When M&A Meets Securitization: A Deeper Dive

Article March 2019

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

By Elizabeth A. Raymond

Elizabeth A. Raymond
eraymond@mayerbrown.com
+1 312 701 7322

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.

Ms. Raymond is a financial institution M&A partner at Mayer Brown LLP. She 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.

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our one-firm culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices") and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies"). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2019 Mayer Brown. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.