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Structured Finance Bulletin

Legal Insights and Trends in the Structured Finance Markets

NOTES FROM THE EDITORS

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In this inaugural edition of our *Structured Finance Bulletin*, we discuss some trending issues that began impacting the structured finance and asset-backed and mortgage-backed securities spaces in late 2018, which will play a more prominent role in the execution and marketing of securitization transactions in 2019.

We also discuss the impact of new European Union securitization regulations on US securitizers, the do's and don'ts of investor meetings and road show presentations, issues that securitization sponsors and servicers may face in M&A transactions, and asset valuation considerations in mortgage loan and real estate warehouse transactions.

Finally, we discuss the impact of recent statutory amendments in Delaware that enable a Delaware limited liability company to be divided into two or more LLCs.

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Securitization – What to Expect in 2019

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This article summarizes some of the key trends to watch in 2019 in the consumer asset-backed securities (non-mortgage) space, the mortgage and residential securitization space, and with respect to the Customer Due Diligence Requirements for Finance Institutions issued by the Financial Crimes Enforcement Network.

Consumer ABS Space

Unlike in years past, there are no new significant laws or rules in the United States that are taking effect in 2019 and that are targeted at the United States ("US") consumer asset-backed securities ("ABS") space. There are, however, a few items and trends to watch that will have an impact on the consumer ABS markets in the United States including: (i) the recently effective EU Securitization Regulation, (ii) the adoption of contractual provisions for LIBOR successor and replacement benchmark rates and (iii) the SF-3 renewal process.

EU SECURITIZATION REGULATION

The next phase of the European Union's (the "EU") new regulatory regime for securitizations took effect on January 1, 2019, pursuant to Regulation (EU) 2017/2402 (the "EU Securitization Regulation"). The EU Securitization Regulation revises and consolidates the existing rules relating to securitizations, including risk retention, disclosure and credit-granting standards.

Consistent with the old regulatory regime, the EU Securitization Regulation does not directly require compliance by US originators or sponsors (except in certain cases where they are subject to supervision on a consolidated basis under the Capital Requirements Regulation with an EU banking entity). However, the EU Securitization Regulation may indirectly result in US entities providing additional disclosures in order for certain EU investors to be able to invest in US securitizations.

Of particular note are the new transparency requirements on originators, sponsors and securitization special purpose entities, requiring that investors obtain specified information and transaction documents, including the requirement to provide investors with regular reports, including, among other items, loan-level information regarding the underlying assets provided on specified reporting templates.

These transparency requirements raise a key interpretive issue for US originators and sponsors, since the disclosures required under the new transparency rules, specifically with respect to loan-level information, vary from those required under the US Securities and Exchange Commission's ("SEC") Regulation AB disclosure regime. The EU Securitization Regulation does not specify the jurisdictional scope of these detailed transparency requirements. So, the key question for US originators and sponsors is, are they obligated to provide the information required under the transparency rules, including loan-level information, when selling securitization exposures to EU institutional investors. Moreover, will those EU investors be able to satisfy their due diligence obligations under the EU Securitization Regulation in connection with a US-based securitization where loan-level information meeting the new transparency requirements is not provided. Although we are aware of different views in the marketplace, we believe that originators, sponsors and securitization special purpose entities that are not established in an EU member state should not generally be directly subject to the transparency requirements of the EU Securitization Regulation. Ultimately, it will be the individual EU investors that will need to make the determination that the applicable US-sponsored securitization is eligible for investment. The differing views on this interpretative issue could have a marketing and pricing impact on US securitizations offered to EU investors, and we could see the pool of potential EU investors shrink to the extent they are not provided with loan-level information.

See "Q&A: The Impact of the EU Securitization Regulation on US Entities" in this newsletter for a more detailed description of the EU Securitization Regulation and its impact on the US securitization market.

SUCCESSOR AND REPLACEMENT LIBOR BENCHMARK RATES

In 2017, the chief executive of the United Kingdom's Financial Conduct Authority ("FCA"), which regulates LIBOR, indicated that the United Kingdom FCA expects to cease taking steps aimed at ensuring the continuing availability of LIBOR by no later than the end of 2021.

Prior to that announcement, it was common practice in auto and equipment loan and lease, credit card and other non-mortgage ABS transactions that, upon the unavailability of published LIBOR, the relevant interest calculation would first revert to the average of quotes obtained by a number of reference banks and, if such quotes were not made available, a fall back to the last published value of LIBOR. Given the relatively short maturity dates of the LIBOR-based securities that have been issued in these asset classes, this methodology has continued to be used in ABS transactions even after the United Kingdom's FCA announcement. Lack of contractual provisions providing for the selection of a successor or replacement benchmark could have the effect of converting floating rate securities to fixed rate instruments referencing the last published value of LIBOR.

Toward the end of 2018, a few new issuances of credit card ABS transactions built on the historical methodology discussed above, by giving the servicer authority to select a successor or replacement benchmark that the servicer determines is the industry-accepted substitute or successor base rate without the need to obtain securityholder consent or follow the rigid amendment standards under the transaction documents.

In December 2018, the Alternative Reference Rates Committee (or "ARRC") released a consultation for public feedback on US dollar LIBOR fallback contract language for securitizations. ARRC has previously selected the Secured Overnight Financing Rate (or "SOFR") as its recommended alternative reference rate to LIBOR.

In its paper, ARRC proposed an approach to fallback language for new LIBOR-based securities issued in connection with securitizations that is much more detailed and rigid than language that exists in current securitizations. The ARRC proposal sets forth a number of "Benchmark Discontinuance Events," or triggers upon which the benchmark rate would be automatically transitioned from LIBOR to a specified replacement benchmark. Some of these triggers include: (i) a public statement by the administrator of the benchmark or a regulatory supervisor, central bank or other authority announcing that such administrator has ceased or will cease to provide the benchmark permanently or that the benchmark is no longer representative or may no longer be used; (ii) the benchmark rate not being published for five consecutive business days; and (iii) more than 50 percent of the underlying securitized assets being indexed to the replacement benchmark.

The ARRC proposal sets forth a detailed "waterfall menu" for designating the replacement benchmark, beginning with SOFR and, if SOFR is not available, moving to a substitute rate recommended by a relevant governmental body, among other specified options.

It is unlikely that ABS transactions closing in 2019, or at least early in 2019 prior to the issuance of ARRC's final paper, will adopt ARRC's rigid and structured methodology. In fact, given the relatively short maturity dates of consumer ABS, it is likely that many of these issuances will either (i) continue to follow the existing practice of locking in the last available LIBOR rate should the benchmark cease to be published or (ii) adopt the flexible methodology implemented by the credit cards ABS issuers as maturity dates on issued securities extend closer to the end of 2021.

SF-3 RENEWAL PROCESS

SEC registrants are required to renew Form SF-3 registration statements three years from the effectiveness of the existing SF-3 registration statement. Many issuers filed SF-3 registration statements in late 2015 and early 2016 following the implementation of the Regulation AB II rules, and thus many renewal filings began in 2018 and will continue through 2019. Thus far, many issuers whose registration statements were previously reviewed by the SEC staff have received either a limited or no review and generally only new SEC-registered issuers are receiving a more thorough review.

Mortgage and Residential Securitization Space

In the mortgage and residential securitization space, there are a few trends to watch in 2019 including: (i) an increased push to use technology, (ii) continued regulatory relief and (iii) continued growth of nontraditional mortgage products.

INCREASED PUSH TO USE TECHNOLOGY

With the growing space of financing technology and the government advocating for modernization of the industry, we expect that an increasing number of originators will look to digitize their mortgage loan documentation and collateral.

