2019/10/high-court-cfpb-review-may-determine-fate-of-fhfa-too.

[12] The Congressional Review Act permits Congress to invalidate recently enacted agency rules. This action may effectively preclude further agency action on a topic because an agency may not issue a new rule that is substantially the same as a rule that has been invalidated. 5 U.S.C. § 801(b)(2).

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January 15, 2020

Legal Update

Could the US Government's Financial Stability Oversight Council Subject the Residential Mortgage Industry or Mortgage REITs to Supervision by the Federal Reserve and Prudential Standards?

Raise your hand if you are an independent mortgage banker, a residential mortgage real estate investment trust ("mREIT") or a non-bank investor in residential mortgage loans that would like to be subject to additional federal government supervision of your entire operations, not just the nuts and bolts of your mortgage lending, servicing or whole loan purchase business. Raise both hands if you also would like to be subject to prudential standards. And, in either case, you would not be entitled to any of the substantive benefits of being a federally-chartered bank. I suspect that no one raised either hand and that is not surprising given the level of federal and state regulation of the residential mortgage business.

Chicken Little was not necessarily right, the regulatory sky is not necessarily falling, but you should be aware of the December 4, 2019, issuance by the Financial Stability Oversight Council (the "Council") of its "Final Interpretive Guidance" regarding its authority to require supervision and regulation of certain nonbank financial companies and subject such companies to prudential standards (the "Guidance"). Replacing earlier guidance that the Council issued in 2012, the Guidance describes the processes the Council intends to follow if it were to consider making a determination to subject a nonbank financial company to supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and prudential standards.

Many of Mayer Brown's nonbank financial company clients, including mREITs, have asked us to provide our thoughts on the risk that nonbank residential mortgage lenders, servicers and purchasers might be subject to such enhanced regulatory scrutiny and prudential standards by the Council or increased state and federal regulation to head off action by the Council. The purpose of this Legal Update is to give a broad overview of this newly revised evaluative process, not to predict what may happen in the future.

Background

Whether to protect taxpayers, consumers or investors, there is no shortage of substantive laws and regulations designed to prevent wrongdoing and harm or of governmental

agencies and instrumentalities to enforce those laws and regulations and, in some cases, supervise and examine market participants. Think, for example, of federal banking agencies, like the Office of Comptroller of the Currency ("OCC"), or the Securities Exchange Commission ("SEC") and state equivalents, or state licensing authorities like the New York Department of Financial Services, state insurance commissioners, or the Consumer Financial Protection Bureau ("CFPB").

In each case, there is a governing statute that (1) creates the governmental authority for a particular public purpose, (2) imposes substantive prohibitions or requirements or delegates rule-making authority to the related government authority to promulgate such substantive prohibitions or requirements pursuant to notice and comment rule-making, (3) empowers the government authority to supervise and examine industry participants that engage in the activity that is the subject of the law for legal and regulatory compliance and (4) authorizes government enforcement actions for non-compliance. Sometimes the supervision, examination and related enforcement processes apply only if the industry participant is approved to participate in a government program, such as residential mortgages that are insured or guaranteed by the Federal Housing Administration or the Department of Veterans Affairs and perhaps pooled to back securities guaranteed by the Government National Mortgage Association ("Ginnie Mae").

While such authority to supervise and examine relevant industry participants typically is explicitly provided in the enabling statute, sometimes the statute provides mere discretionary authority to subject a new class of industry participants to governmental supervision and examination upon a finding of need. Note, for example, the CFPB has express supervisory authority over all nonbank covered persons offering or providing residential mortgage loans, private education loans and payday loans. Its supervisory authority with respect to other consumer asset classes is more muted. The CFPB may assert supervisory jurisdiction over "larger participant[s] of a market for other consumer financial products or services," as the CFPB defines by rule, based on its determination that such supervision is necessary and appropriate to enable the CFPB to administer and carry out the purposes and objectives of federal consumer financial law. For example, it has used this authority to supervise credit reporting agencies, debt collection agencies and auto lenders. This elastic jurisdictional authority gives the CFPB the flexibility to react to problems it subsequently discerns by granting itself supervisory authority over industry participants.

While many industry participants are critical of over-regulation and the sometimes strict hands of provident regulators, occasionally the government does not act fast enough to seek to prevent major harm. This can be and has been true in some cases where there was a governmental entity that had authority to intervene but either did too little too late or not at all, on the one hand, and where there was not even an applicable governmental entity to address the issue in any systematic way, on the other hand. Nevertheless, few regulated industry participants voluntarily will call for themselves to be subject to greater regulatory oversight, although they may wish that their competitors whom they perceive to play "fast and loose" should be so subject. And likely even fewer non-regulated industry participants will lobby to be subject to governmental supervision and regulation, except in cases where they see their industry being eaten away by bad actors and regard governmental intervention as a matter of industry survival.

Forget the philosophical debates over the need for more or less government regulation;

following the financial crisis from approximately 2008-2010, the public policy question was not whether to increase government oversight of financial industry participants, but how. Enacted in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") answered the "how" question. It did so in approximately 2,300 pages of substantive provisions and by authorizing many more thousand pages of regulations to implement those provisions.

An underlying premise permeates the Dodd-Frank Act—namely, that unregulated or under-regulated nonbank financial companies from time to time may pose material risks to the broader US financial system and the federal government may have insufficient tools to reign in and manage that risk until it is too late. To address this concern in part, Section 111 of the Dodd-Frank Act established the Council in order to identify risks to US financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies; promote market discipline; and respond to emerging threats to the stability of the US financial system. The Dodd-Frank Act designed the Council to facilitate a holistic, integrated approach among various federal agencies to manage the potential material risk of nonbank financial companies. In this regard, the voting members of the Council are the Secretary of the Treasury, who shall serve as Chairperson of the Council; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; the Director of the CFPB; the Chairman of the SEC; the Chairperson of the Federal Deposit Insurance Corporation; the Chairman of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairman of the National Credit Union Board; and an independent member appointed by the President, with the advice and consent of the Senate, having insurance expertise.

Among other statutory authorities, the Council may seek to accomplish these statutory purposes by requiring supervision by the Federal Reserve for nonbank financial companies that may pose risks to US financial stability. In making a determination that a nonbank financial company should be subject to such supervision, the Council is obligated under to the Dodd-Frank Act to consider:

- The extent of the leverage of the company;
- The extent and nature of the off-balance-sheet exposures of the company;
- The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, businesses and state and local governments and as a source of liquidity for the United States financial system;
- The importance of the company as a source of credit for low-income, minority or underserved communities and the impact that the failure of such company would have on the availability of credit in such communities;
- The extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
- The nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company;
- The degree to which the company is already regulated by one or more primary financial regulatory agencies;
- The amount and nature of the financial assets of the company;

- The amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- Any other risk-related factors that the Council deems appropriate.

In implementing this statutory mandate, the Council first established guidance and procedures pursuant to which it would determine whether and how to exercise the statutory authorities on which it relied in designating a large insurance company as a "Systemically Important Financial Institution" (a "SIFI")—a determination that the insurance company ultimately successfully challenged in court. This new Guidance represents a "back to the drawing board" approach by the Council.

Summary Description of the Guidance

In a nutshell, the Council intended the new Guidance "…to enhance the Council's transparency, analytical rigor, and public engagement." This is another way of highlighting the prior criticism of the Council's designation process as being opaque, analytically loose and insulated from public scrutiny.

In a major change from the prior guidance, the Council will start with *an activities-based approach*, instead of *an entity-based approach*, to seek to identify, assess and address potential risks and threats to US financial stability. The Guidance clarifies that this change in approach is consistent with the Council's priorities of identifying and assessing potential risks and emerging threats on a system-wide basis and thus reducing the potential for competitive market distortions that might arise if instead its first focus were on individual entities. In utilizing an activities-based approach, the Council intends to examine a diverse range of financial products, activities and practices that could pose risk to US financial stability, in part by considering linkages across products, activities and practices and their interconnectedness across firms and markets. Nevertheless, the Council reserves the ability to make an entity-specific determination but only if a potential risk or threat cannot be adequately addressed through an activities-based approach.

The Council identified four framing questions on which its analysis of any identified risk will focus:

1. How could the potential risk be triggered? For example, could it be triggered by sharp reductions in the valuation of particular classes of financial assets?
2. How could the adverse effects of the potential risk be transmitted to financial markets or market participants? For example, what are the direct or indirect exposures in financial markets to the potential risk?
3. What impact could the potential risk have on the financial system? For example, what could be the scale of its adverse effects on other companies and markets, and would its effects be concentrated or distributed broadly among market participants? This analysis should take into account factors such as existing regulatory requirements or market practices that mitigate potential risks.
4. Could the adverse effects of the potential risk impair the financial system in a manner that could harm the non-financial sector of the US economy?

After identifying and assessing such potential system-wide risks, the Council, in turn, will try to work with the relevant financial regulatory agencies at the federal and state levels to seek to implement a method to mitigate risk to financial stability. This emphasis on collaboration is predicated on the notion that the relevant financial regulatory agencies

generally possess greater information and expertise with respect to company, market and product risks, perhaps putting them in a better position to address potential risks, and at the same time not subjecting the companies to new regulatory authorities.

If existing regulators take appropriate actions, such as modifying their regulation or supervision of companies or markets under their jurisdiction in order to mitigate potential risks to US financial stability identified by the Council, the Council would not need to intervene more directly. The Guidance suggests that appropriate actions that existing regulators could take include restricting or prohibiting the offering of the risky product or requiring market participants to take additional risk-management steps that address the risks.

But if the Council believes the regulators' actions to be inadequate, it has the authority to make formal public, but non-binding, recommendations to the regulators. The Council is required under the Guidance to conduct a cost-benefit analysis prior to making a final recommendation to the regulators, unless the regulators themselves conducted such an analysis. Only if the expected benefits to financial stability resulting from the determination justify the expected costs that the determination would impose may the Council make the final recommendation. During this evaluative phase, the Council is required to engage with companies and their existing regulators to provide greater visibility into the perceived risk factors and greater opportunity for the companies and their regulators to provide timely relevant information. The Council may elect to report to Congress on recommendations for legislation that would prevent identified activities or practices from threatening US financial stability if there does not exist sufficient regulatory oversight of the markets or companies conducting financial activities or practices identified by the Council as posing risks.

The Guidance defines a "risk to financial stability" as the risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy. Interestingly, while not focusing on broader US financial stability, Ginnie Mae, Fannie Mae and Freddie Mac have increased their scrutiny of the financial stability of their respective mortgage servicers, with particular focus on their net worth, liquidity and capital to satisfy their obligations under the respective home finance programs. Ginnie Mae's imposition of stress tests on its "issuers" in the last year is a good example of this.

But all of these agency initiatives principally are designed to minimize the risk of program losses caused by individual issuers. While it is theoretically possible that the significantly large program losses attributable to one or more approved participants could have a "spill-over" effect on the broader economy, that is not the primary focus of these agencies. While they may have a fulsome sense of company, market and products risks that may better inform the Council's evaluation process, none of these agencies is a prudential regulator of the nonbank financial company itself, and the agencies are instead focused on eligibility to participate in their housing finance programs.

In light of this reliance on existing regulatory authorities, the Council indicated in the Guidance that only in rare instances does it anticipate that it would consider a nonbank financial company for a potential determination, such as if the products, activities or practices of a company that pose a potential threat to US financial stability are outside the jurisdiction or authority of financial regulatory agencies. In those rare cases, the Council may determine that a

nonbank financial company will be supervised by the Federal Reserve and be subject to prudential standards if the Council determines that (1) material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States or (2) the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States. In this regard, according to the Guidance, the Council intends to interpret the term "material financial distress" as a nonbank financial company being in imminent danger of insolvency or defaulting on its financial obligations. Any such determination by the Council requires both (1) an affirmative vote of at least two-thirds of the voting members of the Council then serving, including an affirmative vote by the Secretary of the Treasury, as the Chairperson of the Council, and (2) the satisfaction of lengthy process to afford a nonbank financial company the opportunity to challenge a proposed determination by the Council.

In order to make a determination of whether one of the two standards is met, the Council will analyze the 10 specific considerations mandated by the Dodd-Frank Act and any other risk-related factors that the Council deems appropriate. The Guidance says that the Council will emphasize three particular analyses resulting from its review of the considerations.

First is whether the creditors, counterparties, investors or other market participants of a nonbank financial company have significant enough direct or indirect exposure to the nonbank financial company to materially and adversely affect those or other creditors, counterparties, investors or other market participants and thereby pose a threat to US financial stability. In other words, is the financial equivalent of a pandemic flu a likely result of the material financial distress of a nonbank financial company?

Second is whether a nonbank financial company could pose a threat to US financial stability if it liquidated quickly assets that it holds by, for example, causing a decline in asset prices that significantly disrupts trading or funding in key markets or causes significant losses or funding problems for other firms with similar holdings.

Last is whether a nonbank financial company might become unable or unwilling to provide a critical function or service that is relied on by market participants and for which there are no ready substitutes and, as a result, poses a threat to US financial stability. A final determination by the Council is not really final, as it is required to reevaluate the determination annually. If a designated company adequately addresses the potential risks identified by the Council at the time of the final determination and in subsequent reevaluations, the Guidance provides that the Council should generally be expected to rescind its determination.

Attention to Nonbank Mortgage Originators and Servicers

In its 2019 Annual Report (the "Report") issued last December, the Council highlighted the need for continued coordination among federal and state regulators in order to collect data, identify risks and strengthen oversight of nonbank financial companies involved in the origination and servicing of residential mortgages. Underlying this concern is the observation that the share of residential mortgages originated and serviced by nonbanks has increased significantly over the past decade. Among the 25 largest residential mortgage originators and servicers, according to the Report, based on data from Inside Mortgage Finance, nonbanks currently originate approximately 51 percent of

residential mortgages and service approximately 47 percent, up from just 10 percent and 6 percent in 2009, respectively. Nonbanks are particularly heavily involved in the origination of mortgages that are securitized by Ginnie Mae, Fannie Mae and Freddie Mac, notes the Report, accounting for 85 percent of Ginnie Mae MBS, 60 percent of Fannie Mae MBS and 53 percent of Freddie Mac MBS in 2019. As with originations, nonbank servicers have a larger market share for Ginnie Mae than for Fannie Mae and Freddie Mac.

The Report highlights the liquidity issues faced by most nonbank mortgage originators and servicers, as they do not have a stable funding base, heavily relying instead on short-term funding for both originations and servicing advances. This short-term funding generally consists of warehouse and servicing advance lines provided by banks for liquidity. The Report raises the issue of whether the nonbanks' lines may be at risk of cancellation in times of significant stress. It also questions whether nonbanks would be able to perform during a downturn in the housing or mortgage markets and absorb adverse economic shocks because of their relatively limited resources and capital and high debt burden.

Of course, the issue is not whether any particular industry or industry players could fail but instead what impact such a failure might have on the broader US financial system. The Report sees the fragilities noted above as potentially causing the nonbank sector to be a source of weakness if there is a contraction in the largest nonbanks' ability to originate and service mortgages. This perceived weakness, according to the Report, may transmit risk to the broader financial system through several channels:

> Nonbanks are significant counterparties to the FHA, to Ginnie Mae, and to the Enterprises [i.e., Fannie Mae and Freddie Mac]. If delinquency rates rise or nonbanks otherwise experience solvency or liquidity strains, Ginnie Mae and the Enterprises could experience losses and operational challenges associated with transferring servicing to a financially sound servicer, especially the servicing of delinquent mortgages. The FHA and the Enterprises may also have difficulty enforcing contractual provisions that require nonbank originators to remedy defective loans. With their lines of credit to nonbanks, banks are also exposed to losses should a nonbank fail, though the exposures are somewhat limited in size and are generally well-secured by collateral.
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> Nonbanks could also transmit risk through contagion. During a period of significant market stress, strains in one nonbank could cause counterparties to question the viability of others. This could cause stress to spread among market participants. Broader contagion could lead to dislocation in the housing and mortgage markets during periods of stress.
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> Nonbanks are important providers of mortgage credit and mortgage servicing. It is unclear whether substitutes would be available if the largest nonbanks experienced stress or widespread failure during a market downturn. Nonbanks are disproportionately large players in key market segments, such as FHA lending, which is often used by low-income, minority, and first-time homebuyer segments. Should nonbanks not be able to extend credit, these market segments could potentially experience significant changes in the terms of available loans. Banks may also be reluctant to step in to assume servicing from a failing nonbank servicer, creating significant challenges if multiple nonbank servicers simultaneously experienced financial stress.

The Report does not call for any substantive measures to mitigate these risks, other than continued cooperation among federal and state regulators to share data, monitor the risk and strengthen oversight.

Conclusion

I'll leave it to others to evaluate how likely it is that either the residential mortgage banking industry or any independent mortgage banker or mREIT would present the risk profile inviting enough scrutiny by the Council to be subjected to supervision by the Federal Reserve and prudential standards. As detailed above, the federal government would face a high hurdle if it were to seek to subject an independent mortgage banker or mREIT to Federal Reserve supervision and prudential standards. As the Report demonstrates, however, originating and servicing residential mortgage loans by nonbank mortgage originators and servicers are on the Council's radar.

For more information about the topics raised in this Legal Update, please contact.

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Could the middle-market's seller-friendly nature change in the medium to long-term future? "I think if we start to enter a slower economic growth period," he said. "Private equity buyers need to be cautious with their investments—they need to generate returns in a limited timeframe and they don't have a long runway to make a successful exit. So if the economy's prospects start to diminish a bit, I can see pricing going down and buyers gaining a little more leverage."

The full *2019 Middle-Market M&A SurveyBook* can be viewed here: http://seyfarth-ebooks.com/2019-MA-SurveyBook/.

WHEN M&A MEETS SECURITIZATION: A DEEPER DIVE (PART TWO)

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The first part of this article appeared in the April 2019 issue of ***The M&A Lawyer****. Ms. Raymond appreciates the assistance of Julie Gillespie, Angela Ulum, Chadwick Hoyt and Jeffrey Taft, partners at Mayer Brown LLP, and Pablo Puente, an associate at Mayer Brown LLP.*

Issue 5: What Consents Are Required?

Consent Issues

As discussed in the previous part of this article, M&A transactions involving financial assets that are subject to securitization may 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 may be other requirements that the parties must satisfy before closing).

Consent Issues in an Asset Sale. If a buyer and a seller structure a securitization 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 that the buyer and the seller will need to work with during the M&A transaction process are the rating agencies. Under the operative servicing agreements, the identified rating agencies may 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 asset-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 may 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 protections, 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.

Consent-Based Price Adjustments. A purchase price variation seen in securitization-related M&A transactions arises from consent-based price adjustments. Where the primary assets of the business are securitization 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.

Consent Issues in a Merger or Stock Sale. If a buyer and a seller structure a securitization 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's proposed servicer must satisfy several regulatory and financial requirements. For example, in a mortgage transaction the buyer's servicer must generally be Fannie Mae, Freddie Mac and/or HUD approved and its deposits must be FDIC-insured. In addition, the buyer's servicer 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 consumer finance industry, a mortgage M&A transaction may require the approval of state and/or federal mortgage regulators. These regulators may want to confirm that the buyer will adequately manage the financial assets that it is proposing to acquire. These regulatory concerns may lead to detailed pre- and post-closing covenants for the buyer and the seller.

Amendments to Servicing Agreements. In addition to the often lengthy and complicated consent process, the proposed transfer of a securitization sponsor's 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

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(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).

