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

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

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

By Elizabeth A. Raymond

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Issue 5: What Consents Are Required?

Consent Issues

As discussed in the previous part of this article, M&A transactions involving financial assets that are subject to securitization may require the consent of numerous third parties. The consents required to transfer these financial assets, regardless of whether a buyer is proposing to acquire an entire loan origination and/or servicing business or just certain financial assets, is often driven by the transaction structure. Generally, if the transaction is structured as an asset sale, which would trigger the various assignment provisions in the operative servicing agreements, the consent process is more time-consuming and complicated because the transaction will entail a complicated third-party consent process. If the transaction is structured as a merger or a sale of stock (or, in some instances, as a sale of substantially all of the seller's servicing platform assets), however, the transfer process is generally less complicated and time-consuming because the third-party consent provisions may not be triggered (although there may be other requirements that the parties must satisfy before closing).

Consent Issues in an Asset Sale. If a buyer and a seller structure a securitization M&A transaction as an asset sale, nearly all of the operative servicing agreements involved will contain an assignment provision that sets forth extensive requirements that must be satisfied prior to the transfer/assignment. Because servicing is such a critical component of any financial asset financing, third-party stakeholders in the financing will want to confirm that a proposed M&A transaction involving the transfer of servicing to a new servicer will not weaken the performance of the financing. In nearly every instance, therefore, various third-party deliveries will typically need to be obtained prior to closing.

- *Rating Agencies.* Some of the more important third parties in a securitization that the buyer and the seller will need to work with during the M&A transaction process are the rating agencies. Under the operative servicing agreements, the identified rating agencies may have to confirm prior to transfer that the proposed transaction will not result in a reduction of credit ratings, which requires the parties to obtain a "no downgrade" letter from each of these agencies prior to closing. Similarly, servicing agreements in the mortgage context will often require that the new servicer be Fannie Mae- and/or Freddie Mac-approved and that each of Fannie Mae and Freddie Mac provide written consent to the transfer. The buyer may need to complete the relatively complicated and time-consuming Fannie Mae and/or Freddie Mac qualification process prior to servicing the assets. Obtaining written consent from the GSEs can also be time-consuming, and this process, along with the qualification process (if applicable), should be initiated as soon as practicable in the deal timeline.

- *Master Servicer, Trustee, Trust Administrator, Depositor*. Generally, prior written consent of the master servicer, trustee, trust administrator, depositor, purchaser and owner (in each case, as applicable) is also required under servicing agreements prior to a

transfer of servicing. Although time-consuming, obtaining these third-party consents is typically not problematic, except in cases where security holder consent is required.

- *Security Holders*. Some servicing agreements will expressly require the consent of security holders (typically, the noteholders of asset-backed securities) holding a certain percentage (often a majority or 66%) of the outstanding securities prior to the transfer of servicing. In addition, even though trustees may have discretionary powers under servicing agreements as to whether security holder consent should be obtained prior to a servicing transfer, trustees may be more likely to seek security holder consent following the credit crisis in an attempt to insulate the process from potential liability. Soliciting security holder consent is generally undesirable for a buyer and a seller in a M&A transaction because of the inherent difficulty of attempting to obtain consent from a wide pool of public security holders. The time and expense required to properly stage a security holder consent and the potential unpredictability of the results makes it a very onerous process. As such, the parties should work with the trustee as soon as possible in the transaction process to determine whether security holder consent is needed (if it is not expressly required under the servicing agreements). Trustees will typically take into account the experience and creditworthiness of the proposed servicer and the extensiveness of other security holder protections, such as rating agency confirmation and master servicer consent, when determining whether security holder consent is needed. Understanding what a trustee needs to consent to a servicing transfer without obtaining security holder consent in the early stages of the transaction can save the parties considerable transaction costs.

