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

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

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

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

M&A Deal or Loan Portfolio Sale?

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

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

- *Ability to divest an entire business.* A seller that desires to divest an entire business line may find the M&A-style execution more favorable for avoiding trailing liabilities of the business and allowing a "clean break." If the seller divests only the portfolio of assets (and not the platform that supported the operation of those assets), it will be left with a platform (employees, office leases, etc.) that it no longer needs. The buyer will need to consider what effect its acquisition of the operating platform has on value.

- *Ability to limit indemnification remedies.* An M&A indemnity regime may allow the seller to cap certain of the buyer's indemnification remedies to a relatively low threshold, such as 10% to 20% of the purchase price, and to require a relatively high deductible, such as 1% to 3% of the purchase price, before certain of the seller's indemnity obligations kick in. This may contrast favorably for the seller with a more typical loan portfolio remedy, which is to repurchase individual loans on a loan-by-loan basis if the seller's representations are breached. The warranty repurchase is a remedy borrowed from capital markets transactions, such as securitizations. The buyer may seek a warranty repurchase remedy the terms of which mirror as closely as possible the repurchase remedy imposed on the buyer in the capital markets transaction it executes to finance the loan portfolio purchase. However, if the seller is divesting an entire business line, it may no longer be able to service repurchased loans or may find it cost prohibitive to do so. These differing indemnity regimes have tended to infiltrate both types of deals, with warranty repurchases cropping up in M&A-style transactions and caps and deductibles cropping up in the warranty repurchase remedy of loan portfolio sales.

- *Ability to limit representations and warranties*. M&A representations tend to be more general and qualified as to materiality or a "material adverse effect" and knowledge than representations in a securitization or whole loan transaction. The spectrum of representations that can apply to financial assets ranges from the detailed and numerous representations found in capital markets/securitization transactions (e.g., 20 to 30 representations covering the financial assets being financed) to a medium number of representations in performing whole loan transactions to very limited "as is, where is" representations contained in nonperforming loan sales to what may only be a single paragraph of loan representations in an M&A transaction qualified by materiality and knowledge. Where the buyer has the ability to do extensive diligence on the loan portfolio, an "as is, where is" or more limited M&A-style execution may be possible.

- *Risk of receiving a lower purchase price for the portfolio*. A disadvantage that may come hand in hand with the limited recourse and limited representations points discussed above is that the buyer may pay a lower price for the portfolio. In effect, the buyer may "price in" the cost of its limited rights.

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

- *Faster execution and lower cost*. Because only financial assets are being purchased in a whole loan portfolio sale, it is typically quicker and has lower legal and other transaction costs than an M&A-style transaction.

- *Ability to quickly finance or securitize the loans*. Execution as a whole loan portfolio sale will be preferred if the buyer plans to finance or securitize the loans immediately after or simultaneous with the closing of the purchase. The buyer's goal will be to match to the greatest extent possible the representations, warranties and covenants it receives from the seller to those demanded by its underwriters and investors in the capital markets.

- *Ability to accommodate a forward flow arrangement*. The whole loan portfolio style of execution is better suited to a forward flow arrangement, which is a loan sale program that will involve multiple loan sales over a period of time. The seller may seek a forward flow sale arrangement where it has a large portfolio of financial assets for which it can obtain better value by selling in blocks over time.

- *Retention of post-closing liabilities for individual loans*. The seller may achieve higher pricing in a whole loan portfolio sale, but it will retain trailing liabilities for the portfolio, typically on a loan-by-loan basis. As discussed above, the buyer in a portfolio sale typically seeks to obtain a warranty repurchase remedy to sell individuals loans back to the seller if the seller's representations relating to the loans are breached.

- *Importance of data tape*. The data tape for the portfolio of loans takes on heightened importance in a loan portfolio execution. The data tape typically is a large Excel spreadsheet that contains hundreds of line items. It may be difficult to verify the accuracy of each and every line item in the data tape, particularly for an older pool with multiple servicers and information technology systems over time. On the other hand, the buyer must have a high degree of confidence that the loan data is accurate if it intends to launch a capital markets deal immediately after or simultaneous with the closing. As discussed below, an accurate data tape will be essential to the buyer's financing plans, as well as its compliance with the securities laws in capital markets transactions going forward.