Issue 6: Should the Seller Engage in 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. 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. For example, 2014 CFPB regulations 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 transferring loan information and identifying loss mitigation in process. In addition, in 2013 the OCC issued best practices for national banks and federal savings associations involved in consumer debt sales, including requiring that national banks have risk management policies in place and take a number of steps prior to selling any debts to a third party, which include establishing initial and ongoing due diligence of third-party debt buyers and minimum criteria for approving debt buyers. Consent decrees issued by the OCC, the CFPB and states regulators provide strong warnings to banks reselling distressed debt (*e.g.*, a bank cannot sell debts that have been paid, settled, discharged or do not have the required documentation and must not use robo-signed affidavits). Even if the seller is not directly regulated by the OCC or the CFPB, it should consider whether the seller or the buyer may be swept within OCC or CFPB supervision, or similar federal or state supervision, in the future and whether the seller should diligence the buyer as if their rules and guidance applied.

Finally, the bank seller may need to address OCC and FRB guidance regarding outsourcing and third-party vendors. 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 and other servicers. The OCC bulletins are 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 has viewed its UDAAP provisions as applicable to both first- and third-party debt collection. Given the focus by the New York Department of Financial Services and banking regulators on MSR and other financial asset sales to non-bank finance companies, reverse due diligence will continue to be a hot topic.

Issue 7: What SEC Disclosure Issues Arise?

Both the buyer and the seller must be aware of what SEC disclosure requirements will be triggered in connection with an M&A transaction involving a securitization sponsor or servicer. Potential SEC disclosures could be triggered by (i) events or circumstances that occurred prior to the M&A transaction and (ii) any ongoing or future deals after the M&A transaction closes. These potential SEC disclosure requirements are very fact-specific and will heavily depend on the structure of the M&A transaction. A non-exhaustive list of some common disclosure requirements for sponsors and servicers in public securitization transactions during and after M&A transactions is contained below.

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Regulation AB

Sponsor: Rule 1104(c) of Regulation AB ("Reg AB") provides that a description of the sponsor must be provided and that the description must include "to the extent material, a general discussion of the sponsor's experience in securitizing assets of any type. . .." In addition to the general description, a more detailed discussion of the sponsor's experience should be included when securitizing assets of the type included in the current transaction. An example of a material instance that should be disclosed includes "whether any prior securitizations organized by the sponsor have defaulted or experienced an early amortization triggering event." Even though no clear time period for this disclosure requirement is provided in Rule 1104(c)(1), the materiality qualifier makes it clear that, if it is determined the experience is material, it should be disclosed no matter how long ago it happened. The buyer should diligence the sponsor's securitization history and anticipate the need to make these disclosures.

Rule 1104(e) of Reg AB provides that the issuer must disclose the information required by Rule 15Ga-1(a) (17 CFR 240.15Ga-1(a)) concerning "all assets securitized by the sponsor that were the subject of a demand to repurchase or replace for breach of the representations and warranties concerning the pool assets for all asset-backed securities" for a period of three years. Therefore, the buyer must obtain information from the seller as to whether any assets it is buying were subject of a demand during this time frame.

Static Pool: Rule 1105(a)(1) of Reg AB requires that static pool information, to the extent material, should be provided for either (i) the previous five years or (ii) "[f]or so long as the sponsor has been either securitizing assets of the same asset type. . .if less than five years." Static pool information should include delinquencies, cumulative losses and prepayments for prior securitized pools of the sponsor (for the same asset type). Since this potentially ongoing disclosure could affect how investors view current and future transactions, the buyer should diligence this information for at least the relevant time period mentioned above.

Depositor: Rule 1106 of Reg AB contains the same disclosure requirements for the depositor as included in Rule 1104(c) for the sponsor.

Servicer: Rule 1108(b)(2) of Reg AB requires disclosure, to the extent material, of "a general discussion of the servicer's experience in servicing assets of any type as well as a more detailed discussion of the servicer's experience in, and procedure for the servicing function it will perform in the current transaction for assets of the type included in the current transaction." Similar to the sponsor's disclosure requirement, Reg AB only requires a "general" discussion of all other asset types and requires more detail when the current transaction includes the same assets. Rule 1108(b)(3) states that any material changes to the servicer's policies or procedures in the servicing function it will perform in the current transaction for assets of the same type should be disclosed for the previous three years. Since policies and procedures may change when a servicer is purchased by a buyer, it is important to have a clear understanding of the previous policies and procedures and know the differences that will be implemented as a result of the M&A transaction. Finally, Rule 1108(d) provides that the "material terms" of the servicer's removal, replacement, resignation or transfer be disclosed. A buyer may need to provide this information if a servicer is actively servicing one or more of the seller's outstanding deals and will no longer be doing so after the M&A transaction.

Legal Proceedings: Rule 1117 of Reg AB emphasizes a point that should already be taking place in an M&A transaction—a buyer should diligence legal proceedings pending against the sponsor, depositor or servicer, as applicable. This information should be disclosed if it is, or will be, deemed "material to security holders." Once again, there is no clear time period provided in Reg AB. Therefore, as long as the proceeding is pending or active against a relevant entity, it should be disclosed to investors, if material.

Compliance with Applicable Servicing Criteria: Rule 1122(c)(1) of Reg AB includes additional disclosures that should be included in Form 10-K. For example, material instances of noncompliance with the servicing criteria, otherwise known as "MINCs," should be disclosed on Form 10-K. Whether the identified instance involved assets of the same type or different type should be disclosed in the Form 10-K. This is another reason why the buyer should ensure it receives an acceptable data tape and thoroughly review the data tape for diligence reasons. There is no time period included in Rule 1122(c)(1).

Instruction 1 to Rule 1122 clarifies that the "assessment

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should cover all asset-backed securities transactions involving such party that are backed by the same asset type backing the class of asset-backed securities which are the subject of the SEC filing." For example, if the buyer is purchasing both the mortgage and auto businesses of the seller, MINCs arising in servicing the mortgages will not need to be disclosed in the public auto securitizations. This has created an incentive for parties to actively separate its platforms, especially when dealing with a sponsor that securitizes multiple asset types. A buyer may want to keep the newly purchased platforms and assets separate to limit the scope of the required assessment.

Form SF-3: Any registrant that meets the eligibility requirements of Form SF-3 may use Form SF-3 for the registration of asset-backed securities. To be able to use Form SF-3, the transaction and registrant requirements must be met. The transaction requirements specify that the registrant must timely file (i) a certification in accordance with Item 602(b)(36) of Regulation S-K signed by the CEO of the depositor and (ii) all transaction agreements containing Reg AB's asset review, dispute resolution and investor communication provisions. The registration requirements specify that, during the 12 calendar months (and any portion of a month) prior to filing, the depositor and all affiliated depositors of the same asset class must have timely filed (i) all 1934 Act Reports and (ii) all documents listed under the transaction requirements above. The buyer should carefully diligence the seller's compliance with these requirements.

There is an annual compliance check 90 days after the end of the depositor's fiscal year. Failure to timely file the 1934 Act reports will result in (i) the inability to file a new shelf registration statement and (ii) the inability to issue additional securities from the applicable shelf registration statement for a period of one year (starting on the date of the compliance check). However, note that the depositor would be able to complete takedowns from the date of the failure up to the date of the compliance check. This penalty is commonly referred to as the "death penalty" since there is no cure once the filing deadline is missed. Failure to timely file the documents related to the transaction requirements will result in the inability to file a new shelf registration statement. A filing failure in connection with the transaction requirements will be deemed cured 90 days after all required filings are filed. Note that, if the filing failure was corrected at least 90 days prior to the date of the compliance check, there would be no lapse in ability to issue.

However, Form SF-3 includes a carve-out for business combination transactions that states:

> "Regarding an affiliated depositor that became an affiliate as a result of a business combination transaction during such period, the filing of any material prior to the business combination transaction relating to asset-backed securities of an issuing entity previously established, directly or indirectly, by such affiliated depositor is excluded from this section, provided such business combination transaction was not part of a plan or scheme to evade the requirements of the Securities Act or the Exchange Act."

Therefore, assuming the business combination transaction was not completed with the intention of evading SEC requirements, a buyer may be able to avoid liability and/or penalties in connection with missed filing deadlines by the seller. However, the buyer typically seeks a representation from the securitization seller that it has timely filed all of its securities filings in any event.

Form 8-K: Section 6 of Form 8-K provides that, even though many of the disclosure requirements in Form 8-K exclude asset-backed issuers, a change in servicer will still need to be disclosed. If a servicer, as contemplated by Rule 1108 of Reg AB, has "resigned or has been removed, replaced or substituted, or if a new servicer has been appointed," the date of the event and the circumstances surrounding the change must be disclosed in Form 8-K. Therefore, if a seller sells a servicer with outstanding deals, it will have to report the date and circumstances. Similarly, if a buyer is replacing a servicer with a newly purchased servicer for its outstanding deals, it will also have to report the date and circumstances.

Issue 8: Who Will Service the Assets After Closing?

Transfer of Servicing. In addition to the customary covenants present in most M&A deals, in financial asset 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 the 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.

Deficiencies in Loan Files. Depending on the relative bargaining power of the buyer in a financial asset 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.

Interim Subservicing or Servicing Agreements. 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 may be able to 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. Similarly, if the seller retains some of the financial assets after its platform and financial assets are sold, it may require a short-term or long-term servicing agreement from the buyer's servicer.

Issue 9: How Will the Technology Be Transitioned?

A key factor in the current financial services M&A environment is the ongoing convergence of technology and financial services, with regulated industries in particular facing digital transformation. Financial institutions are making huge investments in technology and cybersecurity, as well as developing more sophisticated technology driven products for millennials and Generation Z who interact predominantly online. The rise of non-bank players in financial services has been in part enabled by their lack of cumbersome legacy systems and branch operations often found at large commercial banks. A 2017 McKinsey & Co. report predicted a split between the "manufacturers" of banking (the core business of financing and lending that is hard for technology firms to replace) versus the "distributors" of financial services, which includes the origination and sales side of the business where outside competitors have an easier time entering the financial services system. Distribution platforms according to McKinsey produce 65% of the profits with a much higher return on equity. On the other hand, incumbent financial institutions benefit from vast resources to invest in technology, a massive ability to manufacture financial products and the trust of the customer base, including technology savvy millennials. Successful new digital offerings by large banks include Marcus by Goldman Sachs, Finn by Chase and Ally Bank's solely online bank offering. Even the mortgage industry, which has been slow to adopt technology solutions in part because of state regulations requiring the use of notarized physical notes to transfer real property, is moving towards digital solutions with online mortgage platforms seeing increasing usage. Not surprisingly given this background, M&A deals involving a securitization platform are increasingly impacted by technology.

Key issues in a technology-driven acquisition include the following:

1. **Open Source Software**. Open source software is computer software developed though collaborative efforts in which source code is released under a license in which the copyright holder grants users the rights to use, change and distribute the software to anyone and for any purpose. The presence of open source and third-party software in so-called proprietary technology can seriously undermine the value of the business being purchased and the buyer's business post-closing. Open source software can also present serious security vulnerabilities because the software is dynamic and not within the control of the business or the developer. Other issues with open source software include: (i) the risk of being required to share a business' proprietary technology with third parties or without charging a fee, (ii) the absence of warranty

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and protection against infringement risks, and (iii) the potential for conflicts among the various license terms that govern open source code. Third-party consultants such as Black Duck can scan software for open source usage and categorize risks and propose remediation steps and alternatives. The buyer should also include representations and covenants in the purchase agreement designed to address any open source risks identified.

2. **Cybersecurity and Data Privacy**. Vulnerability to cybersecurity breaches and compliance with increasingly complex data privacy rules are another key issue in buying a technology business. Extensive due diligence should be undertaken relating to a host of related issues, such as reviewing written information security policies, compliance with privacy and data protection laws, and reviewing whether the seller can lawfully disclose or transfer personal data to the buyer at closing. The buyer will typically insist on thorough representations in the purchase agreement to the effect that the seller has complied with its written information security policies, has no known or suspected data breaches or other cyber incidents, and has obtained any consents needed to transfer personal data.

3. **Technology Agreements**. Technology agreements increasingly accompany the main purchase agreement in financial services M&A. These "ancillary" agreements may be as simple as a short-term transition services agreement where the seller provides interim technology services to the buyer pending conversion to the buyer's system. In transition services agreements, the seller typically provides the services as an accommodation to the buyer and at the same level of service that it provided to itself before the sale because the seller is not in the business of providing outsourced services and cannot provide the level of service expected of an outsourced service provider. In other transactions, such as the carve-out of a financial services business from a bank, the bank seller may seek a long term arrangement to receive services back from the buyer. These situations more closely resemble outsourcing agreements than transition services agreements and will result in much more complex and time-consuming negotiations. The bank seller will need to comply with bank regulatory guidance on third-party vendor agreements, which may be viewed as unduly cumbersome to the buyer.

Issue 10: How Will the Purchase Agreement Differ from a "Regular" M&A Deal?

Representations and Warranties

Buyers in M&A transactions for securitization businesses will typically customize traditional M&A representations as appropriate so that they specifically address the issues that are unique to M&A involving securitization sponsors and servicers. Buyers will typically 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. However, these M&A-style representations will typically not be nearly as detailed as those found in a securitization or whole loan purchase of the same financial assets, which may cause difficulties in negotiations.

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 securitization transactions 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.

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 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. Any contractual provisions regarding the incompleteness or inaccuracy of the loan files may serve as a "red flag" to the seller's or the 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 securitization buyer is acquiring the entire business or just a portfolio.

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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 securitization-related 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 platform and assets it is proposing to acquire remain materially unchanged between signing and closing.

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 financial asset transactions and the increase in litigation affecting financial asset 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.

Post-Closing Covenants. Covenants that carry over post-closing were relatively minimal in financial asset 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
- A detailed conversion plan to ensure that the servicing transition occurs in an orderly fashion.

Indemnities

The indemnification provisions in an acquisition agreement involving financial assets are not particularly different from non-finance company deals. However, these M&A-style indemnities are quite different from those found in a securitization or whole loan sale, where the buyer's remedy is typically to have the seller repurchase the financial asset with respect to which a representation has been breached, Some transactions may contain a hybrid set of remedies that combine aspects of both an M&A indemnity regime and a securitization-style warranty repurchase.

Buyer Indemnities. Given the extensive liability that can be associated with financial assets in today's market, buyers in a securitization-related 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 claims based on the buyer's collections activities.

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FROM THE EDITOR

Post-Order Divestitures: An Uphill Chance of Success

Recently-released guidance by the Federal Trade Commission indicates that the agency's appetite for post-order divestitures, which hasn't been strong, is diminishing even further.

In "The Uphill Case for a Post-Order Divestiture," a post on the FTC's website, Ian Conner, Deputy Director of the Bureau of Competition, wrote that "for many years—ever since our 1999 Divestiture Study identified a number of factors that caused remedies to fail—the Bureau of Competition has strongly favored divesting assets to an upfront buyer. Plainly put, while no approach is foolproof, divesting assets to an upfront buyer has been the most consistently effective means for achieving successful merger remedies. That's because upfront buyers minimize the risks that acquired assets will lose value (due to the loss of employees, customers, and business opportunities) or that competition will be diminished while ownership of the assets remains uncertain."

What the bureau *doesn't* favor is a post-order divestiture that allows merging parties to close their primary transaction before finding a buyer(s) for the divestiture. The numbers are harsh: in roughly the past two years, the FTC has approved only three post-order divestitures, less than 14% of all settlements.

Conner wrote that in "limited circumstances," the FTC will agree to a post-order divestiture, but added that parties will face an uphill battle to get this approval. "If you plan to advocate for a post-order divestiture, be prepared to address the factors that will be examined and weighed." These include: whether the to-be-divested assets are an ongoing, standalone business unit; if there's a low risk of lost business opportunities and deterioration to the assets during the post-order/pre-divestiture period; that the divested business doesn't rely on significant support from the merging companies to be viable and; that "there are multiple approvable buyers that can persuade the Bureau that they will likely bid for the assets. The Bureau may request to meet with the potential buyers prior to recommending a post-order divestiture."

The FTC also listed factors that would greatly lessen the chances of a settlement with a post-order divestiture being approved. These include if one of the merging parties had failed to find an approved buyer in a similar case in the past, or if one party had previously missed a deadline for divesting assets in a post-order divestiture "without good cause." Another red flag is if previous post-order divestitures had failed within the same industry as the merging companies.

If a post-order divestiture is still the preferable option for two merging companies, "parties should prepare to show that the divested business and industry competition will not deteriorate and parties should plan for the divestiture process when constructing the deal timeline," as Jones Day attorneys wrote in an analysis of the FTC's statement. But it's more likely that two parties planning a merger which will require divestitures should just assume they need to find an upfront buyer before the transaction closes.

Chris O'Leary

Managing Editor

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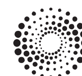

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WHEN M&A MEETS SECURITIZATION: A DEEPER DIVE (PART ONE)

by Elizabeth A. Raymond

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Mergers and acquisition transactions for securitization sponsors and servicers present unique issues that require in-depth knowledge of the underlying securitization structures and risks, as well as related financing, regulatory and technology issues. M&A lawyers and business teams should maintain a holistic view of how M&A affects past and future securitizations by both the seller and the buyer, what financing plans are likely for the buyer, what consents are needed and how the securitization transactions and securitization systems will be integrated post-closing. Some of the more prominent issues are discussed below.

Issue 1: Is It a Securitization? Is It a Whole Loan Deal? No, It's an M&A Deal!

Where the buyer's primary goal is to purchase a large portfolio of loans, leases, or other receivables, a threshold issue for the acquisition of a securitization sponsor or servicer is whether the transaction will be executed as a portfolio sale or a platform sale or both. The securitization sponsor's "platform" includes the assets needed to operate the finance business, including employees, facilities and real estate, information technology and contracts. If the sponsor's platform assets 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 a 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 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, such as a merger or a stock 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. The decision to structure the sale using an M&A or a loan portfolio sale format may depend as much on the experience 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.

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

- *Ability to divest 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

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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. However, 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 securitization or 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, warranties 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. It may be difficult to verify the accuracy of each and every line item in the data tape, 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 the loan data is accurate if it intends to launch a capital markets deal immediately after or simultaneous with the closing. As discussed below, an accurate data tape will be essential to the buyer's financing plans, as well

as its compliance with the securities laws in capital markets transactions going forward.

Whole Business v. Assets Under Management Valuations

The negotiation and drafting of the purchase price for the acquisition of a securitization sponsor or servicer can be quite complex and require a deep understanding of the securitization business being purchased. Once the valuation and purchase price mechanics are set, the rest of the transaction terms should support the valuation and pricing methodology.

The pricing for the acquisition of a securitization business 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.

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 of the liabilities of the business without cherry picking assets and liabilities.

When to Choose an AUM Valuation. If the buyer of a securitization 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. An 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. Acquisitions of securitization sponsors and servicers 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 financial assets that may be more effectively handled by the owner of those financial assets after closing. In a distressed situation, a financial buyer may insist on buying the portfolio at a portfolio valuation price only and essentially purchase the platform for "free" or even value the platform as a subtraction to the purchase price.

Effect of Valuation Method. 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, these 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 the securitization 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.

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Whole Business Valuations and Working Capital or Net Assets 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. 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 buyer's 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 for the closing on that amount. The parties would 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. Within some period (e.g., 60 to 90 days) after closing, a final closing date balance sheet would be prepared and a true up payment made by either the seller or the buyer based on the difference between the estimated and final working capital or net assets.

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 end-of-week 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 the buyer. The seller's compliance with its financing or securitization agreements can also affect the portfolio valuation.

Issue 2: How Will the Purchase Be Financed?

