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Top Ten Issues in Mortgage M&A

The mortgage origination and servicing industry is going through a period of intense change and consolidation, driven by the fallout from the credit crisis, impending regulatory initiatives and recent foreclosure issues. Whether you are a buyer or seller in an M&A transaction in the mortgage industry, the issues described below will likely require substantial focus by lawyers and business people on the deal team.

1. **Liability for Representations and Warranties:** Repurchase claims for representation and warranty breaches have received a huge amount of scrutiny in the press of late, including demands from Congressmen that the FHFA enforce representation and warranty obligations to Fannie and Freddie and new stress tests that will include an examination of banks' repurchase exposure. Subprime businesses will need to deal with private counterparty demands as well, including whole loan buyers, private mortgage insurers, surety bond providers and investors in RMBS securities, many of which may be near bankruptcy or in wind down mode and not particularly worried about their business relationships. Buyers of mortgage businesses will attempt to obtain an unlimited indemnity for pre-closing representation and warranty claims regardless of the validity of financial statement reserves by the seller. Sellers may prefer to settle as many years of claims as possible prior to a sale to clarify their liability picture. The GSEs and private counterparties may, in fact, hold up giving consents that are otherwise needed to transfer the business unless the seller settles their claims.

2. **Foreclosure Defects and MERS Issues:** It is unclear what the ultimate fallout will be from the recent disclosure of widespread foreclosure defects. Ultimately, these defects may be regarded as technical issues that can be fixed by filing new affidavits, but the intense focus on foreclosure processes may be an unpleasant reality for mortgage servicers for a long time, driving up servicing costs, increasing the time-line to complete foreclosures and ultimately lowering recoveries on defaulted mortgages. Buyers should scrutinize the validity of sellers' financial statements and projections, including loan loss and litigation reserves, anticipated

legal, accounting and consultant fees, and staffing plans. Buyers should also expect that the new Consumer Financial Protection Bureau will drive more regulation and stress profits for mortgage originators and servicers, and should build this cost into their projections. MERS issues relating to whether securitization trusts and other buyers of mortgage portfolios have a sufficient ownership interest in mortgages to foreclose on defaulted mortgages will increase litigation costs for the industry, but should ultimately be resolved to recognize the well-established principle that "the mortgage follows the note," which is essential to securitization and the mortgage industry in general. Situations where notes are missing or are not held by the owner or their custodian may be more difficult to resolve.

3. **Consent Issues:** Selling a mortgage business, as with other finance company sales, largely involves selling a pool of agreements and financing transactions. Unlike many other M&A deals, however, the sale of the stock of a mortgage subsidiary may not necessarily decrease the due diligence or consent burden. The vast majority of the due diligence and its cost revolves around the review of mortgage sale and servicing agreements and related securitization and other financing agreements. In our experience, there are techniques to short cut the cumbersome diligence and consent process that may be acceptable to the parties. For example, rather than reviewing every single pooling and servicing agreement, the seller and buyer could agree to review a sampling of agreements from a particular program—perhaps an early, middle and late stage agreement—and assume that the rest contain the same provisions. Issues that need to be diligenced include consent to transfer as well as any restrictions on financing. It may also be possible to use the "batch" approach when obtaining consents from counterparties, such as trustees and master servicers. Deal amendments may be possible without security-holder consent to get around particularly thorny consent issues.

4. **Financing Issues – Servicing Advances:** In the current environment, the largest mortgage originators/servicers—Citi, Bank of America and Wells Fargo—are too busy absorbing their credit crisis mortgage purchases and dealing with upcoming regulatory changes to be buyers. The buyers in today's market tend to be opportunistic financial buyers—private equity and hedge fund buyers of distressed assets—although there are some new signs that middle market and regional banks may ultimately want to get back into the mortgage business. This means that financing will be a key issue for buyers, and the market for financing servicing advances and MSRs is not an easy one at present. Sellers with a bank balance sheet may want to consider providing seller financing for the buyer as long as the seller can still obtain sale accounting treatment for the transaction.