Whole Business v. Assets Under Management Valuations

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

The pricing for the acquisition of a securitization business falls into two primary categories: (1) pricing based on a valuation of the business as a whole; and (2) pricing based on the "assets under management" or "AUM," which are the loans, leases or other financial assets or rights comprising the bulk of the assets being sold. Some transactions share elements of both the whole business and AUM approach. The whole business valuation approach is likely to lead to an M&A platform sale execution while an AUM approach lends itself to a whole loan portfolio execution.

When to Choose a "Whole Business" Valuation. Where a business is thriving and purchasing the entire operation, including hiring substantially all the employees, is attractive to the buyer, a "whole business" valuation may make sense. The buyer may also be more likely to desire the simplicity of a stock acquisition or merger as opposed to an asset acquisition, and may be willing to assume all of the liabilities of the business without cherry picking assets and liabilities.

When to Choose an AUM Valuation. If the buyer of a securitization business perceives the business as risky, the buyer will more likely structure the deal as a loan portfolio transaction or as an asset acquisition and refuse to assume specified or unknown liabilities. A typical valuation formula for a loan portfolio or an asset acquisition would be some percentage, e.g., 105% or 95%, depending on the perceived risk of the financial assets, of the outstanding principal balance of the portfolio of loans, leases or other assets. Similarly, in the acquisition of a servicing business, if the servicer receives a 100 basis point fee in the servicing agreements being assumed, the buyer may offer a price equal to the 100 basis points (or 95 basis points again based on the perceived risk of the servicing rights) times the outstanding principal balance of the loans, leases or other assets being serviced. An asset acquisition may become a loan portfolio purchase that is much more similar to a whole loan purchase or a securitization than a traditional M&A deal. The buyer may close the transaction in multiple closings for tranches of assets as consents to transfer become available, using a structure that is more akin to a whole loan flow purchase or a securitization.

Combination Type Valuations. Acquisitions of securitization sponsors and servicers may combine aspects of both types of valuation methods. For example, a financial buyer like a private equity firm or hedge fund may need the origination and servicing platform to run the target business as well as the financial assets of the business. A financial buyer may initially value the business on a portfolio basis and then add a premium for the whole business and assume various employee, IT and other assets and liabilities, such as litigation tied to the financial assets that may be more effectively handled by the owner of those financial assets after closing. In a distressed situation, a financial buyer may insist on buying the portfolio at a portfolio valuation price only and essentially purchase the platform for "free" or even value the platform as a subtraction to the purchase price.

Effect of Valuation Method. The decision to value a whole business versus a portfolio will generally affect all the deal terms, including the representations, covenants and of course the purchase price mechanics. For example, a portfolio-based valuation will lead to more extensive representations as to the financial assets being purchased and the financing agreements with customers and lenders related to the financial assets. Operations-based representations, such as, for example, these relating to real property and real property leases, employees and employee benefits or environmental issues of the business, will be less important. Some representations, such as those relating to the financial assets themselves and information technology, will likely be relevant to the securitization business regardless of the valuation method. Similarly, covenants between signing and closing will vary depending on whether the focus is the entire business or the portfolio alone.

Whole Business Valuations and Working Capital or Net Assets Adjustments

Closing and post-closing adjustments will vary depending on the type of business being purchased and the valuation method used in calculating the purchase price. If the purchase price is based on a valuation of a whole business, the purchase price may include a traditional adjustment for changes in the working capital (current assets less current liabilities) or the net assets (total assets less total liabilities) of the business from the last audited balance sheet prepared prior to closing or the balance sheet on which the valuation for the buyer's initial offer was prepared. A typical mechanism would value the working capital or net assets as of the specified balance sheet date and base a preliminary purchase price for the closing on that amount. The parties would calculate an estimated closing date purchase price based on an estimated working capital or net assets amount a few days or the last month end date prior to closing. Within some period (e.g., 60 to 90 days) after closing, a final closing date balance sheet would be prepared and a true up payment made by either the seller or the buyer based on the difference between the estimated and final working capital or net assets.