A key consideration for the buyer of a securitization sponsor or servicer is whether and how the business and financial assets will be financed. A related question is whether the current financing on the financial assets placed by the seller is attractive to the buyer or whether the buyer would like to pay it down. A strategic buyer, such as a large bank or finance company, may not need financing or may find the seller's financing less attractive than what it could raise itself. A financial buyer typically will seek financing in part to increase its rate of return on the investment by adding leverage. The buyer will need to do careful diligence of the seller's existing securitizations and other financings as well as any impediments to financing the financial assets. Financing conditions are very unusual in the current M&A environment, but the buyer can reduce many of the risks of financing by obtaining representations and covenants designed to cover their risks. A financial buyer will often negotiate a "reverse termination fee" whereby it pays the seller a termination fee (currently approximately 3% to 5% of the purchase price) as the sole remedy for the seller if the transaction does not close because the buyer fails to obtain financing.

Due Diligence of Financing Arrangements

Buyers and sellers will 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 the Buyer's Existing 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. Private secured credit facilities are typically prepayable at any time, but many public or Rule 144A securitizations ("term securitizations") cannot be

prepaid. As a result, the buyer will need to consider the cost and operational hassle of leaving the seller's term securitizations outstanding while they wind down to the deal's clean-up call, which is typically available when the securitization has amortized down to 5% to 15% of the assets securitized. It may be possible for the buyer to do a tender offer to retire the seller's outstanding asset-backed securities, but the process can be time-consuming and may not fully retire the deal unless a premium is paid.

Review When Retaining the 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 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 lenders.

- ***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 securitization agreements must be reviewed to see if there is any prohibition on subservicing or outsourcing arrangements.

Review When the Buyer Seeks New Securitization Financing. In some cases, a strategic financial buyer will seek to place its own securitization facilities in order to finance the purchase of the financial assets. Like any other leveraged acquisition, the buyer may enter into a short-term bridge facility in the form of a loan warehouse facility pending access to a syndicated secured loan facility or a structured finance capital markets transaction.

Complexity increases if the buyer seeks to finance the financial assets simultaneously with the closing of the acquisition. For example, the buyer may seek to purchase the financial assets as of a "cut-off date" a month or more before closing so that the buyer has an existing pool to use as collateral for its financing. The seller will dislike giving up a month or more of collections without an increase to the purchase price. Integrity of data and access to detailed servicing information will be key issues because the financial assets cannot be financed without accurate data. The buyer's counsel and underwriters will seek to diligence the financial assets in the same way as they would if they were doing a standalone securitization without an M&A deal.

For mortgage loan assets, the buyer may seek to finance the servicer advances or mortgage servicing rights it intends to buy. Each of these securitization facilities have issues specific to the assets being financed and are subject to market conditions at the time. Servicing advances are readily financeable, including simultaneously with closing, in a bilateral or club loan facility at relatively attractive advance rates. Key diligence activities include a review of all servicing agreements for explicitly permissive financing provisions and confirmation that servicer advances are reimbursed at the top of the waterfall. Lenders will give more or less

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credit for advances depending on their type (e.g., principal and interest, escrows and taxes) and the state where the mortgaged property exists. Buyers will need to negotiate acknowledgement agreements with Fannie Mae and reimbursement agreements with Freddie Mac. On the other hand, mortgage servicing rights ("MSRs") financing facilities are less attractive based on the volatility of MSRs and the cliff risk that the MSR asset will disappear if the servicer is terminated. As a result, buyers of MSRs are more likely to seek a general senior secured loan facility at closing with a blanket lien on all assets purchased, including the MSRs.

Issue 3: How Will Licenses Affect Structure and Timing?

Impact of Licensing Issues on Structure

State licensing issues may have a significant impact on structure and speed of execution of an M&A transaction involving a securitization sponsor or servicer. 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 financial 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 in acquisitions involving a securitization sponsor or servicer 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 several 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 after the credit crisis needed 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 a national bank 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, 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.

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 or may enter into an interim or long-term servicing agreement

with the seller or a third-party. Particularly in the mortgage industry, it may be less practical for the buyer to request that the seller provide an interim servicing arrangement pending the buyer's receipt of licenses because, in many states, the buyer will need state licenses merely to hold loans or servicing rights and receipt of these licenses should be a condition to closing. 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 with third-party servicers 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 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 and its implementing regulation, Regulation X, 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.

Licensing and the Marketplace Funding Model

In *Madden v. Midland Funding LLC*,[1] a federal appeals court ruled that federal law did not preempt a state's interest rate limitations when applied to the non-bank debt buyer of a loan seeking to collect interest at the rate originally contracted for by a national bank. Uncertainties surrounding *Madden* and the overall business model of the online marketplace lending sector have negatively impacted investor demand and increased regulatory scrutiny beginning in 2016, resulting in a challenging environment for these lenders. If a court were to find that the *Madden* holding applied to marketplace loan platforms, any such loans carrying annual percentage rates that exceed the amount permitted by usury laws in the relevant states could be found to be unenforceable and void or subject to reduction of the interest rate and/or repayment of interest or subject to other penalties or damages, or parties to any securitization of marketplace loans could be subject to claims for damages or enforcement actions. It is also possible that similar litigation or regulatory actions may have success in challenging the origination bank's status as a loan's true lender, and in such instances, the marketplace lenders and parties to any securitization could be recharacterized by a court or a regulatory agency to be a loan's lender and therefore obligated to comply with state lender licensing and other consumer protection requirements.

As a reaction to *Madden*, investors may avoid buying loans in the Second Circuit or loans with interest rates that exceed usury rates in any Second Circuit state. Most online lenders have restructured their relationships with their origination bank to insert a more obvious ongoing interest by the origination bank in the loans. Examples include the origination bank retaining a 1% stake in loans originated by it or a random allocation of loans originated by it. The originating bank may also receive an oversight fee for loans originated by it as compensation for its ongoing oversight of the loan platform. Techniques such as these are seen as better aligning the incentives of investors and the marketplace lender than a pure "originate to sell" model. Federal legislation was introduced in late 2017 that would clarify that any loan originated by a national or FDIC-insured bank would be entitled to the benefits of federal preemption on claims of usury provided that certain criteria are met. While this legislation was approved by the House of Representatives in 2018, the Senate has not taken action.

Issue 4: What Due Diligence Should Be Performed on the Contracts Relating to the Financial Assets?

Due Diligence and Reverse Due Diligence

The buyer's due diligence in an acquisition of a securitization sponsor or servicer requires extensive familiarity with the underlying securitization transactions, including the structures, risks and regulatory issues that relate to these transactions. 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 Consumer Financial Protection Bureau.

Due Diligence of Loans, Loan Files and Servicing Agreements

Review of Loans, Leases and Other Receivables. The

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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, and 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, Truth in Lending Act 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) 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*. The 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*. 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 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 securitization-related M&A transaction and must be carefully vetted for consents and issues relating to assignability. The 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 obliga-

tions 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.

An active area in M&A involving securitization sponsors and servicers 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.

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, the 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 securitization-related 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. Securitization 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.

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 its technology systems. Large financial institutions may not be able to easily separate the systems for the securitization business from the systems for the businesses it is retaining and thus may not include information technology assets in

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the sale or may need to provide detailed IT transition services to the buyer.

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, 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, many transactions after the credit crisis were structured as asset sales to avoid the many liability issues surrounding mortgage origination and servicing. Significant litigation 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.

This article will conclude in the May 2019 issue of ***The M&A Lawyer***.

ENDNOTES:

[1]*Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), cert. denied, 136 S. Ct. 2505 (June 27, 2016).

FROM THE EDITOR

The Unknowns Get Cloudier

As this issue went to press in early April, the fate of the United Kingdom's "Brexit" from the European Union remained unknown. After multiple Parliamentary defeats in March of PM Theresa May's negotiated Brexit plan with the EU, it seemed most likely (as of our deadline) that the UK would ask for yet another extension from the EU, or that it would crash out of the EU in a "no-deal" Brexit. While in 2016, "no deal" was considered an unlikely worst-case scenario for Brexit, it's now essentially one of a handful of remaining options.

For our cover article, ***The M&A Lawyer*** talked to Jones Day lawyers based in London and Brussels who have been advising clients on how best to manage the various Brexit scenarios. This conversation ranged over a number of topics, one of which was what impact the seemingly endless Brexit negotiations have had on new issuance in the UK and Europe. In short, not good.

Thomson Reuters' data for the first quarter summed it up. Global M&A fell 17% in first-quarter 2019, driven in part by fears of a no-deal Brexit and its potential results—a UK/EU economic slump and the cratering of the value of the UK pound sterling, among others. To no surprise, many companies considering cross-border deals are waiting for some resolution. UK new issue activity fell by 62% while cross-border M&A sunk by 45% in first-quarter 2019. European M&A fell even further, sinking 67% compared to first-quarter 2018 (and in turn, German M&A fared even worse, dropping 76% compared to the year-ago period). What deals got done tended to be on the smaller side, with average deal size falling below $5 billion.

The saving grace for global M&A is the United States, which kicked off the year with its strongest start in nearly two decades: roughly $490 billion in announced deals, up 9.4% compared to the year-ago period. As the number of deals fell by 40% year-over-year, however, it showed this growth was fueled by such "megadeals" as Bristol-Myers Squibb's $74 billion acquisition of Celgene. The U.S. also saw some of the few big-ticket prospective cross-border deals, like Germany's Merck's hostile $5.9 billion offer for Versum Materials, which challenged Versum's agreed-upon merger with Entegris. And Berry Global wooed Britain's RPC Group away from Apollo Global Management by making a higher offer of roughly $4.4 billion.

The healthcare industry, in part thanks to the Bristol-Myers deal, was the dominant sector of the quarter, though deal activity is being driven by other factors. As Sullivan & Cromwell's Krishna Veeraraghavan told Reuters, "between competition for new drugs, improving technology, [and] the aging of the global population, a number of factors will continue to drive M&A in the healthcare sector, whether it's biotech or insurance providers." Another factor driving healthcare M&A is that companies are getting ahead of the 2020 presidential election, in which healthcare companies expect to get bashed on the campaign trail (likely by both Democrats and President Trump) and will be more wary of undertaking mergers or acquisitions then.

Chris O'Leary

Managing Editor

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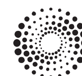
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When M&A Meets Securitization: A Deeper Dive

Article March 2019

Top 10 Issues in M&A for Securitization Sponsors and Servicers

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Mergers and acquisition transactions for securitization sponsors and servicers present unique issues that require in depth knowledge of the underlying securitization structures and risks, as well as related financing, regulatory and technology issues. M&A lawyers and business teams should maintain a holistic view of how M&A affects past and future securitizations by both the seller and the buyer, what financing plans are likely for the buyer, what consents are needed and how the securitization transactions and securitization systems will be integrated post-closing. Some of the more prominent issues are discussed below.

Issue 1. Is It a Securitization? Is It a Whole Loan Deal? No, It's an M&A Deal!

Where the buyer's primary goal is to purchase a large portfolio of loans, leases or other receivables, a threshold issue for the acquisition of a securitization sponsor or servicer is whether the transaction will be executed as a portfolio sale or a platform sale or both. The securitization sponsor's "platform" includes the assets needed to operate the finance business, including employees, facilities and real estate, information technology and contracts. If the sponsor's platform assets 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 a 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 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, such as a merger or a stock 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. The decision to structure the sale using an M&A or a loan portfolio sale format may depend as much on the experience 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.

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

- *Ability to divest 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. However, 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 securitization or 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, warranties 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. It may be difficult to verify the accuracy of each and every line item in the data tape, 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 the loan data is accurate if it intends to launch a capital markets deal immediately after or simultaneous with the closing. As discussed below, an accurate data tape will be essential to the buyer's financing plans, as well as its compliance with the securities laws in capital markets transactions going forward.

Whole Business v. Assets Under Management Valuations. The negotiation and drafting of the purchase price for the acquisition of a securitization sponsor or servicer can be quite complex and require a deep understanding of the securitization business being purchased. Once the valuation and purchase price mechanics are set, the rest of the transaction terms should support the valuation and pricing methodology.

The pricing for the acquisition of a securitization business 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.

- *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 of the liabilities of the business without cherry picking assets and liabilities.
- *When to Choose an AUM Valuation.* If the buyer of a securitization 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. An 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.* Acquisitions of securitization sponsors and servicers 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 financial assets that may be more effectively handled by the owner of those financial assets after closing. In a distressed situation, a financial buyer may insist on buying the portfolio at a portfolio valuation price only and essentially purchase the platform for "free" or even value the platform as a subtraction to the purchase price.
- *Effect of Valuation Method.* 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, these 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 the securitization 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.

Whole Business Valuations and Working Capital or Net Assets 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. 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 buyer's 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 for the closing on that amount. The parties would 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. Within some period (e.g., 60 to 90 days) after closing, a final closing date balance sheet would be prepared and a true up payment made by either the seller or the buyer based on the difference between the estimated and final working capital or net assets.

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 weekend 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 the buyer. The seller's compliance with its financing or securitization agreements can also affect the portfolio valuation.

Issue 2: How Will the Purchase Be Financed?

A key consideration for the buyer of a securitization sponsor or servicer is whether and how the business and financial assets will be financed. A related question is whether the current financing on the financial assets placed by the seller is attractive to the buyer or whether the buyer would like to pay it down. A strategic buyer, such as a large bank or finance company, may not need financing or may find the seller's financing less attractive than what it could raise itself. A financial buyer typically will seek financing in part to increase its rate of return on the investment by adding leverage. The buyer will need to do careful diligence of the seller's existing securitizations and other financings as well as any impediments to financing the financial assets. Financing conditions are very unusual in the current M&A environment, but the buyer can reduce many of the risks of financing by obtaining representations and covenants designed to cover their risks. A financial buyer will often negotiate a "reverse termination fee" whereby it pays the seller a termination fee (currently approximately 3% to 5% of the purchase price) as the sole remedy for the seller if the transaction does not close because the buyer fails to obtain financing.

DUE DILIGENCE OF FINANCING ARRANGEMENTS

Buyers and sellers will 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 the Buyer's Existing 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. Private secured credit facilities are typically prepayable at any time, but many public or Rule 144A securitizations ("term securitizations") cannot be prepaid. As a result, the buyer will need to consider the cost and operational hassle of leaving the seller's term securitizations outstanding while they wind down to the deal's clean-up call, which is typically available when the securitization has amortized down to 5% to 15% of the assets securitized. It may be possible for the buyer to do a tender offer to retire the seller's outstanding asset-backed securities, but the process can be time-consuming and may not fully retire the deal unless a premium is paid.

Review When Retaining the 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 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 lenders.
- *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 securitization agreements must be reviewed to see if there is any prohibition on subservicing or outsourcing arrangements.

Review When the Buyer Seeks New Securitization Financing. In some cases, a strategic financial buyer will seek to place its own securitization facilities in order to finance the purchase of the financial assets. Like any other leveraged acquisition, the buyer may enter into a short-term bridge facility in the form of a loan warehouse facility pending access to a syndicated secured loan facility or a structured finance capital markets transaction.

Complexity increases if the buyer seeks to finance the financial assets simultaneously with the closing of the acquisition. For example, the buyer may seek to purchase the financial assets as of a "cut-off date" a month or more before closing so that the buyer has an existing pool to use as collateral for its financing. The seller will dislike giving up a month or more of collections without an increase to the purchase price. Integrity of data and access to detailed servicing information will be key issues because the financial assets cannot be financed without accurate data. The buyer's counsel and underwriters will seek to diligence the financial assets in the same way as they would if they were doing a standalone securitization without an M&A deal.

For mortgage loan assets, the buyer may seek to finance the servicer advances or mortgage servicing rights it intends to buy. Each of these securitization facilities have issues specific to the assets being financed and are subject to market conditions at the time. Servicing advances are readily financeable, including simultaneously with closing, in a bilateral or club loan facility at relatively attractive advance rates. Key diligence activities include a review of all servicing agreements for explicitly permissive financing provisions and confirmation that servicer advances are reimbursed at the top of the waterfall. Lenders will give more or less credit for advances depending on their type (e.g., principal and interest, escrows and taxes) and the state where the mortgaged property exists. Buyers will need to negotiate acknowledgement agreements with Fannie Mae and reimbursement agreements with Freddie Mac. On the other hand, mortgage servicing rights ("MSRs") financing facilities are less attractive based on the volatility of MSRs and the cliff risk that the MSR asset will disappear if the servicer is terminated. As a result, buyers of MSRs are more likely to seek a general senior secured loan facility at closing with a blanket lien on all assets purchased, including the MSRs.

Issue 3. How Will Licenses Affect Structure and Timing?

IMPACT OF LICENSING ISSUES ON STRUCTURE

State licensing issues may have a significant impact on structure and speed of execution of an M&A transaction involving a securitization sponsor or servicer. 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 financial 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 in acquisitions involving a securitization sponsor or servicer 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 several 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 after the credit crisis needed 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 a national bank 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.

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 or may enter into an interim or long-term servicing agreement with the seller or a third-party. Particularly in the mortgage industry, it may be less practical for the buyer to request that the seller provide an interim servicing arrangement pending the buyer's receipt of licenses because, in many states, the buyer will need state licenses merely to hold loans or servicing rights and receipt of these licenses should be a condition to closing. 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 with third-party servicers 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 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 and its implementing regulation, Regulation X, 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.

LICENSING AND THE MARKETPLACE FUNDING MODEL

In *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (June 27, 2016), a federal appeals court ruled that federal law did not preempt a state's interest rate limitations when applied to the non-bank debt buyer of a loan seeking to collect interest at the rate originally

contracted for by a national bank. Uncertainties surrounding Madden and the overall business model of the online marketplace lending sector have negatively impacted investor demand and increased regulatory scrutiny beginning in 2016, resulting in a challenging environment for these lenders. If a court were to find that the *Madden* holding applied to marketplace loan platforms, any such loans carrying annual percentage rates that exceed the amount permitted by usury laws in the relevant states could be found to be unenforceable and void or subject to reduction of the interest rate and/or repayment of interest or subject to other penalties or damages, or parties to any securitization of marketplace loans could be subject to claims for damages or enforcement actions. It is also possible that similar litigation or regulatory actions may have success in challenging the origination bank's status as a loan's true lender, and in such instances, the marketplace lenders and parties to any securitization could be recharacterized by a court or a regulatory agency to be a loan's lender and therefore obligated to comply with state lender licensing and other consumer protection requirements.

As a reaction to *Madden*, investors may avoid buying loans in the Second Circuit or loans with interest rates that exceed usury rates in any Second Circuit state. Most online lenders have restructured their relationships with their origination bank to insert a more obvious ongoing interest by the origination bank in the loans. Examples include the origination bank retaining a 1% stake in loans originated by it or a random allocation of loans originated by it. The originating bank may also receive an oversight fee for loans originated by it as compensation for its ongoing oversight of the loan platform. Techniques such as these are seen as better aligning the incentives of investors and the marketplace lender than a pure "originate to sell" model. Federal legislation was introduced in late 2017 that would clarify that any loan originated by a national or FDIC-insured bank would be entitled to the benefits of federal preemption on claims of usury provided that certain criteria are met. While this legislation was approved by the House of Representatives in 2018, the Senate has not taken action.

Issue 4. What Due Diligence Should Be Performed on the Contracts Relating to the Financial Assets?

DUE DILIGENCE AND REVERSE DUE DILIGENCE

The buyer's due diligence in an acquisition of a securitization sponsor or servicer requires extensive familiarity with the underlying securitization transactions, including the structures, risks and regulatory issues that relate to these transactions. 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 Consumer Financial Protection Bureau (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, and 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, Truth in Lending Act 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) 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.* The 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.* 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 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 securitization-related M&A transaction and must be carefully vetted for consents and issues relating to assignability. The 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.