   Key issues that arise in financing servicing advances include: (1) estimating recovery timelines for outstanding servicing advances; (2) delinking servicing advances from the performance and financial condition of the servicing; (3) confirming the priority of servicing advance reimbursements; and (4) developing an exit strategy for the potential liquidation of servicing advances post-default. The buyer will want to diligence the seller's advancing practices and stop advance policies because servicers' advancing practices may differ and affect payments to securitization investors.

5. **Financing Issues – MSR Facilities:** At times over the past few years, the finance market for MSRs has been completely shut. MSRs are difficult assets to finance because their value is highly correlated with prepayment speeds on the underlying mortgage loans and with the performance and cost structure of the servicer. Key issues that arise in financing mortgage servicing rights include: (1) valuing the MSR; (2) the fact that the performance of the servicer can impact the value, or cause the termination, of the MSR; and (3) enforcement of the claim against the MSR following a default on the related financing.

6. **Audit of Escrow and Collection Accounts:** With massive amounts of cash flowing through hundreds of escrow, custodial and collection accounts, verifying account balances and ensuring compliance with agreements are perennial problems for mortgage M&A deals. Buyers are demanding that they have the ability to audit account balances and true up shortfalls prior to closing. A seller may want to conduct its own audit prior to sale to ensure that there will be no surprises. Buyers should confirm that the seller's cash management and investor reporting practices comply with financing agreements and that cash is not commingled out of compliance with these agreements.

7. **Licenses:** Obtaining licenses is a huge endeavor for private equity and hedge fund buyers and will impact timing to close. Even for bank buyers, licensing may become an issue given that bank subsidiaries will no longer benefit from preemption under Dodd-Frank but the bank buyer may want to keep its mortgage business in a separate subsidiary for liability reasons. We have developed extensive subservicing technology to deal with licensing issues and allow the transaction to close pending receipt of licenses. Of course, subservicing will lead to additional due diligence and consent issues since many agreements require a consent to subservice the entire servicing function. In some cases, where an M&A deal does not seem like a viable option in part because of consent issues for a sale, subservicing may be an attractive alternative deal structure.

8. **Protection Against Prior Acts:** To unlock the value of any mortgage platform, the buyer must develop a way to adequately protect itself from liabilities existing on the date of acquisition. In most cases these legacy liabilities will be difficult to quantify, and if the protection provider is not a creditworthy entity, then the buyer may want to consider other ways to protect itself against these liabilities, which cannot be simply or easily disconnected from the platform. Possible solutions include amortizing purchase price holdback amounts, escrow accounts and possibly derivative contracts. Properly structured, these protection arrangements can be designed to isolate the value of the protection from the credit risk of the protection provider.

9. **Employee Issues:** Where M&A is driven by the need to consolidate, employee issues will be important. Although mortgage originators and servicers are typically not unionized with the result that labor union consents and renegotiation of collective bargaining agreements are not an issue, buyers must carefully diligence severance costs under benefit plans and employment agreements. Buyers and sellers will also need to comply with Federal and State WARN statutes that typically require 60 days' notice of a mass layoff or plant closing. A clear communication plan for employees and diligent observance of WARN notice rules are essential to avoid claims and litigation. Buyers will also want to diligence change in control triggers in

benefit plans and employment agreements even where employees will be retained. Buyers and sellers will negotiate extensively on who will be responsible for these costs.

10. **Information Technology Issues:** Information technology issues are always important in financial institution M&A. In mortgage acquisitions, buyers will want to be sure that the seller has continued investing in IT and that its systems are up to speed and capable of scaling up for the consolidated business. Where the buyer uses different systems than the seller, complex transition issues will arise and take a good deal of time to work out. The IT transition services agreement often becomes a lengthy side show of its own and should not be ignored until the last minute. Having a skilled IT lawyer on the M&A team will be a huge advantage for the buyer and seller. The parties will also need to negotiate shared services and IT after the transaction closes. ◆

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