CONTINUED REGULATORY RELIEF

A trend to watch in 2019 is additional reglatory relief from the Consumer Financial Protection Bureau ("CFPB"). As acting director, Mick Mulvaney took a lighter touch to regulation as compared to his predecessor, decreasing the size of the staff and budget within which the CFPB operates, and notably during his tenure only one enforcement action was issued. The newly appointed Kathy Kraninger is largely expected to follow this path. This will leave state-level enforcement action to continue to take greater prominence, but state resources are often more constrained than the federal government and are unlikely to be able to entirely fill the regulatory void left by the CFPB.

CONTINUED GROWTH OF NONTRADITIONAL MORTGAGE PRODUCTS

In 2019, we expect to continue to see a rise in Non-Qualified Mortgage securitizations (which have more than doubled since 2016). In addition, while the demand for reverse mortgage loans will continue to exist and likely grow in 2019, we expect to see an increase in private label originations in this space and changes to the Home Equity Conversion Mortgage Program. Further, we have seen, and expect to continue to see, increased interest in "fix and flip" mortgage loans in 2019. We also expect to see a continued appetite for single family rental properties. Lastly, the origination of closed-end second lien home equity loans may pick up along with home price appreciation.

The CDD Rule

The Customer Due Diligence Requirements for Finance Institutions (the "CDD Rule") was issued by the Financial Crimes Enforcement Network ("FinCEN") and requires covered financial institutions (including banks, US branches and agencies of foreign banks, federally insured credit unions, mutual funds and broker dealers) to identify and verify the identity of beneficial owners of its legal entity customers with respect to "accounts" that are opened on or after May 11, 2018. The definition of "account" is broad and includes many securitization transactions, subject to certain exceptions. FinCEN has clarified that the extension of a loan or warehouse facility will be considered the opening of a new account for purposes of the CDD Rule.

While not required under the CDD Rule, we have seen some financial institutions elect to collect information on beneficial owners at a level lower than 25 percent, as well as more than one individual with managerial control. We expect this trend to continue throughout 2019. Most financial institutions have elected to satisfy their due diligence requirement by obtaining a form certification from their customers that identifies their beneficial owners. Certain customers are excluded from the CDD Rule—however, notwithstanding such exclusion, we see some financial instutitions requesting a separate certification from customers that specifies the exemption that the customer is relying on under the CDD Rule. We expect the new CDD Rule to continue to influence the industry in 2019 and that additional clarity will develop as to certain open questions.

Q&A: The Impact of the EU Securitization Regulation on US Entities

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What is the Securitization Regulation, and does it apply to the US entities?

The next phase of the European Union's (the "EU") new regulatory regime for securitizations became applicable from January 1, 2019, pursuant to Regulation (EU) 2017/2402 (the "Securitization Regulation"). The Securitization Regulation revises and consolidates the existing rules relating to securitizations,[1] including with respect to risk retention, disclosure and credit-granting, and introduces a ban on resecuritization. It also specifies criteria that a securitization will need to satisfy if the parties want the transaction to be designated as a simple, transparent and standardized ("STS") securitization. Like past phases of EU regulation regarding securitizations, such as the Capital Requirements Regulation (the "CRR"), the Securitization Regulation does not directly require compliance by United States ("US") entities participating in securitization transactions (except in certain cases where they are subject to supervision on a consolidated basis with an EU regulated institution). However, the Securitization Regulation may indirectly result in US securitization originators, sponsors and securitization special purpose entities ("SSPEs") being required to provide additional disclosure in order for EU institutional investors to be able to invest in US securitization transactions.

Who needs to comply with the due diligence requirements of the Securitization Regulation in connection with a US-sponsored transaction?

EU institutional investors, as defined in the Securitization Regulation, will need to comply with the due diligence requirements of the Securitization Regulation in order to invest in a securitization transaction with a US originator or sponsor.

What are the due diligence obligations imposed on EU institutional investors?

The Securitization Regulation imposes both initial and ongoing due diligence requirements on EU institutional investors. Prior to investing in a securitization transaction, an EU institutional investor must carry out a due diligence assessment that considers risk characteristics, material structural features and, if applicable, compliance with the criteria for STS securitizations. An institutional investor must also verify compliance with credit-granting standards, EU risk retention requirements and, where applicable, the transparency requirements of the regulation (i.e., the requirements regarding disclosure and provision of certain information). After making an investment in a securitization transaction, an EU institutional investor has an ongoing obligation to monitor the compliance and performance of the transaction pursuant to written procedures established by the investor and to meet continued reporting and testing requirements.

Currently, under the CRR, EU institutional investors that invest in securitization transactions with US entities are already required to meet due diligence assessment and monitoring standards. Other than the reference to the transparency requirements, which are discussed below, the Securitization Regulation due diligence requirements are substantially similar to (but not the same as) the CRR due diligence requirements. In recent years, many US entities have already undertaken limited voluntary compliance with the CRR in order to make their securities eligible for purchase by EU investors and already provide disclosure with regard to underwriting standards and risk retention that could be sufficient to allow an EU institutional investor to meet the related due diligence requirements of the Securitization Regulation.

What are the transparency requirements?

The Securitization Regulation establishes transparency requirements for originators, sponsors and SSPEs, requiring that certain specified information and documentation be provided to investors, supervisory authorities and, upon request, potential investors in a securitization transaction. Originators, sponsors and SSPEs must make available all the underlying documentation that is essential for understanding the transaction, together with a prospectus, or, where there is no prospectus, a transaction summary. They are also required to report certain significant events and to meet ongoing regular reporting requirements, which require that certain loan-level information regarding the assets underlying a securitization transaction be provided on specified reporting templates to be established pursuant to technical standards.[2]

While there is some overlap between the transparency requirements and the information required by Regulation AB for publicly registered transactions in the US, which is also typically included in offering memoranda for unregistered US term issuances, providing the loan-level information specified in the reporting templates is beyond the scope of Regulation AB. Providing this additional data may be costly and burdensome for US entities. As a result, the question of whether a US originator, sponsor or SSPE will need to provide the loan-level information on the specified templates when selling securitization exposures to EU institutional investors is one of the most important interpretive issues raised by the Securitization Regulation for US originators and sponsors.

Will EU institutional investors require US entities to comply with the transparency requirements?

While the jurisdictional scope for the transparency requirements is not specified, we believe that originators, sponsors and SSPEs that are not established in an EU member state should not generally be directly subject to the transparency requirements.[3] As discussed below, this interpretation is supported by certain provisions of the Securitization Regulation and other principles of interpretation.

The Securitization Regulation indicates that the regulation applies to institutional investors, originators, sponsors, original lenders and SSPEs,[4] but the Securitization Regulation does not explicitly state that it only applies to such parties if they are established in the EU.[5] However, in certain provisions of the Securitization Regulation, a distinction is drawn between an originator or sponsor "established in the Union" and one "established in a third country." For example, the due diligence verification requirements in Article 5(1) with respect to credit-granting and risk retention[6] provide one verification standard if the relevant entity is "established in the Union" and a comparable but separate verification standard if the relevant entity is "established in a third country." Furthermore, related EU regulations like the CRR have similarly been interpreted as not imposing direct obligations on non-EU entities.

With respect to the obligation in the investor due diligence requirements to verify compliance with the transparency requirements, the phrase "where applicable" in the section that imposes the obligation suggests that the transparency requirements are not applicable in all instances.[7] One interpretation of this language would allow EU institutional investors to conclude that the requirement to verify compliance with certain of the transparency requirements (including potentially burdensome loan-level data requirements) is not applicable with respect to US originators, sponsors or SSPEs because the Securitization Regulation does not directly apply to non-EU entities. If the market adopts this interpretation, it is not likely that the Securitization Regulation will result in a significant increase in the amount of information requested from US entities by EU institutional investors. However, we are aware that different views on this point are currently being taken by certain market participants and law firms.