An active area in M&A involving securitization sponsors and servicers 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.

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, the 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 securitization-related 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. Securitization 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.

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 its technology systems. Large financial institutions may not be able to easily separate the systems for the securitization business from the systems for the businesses it is retaining and thus may not include information technology assets in the sale or may need to provide detailed IT transition services to the buyer.

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, 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, many transactions after the credit crisis were structured as asset sales to avoid the many liability issues surrounding mortgage origination and servicing. Significant litigation 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.

Issue 5. What Consents Are Required?

CONSENT ISSUES

As discussed above, M&A transactions involving financial assets that are subject to securitization may 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 may be other requirements that the parties must satisfy before closing).

Consent Issues in an Asset Sale. If a buyer and a seller structure a securitization 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 that the buyer and the seller will need to work with during the M&A transaction process are the rating agencies. Under the operative servicing agreements, the identified rating agencies may 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 asset-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 may 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 protections, 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.

Consent-Based Price Adjustments. A purchase price variation seen in securitization-related M&A transactions arises from consent-based price adjustments. Where the primary assets of the business are securitization 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.

Consent Issues in a Merger or Stock Sale. If a buyer and a seller structure a securitization 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's proposed servicer must satisfy several regulatory and financial requirements. For example, in a mortgage transaction the buyer's servicer must generally be Fannie Mae, Freddie Mac and/or HUD approved and its deposits must be FDIC-insured. In addition, the buyer's servicer 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 consumer finance industry, a mortgage M&A transaction may require the approval of state and/or federal mortgage regulators. These regulators may want to confirm that the buyer will adequately manage the financial assets that it is proposing to acquire. These regulatory concerns may lead to detailed pre- and post-closing covenants for the buyer and the seller.

Amendments to Servicing Agreements. In addition to the often lengthy and complicated consent process, the proposed transfer of a securitization sponsor's 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).

Issue 6. Should the Seller Engage in Reverse Due Diligence?

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. 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. For example, 2014 CFPB regulations 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 transferring loan information and identifying loss mitigation in process. In addition, in 2013 the OCC issued best practices for national banks and federal savings associations involved in consumer debt sales, including requiring that national banks have risk management policies in place and take a number of steps prior to selling any debts to a third party, which include establishing initial and ongoing due diligence of third-party debt buyers and minimum criteria for approving debt buyers. Consent decrees issued by the OCC, the CFPB and states regulators provide strong warnings to banks reselling distressed debt (e.g., a bank cannot sell debts that have been paid, settled, discharged or do not have the required documentation and must not use robo-signed affidavits). Even if the seller is not directly regulated by the OCC or the CFPB, it should consider whether the seller or the buyer may be swept within OCC or CFPB supervision, or similar federal or state supervision, in the future and whether the seller should diligence the buyer as if their rules and guidance applied.

Finally, the bank seller may need to address OCC and FRB guidance regarding outsourcing and third-party vendors. 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 and other servicers. The OCC bulletins are 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 has viewed its UDAAP provisions as applicable to both first- and third-party debt collection. Given the focus by the New York Department of Financial Services and banking regulators on MSR and other financial asset sales to non-bank finance companies, reverse due diligence will continue to be a hot topic.

Issue 7. What SEC Disclosure Issues Arise?

Both the buyer and the seller must be aware of what SEC disclosure requirements will be triggered in connection with an M&A transaction involving a securitization sponsor or servicer. Potential SEC disclosures could be triggered by (i) events or circumstances that occurred prior to the M&A transaction and (ii) any ongoing or future deals after the M&A transaction closes. These potential SEC disclosure requirements are very fact-specific and will heavily depend on the structure of the M&A transaction. A non-exhaustive list of some common disclosure requirements for sponsors and servicers in public securitization transactions during and after M&A transactions is contained below.

REGULATION AB

Sponsor:

Rule 1104(c) of Regulation AB ("Reg AB") provides that a description of the sponsor must be provided and that the description must include "to the extent material, a general discussion of the sponsor's experience in securitizing assets of any type…." In addition to the general description, a more detailed discussion of the sponsor's experience should be included when securitizing assets of the type included in the current transaction. An example of a material instance that should be disclosed includes "whether any prior securitizations organized by the sponsor have defaulted or experienced an early amortization triggering event." Even though no clear time period for this disclosure requirement is provided in Rule 1104(c)(1), the materiality qualifier makes it clear that, if it is determined the experience is material, it should be disclosed no matter how long ago it happened. The buyer should diligence the sponsor's securitization history and anticipate the need to make these disclosures.

Rule 1104(e) of Reg AB provides that the issuer must disclose the information required by Rule 15Ga-1(a) (17 CFR 240.15Ga-1(a)) concerning "all assets securitized by the sponsor that were the subject of a demand to repurchase or replace for breach of the representations and warranties concerning the pool assets for all asset-backed securities" for a period of three years. Therefore, the buyer must obtain information from the seller as to whether any assets it is buying were subject of a demand during this time frame.

Static Pool:

Rule 1105(a)(1) of Reg AB requires that static pool information, to the extent material, should be provided for either (i) the previous five years or (ii) "[f]or so long as the sponsor has been either securitizing assets of the same asset type…if less than five years." Static pool information should include delinquencies, cumulative losses and prepayments for prior securitized pools of the sponsor (for the same asset type). Since this potentially ongoing disclosure could affect how investors view current and future transactions, the buyer should diligence this information for at least the relevant time period mentioned above.

Depositor:

Rule 1106 of Reg AB contains the same disclosure requirements for the depositor as included in Rule 1104(c) for the sponsor.

Servicer:

Rule 1108(b)(2) of Reg AB requires disclosure, to the extent material, of "a general discussion of the servicer's experience in servicing assets of any type as well as a more detailed discussion of the servicer's experience in, and procedure for the servicing function it will perform in the current transaction for assets of the type included in the current transaction." Similar to the sponsor's disclosure requirement, Reg AB only requires a "general" discussion of all other asset types and requires more detail when the current transaction includes the same assets. Rule 1108(b)(3) states that any material changes to the servicer's policies or procedures in the servicing function it will perform in the current transaction for assets of the same type should be disclosed for the previous three years. Since policies and procedures may change when a servicer is purchased by a buyer, it is important to have a clear understanding of the previous policies and procedures and know the differences that will be implemented as a result of the M&A transaction. Finally, Rule 1108(d) provides that the "material terms" of the servicer's removal, replacement, resignation or transfer be disclosed. A buyer may need to provide this information if a servicer is actively servicing one or more of the seller's outstanding deals and will no longer be doing so after the M&A transaction.

Legal Proceedings:

Rule 1117 of Reg AB emphasizes a point that should already be taking place in an M&A transaction – a buyer should diligence legal proceedings pending against the sponsor, depositor or servicer, as applicable. This information should be disclosed if it is, or will be, deemed "material to security holders." Once again, there is no clear time period provided in Reg AB. Therefore, as long as the proceeding is pending or active against a relevant entity, it should be disclosed to investors, if material.

Compliance with Applicable Servicing Criteria:

Rule 1122(c)(1) of Reg AB includes additional disclosures that should be included in Form 10-K. For

example, material instances of noncompliance with the servicing criteria, otherwise known as "MINCs," should be disclosed on Form 10-K. Whether the identified instance involved assets of the same type or different type should be disclosed in the Form 10-K. This is another reason why the buyer should ensure it receives an acceptable data tape and thoroughly review the data tape for diligence reasons. There is no time period included in Rule 1122(c)(1).

Instruction 1 to Rule 1122 clarifies that the "assessment should cover all asset-backed securities transactions involving such party that are backed by the same asset type backing the class of asset-backed securities which are the subject of the SEC filing." For example, if the buyer is purchasing both the mortgage and auto businesses of the seller, MINCs arising in servicing the mortgages will not need to be disclosed in the public auto securitizations. This has created an incentive for parties to actively separate its platforms, especially when dealing with a sponsor that securitizes multiple asset types. A buyer may want to keep the newly purchased platforms and assets separate to limit the scope of the required assessment.

Form SF-3:

Any registrant that meets the eligibility requirements of Form SF-3 may use Form SF-3 for the registration of asset-backed securities. To be able to use Form SF-3, the transaction and registrant requirements must be met. The transaction requirements specify that the registrant must timely file (i) a certification in accordance with Item 602(b)(36) of Regulation S-K signed by the CEO of the depositor and (ii) all transaction agreements containing Reg AB's asset review, dispute resolution and investor communication provisions. The registration requirements specify that, during the 12 calendar months (and any portion of a month) prior to filing, the depositor and all affiliated depositors of the same asset class must have timely filed (i) all 1934 Act Reports and (ii) all documents listed under the transaction requirements above. The buyer should carefully diligence the seller's compliance with these requirements.

There is an annual compliance check 90 days after the end of the depositor's fiscal year. Failure to timely file the 1934 Act reports will result in (i) the inability to file a new shelf registration statement and (ii) the inability to issue additional securities from the applicable shelf registration statement for a period of one year (starting on the date of the compliance check). However, note that the depositor would be able to complete takedowns from the date of the failure up to the date of the compliance check. This penalty is commonly referred to as the "death penalty" since there is no cure once the filing deadline is missed. Failure to timely file the documents related to the transaction requirements will result in the inability to file a new shelf registration statement. A filing failure in connection with the transaction requirements will be deemed cured 90 days after all required filings are filed. Note that, if the filing failure was corrected at least 90 days prior to the date of the compliance check, there would be no lapse in ability to issue.

However, Form SF-3 includes a carve-out for business combination transactions that states:

"Regarding an affiliated depositor that became an affiliate as a result of a business combination transaction during such period, the filing of any material prior to the business combination transaction relating to asset-backed securities of an issuing entity previously established, directly or indirectly, by such affiliated depositor is excluded from this section, provided such business combination transaction was not part of a plan or scheme to evade the requirements of the Securities Act or the Exchange Act."

Therefore, assuming the business combination transaction was not completed with the intention of evading SEC requirements, a buyer may be able to avoid liability and/or penalties in connection with missed filing deadlines by the seller. However, the buyer typically seeks a representation from the securitization seller that it has timely filed all of its securities filings in any event.

Form 8-K

Section 6 of Form 8-K provides that, even though many of the disclosure requirements in Form 8-K exclude asset-backed issuers, a change in servicer will still need to be disclosed. If a servicer, as contemplated by Rule 1108 of Reg AB, has "resigned or has been removed, replaced or substituted, or if a new servicer has been appointed," the date of the event and the circumstances surrounding the change must be disclosed in Form 8-K. Therefore, if

a seller sells a servicer with outstanding deals, it will have to report the date and circumstances. Similarly, if a buyer is replacing a servicer with a newly purchased servicer for its outstanding deals, it will also have to report the date and circumstances.

Issue 8. Who Will Service the Assets After Closing?

Transfer of Servicing. In addition to the customary covenants present in most M&A deals, in financial asset 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 the 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.

Deficiencies in Loan Files. Depending on the relative bargaining power of the buyer in a financial asset 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.

Interim Subservicing or Servicing Agreements. 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 may be able to 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. Similarly, if the seller retains some of the financial assets after its platform and financial assets are sold, it may require a short-term or long-term servicing agreement from the buyer's servicer.

Issue 9. How Will the Technology Be Transitioned?

A key factor in the current financial services M&A environment is the ongoing convergence of technology and financial services, with regulated industries in particular facing digital transformation. Financial institutions are making huge investments in technology and cybersecurity, as well as developing more sophisticated technology driven products for millennials and Generation Z who interact predominantly online. The rise of non-bank players in financial services has been in part enabled by their lack of cumbersome legacy systems and branch operations often found at large commercial banks. A 2017 McKinsey & Co. report predicted a split between the "manufacturers" of banking (the core business of financing and lending that is hard for technology firms to replace) versus the "distributors" of financial services, which includes the origination and sales side of the business where outside competitors have an easier time entering the financial services system. Distribution platforms according to McKinsey produce 65% of the profits with a much higher return on equity. On the other hand, incumbent financial institutions benefit from vast resources to invest in technology, a massive ability to manufacture financial products and the trust of the customer base, including technology savvy millennials. Successful new digital offerings by large banks include Marcus by Goldman Sachs, Finn by Chase and Ally Bank's solely online bank offering. Even the mortgage industry, which has been slow to adopt technology solutions in part because of state regulations requiring the use of notarized physical notes to transfer real property, is moving towards digital solutions with online mortgage platforms seeing increasing usage. Not surprisingly given this

background, M&A deals involving a securitization platform are increasingly impacted by technology.

Key issues in a technology-driven acquisition include the following:

1. *Open Source Software.* Open source software is computer software developed though collaborative efforts in which source code is released under a license in which the copyright holder grants users the rights to use, change and distribute the software to anyone and for any purpose. The presence of open source and third-party software in so-called proprietary technology can seriously undermine the value of the business being purchased and the buyer's business post-closing. Open source software can also present serious security vulnerabilities because the software is dynamic and not within the control of the business or the developer. Other issues with open source software include: (i) the risk of being required to share a business's proprietary technology with third parties or without charging a fee, (ii) the absence of warranty and protection against infringement risks, and (iii) the potential for conflicts among the various license terms that govern open source code. Third-party consultants such as Black Duck can scan software for open source usage and categorize risks and propose remediation steps and alternatives. The buyer should also include representations and covenants in the purchase agreement designed to address any open source risks identified.

2. *Cybersecurity and Data Privacy.* Vulnerability to cybersecurity breaches and compliance with increasingly complex data privacy rules are another key issue in buying a technology business. Extensive due diligence should be undertaken relating to a host of related issues, such as reviewing written information security policies, compliance with privacy and data protection laws, and reviewing whether the seller can lawfully disclose or transfer personal data to the buyer at closing. The buyer will typically insist on thorough representations in the purchase agreement to the effect that the seller has complied with its written information security policies, has no known or suspected data breaches or other cyber incidents, and has obtained any consents needed to transfer personal data.

3. *Technology Agreements.* Technology agreements increasingly accompany the main purchase agreement in financial services M&A. These "ancillary" agreements may be as simple as a short-term transition services agreement where the seller provides interim technology services to the buyer pending conversion to the buyer's system. In transition services agreements, the seller typically provides the services as an accommodation to the buyer and at the same level of service that it provided to itself before the sale because the seller is not in the business of providing outsourced services and cannot provide the level of service expected of an outsourced service provider. In other transactions, such as the carve-out of a financial services business from a bank, the bank seller may seek a long term arrangement to receive services back from the buyer. These situations more closely resemble outsourcing agreements than transition services agreements and will result in much more complex and time-consuming negotiations. The bank seller will need to comply with bank regulatory guidance on third-party vendor agreements, which may be viewed as unduly cumbersome to the buyer.

Issue 10. How Will the Purchase Agreement Differ from a "Regular" M&A Deal?

REPRESENTATIONS AND WARRANTIES

Buyers in M&A transactions for securitization businesses will typically customize traditional M&A representations as appropriate so that they specifically address the issues that are unique to M&A involving securitization sponsors and servicers. Buyers will typically 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. However, these M&A-style representations will typically not be nearly as detailed as those found in a securitization or whole loan purchase of the

same financial assets, which may cause difficulties in negotiations.

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 securitization transactions 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.

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 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. Any contractual provisions regarding the incompleteness or inaccuracy of the loan files may serve as a "red flag" to the seller's or the 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 securitization 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 securitization-related 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 platform and assets it is proposing to acquire remain materially unchanged between signing and closing.

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 financial asset transactions and the increase in litigation affecting financial asset 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.

Post-Closing Covenants. Covenants that carry over post-closing were relatively minimal in financial asset 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
- A detailed conversion plan to ensure that the servicing transition occurs in an orderly fashion.

INDEMNITIES

The indemnification provisions in an acquisition agreement involving financial assets are not particularly different from non-finance company deals. However, these M&A-style indemnities are quite different from those found in a securitization or whole loan sale, where the buyer's remedy is typically to have the seller repurchase the financial asset

with respect to which a representation has been breached, Some transactions may contain a hybrid set of remedies that combine aspects of both an M&A indemnity regime and a securitization-style warranty repurchase.

Buyer Indemnities. Given the extensive liability that can be associated with financial assets in today's market, buyers in a securitization-related 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 claims based on the buyer's collections activities.

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Opinion Answers to five sticky questions about mortgage company investments

By Lauren Pryor

February 11, 2020, 4:06 p.m. EST

By Lauren Pryor and Krista Cooley

Whether you are considering a minority investment or a whole company carve-out transaction, buyers and sellers should be aware of the following five issues that may pose transaction risk for buyers and sellers in U.S. mortgage company investments.

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Buyers may consider whether an equity investment in a Fannie Mae or Freddie Mac seller/servicer or a Ginnie Mae issuer would pose "cross default" risk with another servicer or issuer under common ownership

or control with the target company. The Ginnie Mae mortgage-backed securities guide, Fannie Mae selling and servicing guides and Freddie Mac seller/servicer guide all include cross-default provisions applicable to parties under common ownership or control. The cross-default provisions provide that a default under the applicable guide or servicing agreement by one entity may be deemed to be a default with respect to another entity under common ownership or control.

The determination as to what constitutes "common ownership" or "common control" varies. Freddie Mac and Ginnie Mae traditionally defer to FAS-57; however, according to accounting professionals, the current standard for evaluating related-party relationships may be ASC-850, a different accounting standard. Fannie Mae does not provide specific guidance with respect to common ownership or control. In connection with related due diligence efforts, buyers in mortgage M&A transactions may consider whether the target has any corporate guaranties, waivers, special approvals and/or unique requirements imposed by the GSEs or Ginnie Mae, including higher net worth or liquidity obligations beyond those set forth in the guides.

In addition to cross-default provisions set forth in the Ginnie Mae guide, Ginnie Mae has, in the past, exercised discretionary authority to limit or prohibit common ownership or control of multiple issuers with the same issuer approval type regardless of whether the parties enter into a cross-default agreement. While the Ginnie Mae Guide only requires 30 days' advance notice of a change of ownership, buyers and sellers evaluating cross default risk may treat Ginnie Mae as a "required approval" for closing based on Ginnie Mae’s broad authority to review and approve common ownership or control of multiple issuers with the same issuer approval type. Moreover, Ginnie Mae may not be able to evaluate the proposed transaction in such 30-day period, and so the parties may prefer to provide a longer "runway" to address any questions raised by Ginnie Mae. If Ginnie Mae does not approve the issuers for continued participation prior to consummation of the transaction and/or imposes conditions on such participation, the parties will typically enter into discussions with Ginnie Mae to curtail activities or surrender one of the issuer approvals within a specified period of time.

Cross-default provisions may pose heightened risks for private equity and hedge fund investors depending on how the proposed investment will be structured and where the target company will be located within the applicable fund structure. Cross-default risk across multiple funds could cause investors in one fund silo to be exposed to regulatory risk based on the acts or omissions of an approved entity held in a completely different fund silo. As a result, careful analysis of common ownership or control is of particular importance for fund investors.

While buyers should be aware of the cross-default risks, sellers may likewise be concerned as a matter of transaction risk. For instance, the presence of multiple Ginnie Mae issuers on the buyer's side may impede or delay change of control approval from Ginnie Mae while a cross-default agreement is finalized. More generally, the possibility of cross-defaults may "spook" a potential buyer. As a result, sellers may consider inquiring as to other issuers and seller/servicers held in the buyer's ownership structure to ensure that these potential risks are identified early in the negotiation process.

Why should I worry about employee classification issues?