Consent-Based Price Adjustments. A purchase price variation seen in securitization-related M&A transactions arises from consent-based price adjustments. Where the primary assets of the business are securitization or customer agreements and multiple consents are needed to transfer ownership, the buyer may only be willing to close on assets for which consents have been received. In this case, each contract is assigned a price and the buyer closes and pays for that contract only when consent is obtained.

Consent Issues in a Merger or Stock Sale. If a buyer and a seller structure a securitization M&A transaction as a merger or a stock sale (or, in some instances, as a sale of substantially all of the servicer's assets), the transfer process can be less difficult, because the transfer provisions in servicing agreements are generally more relaxed in the case of a merger or stock sale. Typically, under these transaction structures, third-party consents are not needed, but the buyer's proposed servicer must satisfy several regulatory and financial requirements. For example, in a mortgage transaction the buyer's servicer must generally be Fannie Mae, Freddie Mac and/or HUD approved and its deposits must be FDIC-insured. In addition, the buyer's servicer may be required to satisfy certain financial thresholds (*e.g.*, have a GAAP net worth of at least $25 million) and the proposed transfer cannot result in a reduction of credit ratings (i.e., a "no downgrade" letter must be obtained from the relevant rating agencies). Given the complex language of servicing agreements and ambiguities that may arise, each relevant agreement should be carefully analyzed by the parties to ensure that the transfer process outlined in the agreements is correctly interpreted.

Approval of State and/or Federal Mortgage Regulators. Finally, because of the heightened scrutiny that governmental authorities have placed on the consumer finance industry, a mortgage M&A transaction may require the approval of state and/or federal mortgage regulators. These regulators may want to confirm that the buyer will adequately manage the financial assets that it is proposing to acquire. These regulatory concerns may lead to detailed pre- and post-closing covenants for the buyer and the seller.

Amendments to Servicing Agreements. In addition to the often lengthy and complicated consent process, the proposed transfer of a securitization sponsor's platform or certain of its assets (in particular, servicing rights) also generally requires that each of the operative servicing agreements be amended in order to effect the proposed transaction. This process is typically document intensive involving numerous parties, which can essentially require a mini-closing for each of the amendments. This process normally involves a negotiation with the trustee and depositor that are parties to the relevant servicing agreement with respect to the language of the amendment, obtaining a "no downgrade" letter from each of the relevant rating agencies

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(the rating agencies typically provide one "no downgrade" letter that covers the consent to the amendment and the transfer of servicing rights), obtaining legal opinions with respect to the authorization of the amendment and tax matters and obtaining miscellaneous third-party consents (e.g., consent from a collection agent if a collection agent agreement is in place).

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

A new issue arising for bank and non-bank sellers that are regulated by the CFPB is what level of due diligence sellers must engage in with respect to their buyers. Non-bank servicers that are owned by private equity or hedge funds have become very common bidders. A seller should be concerned with the regulatory and litigation history of its bidders as well as their licensing status, including whether a prospective bidder has taken aggressive positions relating to compliance matters. These compliance issues can impact a bidder's ability to close a transaction and may present potential liability for the seller. Buyer representations and covenants relating to its pre-closing and post-closing conduct have become much more common and assist the seller in completing its due diligence of the buyer.

The Office of the Comptroller of the Currency (the "OCC") and the CFPB have made it clear that a seller cannot just walk away from a consumer loan portfolio without some assurances that the portfolio will be handled properly after the closing. For example, 2014 CFPB regulations impose affirmative obligations on transferors of servicing to mitigate servicing disruptions when loans are transferred, and provide that examiners will consider the steps taken by the transferor servicer to minimize disruptions, including transferring loan information and identifying loss mitigation in process. In addition, in 2013 the OCC issued best practices for national banks and federal savings associations involved in consumer debt sales, including requiring that national banks have risk management policies in place and take a number of steps prior to selling any debts to a third party, which include establishing initial and ongoing due diligence of third-party debt buyers and minimum criteria for approving debt buyers. Consent decrees issued by the OCC, the CFPB and states regulators provide strong warnings to banks reselling distressed debt (*e.g.*, a bank cannot sell debts that have been paid, settled, discharged or do not have the required documentation and must not use robo-signed affidavits). Even if the seller is not directly regulated by the OCC or the CFPB, it should consider whether the seller or the buyer may be swept within OCC or CFPB supervision, or similar federal or state supervision, in the future and whether the seller should diligence the buyer as if their rules and guidance applied.

