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# Transaction Risks In Residential Mortgage M&A Due Diligence

By **Lauren Pryor, Krista Cooley and Tori Shinohara** (September 12, 2023, 5:04 PM EDT)


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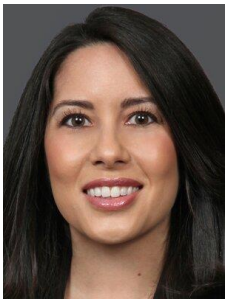
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We are seeing continued consolidation in the residential mortgage market following recent interest rate increases and low housing volume across the U.S.

Investors in residential mortgage companies should be keenly focused on a few critical items when evaluating a target. Whether you are considering a minority investment or a whole company carveout transaction, buyers and sellers should be aware of the following issues that may present transaction risks for U.S. mortgage company investments.

**Financial Condition of the Target**

Originators and servicers are under immense financial pressure in the current market. Many mortgage companies are looking at stock and asset deals as a way to weather the economic storm.

However, mortgage merger and acquisition transactions require state and federal agency change-of-control approvals that may take several months to obtain. The target entity needs to remain in good financial health during this time in order to avoid covenant defaults under agency requirements and warehouse lending facilities.

Buyers and sellers may need to consider creative solutions to help bridge the gap, including cost-cutting measures and convertible debt structures. Buyers should consider the impact of these measures on the overall economics of the transaction, and sellers should consider the possibility of additional capital infusions.

**Warehouse Lender Consents**

Reductions in warehouse lending capacity across the industry are putting additional pressure on mortgage originators. Certain warehouse loan providers have reduced their participation in this market in light of the current banking environment, and a national bank and major player in the warehouse space, Comerica Inc., recently announced that it plans to exit the warehouse lending business altogether.

The decision by any significant financing party to reduce its participation in, or exit, the business puts additional pressure on mortgage originators to obtain new warehouse facilities and lean more heavily

on other existing warehouse lines. Buyers should carefully consider available warehouse capacity post-closing.

Moreover, most warehouse agreements require lender consent in the event of a change of control and other such material events pertaining to the mortgage originator.

In the context of an M&A transaction, buyers and sellers should anticipate that warehouse lenders could use the consent requirement as leverage to negotiate additional or more favorable terms. Negotiating new warehouse lending terms on the eve of closing adds further transaction risk in an already volatile mortgage M&A market.

**Fair Lending Risk**

Federal and state fair lending laws prohibit discrimination in connection with mortgage lending. Federal regulators, including the Consumer Financial Protection Bureau and the U.S. Department of Justice, have been stepping up their enforcement on fair lending issues in recent years. As a result, understanding and evaluating potential fair lending legal and reputational risks in connection with a potential transaction may be prudent.

Common fair lending risks associated with mortgage lending including pricing discrimination, improper denials and geographical redlining. The CFPB and DOJ have recently entered into a number of public and nonpublic settlements related to alleged fair lending violations that have resulted in significant monetary penalties and required other remedial actions, including changes to business practices.

Depending on the structure of the transaction, a buyer may take on the liabilities of the target company, which could include liability for violations of fair lending laws that are subsequently identified by a government agency.

Buyers could be responsible for defending a multiyear fair lending investigation or the payment of civil money penalties or other required restitution. Fair lending settlements can also require changes to business practices, such as changes to pricing practices or the opening of a new branch or loan production office, which could have significant business ramifications.

Because of these potential risks, buyers may consider engaging a third-party consultant to perform a statistical analysis of a target's historical lending performance prior to consummating the transaction. Even in asset transactions where a buyer does not assume all liabilities of the target, there may be reputation risk to consider in connection with a potential fair lending lawsuit or settlement.

**Employee Classification**

Employers are obligated to designate employees as either exempt or nonexempt from the overtime regulations of the federal Fair Labor Standards Act[1] and similar state laws.

Employees are classified depending on their applicable job duties and on the basis of their salary and income level. An exempt or nonexempt classification determines whether an employee is entitled to receive overtime pay for hours worked over 40 in a week, or eight in a day in some jurisdictions.

The determination as to whether an employee is exempt or nonexempt is based on a somewhat subjective analysis and can be difficult. The U.S. Department of Labor has focused specifically on the

misclassification of mortgage loan officers and issued guidance in 2010 stating that generally mortgage loan officers should be classified as nonexempt.[2]

The 2010 guidance overturned a 2006 DOL opinion letter holding that mortgage loan officers may be classified as exempt. The classification analysis for loan officers and underwriters is particularly tricky, because it is possible that persons in these roles may fall within either the administrative exemption or the outside salesperson exemption.

The administrative exemption requires that the employee's duties include the exercise of independent judgment and discretion. This is a fact-specific inquiry that depends on the loan officer's actual duties and responsibilities.

Similarly, the outside sales exemption requires that the employee's primary duty is making sales, as defined by the FLSA, and "who is customarily and regularly engaged away from the employer's place or places of business in performing such primary duty."[3] This, too, is a fact-specific inquiry.

Independent contractors or consultants can also be the subject of misclassification. Whether a service provider is correctly classified as an independent contractor is based on whether the factual circumstances fall within one or more tests.