Employers are obligated to designate employees as either "exempt" or "nonexempt" from the overtime regulations of the federal Fair Labor Standards Act and similar state laws. Employees are classified depending on their applicable job duties and on the basis of their salary and income level. An exempt or nonexempt classification determines whether an employee is entitled to receive overtime pay for hours worked over 40 in a week (or eight in a day in some jurisdictions).

The determination as to whether an employee is exempt or nonexempt is based on a somewhat subjective analysis and can be difficult. The classification analysis for loan officers and underwriters is particularly tricky because it is possible that persons in these roles may fall within either the "administrative" exemption or the "outside salesperson" exemption.

The administrative exemption requires that the employee's duties include the exercise of independent judgment and discretion. This is a fact-specific inquiry that depends on the loan officer's actual duties and responsibilities. Similarly, the outside sales exemption requires that the employee's primary duty is "making sales" (as defined by the FLSA) and "who is customarily and regularly engaged away from the employer's place or places of business in performing such primary duty." This, too, is a fact-specific inquiry.

If an employer misclassifies employees, the employer may be at risk for individual claims or class action lawsuits. The FLSA has a two-year statute of limitations for ordinary violations and a three-year statute of limitations for willful violations. A common remedy for FLSA violations is the payment of back pay — the difference between the pay the employee actually received and the amount that the employee should have received — looking back over a two- or three-year period. In addition, liquidated damages in the amount of twice the backpay amount may also be available. Certain state laws impose even stronger penalties. For instance, the California Labor Code provides for monetary penalties for waiting time violations, wage statement violations, meal and break period violations and pay period violations.

When considering an equity investment in a mortgage company, even for a minority stake, buyers may carefully review the target's employee census to consider how employees are classified. If employees are misclassified, buyers may consider requiring the seller to take mitigating steps to reduce risk, request a special indemnity in the purchase agreement or make adjustments post-closing.

Note that misclassification of employees might also present concerns for purchasers in asset sales. Buyers of substantially all of the assets of a mortgage company (or a significant portion thereof) should be aware of the potential for successor liability in employment actions because courts have held transferees in asset sales liable for employee misclassification claims under the FLSA and similar state laws.

As a matter of "good housekeeping," sellers may consider performing an employee classification audit and taking corrective actions prior to soliciting investments or positioning for an asset sale in order to prevent this issue from posing transaction risk during negotiations.

Why do I need "change of control" approval for nonvoting equity?

It may be surprising to learn that the acquisition of nonvoting stock or nonvoting equity interest investments also may require "change of control" approval as its relates to Ginnie Mae, the GSEs and certain state mortgage finance licensing laws and may require personal disclosures of the ultimate indirect owners of the licensee. The determination of whether the change of control provisions apply may be based on the form of organization of the licensee or entities in the chain of ownership. Debt structures also may warrant change of control analysis depending on the extent of the debt holder's ability to exercise control over, or direct the management or policies of, the licensee.

Some states require approvals for any change of 10% or more in the direct or indirect ownership of a licensee, including in connection with preferred, nonvoting interests. Other states draw the line at a change of 25% or more in the indirect or direct ownership of the licensee. Some states further require personal disclosures (e.g., personal financial statements, fingerprints, etc.) from any individuals holding more than the requisite threshold of indirect ownership interests of the licensee and/or of an entity seeking to acquire an interest in a licensee. Some states exempt public shareholders up the ownership chain.

Personal disclosures may be burdensome and intrusive, so buyers and their investors may carefully consider what information is required to be disclosed and by whom. Hedge funds, strategic investors and private entity firms should analyze this issue carefully because their principals may be required to make such disclosures. (Our licensing team can help navigate the change of control analysis and consider

whether disclosures will be required based on the form of investment proposed, the organizational charts of both buyer and seller and the state licensees held by the licensee.) Similarly, sellers may carefully evaluate whether the proposed ownership structure poses transition risk in the event that certain of a potential buyer's direct or indirect owners may be hesitant to provide personal disclosures, which could delay or adversely impact the issuance of state approvals necessary to proceed with the transaction.

Loans originated precrisis don't pose repurchase risk, right?

Surprising as it may be, residential mortgage companies continue to face private-investor repurchase claims for mortgage loans originated prior to the financial crisis in 2008. Repurchase risk for loans sold more than 10 years ago is difficult to diligence, especially if prior repurchase claims are sporadic such that they would not suggest a pattern of origination or underwriting defects upon review of historic repurchase logs. Similarly, a review of sample loan files from recent years and a review of origination and underwriting practices may not be helpful. We would expect current regulatory compliance policies and procedures to differ from precrisis models based on changes required by the Dodd-Frank Act. Repurchase risk is a matter for consideration by equity investors and asset purchasers alike. Certain private investor repurchase claimants have asserted repurchase demands against asset purchasers based on a theory of successor liability, even in circumstances where a business unit has been bought and sold through multiple asset sales since the financial crisis. Considering the potential challenges with respect to diligence of legacy repurchase claims in both equity and asset transactions, buyers may consider requesting a special indemnity in the applicable purchase agreement to cover legacy repurchase liabilities.

Where is my R&W policy?

While strategic investors and private equity purchasers generally expect R&W insurance coverage in M&A deals, representation and warranty coverage remains uncommon in mortgage M&A transactions. Historically, financial services has been a challenging area for representation and warranty insurers to underwrite policies, particularly with regard to asset level and regulatory compliance matters. Other areas, such as employment and intellectual property matters, are more easily covered across industry sectors. The primary areas of risk in mortgage deals pertain to loan-level representations, repurchase demands and regulatory compliance concerns — areas that few insurers are willing to cover. That said, we understand that certain insurers are seriously considering new products to address mortgage-related risks. This could be an emerging area for insurers able to grapple with the related underwriting challenges and loan repurchase questions. For now, however, indemnification and repurchase continue to be the mainstay remedies in many mortgage M&A deals.

As the above questions and answers illustrate, both buyers and sellers may consider these unique but important matters when contemplating a mortgage company investment, and working with a trusted advisor with experience in these matters can assist in moving the transaction forward.

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No. 2020-05
14 April 2020

Technical Line

How to appropriately use non-GAAP measures to discuss the effects of COVID-19

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What you need to know

- A new accommodation from the SEC staff allows registrants to reconcile non-GAAP measures to provisional GAAP amounts if they haven't completed their accounting measurements due to the effects of the COVID-19 pandemic.
- Item 10(e) of Regulation S-K and Regulation G and the SEC staff's guidance on non-GAAP measures continue to apply to adjustments related to the effects of COVID-19.
- Registrants that want to portray the effects of COVID-19 should limit adjustments in their non-GAAP measures to charges incurred or gains recognized that clearly relate to COVID-19 and are incremental to, and separable from, normal operations. They can't present a non-GAAP measure that includes estimates of lost revenue.
- Registrants can quantify and discuss other effects of COVID-19 on their operations or their financial condition as long as they don't adjust GAAP measures to reflect what their performance or condition would have been without those effects.

Overview

Registrants that are considering using non-GAAP financial measures to discuss the effects of the coronavirus (COVID-19) pandemic need to understand the accommodation the Securities and Exchange Commission (SEC) staff in the Division of Corporation Finance provided in Disclosure Guidance: Topic No. 9, Coronavirus (COVID-19).[1]

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The accommodation relates to the reconciliation requirements in Regulation G and Item 10(e) of Regulation S-K. The SEC staff has said it will not object if a registrant that is facing difficulties reporting financial results due to COVID-19 reconciles a non-GAAP measure to the corresponding GAAP measure, even if that GAAP measure includes provisional items (i.e., best estimates or ranges). The accommodation can be used for measures presented in connection with an earnings release but cannot be used for measures presented in periodic reports filed with the SEC.

The accommodation applies only to measures that have been provided to the board of directors. The SEC staff said it believes that a registrant should disclose only non-GAAP financial measures that are consistent with how management and the board are analyzing the current and potential effects of the COVID-19 pandemic on the registrant's financial condition and operating results. Accordingly, a registrant should not present a non-GAAP measure "for the sole purpose of presenting a more favorable view of the company," the SEC staff said.

The other requirements of Item 10(e) of Regulation S-K, Regulation G and the SEC staff Non-GAAP Compliance and Disclosure Interpretations continue to apply to the use of non-GAAP measures with adjustments related to COVID-19.

The following questions and answers are intended to help registrants understand and use this new accommodation in communications outside of periodic filings and make acceptable non-GAAP adjustments related to the pandemic that comply with the SEC's rules and staff guidance.

Key considerations

Understanding and using the accommodation

Which GAAP items can be estimated for use in a reconciliation of a non-GAAP measure?

While the staff didn't specify which GAAP items would qualify under the accommodation, we believe that they would include line items affected by a broad range of accounting measurements that are challenging and time consuming to complete because of the pandemic. These items include those affected by asset impairments involving inventory, goodwill, indefinite-lived intangible assets and other long-lived assets. Items affected by relief provided by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the $2.2 trillion stimulus package that was enacted on 27 March 2020, may also include provisional measurements.

See our Technical Lines, ***Accounting and reporting considerations for the effects of the coronavirus outbreak*** and ***Accounting for impairment of goodwill and indefinite-lived intangible assets due to the coronavirus,*** for more information about asset impairments and other items that may be affected by COVID-19. See our Technical Line, ***Accounting for the income tax effects of the CARES Act and the COVID-19 pandemic,*** and To the Point, ***Relief provided by the CARES Act will affect accounting and financial reporting***, for information about items that may be affected by provisions of the CARES Act.

Can a non-GAAP measure be reconciled to the corresponding GAAP measure that includes an estimate of the results of an entire consolidated subsidiary if the registrant experiences challenges accessing certain records of that subsidiary and/or its key personnel?

Yes, if enough information is available to develop a reasonable estimate. Excluding the results of a subsidiary would not be appropriate, given the longstanding SEC staff position that presentations that exclude consolidated subsidiaries would be considered a misleading use of individually tailored accounting principles.

What disclosures does a company need to make if it reconciles a non-GAAP measure to a GAAP measure that incorporates provisional amounts?

A registrant should comply with the disclosure requirements in Item 10(e) of Regulation S-K by making sure that the non-GAAP measure is not more prominent than the GAAP measure that incorporates provisional amounts and explaining why the non-GAAP measure provides useful information to investors. In addition, a registrant should disclose, to the extent material, how management and the board of directors use the non-GAAP measure.

The guidance requires a registrant to explain, to the extent practicable, why the GAAP line item(s) or accounting is incomplete, and what additional information or analysis may be needed to complete the accounting. We believe most registrants should be able to make this disclosure.

Can the provisional GAAP measure used in the reconciliation also be presented in the earnings release using a full income statement format?

Yes, if the estimated item or range is clearly identified using parentheses or footnotes and the income statement includes only GAAP line items. A registrant that uses a range in such a presentation should also express the subtotals and totals that follow it as a range.

We believe such a presentation would be acceptable in an earnings release, regardless of whether the release includes any non-GAAP measures.

Registrants must comply with the SEC's rules and guidance when reporting non-GAAP measures that reflect adjustments for COVID-19.

However, the SEC staff does not permit a registrant to use a full income statement format to convey any non-GAAP information.

Can an earnings release present a partial income statement or selected GAAP subtotals without presenting a full income statement?

Yes, unless the partial income statement or individual GAAP subtotals would be misleading without the omitted information. We believe that the staff is more likely to accept the omission of income statement line items that are presented closer to net income because the omission of these items may not materially alter an investor's understanding of the company's performance. For example, a registrant might be able to provide an income statement that ends with income before income taxes or present that line item on its own, along with an explanation about why the registrant couldn't provide a full income statement. We believe such a presentation would be acceptable in an earnings release, regardless of whether the release includes any non-GAAP measures.

How we see it

Registrants with acute challenges in reporting financial information should consider contacting the SEC staff to discuss those challenges. For example, a registrant that cannot release financial information to investors without excluding a material subsidiary affected by the pandemic should consider contacting the SEC staff to discuss alternatives that would allow for disclosure of material information to investors in a timely manner.

COVID-19-related non-GAAP adjustments

What framework can a registrant use to evaluate whether COVID-19-related adjustments are acceptable?

As noted above, the requirements in Item 10(e) of Regulation S-K and Regulation G as well as the SEC staff's related guidance continue to apply to all non-GAAP measures. A registrant must consider how the rules and guidance apply to its own facts and circumstances and should never present a non-GAAP measure in a way that is misleading. We expect the staff to focus intently on how companies use non-GAAP measures in their upcoming earnings release and periodic reports.

The SEC staff's guidance and comment letters on registrants' uses of non-GAAP measures in SEC filings in the past provide a framework to help registrants evaluate whether COVID-19-related adjustments are acceptable.

Therefore, we believe that non-GAAP measures that are adjusted for the effects of COVID-19 should generally exclude only items that are directly attributable to the pandemic and are both:

- Incremental to charges incurred prior to the outbreak and not expected to recur once the crisis has subsided and operations return to normal
- Clearly separable from normal operations

We also note that the SEC staff has not suggested there is a need to revisit whether common adjustments in non-GAAP measures remain appropriate (e.g., asset impairments; restructuring charges, including severance payments). However, a registrant using one of these common adjustments for the first time should retrospectively adjust its non-GAAP measures for prior periods if the item also materially affected those periods.

What types of adjustments would be consistent with this framework?

We believe that adjustments for charges or gains related to the following activities may be acceptable if the charges or gains are attributable to COVID-19 and are incremental to and separable from normal operations:

- Temporarily paying a premium to compensate employees for performing their normal duties at increased personal risk (e.g., hazard pay)
- Cleaning and disinfecting facilities more thoroughly and/or more frequently
- Terminating contracts or complying with contractual provisions invoked directly due to the events of the pandemic (e.g., contract termination fees or penalties)
- Insurance recoveries

A registrant that incurs charges and recognizes gains attributable to COVID-19 should be mindful of the SEC staff's guidance that says a non-GAAP measure can be misleading if it excludes nonrecurring charges but does not exclude nonrecurring gains.

What adjustments should a registrant avoid?

Adjustments related to the following items would not be consistent with the framework described above and should be avoided unless further guidance is provided by the SEC staff:

- Paying idled employees
- Rent and other recurring expenses (e.g., security, utilities, insurance, maintenance) related to temporarily idled facilities
- Excess capacity costs expensed in the period due to lower production
- Paying employees for increased hours required to perform their normal duties
- Paying more for routine inventory costs (e.g., shipping costs)

In addition, a registrant should not use a non-GAAP measure that includes adjustments to normalize operations, such as including estimates of lost revenue to show what results would have been without the effects of the pandemic.

If a registrant cannot use a non-GAAP measure to convey information about a COVID-19-related item and its effects, how can the registrant convey information to investors about the item and its effects?

A registrant can typically supplement its non-GAAP measures with disclosure about other items that had a material effect on the company but could not be reflected as an adjustment. For example, payroll expenses related to employees idled during the pandemic could be highlighted in earnings release materials as follows:

> "Payroll paid to employees idled due to the COVID-19 pandemic of approximately $xx million are included within cost of revenue, selling, general and administrative and research and development expenses."

This type of disclosure is not considered a non-GAAP presentation because it does not provide payroll calculated on both a GAAP basis and an adjusted basis excluding amounts paid to idled employees. It merely draws investors' attention to an unusual expense and conveys useful information about it. Because such a presentation is not subject to the SEC's non-GAAP rules or the staff's guidance, there is neither a prohibition against presenting it more prominently than GAAP information nor any explicit requirements to disclose why the information is useful to investors or how it is used by management or the board of directors.

How we see it

A registrant can describe and quantify the effects of the pandemic (including those that would otherwise be prohibited non-GAAP adjustments) in one place by listing those effects separately without adjusting its GAAP results. For example, this could be done in a supplemental table that describes each item and includes dollar amounts. While the non-GAAP rules and related SEC staff guidance would not apply to this supplemental information, a registrant that presents such a table should consider explaining how and why it can help investors analyze the registrant's results.

Endnote:

[1] See our To the Point, ***SEC extends relief and issues staff guidance on COVID-19 disclosures***, for a full discussion of the guidance.

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April 13, 2020

Legal Update

Chair Clayton and Division Director Hinman Issue Public Statement on the Importance of Disclosure in the Current COVID-19 Environment

On April 8, 2020, the Chair of the U.S. Securities and Exchange Commission (the "SEC") – Jay Clayton – and the Director of the SEC's Division of Corporation Finance – William Hinman – issued a joint statement titled The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19 (the "Statement").[1]

In the Statement, Chair Clayton and Division Director Hinman noted that "[i]n the coming weeks, our public companies will be issuing earnings releases and conducting analyst and investor calls." They urged "companies to provide as much information as is practicable regarding their current financial and operational status, as well as their future operational and financial planning." Finally, they provided several observations and requests for companies to consider as they prepare their disclosures, focusing primarily on forward-looking statements. These observations and requests build upon previous guidance issued by the Division of Corporation Finance.[2]

In short, Chair Clayton and Division Director Hinman highlighted several disclosure points, including:

- Company disclosures should reflect the current state of COVID-19 affairs and outlook and, in particular, respond to investor interest in:
  - Where the company stands today, operationally and financially,
  - How the company's COVID-19 response, including its efforts to protect the health and well-being of its workforce and customers, is progressing, and
  - How the company's operations and financial condition may change;
- Historical information may be relatively less significant;
- Providing detailed information regarding future operating conditions and resource needs is challenging, but important;
- High quality disclosure will not only benefit investors and companies, it will promote valuable communication and coordination across the economy;
- Companies that respond to the call for forward-looking disclosure should avail themselves of the forward-looking safe harbors in the U.S. federal securities laws; and

- Good faith attempts to provide appropriately framed forward-looking statements would not be second-guessed by the SEC.

There are four important takeaways for public companies to consider as they plan their upcoming earnings calls and quarterly disclosures.

1. First quarter earnings reports and related investor and analyst calls will not be routine. Historical information may be substantially less relevant as shareholders want to know where companies stand today, and how they have adjusted and expect to adjust in the future as they continue to deal with COVID-19. While recognizing that producing comprehensive financial and operational reports, both historical and forward-looking, may present challenges for public companies, the SEC continues to encourage earnings and related disclosures to be as timely, accurate and robust as practicable under the circumstances.
2. Chair Clayton and Division Director Hinman request that companies provide as much information as practicable regarding their current status and plans for addressing the effects of COVID-19, including information regarding their current operating status and their future operating plans under various COVID-19-related mitigation conditions. They noted that investors and the markets may be particularly interested in, among other things, detailed discussions of current liquidity positions and expected financing needs, whether the company is receiving or intends to apply for financial assistance under various COVID-19 related federal and state programs, including the CARES Act, and how such assistance has had or may have a material effect on the company.
3. In requesting companies to produce more forward-looking information under the current circumstances, the SEC recognizes the particular challenges companies will face to produce forward-looking information in light of the unknowns that still exist. The SEC recognizes that companies will have to make a variety of assumptions, including some that relate to factors that are beyond their control. Nonetheless, they encouraged companies to consider the broad frameworks that have been proposed to have the economy move forward and discuss how following those frameworks may affect their operations if it would be of material interest to investors, while avoiding generic or boilerplate discussions.
4. As is always the case, companies providing forward-looking information are encouraged to avail themselves of the safe harbors for forward-looking statements in the U.S. federal securities laws. The SEC recognizes that in many cases actual results may differ substantially from what were reasonable estimates when the forward-looking statements were made. In light of this, they would not expect to second guess good faith attempts to provide investors and other market participants appropriately framed forward-looking information.