Finally, the bank seller may need to address OCC and FRB guidance regarding outsourcing and third-party vendors. While the outsourcing guidance may not typically apply in a sale context, where a transaction contemplates future loan sales on a flow basis or a subservicing agreement for certain assets not transferred, this guidance should be considered. Covenants addressing third-party risk management issues (audit, compliance, indemnity, etc.) may be needed for the seller.

While the OCC guidance only applies to national banks and federal savings associations, the CFPB guidance and regulations are applicable to all residential mortgage and other servicers. The OCC bulletins are generally applicable to national banks, which includes most of the largest issuers of credit cards. However, the CFPB has also expressed some similar concerns about these types of practices and has viewed its UDAAP provisions as applicable to both first- and third-party debt collection. Given the focus by the New York Department of Financial Services and banking regulators on MSR and other financial asset sales to non-bank finance companies, reverse due diligence will continue to be a hot topic.

Issue 7: What SEC Disclosure Issues Arise?

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

Regulation AB

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

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

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

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

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

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

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

Instruction 1 to Rule 1122 clarifies that the "assessment

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

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

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

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

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

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

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

Issue 8: Who Will Service the Assets After Closing?

Transfer of Servicing. In addition to the customary covenants present in most M&A deals, in financial asset M&A transactions, because the transfer of an origination and/or servicing platform and any related securitization or other financing agreements can be such a complicated and technical process, the buyer and the seller often agree to cooperate with each other to work to effectuate the transfer of servicing. This covenant will generally set forth the transfer

procedures and require the parties to develop a more comprehensive set of transfer instructions in order to ensure that all rights and obligations are properly transferred under the operative securitization or other financing documents.

Deficiencies in Loan Files. Depending on the relative bargaining power of the buyer in a financial asset M&A transaction, it can also require the seller to covenant that it will address the deficiencies in its loan files between signing and closing. Because loan origination and servicing activities are so paper intensive and the loan portfolios are so voluminous, platform operators often fail to fully comply with the regulatory requirements regarding the contents of each of its loan files. To ensure that it does not assume any liability with respect to deficient loan files post-closing and to ensure that it can enforce the debt and has received clean title to any underlying security, the buyer can require the seller to clean up its files and to cure any deficiencies before closing. Who bears the cost of these clean-up activities is a negotiated point between the buyer and the seller.

Interim Subservicing or Servicing Agreements. If the parties are unable to obtain all necessary consents and/or satisfy all necessary requirements to transfer the servicing business under the servicing agreement prior to closing, the parties may be able to enter into an interim subservicing arrangement where the seller will continue to service the receivables acquired by the buyer until the buyer is fully qualified to do so, including as required under any securitization or other financing agreements. In these circumstances, the parties will negotiate an interim subservicing agreement prior to closing, which will remain in effect for a relatively short period of time post-closing. Similarly, if the seller retains some of the financial assets after its platform and financial assets are sold, it may require a short-term or long-term servicing agreement from the buyer's servicer.

Issue 9: How Will the Technology Be Transitioned?

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

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

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

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

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

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

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

Representations and Warranties

Buyers in M&A transactions for securitization businesses will typically customize traditional M&A representations as appropriate so that they specifically address the issues that are unique to M&A involving securitization sponsors and servicers. Buyers will typically request that the seller make detailed representations as to the loans, leases or other financial assets being purchased and the servicing and securitization or other financing transactions related to the business. These additional representations allow the buyer to obtain information regarding, and assess the risks associated with, the financial assets that the buyer is proposing to acquire. However, these M&A-style representations will typically not be nearly as detailed as those found in a securitization or whole loan purchase of the same financial assets, which may cause difficulties in negotiations.