In addition, it is also worth noting that there may be a different interpretation of this point in the United Kingdom (the "UK") following Brexit. On December 19, 2018, a draft of the Securitisation (Amendment) (EU Exit) Regulations 2019 (the "Proposed UK Securitization Regulation Amendment") was published in the UK, the purpose of which is to amend the Securitization Regulation (which is directly applicable in the UK) to ensure that it can operate in a UK-only context from the date that the UK leaves the EU. The Proposed UK Securitization Regulation Amendment adds a new subsection to the article relating to the diligence requirements, which says that an institutional investor must verify that an originator, sponsor or SSPE "established in a third country" has "where applicable" provided information that is "substantially the same" as the information it would have provided under the transparency requirements if it had been established in the UK.

Each EU institutional investor will need to make its own assessment regarding its compliance with the due diligence requirements under the Securitization Regulation, and some EU investors may determine that the requirement to verify compliance with the transparency requirements, including the provision of loan-level data, is applicable with respect to US originators, sponsors and SSPEs.

Will the Securitization Regulation impact EU investor participation in pre-2019 transactions?

The Securitization Regulation will not apply to transactions entered into before January 1, 2019, unless new securities are issued or a new securitization position is created on or after that date. Therefore, the Securitization Regulation is not expected to impact the liquidity of previously issued transactions as long as they remain grandfathered; an EU institutional investor can still invest in securitizations issued prior to January 1, 2019, even if those transactions do not comply with the Securitization Regulation. The Securitization Regulation does not make clear how its provisions should be applied to master trust structures where different series of securities may be issued before and after the Securitization Regulation becomes effective. While it could be argued that each series issued by a master trust is a separate securitization, we understand that the prevailing market view is that the master trust constitutes a single securitization such that the issuance of a new series after the Securitization Regulation becomes effective will subject the entire master trust to the Securitization Regulation. While not made clear in the Securitization Regulation, the market view appears to be that, in that instance, an EU institutional investor's existing investment in a pre-2019 series would be considered compliant even if not in compliance with all aspects of the Securitization Regulation. However, an EU institutional investor investing in a pre-2019 series of a master trust that issued a series in 2019 or at a later date would potentially need to assess compliance with the Securitization Regulation.

What is the potential impact of the Securitization Regulation on warehouse facilities and conduit arrangements with EU banks?

An EU bank or other institutional investor that is a lender to a US originator or SSPE in a warehouse facility or through a variable funding note will be required to comply with the Securitization Regulation if the transaction falls within the definition of a securitization. If that EU entity is funding its advances directly, then it will be subject to the due diligence requirements of the Securitization Regulation as discussed above, and the disclosure of loan-level data by the US originator or SSPE using the applicable reporting templates could be required. If the advances are being funded through an asset-backed commercial paper ("ABCP") program for which an EU bank acts as sponsor, then that EU bank will itself be subject to the transparency requirements imposed on sponsors. In order to comply with its own obligations as a sponsor under the transparency requirements, the EU ABCP sponsor may require its US counterparty to provide certain information that the ABCP sponsor could aggregate for use in its program-level disclosure to ABCP investors (depending on what is required to be reported by the ABCP sponsor in the final form of the reporting templates for ABCP securitizations). Loan-level data also may need to be made available to the ABCP program sponsor.[8] US originators should discuss with their EU bank lenders and ABCP sponsors what data they will require for compliance.

Can a US-sponsored transaction qualify as an STS securitization?

A transaction cannot qualify as an STS securitization under the Securitization Regulation unless the originator, sponsor and SSPE are all established in the EU. There will be a separate STS regime in the UK after Brexit, which based on the Proposed UK Securitization Regulation Amendment, will require the originator and sponsor (in the case of non-ABCP securitizations) or the sponsor only (in the case of ABCP programs or transactions), to be established in the UK, provided that securitizations that meet the STS requirements under the Securitization Regulation and that are notified to ESMA prior to Brexit or during the two-year period thereafter will still be considered STS in the UK. It is possible that certain EU or UK institutional investors will have more interest in investing in securitizations that meet the STS requirements under the Securitization Regulation or those under the UK regime, as applicable ("STS Securitizations") than those that do not. Institutional investors may find STS Securitizations more attractive due to lower regulatory capital requirements compared with non-STS Securitizations, or they may take the view that an investment in an STS Securitization would be more liquid. Therefore, transactions with US entities may be less marketable than STS Securitizations. It is not yet clear what proportion of securitization transactions will be STS Securitizations, but it is expected that there will still be a market with EU and UK institutional investors for non-STS Securitizations, including non-STS Securitizations with US entities.

Endnotes

1 The Securitization Regulation defines "securitisation" broadly to mean any "transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched," having certain enumerated characteristics. See Article 2(1).

2 The European Securities and Markets Authority ("ESMA") published its final draft of the technical standards with respect to the detailed reporting requirements and the associated templates in August 2018. However, market participants have expressed a number of concerns about the templates. The European Commission (the "Commission") has notified ESMA that it intends to endorse the draft technical standards only once certain amendments are introduced and has requested ESMA to consider whether certain "No Data" options could be available for additional fields of the draft templates, particularly with respect to the templates for ABCP securitizations. See https://www.esma.europa.eu/document/european-commission-letter-esma-draft-rts-and-its-securitisation-disclosures. A revised version of the technical standards is expected to be submitted by ESMA to the Commission shortly. If approved by the Commission, the technical standards will need to be approved by the Council of the European Union and the European Parliament.

The Securitization Regulation requires that, in the event the new technical standards were not in place by January 1, 2019, the reporting templates established pursuant to Article 8b of the Credit Rating Agencies Regulation be used in the interim period. See Regulation (EC) No 1060/2009 on credit rating agencies, as amended, including by Regulation (EU) No 462/2013. It is anticipated that national supervisors will exercise their powers in a proportionate and risk-based manner during that period, taking into account the type and extent of information already being disclosed by reporting entities, on a case-by-case basis. See the joint statement of the European Supervisory Authorities at https://esas-joint-committee.europa.eu/Publications/Statements/JC_Statement_Securitisation_CRA3_templates_plus_CRR2_final.pdf.

3 Note that certain non-EU subsidiaries of EU banking entities that are subject to consolidated supervision under the CRR could become subject to the requirements of the Securitization Regulation directly. It is expected that the rules will be amended to limit the application of these requirements with respect to these non-EU entities to the due diligence requirements. EU competent authorities are expected to take this pending amendment into account when assessing compliance with the Securitization Regulation. See the joint statement of the European Supervisory Authorities at https://esas-joint-committee.europa.eu/Publications/Statements/JC_Statement_Securitisation_CRA3_templates_plus_CRR2_final.pdf.

4 See Article 1(2) of the Securitization Regulation.

5 The term "institutional investor" is defined in Article 2(12) by reference to entities that are defined in or fall under certain EU regulations that are only applicable to EU investors. Therefore, only institutional investors that are established or located in the EU will be directly required to comply with the Securitization Regulation (except

as discussed in the previous footnote). The definitions of "securitization special purpose entity," "originator," "sponsor" and "original lender" contained in Article 2 are not limited to entities in the EU.

6 The credit-granting and risk retention requirements are similar (but not identical) to the requirements in the CRR.

7 See Article 5(1)(e): "Prior to holding a securitisation position, an institutional investor, other than the originator, sponsor or original lender, shall verify that:… the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article." (emphasis added).

8 See Article 7(1): "In the case of ABCP, the information described in points (a), (c)(ii) and (e)(i) of the first subparagraph shall be made available in aggregate form to holders of securitisation positions and, upon request, to potential investors. Loan-level data shall be made available to the sponsor and, upon request, to competent authorities."

Certain Securities Law Considerations for ABS Investor Presentations

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Some common questions raised by issuers in connection with ABS conferences are: what legal rules and issues should we consider when meeting with investors, can written investor presentations be used and what can be included in those written materials and, more specifically, can such presentations be left behind with investors? Questions about investor presentations arise in connection with different types of investor meetings, and the context, content and timing of the investor presentations will give rise to different legal considerations. For example, certain meetings are not conducted in connection with particular offerings of securities but may include attendees that are representatives of existing or potential investors. Other meetings and presentations are conducted as part of the offering process for specific ABS programs and may be conducted as part of a registered offering or as part of a private placement or other unregistered offering. An investor meeting at an ABS conference may fall under any of these categories depending on the circumstances, so it is important for issuers to discuss their issuance and marketing plans with counsel before jumping on the plane to the conference.