Practical Considerations

Companies considering providing enhanced forward-looking information should take all appropriate steps to make sure that any such disclosure is based on reasonable estimates and assumptions and to disclose them. Companies should allow sufficient time for drafting and internal review of any new disclosures and ensure that any such disclosure is tailored to their own situation.

Although the Statement says that the SEC would not expect to second-guess good faith attempts at providing forward-looking information, the SEC will not be the only interested party reviewing disclosures. Investors, and more particularly the U.S. plaintiff's bar, will have the benefit of hindsight when deciding how to view the adequacy of disclosure previously made. Since these parties will not be bound by the views of the SEC, it is important to follow the conditions necessary to take advantage of the safe harbor provisions of the U.S. federal securities laws to provide a defense against any future lawsuits in the event actual results differ from the forward-looking information.

It is still important not to selectively disclose material non-public information, including forward-looking information, to any investor. To the extent a company is ready to disclose material non-public information relating to COVID-19, that information should be disclosed in a Regulation FD compliant method. If there has been an inadvertent selective material disclosure regarding COVID-19, the company must promptly disseminate such information by a press release, a Form 8-K or another accepted method. Given the Statement's warning regarding safeguarding material non-public information and the recent statement by the co-directors of the SEC's Division of Enforcement on market integrity,[3] companies should also consider reviewing their insider trading policies and reminding employees of their obligations thereunder.

The Statement repeats previous statements that the SEC is willing to discuss on a case-by-case basis issues in complying with U.S. federal securities laws that may arise in connection with COVID-19. Companies that have particular concerns should reach out to the SEC staff to discuss how to handle issues that may arise.

As the COVID-19 pandemic continues and governments and companies take additional precautionary measures that may impact businesses, more disclosure-related and filing or compliance issues may arise. Therefore, companies should monitor SEC announcements for any further developments.

The Statement is part of an evolving COVID-19 response that is moving across regulatory agencies. Please visit our website[4] to learn more. In addition, companies might find the SEC's COVID-19 Response webpage[5] to be a helpful resource.

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Endnotes

[1] Available at https://www.sec.gov/news/public-statement/statement-clayton-hinman

[2] For example, see our Legal Update "SEC Extends Conditional Reporting Relief and Issues COVID-19 Guidance for Public Companies," dated March 26, 2020, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/03/sec-extends-conditional-reporting-relief-and-issues-covid19-guidance-for-public-companies_3.pdf and "SEC Disclosure and Related Ramifications," dated March 17, 2020, available at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/03/covid19secdisclosuresandrelatedramifications.pdf

[3] Available at https://www.sec.gov/news/public-statement/statement-enforcement-co-directors-market-integrity.

[4] Available at https://www.mayerbrown.com/en/capabilities/key-issues/coronavirus-covid-19?tab=overview

[5] Available at https://www.sec.gov/sec-coronavirus-covid-19-response

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March 17, 2020

Legal Update

COVID-19: SEC Disclosures and Related Ramifications

In addition to a host of significant general business concerns, such as those relating to liquidity and financing opportunities, revenues, supply chain and employee and community health and welfare, the novel coronavirus known as COVID-19 has raised a number of issues specific to public companies that file reports with the US Securities and Exchange Commission (SEC). These matters include the application of SEC disclosure requirements, logistics for upcoming shareholder meetings and administrative challenges in complying with SEC requirements.

SEC Disclosures and Related Requirements

To a large degree, SEC disclosure requirements are principles-based. Applying the concept of materiality to the impact of COVID-19, there are many areas where existing SEC rules, while not expressly mentioning pandemics, could require disclosure. Such disclosure considerations could arise in the context of a regularly scheduled periodic report, such as an annual or quarterly report. Or, there could be an issue that requires more immediate disclosure through a current report on Form 8-K, Form 6-K, or in a press release. Depending on the circumstance, COVID-19 disclosures also may need to be discussed in registration statements, prospectuses, proxy statements or information statements. However, as discussed further below, disclosures should be specific, not generic, and should be tailored to the particular facts and circumstances applicable to the issuer.

Risk Factors. With the impact from COVID-19 intensifying rapidly, companies may become increasingly aware of additional ways in which the pandemic poses specific risks beyond what they may have previously disclosed. It would be useful for companies to begin drafting more detailed risk factors relating to COVID-19 for inclusion in their next SEC filing that requires risk factor disclosure. If a company determines that a particular risk or development relating to COVID-19 is sufficiently material that it should be disclosed prior to its next periodic report or registration statement filed with the SEC, such as might be the case if it is currently in the market buying or selling its securities, it may decide to disclose a new COVID-19 risk factor through a current report filing.

Forward-Looking Statements. Companies disclosing how COVID-19 may affect their future performance should consider framing their discussions to take advantage of the safe harbor for forward-looking statements set

forth in Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act). For example, when discussing COVID-19 matters, companies may want to include an explanation regarding the use of forward-looking statements, indicating that actual results of the impact of COVID-19 may be materially different and identifying forward-looking remarks with words such as "believes," "expects," or "hopes." Companies may also want to expressly include the impact of COVID-19 as a factor that could impact actual results in their more general discussions of forward-looking information.

Management's Discussion and Analysis. Management's discussion and analysis (MD&A) must include information that a company "believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." With COVID-19 impacting so many companies, often negatively, but in some cases providing opportunities, it is important for the MD&A to not only disclose COVID-19 as a known trend or uncertainty but also management's perspective on the type and extent of COVID-19's effect on the company, to the extent material. There are many possible questions for companies to assess for materiality in the COVID-19 context as they prepare their MD&A. For example, has the company experienced supply chain issues? Are these supply chain issues anticipated to be ongoing? How has COVID-19 affected liquidity? Has the company drawn down on bank facilities for any reason, including because it has not been able to finance in the capital markets? Has the company needed to close any locations? If the company switched its workforce to telecommuting, has there been any reduction in productivity? Is the company party to contracts with force majeure provisions that are or may be triggered by the COVID-19 pandemic, and if so, is that having a material impact on the company's business? Is the company having a dispute with its insurance carrier regarding business continuity coverage?

Financial Statement Footnotes. Companies should discuss with their accountants whether COVID-19 disclosure is needed as part of their financial statement footnotes. This could include a subsequent event footnote.

Business. To the extent a company is filing a report or registration statement with the SEC that requires a business description, the company will need to consider whether additional or revised disclosure is needed to the extent that COVID-19 has materially changed its business. For example, did the company exit any business line? Did the company close any facility? Is the company having difficulty sourcing inventory and considering alternative sources than those previously used? Are some segments of the company's business impacted more than others? Did the company lay off workers as a result of a business slowdown? Were any acquisitions or organic growth initiatives put on hold?

Litigation. Litigation arising out of COVID-19 may also require disclosure. For instance, it is possible that some companies might face class action lawsuits alleging failure to protect customers or workers from the virus.

Earnings Releases, Earnings Calls and Guidance. Because of the widespread impact of COVID-19, companies should consider addressing, to the extent material, the impact of COVID-19 in upcoming earnings releases. They should also be prepared to answer analysts' questions about the effect of COVID-19 on their earnings calls. It may be useful to script and practice answers to such questions in advance.

Although the federal securities laws do not mandate a specific duty to update prior statements, including guidance, some courts have recognized a duty to update in certain

situations. Consequently, companies that have provided guidance to investors should consider updating that guidance, or advising investors to no longer rely on that guidance, to the extent their guidance has materially changed.

Regulation FD. Companies may be fielding many questions regarding COVID-19 because of its pervasive effect on the global economy. Public companies must be careful to avoid selective disclosure of material non-public information about how COVID-19 is affecting them by disseminating such information in a Regulation FD-compliant manner, such as a press release or an Item 7.01 Form 8-K.

Insider Trading; Stock Repurchases. Directors, officers and employees of public companies should not be trading in securities while in possession of material, non-public information. The COVID-19 pandemic is a rapidly evolving situation. If a company becomes aware of a COVID-19 development that may have material ramifications to the company, the company, as well as its directors, officers and employees should avoid trading in the company's securities until that development has been publicly disclosed, unless such trading is accomplished pursuant to a Rule 10b5-1 trading plan entered into while not in possession of material non-public information regarding the company. Companies may need to consider whether any special black-out period should be implemented to prevent insider trading when there is material information that has not been disclosed to the public. Given recent stock price deterioration as a result of generalized market volatility, some companies may be considering effecting stock repurchases. Careful consideration should be given to the company's quarterly blackout period, as well as to whether all information material to the company has been disclosed.

Controls and Procedures. Because the COVID-19 pandemic is affecting so many aspects of business, companies should consider what changes should be made to their disclosure controls and procedures, including making the potential impacts of COVID-19 an express part of their disclosure controls and procedures. Companies may also need to assess whether COVID-19 is having any impact on their internal controls over financial reporting.

Effecting Securities Offerings. All of the considerations discussed above become particularly timely should a company be contemplating issuing securities.

Shareholder Meeting Logistics

Companies planning for shareholder meetings should consider whether they should change the date or location of their annual meeting in response to COVID-19, either as a precautionary measure or as a result of local prohibitions on large gatherings. In addition to concerns about the ability of officers, directors and shareholders to attend annual meetings in person, a number of service providers that are part of the annual meeting process, including inspectors of election, already have sent notices alerting companies that their personnel will not travel to be present physically at annual meetings.

If the law of the jurisdiction of formation permits a company to conduct a virtual meeting, it may want to replace or supplement an in-person meeting with an online meeting that shareholders may attend remotely. Companies considering a virtual meeting should also confirm that nothing in their governing documents restricts their ability to convene a virtual meeting.

On March 13, 2020, the SEC staff issued guidance[1] (Guidance) for conducting annual meetings in light of COVID-19 concerns. According to the Guidance, the staff takes the position that if a company has already mailed and filed its definitive proxy materials, it may

notify shareholders of a changed date, time or location for its annual meeting without mailing additional soliciting materials or amending its proxy materials if, promptly after making its decision, the company:

- issues a press release announcing the change;
- files the announcement as definitive additional soliciting material on EDGAR; and
- takes all reasonable steps necessary to inform other intermediaries in the proxy process (such as proxy service providers) and other relevant market participants (such as appropriate securities exchanges) of such change.

The Guidance also suggests that companies that have not yet mailed and filed their definitive proxy materials should consider, based on their particular facts and circumstances, whether to include disclosure regarding the possibility that the date, time, or location of the annual meeting may change due to COVID-19.

The Guidance indicates that if a company plans to conduct its shareholder meeting either as a virtual meeting (conducted solely through the Internet or other electronic means) or as hybrid meeting (allowing shareholders to participate either in person or through electronic means), the company should notify shareholders, intermediaries and other market participants of such plans in a timely manner. Companies need to provide clear directions as to the logistical details of the virtual or the hybrid meeting, specifying how shareholders can remotely access, participate in, and vote at the annual meeting. To the extent that the company has not yet filed and delivered its definitive proxy materials, such disclosures should be in the definitive proxy statement and other soliciting materials. Companies that have already filed and mailed their definitive proxy materials would not need to mail additional soliciting materials (including new proxy cards) solely for the purpose of switching to a virtual or hybrid meeting if they follow the steps specified for announcing a change in the meeting date, time, or location.

Some companies are already including disclosures in proxy statements advising of the possibility of changes from in-person meetings and where information about any such changes will be made available so precedent language is available to review as a starting place for such disclosures.

Companies that use e-proxy to make proxy materials available through the Internet, must post definitive additional proxy solicitation materials, including those addressing changes in meeting logistics, on their proxy voting websites. Companies making such changes after filing and mailing their definitive proxy statements should also consider whether their governing documents or the laws of their jurisdictions of formation have any additional notice requirements.

With respect to the presentation of shareholder proposals, the Guidance also encourages companies to permit the proponents or their representatives to present their proposals through alternative means, such as by phone, during the 2020 proxy season if feasible under governing law. In addition, if the proponent or representative is unable to attend the annual meeting and present the proposal as a result of COVID-19, the SEC staff would consider this failure to appear and present the shareholder proposal to be “good cause” for the purposes of Rule 14a-8(h). This means companies would not be able to assert Rule 14a-8(h)(3) as a basis to exclude a proposal submitted by the shareholder proponent for any meetings held in the following two calendar years.

SEC Exemptive Order

On March 4, 2020, the SEC issued an exemptive order[2] (Order) under the Exchange Act to provide relief to public companies and persons required to make filings with respect to public companies that are unable to meet an SEC filing deadline as a result of circumstances related to COVID-19. The Order covers the period from March 1, 2020, to April 30, 2020, and the SEC indicated that it may extend the time period if necessary, with any additional conditions it deems appropriate.

Any company relying on the Order must furnish to the SEC a current report on Form 8-K or, if eligible, a Form 6-K, by the later of March 16, 2020, or the original filing deadline for the report. This interim disclosure must state that the company is relying on the Order and briefly describe the reasons why the company could not file the report, schedule or form (Required Document) on a timely basis. In addition, the Form 8-K or Form 6-K must state the estimated date by which the company expects to file the Required Document and, if material, include a risk factor explaining the impact of COVID-19 on the company's business. If the Required Document cannot be filed on time because of the inability of a third person to furnish a necessary opinion, report or certification, the Form 8-K or Form 6-K must attach as an exhibit a statement signed by such person explaining the reason for the delay. The company or the person relying on the Order must file the Required Document with the SEC no later than 45 days after its original due date and must disclose that the Order is being relied on and the reasons why the Required Document could not be filed on a timely basis.

Any company meeting the requirements of the Order will be considered current and timely in its Exchange Act filing requirements, and therefore eligible to use Form S-3, if it was current and timely as of the first day of the relief period and it files the Required Document that was due during the relief period within 45 days of its original filing deadline. A company relying on the Order will be deemed to satisfy Form S-8 and Rule 144(c) requirements if it was current as of the first day of the relief period and it files the Required Document that was due during the relief period within 45 days of its original filing deadline. Companies will be permitted to rely on Rule 12b-25 if they are unable to file the required reports on or before the extended due date.

The Order also provides relief relating to the obligations under the SEC's proxy rules to furnish materials to security holders when mail delivery is not possible, as long as certain conditions are satisfied. For this exemption to apply, the company's security holder must have a mailing address located in an area where the common carrier has suspended delivery of service of the type or class usually used for the solicitation as a result of COVID-19 and the company or other person making the solicitation must have made a good faith effort to furnish the soliciting materials to the security holder.

Practical Considerations

Investors and the SEC are likely to review COVID-19 disclosure carefully. Therefore, public companies should start thinking now about upcoming COVID-19 disclosures in order to allow time for drafting and internal review of appropriate language. For example, it would be useful for companies to begin drafting more detailed risk factors relating to COVID-19 for inclusion in their next SEC filing for which risk factor disclosure is required or otherwise appropriate. Similarly, companies may want to start preparing and discussing the COVID-19 disclosure for their MD&A in advance of their next SEC filing requiring it.

Companies should also coordinate responses they are providing when responding to COVID-19 inquiries. It is important not to selectively disclose material non-public information to any investor. To the extent a company has material information to disclose relating to COVID-19, that information should be disclosed in a Regulation FD compliant method. If there has been an inadvertent selective material disclosure regarding COVID-19, the company must promptly disseminate such information by a press release or a Form 8-K.

Because of the swiftly moving changes in the COVID-19 situation and related impacts on companies, it is especially important for companies to take into account all aspects of their business, including reaching out to areas that may not normally be part of their disclosure controls and procedures, to ascertain whether anything is happening that could require disclosure.

Companies for which virtual meetings are permissible statutorily and by governing documents and that are considering switching in-person annual meetings to virtual meetings should be familiarizing themselves with the necessary technical logistics as far in advance of the meeting as practical, especially if this would be their first experience conducting a virtual shareholder meeting. It would be worthwhile to reach out to third-party providers that have experience hosting virtual meetings to get their input and to check their availability. Companies that are not planning to conduct virtual annual meetings may want to investigate the technical requirements, and applicable legal constraints from their jurisdiction of formation or their governing documents, for telephonic participation by officers and directors who may not be able to attend the shareholder meeting in person. Companies not conducting virtual meetings may also want to consider making their annual meetings available for shareholders to listen to via telephone or webcast, even if voting is only available through proxy or in-person attendance. In these situations, companies that are using technology for their annual meetings should be familiarizing themselves in advance with the tools to be used at the meeting.

Companies that decide to host a virtual meeting after filing their definitive proxy statement must file definitive additional proxy solicitation materials with the SEC, providing the details for participation in the virtual meeting, no later than the date first used. Similarly, companies using e-proxy must also post such material on their proxy voting website no later than the date such materials are first made public.

The SEC has publicized its willingness to discuss on a case-by-case basis administrative issues in complying with federal securities laws that may arise in connection with COVID-19 in addition to the ones addressed in the Order. Companies that have particular concerns should reach out to the SEC staff to discuss how to handle issues that may arise.

As the COVID-19 pandemic continues and governments and companies take additional precautionary measures that may impact business, more disclosure-related and filing or compliance issues may arise. It is possible that the SEC may issue additional guidance or orders in this area, so companies should monitor any further SEC developments.

The Order and Guidance are part of an evolving COVID-19 response that is moving across regulatory agencies. Please visit our website[3] to learn more. In addition, companies might find the SEC's COVID-19 Response webpage[4] to be a helpful resource.

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Endnotes

[1] Available at https://www.sec.gov/ocr/staff-guidance-conducting-annual-meetings-light-covid-19-concerns?auHash=zrsDVFen7QmUL6Xou7EIHYov4Y6IfrRTjW3KPSVukQs.

[2] Available at https://www.sec.gov/rules/other/2020/34-88318.pdf

[3] Available at https://www.mayerbrown.com/en/capabilities/key-issues/coronavirus-covid-19?tab=overview

[4] Available at https://www.sec.gov/sec-coronavirus-covid-19-response

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SEC Issues MD&A Guidance

On January 30, 2020, the US Securities and Exchange Commission (SEC) provided guidance[1] (MD&A Guidance) regarding the disclosure of key performance indicators and metrics used in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of SEC filings. This commission-level guidance, which reflects the SEC's interpretation of existing MD&A requirements, becomes effective on the date of its publication in the *Federal Register*, which will make it applicable to annual reports on Form 10-K and Form 20-F that are currently being prepared. In addition, on January 24, 2020, the SEC's Division of Corporation Finance issued three MD&A compliance and disclosure interpretations (C&DIs).[2]

Commission-Level MD&A Guidance

For some time now, SEC representatives have expressed concerns regarding the use of key performance indicators, or KPIs, concerns which are similar to those raised by the SEC with respect to the use of non-GAAP financial measures.[3] The SEC's Division of Enforcement also has taken action in recent years against companies relating to the use of misleading key performance metrics. The MD&A Guidance describes how Item 303(a) of Regulation S-K and comparable requirements of Forms 20-F and 1-A apply to key performance indicators and metrics. Item 303(a) not only specifies particular items for disclosure in the MD&A (such as liquidity, capital resources and results of operations), it also requires discussion of "such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." In addition, Instruction 1 to Item 303(a) requires discussion of "statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition, and results of operations."

The MD&A Guidance observes that some companies disclose non-financial and financial metrics when describing the performance or the status of their business. These metrics vary by company and industry, and some metrics include company- or industry-specific matters. These metrics may reflect external or macro-economic matters, or they may be a combination of external or internal information.

The MD&A Guidance reminds each registrant that uses metrics in its MD&A that, under existing requirements, it "need[s] to include such further material information, if any, as may be necessary in order to make the

presentation of the metric, in light of the circumstances under which it is presented, not misleading." According to the MD&A Guidance, a registrant must consider whether an existing regulatory disclosure framework—such as Generally Accepted Accounting Principles (GAAP) or, for non-GAAP financial measures, Regulation G or Item 10 of Regulation S-K—applies in the context of the metrics it uses and assess what "additional information may be necessary to provide adequate context for an investor to understand the metric presented."