Loans or Leases. Regardless of whether a buyer is proposing to acquire an entire origination and/or servicing platform or just specific financial assets, it should consider negotiating with the seller for representations that cover the loan or lease portfolio, including any related servicing agreements and securitization transactions and the underlying loans or leases being acquired. In this regard, the buyer should request that the seller provide:

- a current loan or lease schedule that sets forth the information required under, and is prepared in accordance with, the servicing agreements with respect to the financial assets that are part of the transaction; and
- an electronic data tape that sets forth detailed information regarding each loan or lease and any security that the buyer is acquiring, including the unpaid principal balance of each loan, interest terms, payment terms and any modifications.

Often times, if there is a period of time between signing the acquisition agreement and closing, the seller will deliver to the buyer monthly updated loan schedules and data tapes

in order to provide the buyer with the most current information regarding the loan portfolio that it is acquiring. The buyer may request that the seller represent that the information contained in each of these loan schedules, or at least specific data fields in the loan schedules and data tapes, is true and correct as of the date that each schedule and data tape is delivered.

Compliance with Law. Given the current regulatory environment, the seller may also be concerned with what it needs to disclose under the typical "compliance with law" representation. The seller's counsel may encourage the seller to disclose anything that could possibly have gone or go wrong from a legal compliance point of view on the seller's disclosure schedules despite the fact that none of those issues are likely to be material. The buyer may seek several compliance with law representations that separately address multiple layers of legal compliance under several statutes. This proliferation of legal compliance representations will likely lower the level of materiality for a breach of representations by the seller, again forcing the seller to disclose any conceivable compliance issue. Disclosure issues can be aggravated where there are emerging views on "best practices" for compliance by finance companies, as is the case with CFPB regulation. Both the buyer and the seller need sophisticated regulatory counsel to navigate these issues. The question of whether the seller can update the disclosure schedules between signing and closing also becomes trickier when legal compliance standards are rapidly changing.

Buyer Representations. Another product of the current regulatory environment is that the seller is much more likely to seek representations and covenants from the buyer.

- *Privacy and Data Security*. The seller may seek assurances that the buyer has and will handle nonpublic personal information of borrowers in accordance with the Gramm-Leach-Bliley Act and other applicable laws both before and after the closing, particularly if any consumer information is disclosed during the buyer's due diligence. Because of the potential impact on businesses and their customer relationships, privacy and data security are increasingly important considerations in transactions involving consumers and nonpublic personal information. Note that the seller may be inclined to not include any nonpublic personal information on the pre-closing data tapes so this covenant would only apply to the buyer's review of loan files prior to the closing and servicing activities after closing.

- *Licenses, Registration and Insurance*. The seller should also seek assurances that the buyer has all licenses, registration and insurance that it needs to originate, own, service and collect on the loans or leases being purchased and to fund any open-end lines of credit.

- *Loss Mitigation*. The seller may also seek assurances (and may be required by its own regulators to seek assurances) that the buyer has the employee, technology and compliance resources to allow it to continue any loss mitigation programs relating to the loans or leases being purchased. Proper continuation of loss mitigation arrangements is a huge concern for regulators with respect to subprime and other legacy mortgage loans. Furthermore, the Home Affordable Modification Program and other loss mitigation programs may require written assurances from the buyer.

- *Loan File Due Diligence*. Depending on the seller's leverage, it may seek assurances from the buyer that the buyer has been able to conduct loan and loan file due diligence as it deems appropriate and that the buyer is aware that the loan files are incomplete and that no representations are being made as to the collectability of the loans or leases. Any contractual provisions regarding the incompleteness or inaccuracy of the loan files may serve as a "red flag" to the seller's or the buyer's regulators and raise questions about the ability to properly service the loans. For example, OCC guidance and regulatory actions would generally preclude issuers from selling delinquent accounts without the records needed to collect them properly.