AUM Valuation and Adjustments Tied to Portfolio Fluctuations

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

Issue 2: How Will the Purchase Be Financed?

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

Due Diligence of Financing Arrangements

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

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

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

- ***Review in a Stock Deal***. In a stock deal, if the seller has multiple securitizations, the buyer will need to understand the merger and change in control provisions contained in the securitization deal documents. In term securitizations, the merger provision is typically permissive and only applies to the entities in the deal—typically the deal sponsor (which may be the entity whose stock is being sold to the buyer), the depositor and the issuer trust or limited liability company. Other transaction parties, such as the rating agencies, trustees and perhaps third-party credit enhancement providers, typically only get notice of the merger. In private deals and bank lending facilities, change in control covenants and events of default are much more common and will likely require direct negotiations with lenders.

- ***Review in an Asset Deal***. In an asset deal, the analysis is even more complex. The buyer needs to determine exactly which assets it wants to purchase. For example, it may seek to purchase the stock of the depositors in each securitization and the seller's residual interests in the transactions, each of which will likely require their own analysis. Consents and multiple legal opinions (as to compliance with the securitization agreements and tax and UCC matters) may be required for each transaction. For the purchase of several repeat securitizations issued by the same sponsor, it may be possible to aggregate consents so that each rating agency, indenture trustee and credit enhancement provider consents for the assignment of all the deals in which it is involved. The buyer must also be sure that it meets all eligibility requirements for the sponsor, depositor or servicer roles and consider amending the transaction documents if needed. Where consents will be protracted and the parties seek to close quickly, it may be possible to structure an interim servicing arrangement whereby the seller runs the transaction on behalf of the buyer until all consents are received. Here again, the securitization agreements must be reviewed to see if there is any prohibition on subservicing or outsourcing arrangements.

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

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

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

Issue 3: How Will Licenses Affect Structure and Timing?

Impact of Licensing Issues on Structure

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

Required Licenses

Licenses and notifications or approvals that may be required in acquisitions involving a securitization sponsor or servicer include the following:

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

Mortgage Servicing Licenses. For mortgage transactions, every state requires mortgage servicing and/or debt collection licenses to service and make collections on mortgage loans. The government-sponsored enterprises, the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Government National Mortgage Association ("Ginnie Mae"), will also require that a new servicer be an eligible originator and servicer to originate, hold and service conforming mortgage loans.

Debt Collection Licenses. For consumer loans other than mortgages, the buyer may need debt collection licenses (especially if the loans were in default at the time of the acquisition) or may need to file notifications with state regulators.

Change of Control Filings/Approvals. As noted above, acquiring the seller's licenses will typically require change of control filings and approvals from the various state regulators.

Servicing Arrangements

As mentioned previously, obtaining all of the necessary licenses, even if the transaction is structured as a stock purchase or a merger, can take a significant amount of time. In order to present a more attractive bid, the financial buyer may team up with an existing servicer to make its bid or may enter into an interim or long-term servicing agreement with the seller or a third-party. Particularly in the mortgage industry, it may be less practical for the buyer to request that the seller provide an interim servicing arrangement pending the buyer's receipt of licenses because, in many states, the buyer will need state licenses merely to hold loans or servicing rights and receipt of these licenses should be a condition to closing. The seller may be willing to provide interim servicing as an accommodation with "as is, where is" servicing standards as opposed to the quite robust service level agreements currently seen for consumer loan servicing. In the mortgage industry, mortgage loan servicing agreements with third-party servicers follow relatively established patterns. For other consumer assets, the practice is less uniform and the liability and service level standards may be hotly negotiated. Regulatory considerations for any servicing relationship should include credit reporting obligations, debt collection issues and the possible need for borrower notices of the sale or transfer of servicing. The obligations of the servicer and the time frame for performance of these obligations should be clearly established by the servicing agreement. The buyer and the seller should also agree on the timing and content of any borrower notices. For example, the Real Estate Settlement Procedures Act and its implementing regulation, Regulation X, generally requires the new and old servicer to provide notice to borrowers within a prescribed period of time regarding the transfer of servicing for their residential mortgage loans.