Based on the facts and circumstances, the MD&A Guidance states that the SEC generally expects that a metric be accompanied by the following disclosure:

- a clear definition of the metric and how it is calculated;
- a statement indicating the reasons why the metric provides useful information to investors; and
- a statement indicating how management uses the metric in managing or monitoring the performance of the business.

According to the MD&A Guidance, a registrant needs to consider whether there are underlying estimates or assumptions for a metric or its calculation that need to be disclosed in order for the metric not to be materially misleading. And, if a company changes the calculation method or presentation of a metric from one period to another or otherwise, it should consider disclosing, to the extent material:

- the differences in the way the metric is calculated or presented compared to prior periods;
- the reasons for the change;
- the effects of the change on the amounts or other information being disclosed or previously reported; and
- other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.

Depending on significance, following a change in methodology or presentation, it may be necessary to recast prior metrics to conform to the current presentation and place the current disclosure in the appropriate context.

The MD&A Guidance emphasizes the importance of disclosure controls and procedures in the context of key performance indicators and metrics that are derived from the company's own information. If these indicators and metrics are material to either an investment decision or a voting decision, the MD&A Guidance states that "the company should consider whether it has effective controls and procedures in place to process information related to the disclosure of such items to ensure consistency as well as accuracy."

The MD&A Guidance contains the following non-exclusive list of examples of metrics to which this guidance applies:

- operating margin;
- same store sales;
- sales per square foot;
- total customers/subscribers;
- average revenue per user;
- daily/monthly active users/usage;
- active customers;
- net customer additions;
- total impressions;
- number of memberships;
- traffic growth;
- comparable customer transactions increase;
- voluntary and/or involuntary employee turnover rate;

- percentage breakdown of workforce (e.g., active workforce covered under collective bargaining agreements);
- total energy consumed; and
- data security measures (e.g., number of data breaches or number of account holders affected by data breaches).

At the same time that the SEC issued the MD&A Guidance, it proposed amendments to the current MD&A, selected financial data and supplementary financial information rules.[4] We will issue a separate Legal Update on those proposed amendments.

MD&A Compliance and Disclosure Interpretations

As a result of amendments to the MD&A that became effective in May 2019, companies are permitted to omit a discussion of the earliest of three years in a filing that includes financial statements covering three years to the extent that the discussion of that earlier year was already included in an SEC filing and such presentation identifies the location in the prior filing where the omitted disclosure may be found. The SEC's Division of Corporation Finance issued three new C&DIs to provide guidance in connection with that change.

C&DI 110.02 clarifies that a "statement merely identifying the location in a prior filing where the omitted discussion can be found does not incorporate such disclosure into the filing unless the registrant expressly states that the information is incorporated by reference."

C&DI 110.03 explains that a company may not omit the discussion of the earliest of the three years if it believes it "necessary to an understanding of its financial condition, changes in financial condition and results of operations."

C&DI 110.04 addresses the situation where a company files a Form 10-K in which the discussion of the earliest of the three years of financial statements is omitted from the MD&A and that Form 10-K thereupon becomes incorporated into a registration statement that is already effective. According to this C&DI, the filing of a Form 10-K for a newly completed fiscal year establishes a new effective date for the registration statement, and, as of the new effective date, the registration statement incorporates by reference only the latest Form 10-K, which does not contain the company's discussion of results for the earliest of the three years unless, as indicated in C&DI 110.02, the information is expressly incorporated by reference.

Practical Considerations

A registrant should assess whether it currently uses, or plans to use, any key performance indicators or metrics. If the answer is yes, a registrant should consider whether there is additional information that should be disclosed and develop the presentation for that new disclosure.

Because the MD&A Guidance becomes effective as soon as it is published in the *Federal Register*, it will be applicable to the MD&A that a calendar year-end company is drafting for its upcoming annual report. As a result, each such company should promptly assess whether it needs to make any changes to the MD&A to reflect the new guidance.

The MD&A Guidance is not limited to annual reports. It applies to other SEC filings containing MD&A, including quarterly reports and certain registration statements. Therefore, every company subject to the SEC's MD&A requirements should review this guidance now in order to prepare to apply it in the next MD&A to the extent necessary.

A company that discloses performance indicators and metrics in its MD&A section that are derived from the company's own information should review its disclosure controls and procedures to be sure these are effective with respect to the calculation of

these indicators and metrics. The review should also include a discussion with the audit committee. The audit committee should understand the performance indicators that are used—what their purpose is, whether they are well-understood and well-defined, what the methodology is for their calculation and whether there have been any significant changes in the indicators presented by the company or in their calculation methodology. This review and any update of disclosure controls and procedures should be completed before the company files its next annual report on Form 10-K or quarterly report on Form 10-Q.

Often, a company will use key performance indicators in its investor presentations, including in its earnings releases. The same level of review and care should be undertaken in relation to the preparation of these presentations and the use of performance indicators in these materials.

Companies that are considering omitting the discussion of the earliest of three years of financial statements from their MD&A should carefully review Instruction 1 to Item 303(a), which sets forth the requirements for doing so, and the recently issued C&DIs for the appropriate way to proceed. In particular, before omitting all or any part of such discussion, companies must conclude that they would not be excluding any information that they believe is necessary to the understanding of their financial position.

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Endnotes

[1] https://www.sec.gov/rules/interp/2020/33-10751.pdf

[2] https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm

[3] See, for example, remarks by then-Commissioner Kara Stein addressing KPIs, available at https://www.sec.gov/news/speech/speech-stein-102318

[4] https://www.sec.gov/rules/proposed/2020/33-10750.pdf

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April 10, 2020

Legal Update

TALF 2020 and CLOs

On April 9, 2020, the U.S. Federal Reserve announced revised preliminary terms for the Term Asset-Backed Securities Loan Facility ("TALF 2020"). Certain CLO securities that are rated AAA by at least two rating agencies and are not rated below AAA by any other rating agency will be eligible collateral for loans under the TALF 2020 program. In order to be eligible, the AAA CLO securities must be collateralized by static pools of leveraged loans and all or substantially all of these leveraged loans must be "newly issued."

Mayer Brown has separately published an overview of the preliminary terms of TALF 2020;[1] below we highlight several aspects with particular relevance to CLOs. It is expected that the preliminary terms will be supplemented by detailed terms and conditions that may provide definition around some or all of the points discussed herein. This is not an exhaustive summary, and there will be other considerations relevant to CLOs; for example, questions have been raised about the efficacy of the program from a commercial perspective in light of current pricing levels in the CLO market.

Eligibility of Underlying Credit Exposures[2]

The preliminary terms for TALF 2020 require that "all or substantially all of the underlying credit exposures must be newly issued, except for legacy CMBS." While the scope of the requirement that underlying credit exposures be "newly issued" is unclear, it is instructive that in a report to Congress,[3] the Federal Reserve stated that the TALF 2020 program would provide lending to holders of certain ABS backed by "newly or recently originated" underlying credit exposures. This report suggests that the Federal Reserve does not intend for the origination windows applicable to underlying credit exposures in TALF 2020 to be substantially different from those in the TALF program established in connection with the global financial crisis ("TALF 2008"). The terms and conditions for TALF 2008, which at the outset of TALF 2008 used the same "newly or recently originated" formulation with respect to underlying credit exposures,[4] permitted underlying exposures for static ABS that were originated as early as 12-20 months (depending on asset class) prior to the commencement of TALF 2008 to constitute all or substantially all of an applicable portfolio.[5]

TALF 2020 will have a greater capacity to provide liquidity to the leveraged loan market if the final terms and conditions for TALF 2020 were to make clear that underlying credit exposures for static ABS (including CLOs) will be eligible to constitute all or substantially all of an applicable portfolio if they were originated in a specified period (not shorter than 12-20 months) prior to the commencement of TALF 2020—consistent with the terms and conditions for TALF 2008—and that underlying credit exposures originated within the specified time frame will be eligible whether purchased in the secondary market or the primary market.

Eligibility of CLO Issuers

The preliminary terms for TALF 2020 require that the issuer of eligible ABS must be a U.S. company, defined as "a business that is created or organized in the United States or under the laws of the United States and that has significant operations in and a majority of its employees based in the United States."

Although many issuers of U.S. CLOs collateralized by middle market loans are U.S. entities, the vast majority of issuers of U.S. CLOs collateralized by broadly syndicated loans are Cayman Islands entities, frequently with a Delaware-domiciled entity as co-issuer of the AAA tranche and certain other tranches. While it would be possible for U.S. CLOs collateralized by broadly syndicated loans to be structured with a U.S. entity as sole issuer, doing so would result in certain departures from prevailing market practice. We note also that CLO co-issuers are special purpose entities without employees and that a collateral manager is engaged to select the credit exposures underlying the CLO securities. In order to cause as little disruption as possible to the prevailing market approach for providing funding to leveraged loan borrowers via CLOs, it would be beneficial if the final terms and conditions for TALF 2020 were to clarify that a U.S.-domiciled co-issuer qualifies as an eligible issuer if the selection of the credit exposures underlying the ABS is carried out by a collateral manager that is a U.S. entity with significant operations in, and a majority of its employees based in, the United States.

Eligibility of TALF 2020 Borrowers

The requirement that a borrower under TALF 2020 be a U.S. company raises similar questions to those considered above with respect to eligible issuers. TALF 2020 would be most effective in facilitating the provision of liquidity to the U.S. consumers and businesses that are the obligors on the underlying credit exposures if the final terms and conditions of TALF 2020 were to confirm the status of the following entities as eligible borrowers:

- A U.S. branch or agency of a non-U.S. bank.
- A U.S. entity with a non-U.S. parent company.

While these cases may be of varying relevance for CLOs given the historical principal buyer base for AAA CLO securities, in both of these cases there is a meaningful nexus with the U.S. that supports eligibility from a policy perspective, particularly given the U.S. connection that will be required with respect to the U.S. consumers and businesses that are the obligors on the eligible underlying exposures.[6]

We note that the initial term sheet for TALF 2020 expressly included both of the above cases as eligible borrowers, while the revised terms substitute the language quoted above under "Eligibility of CLO Issuers." That new language corresponds to the concept of a United States business under Title IV of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"),[7] suggesting that the change in language may have been motivated by a desire for consistency across Federal Reserve stimulus programs rather than any

specific intent to exclude the borrowers identified in the deleted language. Therefore we do not view the change as establishing that a U.S. branch or agency of a non-U.S. bank, or a U.S. entity with a non-U.S. parent company, would be ineligible to qualify as a borrower in TALF 2020. We note additionally that there is support in the CARES Act for distinguishing an eligible business from its parent.[8]

Interest Rate Basis

The interest rate for loans collateralized by CLOs under TALF 2020 will be 150 basis points over the 30-day average SOFR. Presumably a factor in the selection of SOFR for this purpose was the fact that the three-year maturity of TALF 2020 loans will extend beyond LIBOR's expected cessation at the end of 2021. Nonetheless, most leveraged loans currently continue to use LIBOR as their interest rate benchmark. To the extent that the use of SOFR as the interest rate benchmark applicable to TALF 2020 loans results in eligible AAA CLO tranches being issued with SOFR as the interest rate benchmark, a basis mismatch would be created relative to the interest rate benchmark applicable to the CLO's underlying credit exposures. While such a mismatch would perhaps have a limited adverse impact on the AAA CLO tranche given the typical quantum of interest coverage cushions in CLOs, the potential adverse impact would increase moving down the CLO capital stack and could therefore be a headwind to the use of TALF 2020 funding in the CLO market.

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Endnotes

[1] *See* https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/04/federal-reserve-revises-new-talf-program-term-sheet.pdf.

[2] We note that the TALF 2020 preliminary terms require that all or substantially all of the underlying credit exposures must have been "**originated by a U.S. company**," in an apparent departure from the TALF 2008 terms which required that all or substantially all of the underlying credit exposures must be "exposures to **U.S.-domiciled obligors**" (emphasis added in each case). Consistent with the TALF 2008 approach, the report on TALF 2020 cited in footnote 3 below refers to "exposures to U.S. borrowers." U.S. CLOs typically require that a specified percentage (typically at least 80% by par amount) of loans in the portfolio consist of obligations of U.S.-domiciled obligors, but U.S. CLOs typically do not impose a requirement with respect to the domicile of the originators of the loans in the portfolio. It remains to be seen whether the final terms and conditions for TALF 2020 will impose any requirement as to the domicile of the underlying obligors.

[3] *See* https://www.federalreserve.gov/monetarypolicy/talf.htm, linking to https://www.federalreserve.gov/publications/files/term-asset-backed-securities-loan-facility-3-29-20.pdf.

[4] *See* https://www.federalreserve.gov/monetarypolicy/files/monetary20081125a1.pdf.

[5] As regards the meaning of "newly issued," we also find it instructive that in the terms and conditions for TALF 2008 published in November 2009, the Federal Reserve considered "newly issued ABS" to include ABS issued on or after January 1, 2009, almost 11 months prior (or even earlier in the case of SBA Pool Certificates or Development Company Participation Certificates, which were considered "newly issued" if issued on or after January 1, 2008). *See* https://www.newyorkfed.org/medialibrary/media/markets/talf/Terms_Blackline_091030.pdf.

[6] It would also be helpful if, consistent with TALF 2008 eligibility, the final terms and conditions of TALF 2020 were to confirm that an investment fund that is U.S.-organized and managed by an investment manager that has its principal place of business in the United States is an eligible borrower.

[7] *See*, *e.g.*, Section 4003(c)(3)(C) of the CARES Act.

[8] *See* Section 4003(c)(3)(A)(ii)(I) of the CARES Act, referring to "the eligible business or any parent company of the eligible business." Similar language distinguishing an eligible business or funding recipient from affiliates or from a parent company is set out in Sections 4003(c)(2)(E) and 4003(c)(3)(D)(i)(VII) of the CARES Act. *See also* "The CARES Act and CLOs" at https://covid19.mayerbrown.com/stimulus-the-cares-act-and-clos/ and "Legal Update on Section 4003 of the CARES Act – Liquidity for Eligible Businesses, States, and Municipalities" at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/03/section-4003-of-the-cares-act-v3-final.pdf.

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April 02
2020

The CARES Act and CLOs

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On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act, or the CARES Act,[1] was signed into law. Among other things, Section 4003 of the CARES Act authorizes $500 billion of liquidity to support businesses, states and municipalities "related to losses incurred as a result of coronavirus." Moreover, Treasury Secretary Mnuchin has said that much of this $500 billion will be leveraged in Federal Reserve facilities such that the total liquidity under Section 4003 of the CARES Act could be as high as approximately $4 trillion.[2] It can be expected that a portion of this liquidity will take the form of loans to companies that are borrowers under loans held by collateralized loan obligation vehicles ("CLOs"). This, in turn, could ease the impact of the COVID-19 crisis on CLOs, possibly also leading to renewed CLO formation, which plays an important role in the U.S. economy by providing an important source of stable funding to U.S. businesses.

For a full summary of Section 4003 of the CARES Act, please see our March 31 publication, "*Legal Update on Section 4003 of the CARES Act – Liquidity for Eligible Businesses, States, and Municipalities*."[3] In addition, for a summary of certain aspects of the Paycheck Protection Program authorized by the CARES Act related to liquidity for small businesses, please see our March 27 publication, "*Government: Small Business Loans Under the CARES Act*."[4] Because credits in CLOs that are collateralized by broadly syndicated loans typically consist of obligations of larger companies, in this Legal Update we focus on highlighting certain notable features of Section 4003 (as well as related parts of Title IV) of the CARES Act in respect of CLOs.

Aspects of Section 4003 of the CARES Act That Are Relevant to CLOs and Leveraged Borrowers

1. The liquidity authorized by Section 4003 of the CARES Act is likely to be more helpful to CLOs and leveraged companies than other crisis-related programs to date.

Crisis-related programs that were introduced prior to the enactment of the CARES Act appear largely unhelpful to CLOs. The Primary Dealer Credit Facility, established by the Federal Reserve on March 17, 2020, permits CLO notes as collateral, but only those with a AAA rating.[5] The new Term Asset-Backed Securities Loan Facility, established by the Federal Reserve on March 23, 2020, does not recognize CLO notes – not even if AAA-rated – as eligible assets.[6] And the Primary Market Corporate Credit Facility and the Secondary Market Corporate Credit Facility, also established by the Federal Reserve on March 23, 2020, are restricted to investment grade companies and investment grade debt, and are therefore generally unhelpful to leveraged borrowers whose loans are held by CLOs.[7]

Unlike the above-mentioned crisis-related programs, liquidity under Section 4003 of the CARES Act has the potential to benefit CLO credits because it is not restricted to businesses with investment grade ratings. Leveraged borrowers, including those that are CLO credits, will not be precluded under the statutory terms from accessing such liquidity based on a specified ratings threshold.

2. Section 4003 of the CARES Act provides for liquidity support for both large and mid-sized businesses that could include CLO credits.

Section 4003 of the CARES Act authorizes up to $46 billion for direct Treasury support for passenger air carriers (and certain specified related businesses), cargo air carriers, and businesses critical to maintaining national security. CLO credits include airline businesses.[8] Perhaps more significantly, the bulk of the liquidity authorized by Section 4003 of the CARES Act, in an amount up to $454 billion (plus any amount remaining from the $46 billion allocated to air carriers and related businesses, and businesses critical to maintaining national security), is not restricted to particular industries or business sizes. While it is true that businesses that qualify for the liquidity authorized to be made available to mid-sized businesses under Section 4003(c)(3)(D) of the CARES Act will benefit from an interest rate cap of 2% and a repayment holiday of 6 months after borrowing (or such longer period as the Secretary of the Treasury may determine in his discretion), businesses that are too large to qualify for the special program or

facility for mid-sized businesses should not be ineligible, based on size, for liquidity under other Federal Reserve programs or facilities that are expected to be established under Section 4003 of the CARES Act, for which the statute does not impose any size limits.

To be eligible for the mid-sized business funding under Section 4003(c)(3)(D) of the CARES Act, a business must have between 500 and 10,000 employees. Unlike eligibility for small business loans under Title I of the CARES Act, which (with certain important exceptions) is subject to rules requiring that affiliated companies be aggregated for purposes of evaluating employee-based and other size standards, Title IV of the CARES Act does not specify that affiliated businesses must be aggregated for purposes of the mid-sized business threshold. It is possible that further details regarding determining compliance with the mid-sized business thresholds will be included in the terms of such programs that have not yet been released.

3. Section 4003 of the CARES Act authorizes funding to eligible United States businesses, and U.S. CLOs predominantly hold obligations of U.S.-domiciled borrowers.

CLOs frequently include concentration limitations requiring that a specified percentage of the loans in their portfolios (typically a minimum of 80% by par amount) must be obligations of U.S.-domiciled businesses. While the domicile specifications of CLO indentures are not co-extensive with the concept of "United States businesses" under Title IV of the CARES Act, one would expect material overlap in the concepts.

As detailed in our March 31 Legal Update on Section 4003 of the CARES Act,[9] a business other than an air carrier must be a United States business in order to be eligible for support under Section 4003 of the CARES Act. In order to be considered a United States business, it appears that an entity must be created or organized in the United States and have significant operations in and a majority of its employees based in the United States.[10]

The scope of what constitutes a “business” in relation to affiliated entities is not specified in the CARES Act. But reference in certain provisions of Section 4003 of the CARES Act to “the eligible business and any parent company” suggests that a “business” does not necessarily need to encompass an entire corporate family.[11] This may be relevant for purposes of determining whether a majority of the employees of a

business are based in the United States – *e.g.*, in the case of a U.S.-domiciled and -headquartered business entity, a majority of whose employees are based in the U.S., but which is part of a global corporate family a majority of whose employees are not based in the U.S.