For example, the Internal Revenue Service website states that all information that provides evidence of the degree of control and independence must be considered in determining whether an individual is an independent contractor.

These common law factors are behavioral and financial. This would include considerations related to who controls what the worker does, how the worker is paid, whether expenses are reimbursed, who provides tools and supplies, etc. and the type of relationship.

Here, too, certain states, such as California and New Jersey, impose narrower restrictions on the facts that support an independent contractor classification.

If a business misclassifies employees or independent contractors, the business may be at risk for individual claims or class actions. A common remedy for FLSA violations is the payment of back pay — the difference between the pay the employee actually received and the amount that the employee should have received — looking back over a two- or three-year period.

In addition, liquidated damages in the amount of twice the backpay amount may also be available. Certain state laws impose even stronger penalties. For instance, the California Labor Code[4] provides for monetary penalties for waiting time violations, wage statement violations, meal and break period violations, and pay period violations.

Because taxes are not withheld from independent contractors and paid over to the taxing authorities by the business, one of the primary risks of a business engaging an independent contractor is the obligation to provide unpaid federal, state and local income tax withholdings and Social Security and Medicare contributions, and unpaid unemployment insurance taxes, both to the federal government and the state government, in the event the worker should have been classified as an employee.

Further, the federal, state and local taxing authorities may issue penalties; for example, the IRS penalty for failure to withhold and pay over income and other taxes is an amount equal to 100% of the tax.

In addition, workers who were misclassified as independent contractors but should have been classified as employees may be eligible for unpaid overtime compensation or minimum wages, unpaid work-related expenses, and unpaid sick or vacation pay.

A worker who was misclassified as an independent contractor but should have been classified as an employee may become eligible for or entitled to receive benefits under the employer's benefit plans.

Whether benefits may be provided only prospectively, or must be provided retroactively, should be reviewed under the terms of the applicable plans. There have been cases under which companies were required to provide retroactive benefits as a result of the retroactive reclassification of independent contractors.

As a result, many plans now contain language providing that an individual will not be retroactively eligible to participate in the plan even if that individual is reclassified retroactively.

An employer should also review misclassification issues under the Affordable Care Act, which generally requires that employers provide affordable, minimum value coverage to its full-time employees or pay an employer shared responsibility payment if the employer fails to do so.

A failure to offer coverage to one or more individuals who are determined to be full-time employees could trigger significant penalties — in some cases, determined on an entitywide basis.

When considering an equity investment in a mortgage company, even for a minority stake, buyers may carefully review the target's employee census to consider how employees are classified. If employees are misclassified, buyers may consider requiring the seller to take mitigating steps to reduce risk, request a special indemnity in the purchase agreement, or make adjustments post-closing.

Note that misclassification of employees may also present concerns for purchasers in asset sales. Buyers of substantially all the assets of a mortgage company or a significant portion thereof should be aware of the potential for successor liability in employment actions because courts have held transferees in asset sales liable for employee misclassification claims under the FLSA and similar state laws.[5]

**Nonvoting Stock and Change-of-Control Approvals**

It may be surprising to learn that the acquisition of nonvoting stock or nonvoting equity interest investments also may require change-of-control approval as it relates to Ginnie Mae, Fannie Mae, Freddie Mac and certain state mortgage finance licensing laws and may require personal disclosures of the ultimate indirect owners of the licensee.

The determination of whether the change-of-control provisions apply may be based on the form of organization of the licensee or entities in the chain of ownership. Debt structures also may warrant change-of-control analysis depending on the extent of the debt holder's ability to exercise control over, or direct the management or policies of, the licensee.

Some states require approvals for any change of 10% or more in the direct or indirect ownership of a licensee, including in connection with preferred, nonvoting interests.

Other states draw the line at a change of 25% or more in the indirect or direct ownership of the licensee.

Some states further require personal disclosures, e.g., personal financial statements, fingerprints, etc., from any individuals holding more than the requisite threshold of indirect ownership interests of the licensee or of an entity seeking to acquire an interest in a licensee.

Some states exempt public shareholders up the ownership chain.

Personal disclosures may be burdensome and intrusive, so buyers and their investors may carefully consider what information is required to be disclosed and by whom.

Hedge funds, strategic investors and private entity firms should analyze this issue carefully because their principals may be required to make such disclosures. Licensing counsel should help navigate the change-of-control analysis and consider whether disclosures will be required based on the form of investment proposed, the organizational charts of both buyer and seller and the state licensees held by the licensee.

Similarly, sellers should carefully evaluate whether the proposed ownership structure poses transition risk in the event that certain of a potential buyer's direct or indirect owners may be hesitant to provide personal disclosures, which could delay or adversely affect the issuance of state approvals necessary to proceed with the transaction.

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[1] 29 C.F.R. Part 541.

[2] https://www.dol.gov/agencies/whd/opinion-letters/administrator-interpretation/flsa/2010-1.

[3] 29 U.S.C. 213(a)(1).

[4] Cal. Lab. Code.

[5] See, Teed v. Thomas & Betts Power Solutions, 711 F.3d 763, 764 (7th Cir. 2013).