Covenants

The majority of the key covenants in the acquisition agreement cover the period between signing and closing, but certain covenants remain in effect after the closing. As with representations and warranties, covenants will also vary depending on whether the securitization buyer is acquiring the entire business or just a portfolio.

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Conduct of the Business between Signing and Closing. As with most M&A transactions, one of the most important covenants made by the seller in a securitization-related M&A transaction concerns the operation of the acquired business during the period between signing and closing. The seller generally agrees to conduct its business operations in the ordinary course and to maintain the assets of the business to provide the buyer with comfort that the platform and assets it is proposing to acquire remain materially unchanged between signing and closing.

Consents. The parties can also covenant to work together to obtain the necessary consents needed under the servicing agreements, which is a complicated process that typically requires the active involvement of both parties.

Governmental Inquiries. Moreover, given the increased scrutiny that governmental agencies now give to financial asset transactions and the increase in litigation affecting financial asset participants, the parties will also typically agree to cooperate with each other to handle any governmental inquiries regarding the proposed transaction and current litigation affecting the financial assets being transferred. These covenants will also typically require the parties to work together following the closing to take any action to complete the transfer to the extent the action was not (and should have been) taken prior to closing.

Post-Closing Covenants. Covenants that carry over post-closing were relatively minimal in financial asset M&A transactions in the past but have become much more extensive in the wake of the post-credit crisis regulatory environment. Other covenants that may apply to sellers and buyers after closing include:

- Delivery of loan files, including from third-party storage facilities;
- Procedures to notify credit reporting agencies of the loan sale;
- Procedures to terminate or transfer agreements with third-party subservicers, collection agents and other vendors;
- Procedures to properly transfer servicing on loans undergoing loss mitigation;
- Procedures to handle any ancillary products, such as credit or other insurance related to the loans or leases;
- Procedures to transfer ordinary course collections litigation that will follow the loans or leases to the buyer; and
- A detailed conversion plan to ensure that the servicing transition occurs in an orderly fashion.

Indemnities

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

Buyer Indemnities. Given the extensive liability that can be associated with financial assets in today's market, buyers in a securitization-related M&A transaction may insist on an asset sale structure with clear language in the indemnification provisions that provides that all pre-closing liabilities remain with the seller without regard to time limits or caps. Although less common in a stock deal, the buyer may also insist that the seller indemnify it for particular pre-closing liabilities in a stock deal. This "our watch, your watch" approach is not uncommon in non-finance company M&A transactions, but it is likely more standard in consumer finance company M&A transactions.

Given the current regulatory environment, the buyer may seek broad indemnification for certain identified pre-closing liabilities, such as liabilities relating to litigation (other than any ordinary course collections proceedings that the buyer will assume), breach of the loan documents to the extent arising prior to the closing and any violations of law prior to the closing.

Seller Indemnities. The seller will seek to clarify that the buyer is solely responsible for how it operates the business after closing, even if the buyer is continuing practices of the seller prior to closing. In other words, the buyer needs

to assess the seller's operations, servicing and legal compliance and make any changes it deems necessary after closing in light of a fast evolving regulatory environment. Depending on its leverage, the seller may seek to carve out known deficiencies in its operations or compliance regime that it has disclosed to the buyer in reasonable detail.

The seller will seek indemnification for the buyer's operation of the business after the closing and the liabilities the buyer is assuming. The seller may also seek an indemnity for the buyer's misuse of any power of attorney granted by the seller, which is essentially protection against post-closing claims based on the buyer's collections activities.

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FROM THE EDITOR

Post-Order Divestitures: An Uphill Chance of Success

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

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

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

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

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

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

Chris O'Leary

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