Licensing and the Marketplace Funding Model

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

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

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

Due Diligence and Reverse Due Diligence

The buyer's due diligence in an acquisition of a securitization sponsor or servicer requires extensive familiarity with the underlying securitization transactions, including the structures, risks and regulatory issues that relate to these transactions. Increasingly, a seller must also engage in due diligence of the buyer, especially if the seller is a bank or finance company subject to regulation by the banking regulators or the Consumer Financial Protection Bureau.

Due Diligence of Loans, Loan Files and Servicing Agreements

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

- *Selective Review/Sampling*. Buyers and sellers will debate over how extensive the buyer's review of actual loan files should be. Most buyers will insist on at least sampling a statistically significant number of loan files for missing documents and other potential defects. The buyer's accountants or financial advisors can assist in determining what represents a statistically significant number of files, which will depend in part on the diversity of the loan assets. Consumer law counsel should undertake at least a selective review of the basic form of loans, leases or other receivables to ensure that they comply with relevant consumer laws on both a federal and state level, as applicable. In a consumer business, it may not be practical or cost effective for legal counsel to review all the forms in every state. In this case, it should be possible for legal counsel to review a sampling of the loan forms, perhaps in the more important states for the portfolio, and provide a checklist for outside due diligence consultants to review the forms for consumer law or other regulatory compliance. For example, does the form contain the mandated Regulation Z, Truth in Lending Act disclosure, and an arbitration waiver if arbitration is desired? If a mortgage is a "high cost loan," does it contain the disclosure required under the Truth in Lending Act as amended by the Home Ownership and Equity Protection Act?

- *APR Calculations and "High-Cost Mortgages" Laws*. An outside consultant may also be hired to review the lender's original calculations regarding the Annual Percentage Rate (APR) and finance charge disclosures required under the Truth in Lending Act. In addition, a review of the points and fees paid by the borrower (as set forth in the Truth in Lending Act disclosures and the HUD-1 or HUD-1A required by the Real Estate Settlement Procedures Act) is often conducted to determine whether the loan exceeded the "points and fees" trigger and should have been treated as a federal or state "high-cost mortgage" laws. If the loan is a "high-cost mortgage," the buyer may be potentially liable for the acts or omissions of the originator.

- *Process to Update Forms*. The buyer's counsel should also review the seller's process for updating its forms or agreeing to changes to its forms. Any lender engaged in a nationwide lending program will need to rely upon legal counsel, trade associations and other vendors to track changes to the applicable laws and regulations and ensure that such changes are reflected in the revised loan agreements.

- *Assignability*. In an asset deal or loan portfolio sale, counsel should confirm that the loans, leases or other receivables are freely assignable by the seller as lender without notice to or consent from the borrower. In a commercial lending business where the borrowers may have more leverage to negotiate their form of lending arrangement, the loans may not be assignable by the seller as lender and consents will be required.

- *Effect of Defects on Purchase Price and Structure*. Older consumer loan and mortgage portfolios may have a host of defects and be missing key documents that will affect the value of the portfolio even if the loans are performing. If the loans are non-performing and the loan files show a high level of defects, the purchase price will be severely affected. The buyer may seek to exclude certain types of loans if it determines that the risk of enforcing these loans is too high or servicing the loans is not cost-effective. The seller may be willing to entertain a lower price from the buyer if the buyer is willing to take on all types of loans on essentially an "as is, where is" basis.

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

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

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

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

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

Data Tape Issues and Information Technology

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

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

Litigation and Regulatory Issues

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

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

ENDNOTES:

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

FROM THE EDITOR

The Unknowns Get Cloudier

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

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

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

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

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

Chris O'Leary

Managing Editor

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