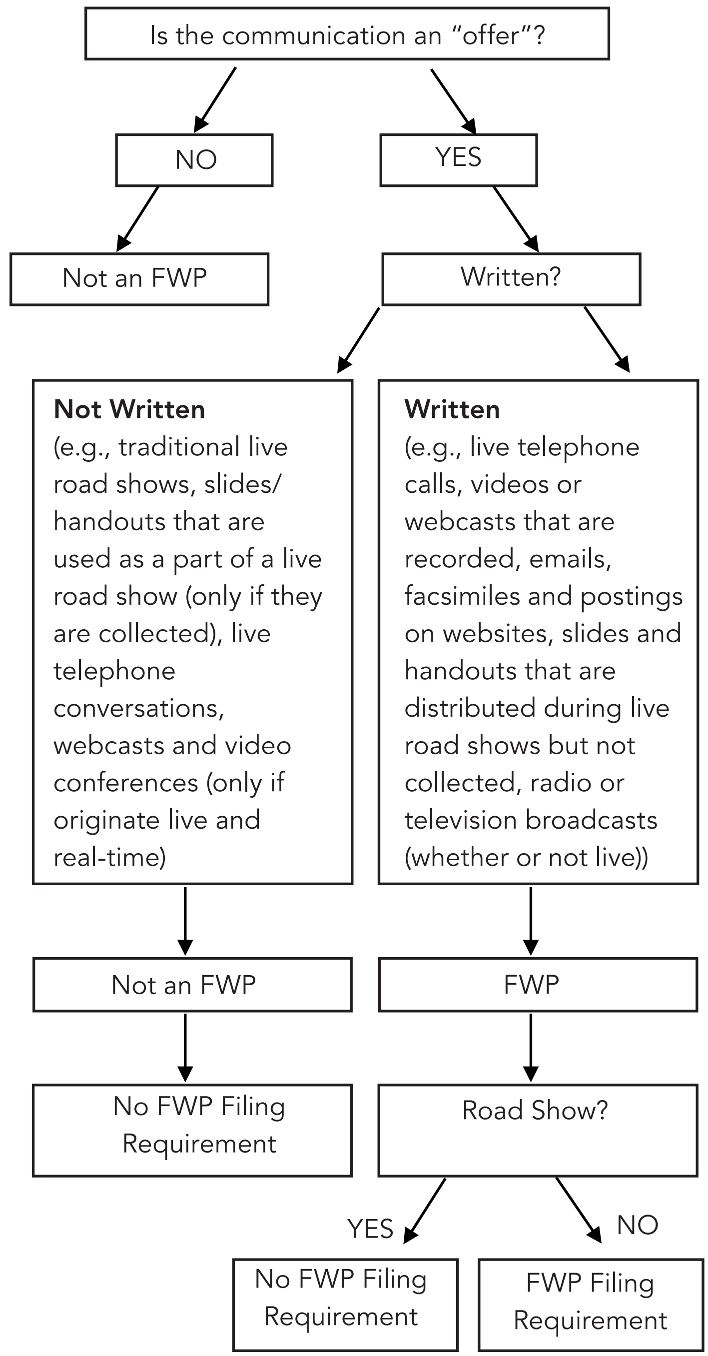
This article is intended to highlight certain securities law considerations that may arise in connection with investor meetings, the distribution of written materials to existing and potential investors, road shows for ABS offerings, and potential Securities and Exchange Commission ("SEC") filing requirements.[1]

Registered Offerings: Free Writing Prospectus Requirements

FWP FILING REQUIREMENT

Written materials that are distributed to potential investors and some electronic road shows may constitute free writing prospectuses (commonly referred to as "FWPs"). The term "free writing prospectus" generally includes any written communication (other than a statutory prospectus[2]) that constitutes an offer to sell or a solicitation of an offer to buy securities relating to a registered offering that, in the case of an ABS issuer, is used after the registration statement in respect of the offering is filed.[3] Oral communications are not FWPs. Rules 163 and 164 under the Securities Act of 1933, as amended (the "Securities Act"), generally require FWPs to be filed with the SEC no later than the day of their first use (the "FWP Filing Requirement")[4] and to contain specific legends.[5] There are three important questions to ask when determining whether a communication constitutes an FWP and, if so, whether the communication is subject to the FWP Filing Requirement: (1) is the communication a "road show," (2) is the communication an "offer" in connection with a registered offering and (3) is the communication a "written communication?" The answers to these questions will determine whether the investor presentation or meeting constitutes an FWP and whether the issuer must satisfy the FWP Filing Requirement.

Is the communication an FWP that needs to be filed?



The FWP Filing Requirement, the legend requirement and other rules relating to FWPs discussed below do not apply to unregistered offerings. Many of the practices observed with investor meetings in connection with SEC registered offerings (such as collecting copies of presentation slides provided to investors during the meeting), however, have carried over and are applied to investor meetings in connection with unregistered private offerings.

1. IS THE COMMUNICATION A ROAD SHOW?

In the ABS context, a road show is a presentation by management involved in the securitization or servicing function that includes a discussion of the issuer, management and/or any securities being offered.[6] Road show presentations can be done in-person or by telephonic or graphical means and are usually accompanied by presentation slides. A road show can allow for a more personal and interactive conveyance of information to investors, allowing for a back-and-forth exchange between the issuer and potential investors.

In the ABS context, these presentations typically cover, among other items, the issuer's origination and servicing practices, portfolio characteristics and loss and delinquency trends, any prior securitization experience and prior transaction performance and, if in connection with a specific transaction, a discussion of key terms of such transaction and any offered securities. The meeting may also include the opportunity for investors to ask, and the issuer to address, any questions or concerns regarding the issuer, the ABS program or the specific transaction.

Any presentation by management involved in the securitization or servicing function, regardless of the number of participants, can be considered a road show under SEC rules. Traditionally, road shows have taken the form of in-person presentations scheduled in multiple locations across the country wherever institutional investors are located. Road shows have also commonly taken an electronic form, as pre-recorded presentations posted to a password-protected website. Individual meetings or a series of meetings at a conference can be considered a road show if the presentation involves members of management involved in the securitization or servicing function and the content of the meeting covers the areas described above. A presentation or meeting is considered a road show for securities law purposes, however, only if it involves an offer of securities. We will discuss what constitutes an "offer" in more detail below.

So, why does it matter whether a presentation or meeting is considered a "road show" under SEC rules? We will discuss the implications and considerations in more detail below, but a key consideration for SEC-registered offerings is whether the road show constitutes a "free writing prospectus" that necessitates a filing with the SEC. A road show for an offering that is a written communication is an FWP and, generally, use of an FWP triggers the FWP Filing Requirement. But in the context of the typical ABS offering,[7] a road show is not subject to the FWP Filing Requirement.[8]

2. IS THE COMMUNICATION AN OFFER IN CONNECTION WITH A REGISTERED OFFERING?

FWPs only include those "written communications" (which we will discuss in more detail below) that are offers to sell or solicitations of offers to buy securities relating to registered offerings. Section 2(a)(3) of the Securities Act defines "offer to sell" in terms of any activity that is reasonably calculated to solicit or generate a buying interest. As a general matter, a determination as to whether a communication constitutes an offer to sell in connection with a registration statement entails a fact-intensive analysis, the outcome of which will depend on the specific circumstances of such communication.