4. Section 4003 of the CARES Act does not specify particular loss criteria for funding under the Section 4003(b)(4) programs.

While liquidity available to air carriers (and certain related businesses) and businesses critical to national security under Sections 4003(b)(1), (2) and (3) of the CARES Act is conditioned upon the Secretary of the Treasury's determining that the eligible business has incurred or is expected to incur covered losses[12] such that the continued operations of the business are jeopardized, the statute does not specify any equivalent condition to liquidity for eligible businesses under Section 4003(b)(4) of the CARES Act.[13] While it can be expected that borrowers will be required by program terms to demonstrate financial need, the difference in statutory terms in the text of Section 4003 of the CARES Act could potentially result in access to liquidity for a broader range of leveraged borrowers experiencing various coronavirus-related business disruptions than would otherwise be the case.

5. Section 4003(b)(4) of the CARES Act has more limited restrictions on business operations than Sections 4003(b)(1), (2) and (3).

It is also notable that Section 4003(b)(4) generally does not include all of the same restrictions on business operations that apply under Sections 4003(b)(1), (2) and (3) of the CARES Act. For example, the condition that, until September 30, 2020, a funding recipient shall not reduce its employment levels by more than 10 percent applies under Section 4003(b)(4) of the CARES Act to businesses accessing funding under the mid-sized business provisions, but otherwise is not applied by Section 4003 of the CARES Act to funding recipients other than air carriers (and certain related businesses) and national security-related companies accessing funds under Sections 4003(b)(1), (2) or (3).

Additional Information

As more fully described in our March 31 Legal Update, several requirements applicable to loans or loan guarantees made under Section 4003 of the CARES Act may, for many potential recipients, raise issues under those businesses' existing contractual

arrangements, including shareholder agreements and debt documentation. It will be important for the programs and facilities established under Section 4003 of the CARES Act to be structured in a way that is workable in light of the existing contractual arrangements to which eligible businesses are subject.

The application procedures and terms and conditions of programs and facilities under Section 4003 of the CARES Act must first be published by Treasury and or/the Federal Reserve before eligible businesses may apply for funding. On March 30, 2020, Treasury published preliminary application procedures and minimum requirements, to be "supplemented promptly with additional terms," for Treasury's direct lending under Sections 4003(b)(1), (2) and (3) of the CARES Act to air carriers and businesses related to national security. This was almost a week before the April 6 deadline for publication of application procedures and minimum requirements under the statute. The CARES Act does not provide a timetable for publishing application procedures and minimum requirements for the Federal Reserve programs and facilities contemplated by Section 4003(b)(4) of the CARES Act. That said, Section 13(3) of the Federal Reserve Act requires that within seven days of a vote by the Federal Reserve Board of Governors to authorize a program or facility under "unusual and exigent circumstances," the Federal Reserve must publish information about such program or facility, including the terms and conditions for participation.

While this Legal Update provides a summary of certain aspects of the recently enacted CARES Act, the ultimate terms and conditions for any programs established thereunder could change dramatically as Treasury and the Federal Reserve determine the most efficient and expeditious way to distribute the funds authorized under the Act. For example, the Troubled Asset Relief Program (TARP) legislation enacted in October 2008 provided that the Federal government would purchase troubled assets from various financial services firms. Ultimately, no assets were ever purchased by the Federal government, as Treasury decided to directly inject capital funds into the financial system through the Capital Purchase Program by purchasing preferred shares from depository institutions and their holding companies.

If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

And for any legal questions related to this pandemic, please contact the authors of this article or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com."

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[1] H.R. 748.

[2] "*Fed will make up to $4 trillion in loans to businesses to rescue the U.S. economy*," MarketWatch, March 28, 2020. Secretary Mnuchin's comments regarding leveraging of Treasury Department investments in Federal Reserve CARES Act facilities is consistent with announcements concerning Treasury Department equity investments for other Federal Reserve programs established to address the COVID-19 crisis: the Primary Market Corporate Credit Facility, the Secondary Market Credit Facility, the Commercial Paper Funding Facility, and the Term Asset-Backed Securities Loan Facility. For initial summaries of these programs see "*US Treasury and Federal Reserve Announce Two Corporate Credit Facilities for Large Employers*," March 25, 2020 (https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/03/us-treasury-and-federal-reserve-announce-two-new-corporate-credit-facilities-for-large-employers.pdf); "*Government: Federal Reserve launches commercial paper funding facility*," March 24, 2020 (https://covid19.mayerbrown.com/government-federal-reserve-launches-commercial-paper-funding-facility/); and "*Financing: New Term Asset-Backed Securities Loan Facility*," March 25, 2020 (https://covid19.mayerbrown.com/financing-new-term-asset-backed-securities-loan-facility/)." *See also* "*How the Fed's Magic Money Machine Will Turn $454 Billion into $4 Trillion*," *New York Times*, March 27, 2020.

[3] At https://www.mayerbrown.com/en/perspectives-events/publications/2020/03/legal-update-on-section-4003-of-the-cares-act-liquidity-for-eligible-businesses-states-and-municipalities.

[4] At https://covid19.mayerbrown.com/small-business-loans-under-the-cares-act/. *See also* "Paycheck Protection Program FAQs for Small Businesses" at https://www.covid19.law/2020/03/paycheck-protection-program-faqs-for-small-businesses/.

[5] See *Term Sheet for Primary Dealer Credit Facility (PDCF)*, https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200317b1.pdf .

[6] See Term Sheet, "Term Asset- Backed Securities Loan Facility," https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b3.pdf

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[7] See "*US Treasury and Federal Reserve Announce Two Corporate Credit Facilities for Large Employers*," cited at footnote 1.

[8] *U.S. CLOs in the Time of Coronavirus*, S&P Global Ratings, March 27, 2020. S&P reports that the airline sector represents 1% of CLO assets.

[9] At https://www.mayerbrown.com/en/perspectives-events/publications/2020/03/legal-update-on-section-4003-of-the-cares-act-liquidity-for-eligible-businesses-states-and-municipalities.

[10] *See* Sections 4003(c)(2)(H); 4003(c)(3)(C); and 4003(d)(i)(6).

[11] *See* 4003(c)(3)(A)(ii)(I)

[12] Section 4002 of the CARES Act provides that a "**covered loss**" includes losses incurred directly or indirectly as a result of coronavirus, as determined by the Secretary.

[13] It is a condition to funding for mid-sized businesses that the borrower makes a good-faith certification that the uncertainty of economic conditions as of the date of the application makes necessary the loan request to support the ongoing operations of the recipient.

MAYER | BROWN

April 02
2020

COVID-19 and US Securitization Impacts

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On March 11, 2020, the World Health Organization officially characterized COVID-19 as a pandemic, raising the health emergency to its highest level. To date, a number of governmental programs have been enacted in response to the hardships created by the pandemic, including:

- On March 13, 2020, President Trump declared a national emergency under the National Emergencies Act and an emergency under the Robert T. Stafford Disaster Relief and the Emergency Assistance Act.
- On March 15, 2020, the Board of Governors of the Federal Reserve System (the "Federal Reserve") announced it would drop interest rates to zero and buy at least $700 billion in government and mortgage-related bonds as part of a wide-ranging emergency action to protect the economy.
- On March 16, 2020, the US Securities and Exchange Commission ("SEC") announced that it will not take final action before April 24, 2020, regarding certain proposed actions that have comment periods expiring in March, to allow commenters additional time to submit comments.
- On March 17, 2020, the Division of Swap Dealer and Intermediary Oversight of the Commodity Futures Trading Commission ("CFTC") issued five letters providing temporary regulatory relief to certain categories of market participants with respect to COVID-19.
- On March 17, 2020, the Federal Reserve re-started the Primary Dealer Credit Facility and the Commercial Paper Funding Facility, each of which originally came about during the 2008 financial crisis in an effort to support the flow of credit to American households and businesses.
- On March 18, 2020, President Trump signed into law the Families First Coronavirus Response Act. This bill provides for paid sick leave and free COVID-19 testing,

expands unemployment benefits and food assistance, and requires employers to provide additional protections for healthcare workers.

- On March 18, 2020, the Federal Reserve established the Money Market Mutual Fund Liquidity Facility that will provide liquidity to certain types of money market mutual funds ("MMFs") by making secured loans to financial institutions that purchase certain assets from MMFs.
- On March 20, 2020, the Internal Revenue Service ("IRS") released Notice 2020-18, which postpones the due date for making federal income tax payments (including payments of tax on self-employment income) for the 2019 taxable year due April 15, 2020, to a new due date of July 15, 2020.
- On March 23, 2020, the Federal Reserve re-started the Term Asset-Backed Securities Loan Facility, which originally came about during the 2008 financial crisis in an effort to ease liquidity concerns and generally stimulate deal flow.
- On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act, or the "CARES Act". This bill provides economic stimulus, including (1) direct financial help to Americans, (2) loans and benefits for businesses, (3) loans for directly impacted industries such as air carriers, and (4) assistance for healthcare.

The situation currently appears ominous as the number of cases of the virus has increased exponentially globally, with many countries severely impacted economically as well as socially.

In addition to a host of general business concerns, such as stock price, revenues, supply chain and employee and community health and welfare, the novel coronavirus, COVID-19, has raised a number of issues in the securitization markets both domestically and offshore. In this article, we will focus on the following issues—

1. SEC disclosures and related requirements;
2. Term Asset-Backed Securities Loan Facility;
3. Servicing modifications;
4. Servicing and labor disruptions;
5. Force majeure provisions and material adverse change clauses; and
6. Exacerbation of LIBOR issues.

SEC Disclosures and Related Requirements

To a large degree, SEC disclosure requirements are principles-based. Applying the concept of materiality to the impact of COVID-19, there are many areas where existing SEC rules, while not expressly mentioning pandemics, could require disclosure. Such disclosure considerations could arise in the context of a regularly scheduled periodic report, such as an annual or quarterly report. Or, there could be an issue that requires more immediate disclosure through a current report on Form 8-K or Form 6-K or a press release. For transactions currently being contemplated, we also anticipate that securitizers will make disclosures in risk factors regarding the impact of the pandemic on their business and the transaction generally.

In addition to more general risks, with the impact from COVID-19 growing rapidly, companies may become increasingly aware of additional ways in which the pandemic is posing specific risks to their operations that warrant disclosure as much of their workforce transitions to working from home and/or production facilities are forced to close. Due to these rapidly evolving changes to operations, companies will likely find it useful to begin drafting more detailed risk factors relating to COVID-19 for inclusion in their next SEC filing that requires risk factor disclosure. It will also be important for securitizers to make appropriate disclosures in offering documents to set forth risks that are specific to the asset-class and business as well as to the transaction as a whole. We expect to see fulsome risk factors covering COVID-19 in offering documents as well as due diligence questions related thereto for purposes of underwriter and initial purchaser diligence.

Additionally, the SEC has publicized its willingness to discuss on a case-by-case basis administrative difficulties in compliance with federal securities laws that may arise in connection with COVID-19. The official beginning of the COVID-19 pandemic occurred in March, which is the same month that most periodic securitizers are obligated to file a Form 10-K.

Term Asset-Backed Securities Loan Facility

The Term Asset-Backed Securities Loan Facility ("TALF") was established by the Federal Reserve on March 23, 2020 to support the flow of credit to consumers and businesses. The Federal Reserve expects that the TALF will enable the issuance of asset-backed securities backed by underlying credit exposures in the following specified assets classes: student loans, auto loans and leases, commercial and consumer credit card receivables, equipment loans, floorplan loans, insurance premium finance loans, certain loans guaranteed by the Small Business Administration and eligible servicing advance receivables. Under the TALF, the Federal Reserve Bank of New York will commit to

lend to a special purpose vehicle and such special purpose vehicle will then make available up to $100 billion in non-recourse three-year loans to investors in asset-backed securities. The loans made to such investors will be secured by a pledge of the related asset-backed securities as collateral. The pledged eligible collateral will be valued and assigned a haircut based on the asset class and the historical volatility and weighted average life of the pledged asset-backed securities.

Based on the TALF term sheet, to be eligible as collateral for the TALF, the asset-backed securities must: (1) have a credit rating in the highest investment grade category (long-term or short-term) from at least two rating agencies; and (2) be issued on or after March 23, 2020. In addition, the credit exposures underlying such asset-backed securities must: (1) fall within one of the specified asset classes listed above; (2) all, or substantially all, have been originated by a U.S. company; and (3) all, or substantially all, have been newly issued. Although investors in asset-backed securities will likely need to wait for the release of the more detailed terms and conditions to confirm eligibility, the Federal Reserve has indicated that such terms and conditions will be primarily based off of the terms and conditions used for the TALF established in 2008.

Servicing Modifications

The concept of permitted servicing modifications is prevalent in securitization transactions. Most servicers are allowed to modify the terms of the underlying assets if the modification, among other things, would maximize collections or in the event of a national disaster. Since President Trump declared a national emergency under the National Emergencies Act and an emergency under the Robert T. Stafford Disaster Relief and the Emergency Assistance Act on March 13, 2020, it is likely that we will see many servicers in securitizations granting payment extensions or deferrals to obligors. The extent to which such modifications are permitted is governed by the servicing standard set forth in the related securitization documents. While these modifications will likely impact deal cash-flows in the short-term, these disruptions will likely only be temporary as servicers are not likely to grant long-term extensions and deferrals.

Servicing and Labor Disruptions

As the outbreak of COVID-19 in China continues to spread to and within additional countries, including the United States, it has begun to disrupt business in the travel and hospitality industries, among others, and there is a risk that the outbreak will reduce

general economic and commercial activity in the United States and offshore in a way that delays or reduces the origination of new assets. Disruptions flowing from the outbreak will also have negative credit and cash-flow implications on transactions as borrower ability to pay will be stressed.

The continued spread of COVID-19 is starting to result in labor disruptions as manufacturing plants are closing and only essential businesses are permitted to remain open by decree of various state governmental officials. Additionally, staffing problems are arising in various industries and businesses as staff members become ill or seek to avoid becoming ill. Many businesses are reviewing and adjusting their business continuity plans to potentially change how and from where their staff members work in light of the outbreak, particularly with work from home policies. Those staffing problems and adjustments could cause changes in obligor behavior and in the ability of servicers to seek timely payments on receivables and also result in delayed or reduced demand for loans. It is also possible that the spread of COVID-19 could result in staffing problems at government offices (such as department of motor vehicles or UCC filing offices), the trustees and other deal parties, including financing sources, investors and prospective investors. It is likely that the impact of the servicing and labor disruptions will be felt acutely in transactions.

Force Majeure Provisions and Material Adverse Change Clauses

Most securitization documents contain force majeure provisions. *Force majeure* translates from French roughly as "a major force" and excuses a party, typically the securitization issuer, the servicer or their affiliates, from performance under the transaction documents. While the concept of an excuse from performance of contractual obligations due to unexpected events is common to securitization transactions, there are differences in its scope and operation. Business parties need to carefully consider the specific wording of force majeure clauses when they appear in a contract.

Even in the absence of a contractual force majeure provision, common law principles of impracticability, frustration of purpose, or prevention by government regulation are available in most states and are incorporated into the Restatement (2d) of Contracts, which is followed in most state jurisdictions. Under the doctrine of impracticability, a party's contractual obligations may be discharged if, after the contract is made, the party's performance becomes impracticable due to the occurrence of an event that is:

- outside of a party's control; and

- a basic assumption on which the contract was made (Restatement (2d) Contracts § 261).

Similarly, under the doctrine of "frustration" of contract, a party's contractual obligations may be discharged if, after the contract is made, the party's principal purpose is substantially frustrated:

- without the party's fault; and
- where the occurrence or non-occurrence of an event was a basic assumption on which the contract was made (Restatement (2d) Contracts § 265).

The party asserting the existence of the force majeure event will bear the burden of demonstrating the existence of such event. Whether events related to COVID-19 will constitute force majeure will turn on the language used in the agreement, the specific events that are being referenced, and the extent to which those events were foreseeable or under a party's control. For example, if an agreement defines a force majeure as an "Act of God," and the event triggering the force majeure is a voluntary directive to work from home, such directive may not sufficiently fall within the definition of force majeure. Similarly, in the event of a government-mandated business shut down, a party's right to discharge its contractual obligation may be more naturally adjudicated under the doctrine of impracticability due to government regulation, rather than under a force majeure clause. On the other hand, if a force majeure provision specifically includes a pandemic, parties may have a better argument for relying on such provisions to excuse their contractual obligations.

In addition to the above, material adverse change ("MAC") clauses are a common feature in most securitization documents and most frequently, although not exclusively, relate to events that have a material adverse impact on the securitizer's, servicer's or a related party's capacity to perform under the securitization documents or that otherwise have a material adverse impact on noteholders. Similar to a force majeure event, the party asserting a breach of a MAC clause will bear the burden of demonstrating the existence of such event. However, in contrast to a force majeure event, in the case of securitizations, the party invoking a MAC clause is more likely to be an investor, rather than the securitizer, servicer or one of their respective affiliates. With respect to COVID-19, assuming the invoking party can show that COVID-19 has or will have a substantial adverse impact on the securitizer's, servicer's or other party's capacity to perform under a securitization agreement, on the noteholders or on any other covenant containing a MAC clause, the primary question may be whether

COVID-19, and the harm it has caused, will persist for a significant period of time. To the extent the harm caused by COVID-19 persists, and economic dislocation increases in severity and duration, the argument that a MAC clause has been triggered may well grow stronger. How severity and duration are measured and evaluated at any point in time remains to be seen, and these questions will need to be carefully considered in interpreting a MAC clause.

Parties considering exercising their force majeure rights should carefully review the contract's language to determine if a force majeure event (or non-occurrence thereof) is a condition to contracting, an excuse from performing certain obligations, or creates a mutual right for both parties to terminate their obligations. Further, parties should note the procedural requirements to exercising the force majeure rights, as most courts will require rigid adherence to such procedural mechanisms. In addition, securitizers should carefully review any MAC clauses in their securitization documents and consider whether they will arguably breach any of these covenants based on the effects COVID-19 may have on their operations or their ability to timely pay interest and principal on their securities.

Exacerbation of LIBOR issues

In May 2019, the Alternative Reference Rates Committee ("ARRC") published "ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations" ("ARRC Recommendations"). While the ARRC Recommendations included a definition of what constitutes a cessation of LIBOR and provided a "waterfall" of replacement rates to be used when LIBOR is no longer published or is no longer representative, the securitization industry has been hesitant to adopt the ARRC Recommendations. Instead, we have seen some securitization sponsors adopting a modified ARRC approach or not adopting the ARRC Recommendations at all. The time and attention that securitizers would have spent developing LIBOR transition plans has now been diverted to more pressing needs caused by the pandemic.

While the disruption of LIBOR would pose some issues in a normally functioning financial market, the COVID-19 outbreak has exacerbated any such LIBOR disruption issues. Specifically, with the Federal Reserve setting interest rates at zero, it is possible that certain securities indexed to LIBOR could be in the odd position of bearing a negative interest rate whereby the investors would theoretically have to pay the securitization issuer interest. While many deals set a LIBOR indexed floor of zero in

transactions, most older transactions do not have this feature. Although this anomaly may benefit buyers of the equity portions of the capital stack in a transaction, most transactions are simply not legally or operationally equipped to handle a reversal in cash-flow.