SEC releases and relevant case law suggest that the scope of the definition of "offer to sell" is indeed very broad. For instance, the SEC has indicated that it is possible to generate a buying interest and therefore have an offer to sell in promotional material that does not even mention the upcoming offering, especially where the materials are used as part of a plan to prepare the market in advance of a dissemination of offering materials.[9] Similarly, courts have held that dissemination of information in the ordinary course of business becomes questionable when the timing of such activities seems to be gearing up to an impending public offering.[10]

An issuer may engage in a non-deal road show that is not intended to offer securities, but rather with the intent of providing information about the issuer and its ABS program to investors. If an issuer's meeting with investors or potential investors is in fact a non-deal road show (i.e., not in connection with an offering), then any communication in connection with such meeting is not an offer and is not an FWP subject to the FWP Filing Requirements. Issuers should be careful in taking this position, however, because of the broad view of when an offer of securities has occurred. Communications to potential investors before an offering is officially announced, even if the communication does not mention specific securities, may be viewed as conditioning the market and part of the selling effort of an upcoming offering. In the instance where an offering has not yet been announced or where presentation materials do not make reference to a specific offering, an ABS issuer that is considering taking the position that a meeting or presentation is a non-deal road show should consider where they stand in relation to the initiation of any upcoming offering and, for frequent issuers, where they stand in relation to their programmatic funding plan. Although a bright-line does not exist as to when a communication is in connection with an offering or when a communication is in fact a non-deal road show, issuers should consider the following factors, among other factors, that may be present at the time of the investor meeting or presentation:

- Does the issuer have an effective shelf registration statement on file;
- Has the issuer selected a pool of assets to be securitized or begun other internal work

on an upcoming offering;

- Has the issuer engaged legal counsel or an investment bank to begin structuring a transaction or hired a rating agency to begin reviewing proposed structures or asset characteristic and performance data; and
- If the ABS issuer is a frequent and programmatic issuer, how close in proximity is the meeting or presentation to the closing of its prior offering, and when has the issuer historically begun work on or announced its subsequent offering?

Because the SEC and relevant case law have taken such a broad view on what constitutes an offer, many issuers have taken a conservative approach when engaging in meetings, even when a specific transaction is not discussed, and have operated under the assumption that any meeting or presentation with investors and potential investors could be deemed to be an offering of securities under SEC rules.

3. IS THE COMMUNICATION A "WRITTEN COMMUNICATION"?

Only written communications are FWPs; however, what constitutes "written communications" under Securities Act Rule 405 may not be entirely obvious. For purposes of the FWP definition, written communications include any communication that is written, printed, a radio or television broadcast, or the following forms of "graphic communications":

> "[a]ll forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet Web sites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation."

Except for the live, real-time road communications (including, in certain circumstances, when transmitted electronically in real-time, as will be discussed below), all communications made through electronic means are graphic communications and therefore considered to be written communications. For example, presentations that are recorded and posted on Internet websites are considered graphic communications that are written communications and should be treated as FWPs.

Graphic communications do not include communications that, at the time of communication, originate live, in real-time to a live audience and do not originate in recorded form or otherwise as a graphic communication, even if the communication is transmitted through graphic means.[11] For example, a live road show presented via videoconference from a conference room in New York and transmitted real-time to a live audience in a conference room in London would not be a graphic communication and would therefore not be a written communication and, consequently, would not be an FWP. Likewise, an in-person road show at a conference would not be an FWP and not subject to the FWP Filing Requirements. Live, in-person road shows are treated as oral communications.

The notes to Rule 433 provide an exception that would allow certain communications that would otherwise be written communications to be deemed not to be written communications if they are used simultaneously in connection with a live road show. The notes to Rule 433 provide:

> "A communication that is provided or transmitted simultaneously with a road show and is provided or transmitted in a manner designed to make the communication available only as part of the road show and not separately is deemed to be part of the road show. Therefore, if the road show is not a written communication, such a simultaneous communication (even if it would otherwise be a graphic communication or other written communication) is also deemed not to be written."

An example of such a communication would be a written presentation handed out in connection with a live, in-person road show and collected at the end of the road show presentation. Because the road show (i.e., the in-person presentation) is not a written communication, the slides or handouts used in connection with the road show would also be deemed to be part of the non-written road show and would therefore not be FWPs and not subject to the FWP Filing Requirements. Any written materials left with investors would nevertheless be FWPs and would be subject to the FWP Filing Requirements.

In contrast, a recorded electronic road show would be a graphic communication; therefore, any materials, such as slides or handouts used in connection with the presentation, would be written materials and would therefore be FWPs. As noted above, although such road shows are FWPs (and should include a required FWP legend as described below), they are not subject to the FWP Filing Requirement.

The notes to Rule 433 also clarify that "a written communication that is an offer contained in a separate file from a road show, whether or not the road show is a written communication, or otherwise transmitted separately from a road show, will be a free writing prospectus subject to any applicable filing conditions of paragraph (d) of this section." For this reason, it is advisable for an audio presentation and slides to be combined in one file rather than transmitted as separate files. Also, investors viewing a recorded road show through an Internet website should not be able to separately download or print any accompanying presentation slides.

FWP LEGEND REQUIREMENT

A legend substantially similar to the following is required to be included in any FWP in connection with a registered offering of an ABS issuer:

> "The issuer has filed a registration statement (including a prospectus) with the SEC for the offering to which this communication relates. Before you invest, you should read the prospectus in that

registration statement and other documents the issuer has filed with the SEC for more complete information about the issuer and this offering. You may get these documents for free by visiting EDGAR on the SEC Web site at www.sec.gov. Alternatively, the issuer, any underwriter or any dealer participating in the offering will arrange to send you the prospectus if you request it by calling toll-free 1-8[xx-xxx-xxxx]."[12]

The legend may also provide an email address at which the documents can be requested and may indicate that the documents are also available by accessing the issuer's website and provide the Internet address and the particular location of the documents on the website.

RESTRICTIONS ON CONTENT FOR FWPS

An FWP may include information the substance of which is not included in the registration statement or in the prospectus included in the registration statement, but such information may not conflict with: (i) information contained in the registration statement, including any prospectus or prospectus supplement that is part of the registration statement and not superseded or modified; or (ii) information contained in the issuer's periodic and current reports filed or furnished to the Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference into the registration statement and not superseded or modified.[13]

Although Rule 433 permits an FWP to include information that is not included in the registration statement, as discussed below, it is advisable not to include information that goes materially beyond the information in the prospectus, which could call into question the adequacy of the information included in the prospectus.

In addition, an FWP may not contain disclaimers of responsibility or liability that are impermissible in a registration statement or statutory prospectus.

Examples of impermissible legends for an FWP are:

- ✓ Disclaimers regarding accuracy or completeness or reliance by investors;
- ✓ Statements requiring investors to read or acknowledge that they have read or understand the registration statement or any disclaimers or legends;
- ✓ Language indicating that the communication is neither a prospectus nor an offer to sell or a solicitation of an offer to buy; and
- ✓ With regards to information that must be filed with the SEC, statements that the information is confidential.

Regulation FD

Regulation FD generally requires that when a reporting issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to certain categories of persons described below, the issuer must simultaneously[14] publicly disclose that information as described below. In the ABS context, Regulation FD applies to ABS issuers that file 10-Ds, 10-Ks and other reports under Section 15(d) of the Exchange Act. The sponsor of an ABS issuer may also be a reporting issuer subject to Regulation FD, so it may be necessary to consider whether information disclosed in connection with an ABS offering, for example, information regarding the sponsor's business, may be considered material nonpublic information relating to the sponsor or its securities.

Regulation FD only applies to a disclosure made to certain categories of persons that include brokers, deals, investment advisors, institutional investment managers, and holders of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information.

Given that investor meetings typically involve persons falling within the above categories, reporting issuers should consider whether any presentation materials or road shows contain any material nonpublic information regarding that issuer or its securities, or a sponsor that is subject to Regulation FD, and whether any of the applicable exceptions to Regulation FD apply. In the context of an ABS offering, there are two exceptions that are particularly relevant.

First, in the case of an unregistered offering by a reporting issuer, Regulation FD will not apply to disclosures made to a person who expressly agrees to maintain the disclosed information in confidence. So, an issuer may avoid compliance with Regulation FD in connection with an investor presentation for an unregistered offering by first obtaining a confidentiality agreement from the recipient of the information.

Second, in the case of an ABS offering registered under the Securities Act, Regulation FD will not apply if the disclosure is by a registration statement, prospectus or FWP used after filing of the registration statement for the offering or an oral communication made in connection with the registered securities offering after filing of the registration statement for the offering under the Securities Act

Additional Information Not Included in the Prospectus or Offering Memorandum

As noted above, an FWP may include additional information that is not included in the registration statement or in the prospectus as long as such information does not conflict with the registration statement, prospectus or the issuer's periodic and current reports that are incorporated by reference into the registration statement and not superseded or modified.[15] However, in all offerings—whether registered or unregistered—issuers and sponsors should nevertheless carefully evaluate information contained in an investor presentation that is not included (or expected to be included) in the offering memorandum or prospectus for an offering to determine whether such information is material. So, members of the deal team should evaluate the information in the investor presentation to confirm that, if such information is material, it is contained in the offering memorandum or prospectus, and, if such information is not material, that it does not conflict with the issuer's other filings. Although it is not uncommon for investor presentations to include some additional information that is not in the offering memorandum or prospectus or to present information from the offering document in a more detailed fashion or in a different format in the investor presentation, such practice may give rise to a number of potential concerns.

First, investor presentations will often not be delivered to all investors that ultimately receive an offering memorandum or prospectus for an ABS offering. As a result, questions may arise as to whether material information has been selectively disclosed to some, but not all, potential investors. In addition to causing potential relationship issues with investors who have not received the investor presentation, selective disclosure can also raise questions as to whether failure to include such information constituted a material omission under the securities laws in connection with the purchase of a security by an investor that did not receive the investor presentation as discussed in the following paragraph.

Second, issuers and other offering participants may mistakenly believe that information delivered to investors in a road show, whether orally or in any related presentation slides—rather than an offering memorandum or prospectus—is subject to a lower standard in terms of assuring that such information is accurate or that such information does not give rise to potential liability under the securities laws. Rule 10b-5 under the Exchange Act provides that it is unlawful for any person to employ any device, scheme or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security. Any material misstatement in a road show or other investor presentation, used in connection with the purchase and sale of a security, can give rise to potential claim under Rule 10b-5 if the investor is able to establish the requisite elements for a cause of action, including scienter or intent. Therefore, care should be taken to confirm the accuracy of all information contained in investor presentations, including that the presentation does not conflict with the prospectus or other offering materials and does not include information, the omission of which from the prospectus or offering memorandum could call into question the sufficiency of the disclosure in the prospectus or offering memorandum. In particular, road show materials may include financial and other numerical information that is not included in the prospectus or offering memorandum and is not otherwise comforted by the issuer's accountants. Information may also be derived from sources other than the issuer, such as industry or rating agency market reports. Issuers should be sure to obtain backup for any statements or projections included in the road show materials.

Endnotes

1 This article dœs not address similar presentations and road shows outside of the ABS context, and a number of the rules discussed in this article, including the free writing prospectus filing requirements, would be different for equity offerings and other non-ABS debt offerings.

2 The definition of free writing prospectus also excludes written communications used in reliance on Rules 167 and 426 under the Securities Act (ABS informational and computational materials).

3 Rule 405 under the Securities Act.

4 Rule 433(d) under the Securities Act specifies a number of exceptions to the FWP Filing Requirement, for example, for an FWP that dœs not contain substantive changes from or additions to an FWP previously filed with the SEC (Rule 433(d)(3)), issuer information contained in an FWP of an offering participant other than the issuer that is included in a previously filed prospectus or FWP and that relates to the offering (Rule 433(d)(4)) and an FWP or portion thereof that contains a description of the terms of the securities or the offering and that dœs not reflect the final terms (Rule 433(d)(5)(i)). In addition, certain FWPs that contain only a description of the final terms of the issuer's securities or the offering are required to be filed by the issuer within two days of the later of the date such final terms have been established for all classes of the offering and the date of first use (Rule 433(d)(5)(ii)). This article dœs not contain a detailed description of all applicable rules relating to the filings of FWPs and the timing thereof.

5 The required legend (and other content requirements) for FWPs are discussed below.

6 Rule 433 under the Securities Act defines a "road show" as "[a]n offer (other than a statutory prospectus or a portion of a statutory prospectus filed as part of a registration statement) that contains a presentation regarding an offering by one or more members of the issuer's management (and in the case of an offering of asset-backed securities, management involved in the securitization or servicing function of one or more of the depositors, sponsors or servicers (as such terms are defined in Item 1101 of Regulation AB) or an affiliated depositor) and includes a discussion of one or more of the issuer, such management and the securities being offered."

7 Rule 433(d)(8) under the Securities Act dœs require filings of FWPs in cases of road shows that are written communications for an offering of common equity or convertible equity securities by an issuer that is, at the time of the filing of the registration statement for the offering, not required to file reports with the SEC pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934, unless the issuer of the securities makes at least one version of a bona fide electronic road show available without restriction by means of graphic communication to any person, including any potential investor in the securities (and if there is more than one version of a road show for the offering that is a written communication, the version available without restriction is made available no later than the other versions).

8 Rule 433(d)(8) under the Securities Act. Although road shows generally are not required to be filed, it is still important to determine whether the road show is a "written communication" and therefore an FWP because the legend (and other content) requirements for FWPs and the retention requirements for FWPs will still apply to road shows that are FWPs.

9 SEC Release 33-3834 Example 1, 1957 WL 3605 (1957).

[10] See, e.g., Georgeson & Co., 1977 WL 13861 (SEC No Action Letter Feb. 3 1977).

[11] See definition of "Graphic Communication" in Rule 405 under the Securities Act.

[12] See Rules 164(a) and 433 under the Securities Act.

[13] Rule 433(c)(i) under the Securities Act.

[14] Information that is the subject of a non-intentional disclosure must promptly be disclosed.

[15] Rule 433(c)(i) under the Securities Act.

A Brief Overview of the Top 10 Issues in M&A for Securitization Sponsors and Servicers

ELIZABETH A. RAYMOND[1]

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. A summary of some of the more prominent issues appears 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. 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.

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, and to require a relatively high deductible, 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. 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.
- *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 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.
- *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.
- *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. 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 requires a deep understanding of the securitization business being sold. Once the valuation and purchase price mechanics are set, the rest of the transaction terms should support the valuation and pricing methodology. The whole business valuation approach is likely to lead to an M&A platform sale execution while an assets under management approach lends itself to a whole loan portfolio execution. With either valuation approach, closing and post-closing adjustments may be used to reflect fluctuations in value of the entire business or the portfolio alone, as applicable.

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 its risks.

DUE DILIGENCE OF FINANCING ARRANGEMENTS

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.

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. 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. 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.

Issue 3. How Will Licenses Affect Structure and Timing?

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. 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.

Licenses and notifications or approvals that may be required in acquisitions involving a securitization sponsor or servicer include state licenses to hold consumer loans, mortgage servicing licenses, debt collection licenses and change of control filings and approvals. 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. 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.

Issue 4. Due Diligence of 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. In addition, most buyers will insist on at least sampling a statistically significant number of loan files for missing documents and other potential defects. 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. 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 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.

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.

Servicing Agreements and Underlying Servicing Rights. Because the relevant servicing agreements and the underlying servicing rights are critical to many securitization-related acquisitions, a seller will often provide representations specifically related to the quality of these documents, including 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. 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. Pending regulatory investigations must be explored with careful consideration as the parties must refrain from revealing confidential supervisory information or waiving attorney-client privilege. Significant litigation or regulatory issues may cause the buyer to seek to restructure a stock sale as an asset sale to attempt to isolate the buyer from any lingering liabilities.

Issue 5. What Consents are Required?

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 agreements, the consent process is more time consuming and complicated. If the transaction is structured as a merger or a sale of stock (or, in some instances, as a sale of substantially all of the seller's servicing platform assets), however, the transfer process is generally less complicated and time consuming because the third-party consent provisions may not be triggered (although there are other requirements that the parties must satisfy before closing).

Consent-Based Price Adjustments. Another 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 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 (e.g., rating agencies, master servicers, trustees and in some cases security holders) 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.

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.

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.

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

An emerging area in the consumer financial assets M&A market is whether the seller needs to complete "reverse due diligence" on prospective buyers. A new issue arising for bank and non-bank sellers that are regulated by the Office of the Comptroller of the

Currency ("OCC") or the CFPB is what level of due diligence sellers must engage in with respect to their buyers prior to and after a sale of consumer assets. 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. The bank seller may also need to address OCC and Federal Reserve Board 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.

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 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 and considerations for sponsors and servicers in public securitization transactions during and after M&A transactions include disclosures required by Regulation AB relating to sponsors, depositors, servicers, static pool, legal proceedings and attestation criteria as well as the requirement to disclose a change in servicer on Form 8-K. In addition, a buyer should complete an analysis of whether a failure to timely file required securities filings by the seller will have an impact on the ability of the buyer's eligibility to register the sale of securities on Form SF-3 or could expose the buyer to liability or penalties in connection with missed filing deadlines by the seller.

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. Who bears the cost of clean-up activities relating to deficient loan files 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. M&A deals—particularly those involving financial assets—are increasingly impacted by technology. Key issues in a technology—driven acquisition include risks relating to open source software and cybersecurity and data privacy compliance. The parties may enter into technology agreements, including short-term transition services agreements where the seller provides interim technology services to the buyer pending conversion to the buyer's system or long-term arrangements to receive services back from the buyer, which more closely resemble outsourcing agreements.

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. 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.

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. Disclosure issues can be aggravated where there are emerging views on "best practices" for compliance by finance companies, as is the case with CFPB and state consumer law regulation.

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 covering topics such as (i) privacy and data security, (ii) licenses, registration and insurance, (iii) loss mitigation, and (iv) loan file due diligence.

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, and may cover topics such as (i) conduct of the business between signing and closing, (ii) consents, (iii) governmental inquiries, (iv) post-closing covenants addressing delivery of loan files, notifications to credit reporting agencies, terminations and transfers of vendor agreements and transfers of ordinary course collections litigation, and (v) post-closing transition of servicing.

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.

Endnotes

[1] 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, and Pablo Puente, an associate at Mayer Brown.

This article is a condensed version of a more in-depth analysis of issues in mergers and acquisition transactions for securitization sponsors and servicers. A more detailed review and discussion of the key considerations can be found in the complete article, *Top 10 Issues in M&A For Securitization Sponsors and Servicers*, at www.mayerbrown.com/Top-10-Issues-in-MA-for-Securitization-sponsors-and-Servicers-02-08-2019/

Asset Valuations in the Mortgage Loan and Real Estate Warehouse Contexts

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A primary financial driver in any asset-based warehouse deal is how the borrowing base is determined. Typically, the borrowing base is based on a percentage of the value of the underlying assets. How valuations are determined in the mortgage loan and real estate warehouse and repurchase facility contexts is subject to much negotiation. If these valuations are based on objective metrics that do not vary over the time the underlying asset is pledged, the borrower has certainty over its lending base. However, if the valuations can be increased or decreased, the borrower may be able to extract more financing from the underlying appreciating asset, or the borrower may have to contribute cash or other assets related to a depreciating asset. While there is a benefit to both parties to have a true valuation of the underlying asset, lenders typically want control over the valuation process. How this control is exerted through contractual language may introduce a level of subjectivity, which borrowers will typically try to combat through contractual negotiations. The following are our observations in how these market valuation provisions are negotiated with respect to different real estate and mortgage loan warehouse facility contexts.

Residential Real Estate Mortgage Loans

The advance rate for most plain vanilla residential real estate loan warehouse facilities is based on the lesser of the unpaid principal balance of the loan, the takeout price with respect to a loan (if applicable) and the "market value." While the unpaid balance and takeout price are two objective tests, the determination of the "market value" introduces a level of subjectivity that may differ from lender to lender. The "market value" is typically the value of a loan determined by the lender, which may take into account the price at which the loan can be sold while a borrower is in default and other macro-economic forces. Because this standard permits the lender to predict the future with respect to the housing market, it can become very difficult for a borrower to predict on any given day what financing it will have in place and what will need to be repaid. In addition, because of the opaque nature of these determinations, borrowers are typically concerned that this subjectivity could enable a lender to mark down certain assets of a particular borrower unfairly, tying the value of the loan to the credit quality of the borrower. To help control some of this subjectivity, borrowers may request that the determination be made in good faith or on terms consistent with how the lender would value other similar residential mortgage loans for different lenders or for similar loans held for their own account. The purpose of this request by borrowers is to try to ensure that, at the very least, the borrower won't be adversely selected by the lender for reasons outside of such borrower's control. Because the typical number of loans in a pool tends to be quite large and because of the relative homogeneity based on certain product types, some lenders will agree to this.

Commercial Real Estate Mortgage Loans

Commercial real estate loan warehouses are usually secured by "lumpier" pools than are residential mortgage loan financings. They generally include a small number of loans with much higher principal balances than residential loan balances. As a result, lenders are very sensitive to risk regarding the value of the assets and insist on the right to mark all assets on a daily basis in their sole discretion. If a borrower has any leverage to negotiate these provisions, they will usually ask that a lender mark their assets consistently with their practice of marking similarly situated commercial real estate. However, some lenders are reluctant to offer even this concession. Since commercial real estate can be so heterogeneous, some lenders are uncomfortable representing that they have consistent marking practices across assets.

Fix and Flip Mortgage Loans

In recent years, "fix and flip" mortgage loans have been increasingly popular assets for warehouse lenders. Also known as residential bridge loans or residential construction loans, these are business purpose loans secured by single-family homes. Typically, the mortgagor intends to rehabilitate the mortgaged property and sell it within a short period of time. Historically, these loans were originated by small "hard money" lenders operating in local markets. Recently, larger finance companies have moved into this space, attracted by the high yield and short maturities that fix and flip loans usually feature. This in turn has led to an increasing number of commercial banks offering warehouse financing. Fix and flip loan facilities present unique challenges for warehouse lenders looking to mark the assets. Similar to transition commercial loans, the mortgaged properties are often in a state of disrepair and their value is highly dependent on the skill of the mortgagors in rehabilitating the properties. On the other hand, there are more assets spread over a wider geographic area than in a commercial mortgage pool, so lenders are exposed to less risk with respect to any particular asset or real estate market. As a result, many fix and flip facilities do not have mark to market provisions at all. Instead, the lender relies on third-party appraisals to determine the value of the assets. Typically, the lender also has the right to request new appraisals or broker price opinions if an asset becomes delinquent or is otherwise in default. In addition, a warehouse lender will sometimes have the right to challenge an appraised value and ask for a new appraisal if they determine that the original appraisal used unfounded assumptions or was otherwise invalid. Of course, some lenders insist on full mark to market provisions for fix and flip loans, in which case the provisions are negotiated on the same basis as a commercial mortgage loan facility.

REO Properties

A first cousin to "fix and flip" mortgage loan financing is the financing of real estate-owned (REO) properties. Like "fix and flip," REO properties are often in a state of disrepair; however, the valuations do not take into account any rehabilitation of the property. While sometimes appraisals are required for these properties, because appraisals add to the cost of what is already a distressed asset, lenders will often reduce the advance rate for real estate-owned properties and base the valuations on market valuations similar to residential mortgage loans.

Single Family Rental Properties

Single family rentals present another type of asset class where "market valuations" are important. Single family rental facilities are unique in that their values can be based on the rental income stream and the underlying valuation of a property if such property is owned by the borrower. Frequently, the advance rate may be based on a valuation of the property determined by an appraisal, a broker-priced opinion (BPO) or an automated valuation mode (AVM). While these valuations introduce a third-party mark on the asset, lenders will frequently try to introduce an obligation that the valuations will be refreshed after a period of time or when certain trigger events occur. Obtaining these new valuations can be costly and inefficient. To minimize these costs, borrowers may negotiate what will be reviewed in a valuation and how frequently they can occur. Valuations that take into account solely an exterior inspection are much less costly than those that have both the interior and exterior examined.

Dispute Mechanics

Regardless of asset class, if a lender has the right to mark asset values, borrowers may ask for the right to challenge the lender's mark. In the context of plain vanilla residential mortgage loans, lenders are typically reluctant to give challenge rights on valuations. However, in commercial real estate, single family rental and fix and flip facilities, these challenges usually come in two varieties. First, the borrower (at its own cost) can order new appraisals for any assets that the lender marks down. If the new appraised value is materially higher than the lender's mark, the new appraised value will control. Even if a lender is willing to subject its mark to such a challenge, it will usually retain the right down again in the future in its sole discretion. Alternatively, the borrower sometimes has the right to solicit bids from bona fide third parties to purchase the pool. If the borrower can find some minimum number of good faith bids (often three) that are for a higher value than the lender has marked the assets, the higher value will control. However, it is not clear if in practice a borrower would ever be able to find the required number of bidders. In any case, while a mark is subject to challenge, the borrower is generally required to post cash collateral with the lender to cure any borrowing base deficiency if they lose the challenge.

Regardless of the specific asset type, the ability for lenders to value the underlying asset is a critical component to any warehouse facility. Negotiating these provisions should be undertaken with the utmost care from a drafting perspective in order to preserve as much objectivity in this process as is permitted.

Divisive Mergers: Hazards and Opportunities

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Effective August 1, 2018, the Delaware Limited Liability Company Act ("LLC Act") was amended to enable a limited liability company ("LLC") to be divided into two or more LLCs (a "divisive merger").[1] Allowing divisive mergers provides additional flexibility for Delaware LLCs to manage and dispose of assets and liabilities and facilitates spinoffs. These changes may create structuring opportunities in asset-backed deals, but may also create potential hazards for lenders/investors to keep in mind.

Overview of New Law

There are three key amendments set forth in Section 18-217 of the LLC Act. First, the LLC Act provides LLCs with the ability to divide:

"Pursuant to a plan of division, any domestic limited liability company may, in the manner provided in this section, be divided into two or more domestic limited liability companies." Section 18-217(b).

The LLC Act also sets forth certain key terminology:

- *"Dividing company"* – the LLC that is being divided into two or more entities. Section 18-217(a)(1).
- *"Resulting company"* – the LLC that results from the division as a separate and distinct entity from the dividing company. Section 18-217(a)(6).
- *"Division company"* – refers to both the dividing company and the resulting company. Section 18-217(a)(3).

The plan of division must include, among other things, the names of each division company post-division and the allocation of assets, property, rights, series, debts, liabilities and duties of the dividing company among the division companies. Section 18-217(g). Although the plan of division is not publicly filed, both a certificate of division, which includes, among other things, a statement that the plan of division is on file with each division company, and the certificate of formation of each resulting company must be filed with the Delaware Secretary of State. Section 18-217(h).

Second, the LLC Act sets out the effect of the division, which includes, among other things, that:

"Each division company shall, from and after effectiveness of the certificate of division, ***be liable as a separate and distinct domestic limited liability company for such debts, liabilities and duties of the dividing company as are allocated to such division company pursuant to the plan of division*** *in the manner and on the basis provided in subsection (g)(1)(ii) of this section."* Section 18-217(l)(3) (emphasis added).

This provision makes clear that a division company is only liable for obligations allocated to it under the plan of division,[2] which may allow assets to be split from liabilities to the potential detriment of lenders/investors.

Third, the LLC Act provides that a division is not a transfer or assignment:

"The rights, privileges, powers and interests in property of the dividing company that have been allocated to a division company, as well as the debts, liabilities and duties of the dividing company that have been allocated to such division company pursuant to a plan of division, shall remain vested in each such division company and shall not be deemed, as a result of the division, to have been assigned or transferred to such division company for any purpose of the laws of the State of Delaware." Section 18-217(l)(8).

This provision makes clear that assets and liabilities allocated to a division company are not transferred or assigned, which may give rise to structuring opportunities where transfers are undesirable or may be used to avoid restrictions on transfers

Opportunities in Structuring

The ability to do divisive mergers will enable creative parties to structure transactions in unique ways to solve problems. This opportunity is especially true given that Section 18-217(l)(8) provides that *"rights, privileges, powers and interests in property of the dividing company that have been allocated to a division company … shall not be deemed, as a result of the division, to have been assigned or transferred to such division company for any purpose of the laws of the State of Delaware."* For example, this provision may create opportunities in structuring transactions to provide for transferring of assets or liabilities that might otherwise be difficult to effectuate, such as licenses, recorded or titled property, structured settlements or risk retention pieces.

Hazards to Consider

Although the LLC Act does provide a bit of protection for deals entered into before August 1, 2018 with LLCs created before such date,[3] most transaction documents do not yet restrict divisive mergers. Additionally, since assets reallocated are not "transferred," traditional restrictions on transfer may provide little protection to lenders/investors. Moreover, although the LLC Act provides that *"all liens upon any property of the dividing company shall be preserved unimpaired"* (Section 18-217(l)(4)), a dividing company could allocate assets to one division company and liabilities to another, thereby creating opportunities to avoid restrictions in transaction documents. Furthermore, although such an existing lien would apply to the assets in existence at the time of division, subsequently originated assets would not be subject to the lien, unless the applicable division company were subject to the security arrangement and UCC financing statements were properly filed. Given the foregoing, lenders/investors will need to make sure that their facilities include appropriate limitations or restrictions on divisive mergers as well as certain further assurance provisions, if applicable, to ensure that appropriate security arrangements are put in place and necessary UCC financing statements are properly filed, in connection with a divisive merger.

Application beyond Delaware LLCs

Although the LLC Act currently only applies to Delaware LLCs, it is expected that the divisive merger concept will be expanded to other Delaware entities. Additionally, several states, such as Arizona,[4] Pennsylvania[5] and Texas,[6] already have divisive merger statutes in place and others, such as Illinois, are contemplating such statutes. As a result, it is important that any restrictions on divisive mergers be broadly drafted to contemplate an expansion of applicability.

Conclusion

Delaware's divisive merger law will provide opportunities to structure transactions in new ways that may overcome previous obstacles. However, lenders/investors not only need to be mindful of this new flexibility but also need to adopt appropriate limitations or restrictions to protect their interests.

Endnotes

1. Note that the term "divisive merger" is often referred to by commentators but not explicitly used in the LLC Act.
2. There are two exceptions to this rule where joint and several liability would apply: 1) to fraudulent transfers (Section 18-217(l)(5)); and 2) to debts and liabilities not allocated under the plan of division (Section 18-217(l)(6))
3. "All limited liability companies formed on or after August 1, 2018, shall be governed by this section. All limited liability companies formed prior to August 1, 2018, shall be governed by this section; provided, that if the dividing company is a party to any written contract, indenture or other agreement entered into prior to August 1, 2018, that, by its terms, restricts, conditions or prohibits the consummation of a merger or consolidation by the dividing company with or into another party, or the transfer of assets by the dividing company to another party, then such restriction, condition or prohibition shall be deemed to apply to a division as if it were a merger, consolidation or transfer of assets, as applicable." Section 18-217(o).
4. 29 Ariz. Rev Stat §2601 et seq.
5. 15 Pa. Consol. Stat. §361 et seq.
6. Texas Business Organizations Code §10.001 et seq.

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