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Specialty Finance Mergers and Acquisitions: Developments and Considerations

In a rapidly evolving financial services landscape, mergers and acquisitions activity in the specialty finance sector was robust in 2012 and early 2013, and the pipeline for transactions in this space continues to be strong. With traditional bank-to-bank M&A activity remaining at depressed levels, some depository institutions have sought to boost their earning assets through acquisitions of alternative lending divisions (*e.g.*, Wells Fargo's acquisition of BNP Paribas' U.S. and Canadian oil and gas reserve-based lending business, EverBank's acquisition of GE Capital's Business Property Lending unit and MB Financial's acquisition of Celtic Leasing). In other cases, regulatory pressures to raise capital and/or focus on core operations, as well as greater sensitivity to consumer enforcement risk in response to the creation of the Consumer Financial Protection Bureau and increased state enforcement activism, have led banking organizations to dispose of non-core lending platforms (*e.g.*, Flagstar's sales of its Northeast-based commercial loan portfolio to CIT and Customers Bank in separate transactions and Ally Financial's ResCap unit's sale of its mortgage servicing platform and related servicing rights to Ocwen Financial and Walter Investment Management in a bankruptcy proceeding). In addition, in response to less favorable capital treatment of mortgage servicing rights under Basel III and other regulatory pressures on the mortgage servicing business, banks with the largest MSR concentrations have sought to shrink their MSR portfolios, providing an opportunity for non-bank lenders, servicers and investors to acquire these assets at attractive prices (*e.g.*, Bank of America's MSR sales to Walter Investment Management and Nationstar, and Nationstar's subsequent sale of excess servicing rights to Newcastle). These transactions have spurred additional deal activity, as potential MSR investors needing the necessary state licenses to hold these assets, as well as existing servicers looking to increase scalability, have pursued acquisitions of mortgage servicing platforms as a precursor to MSR trades (*e.g.*, Walter Investment Management's acquisition of MetLife's residential mortgage servicing platform, announced on the same day as Walter's MSR acquisition from Bank of America).

While specialty finance transactions present all of the issues that typically arise in an M&A transaction, potential buyers should also be mindful of the following when considering an acquisition in this space:

Industry Risk

The consumer lending industry is in a state of regulatory reform and increased enforcement risk. At the federal level, the CFPB is still a new organization, but it has already made clear that it will be quite active in both enforcement and rulemaking. In addition, the Comptroller of the Currency has signaled in recent remarks that the OCC will be more assertive in enforcing consumer protection matters. At the state level, attorneys general have responded to the financial crisis with a renewed focus on compliance issues with respect to a wide range of financial products and practices. There are many types of loans made in the consumer lending space — mortgage loans, auto and other vehicle loans, personal loans, payday loans, credit card loans and merchant finance loans, just to name a few — to borrowers of various socioeconomic classes. Prior to making an investment decision, one must understand the political and regulatory environment surrounding the asset class that is the subject of the proposed transaction, including the level of scrutiny to which the industry will be subjected and whether regulators will seek to impose further burdens or restrictions on the types of products and services offered by the business to be acquired.

Due Diligence

In addition to the matters that are the focus of legal due diligence irrespective of industry, a number of industry-specific compliance issues require close attention in the specialty finance space. These include the business' products and practices with respect to overall compliance management, fair lending, advertising, complaint activity, ancillary product offerings and training. A review of these matters sheds light on, among other things, potential contingent liabilities, the risk that certain products and services could subject the business to greater regulatory scrutiny going forward, and whether the buyer will need to incur expense following the closing to enhance the compliance function of the acquired business (including by hiring additional personnel). Furthermore, many specialty finance companies finance their lending activities in whole or in part via sales of the loans they originate. A prospective buyer should thoroughly review the agreements governing these sales to assess potential contingent liabilities, including obligations of the target to repurchase loans previously sold as a result of breaches of representations and warranties or other events, as well as settlement agreements regarding previous origination and servicing activities. The prospective buyer should also diligence litigation and other disputes particular to the industry, including state attorney general claims, class action lawsuits brought by borrowers and disputes with GSEs (*e.g.*, Fannie Mae, Freddie Mac, etc.).

Financing

A threshold issue for any non-bank buyer of a specialty finance business is how it will fund the business on an ongoing basis. Where the seller is a bank, it is likely that the business has been historically funded through the bank's deposits, and that the buyer will need to find replacement financing, normally on terms less favorable than previously available to the business, upon the closing. A buyer may seek financing directly from the seller, in which event the seller typically would want to ensure that such financing is structured in a manner that would not prevent it from treating the sale of the assets as a "true sale" for financial accounting purposes. In situations where the seller is not a bank, the buyer will need to assess whether the amount of financing in place is adequate for the buyer's growth plan and sufficiently locked in to manage through adverse conditions in the debt markets, as well as whether the duration of the financing is appropriate for the buyer's investment horizon. The buyer's counsel will also need to review the underlying financing documentation to determine whether the transaction triggers any defaults or consent rights on the part of the lender.

State Licensing

Specialty finance companies are typically licensed in each of the states in which the target conducts its lending, servicing and related activities. Where the seller is a bank, the business being sold may have previously relied on certain exemptions to state licensing requirements that will not be available to a non-bank buyer, requiring the target to obtain the requisite state licenses prior to closing. In circumstances where the target already has the necessary licenses, many states require the applicable state regulator to approve the change in control of the licensee. In cases where the buyer is a financial buyer without an existing portfolio company that holds the requisite state licenses to operate the business, it generally will be preferable to structure the transaction as a stock purchase rather than asset purchase because the target company's existing licenses are non-transferable, and the change in control process is generally simpler and faster than the process of applying for new licenses. This structure puts further pressure on understanding completely the legacy liabilities of the target company and putting in place adequate indemnification rights with respect to such potential liabilities. Financial buyers also have different sensitivities to certain requirements that may be imposed by state financial regulators that are not shared by public companies or other strategic buyers, such as disclosure requirements relating to personal background and financial information of control persons. Financial buyers must understand these requirements in detail before a deal is signed so they can appropriately address any limitations on their obligations to make such disclosure.

Insurance

In many cases, consumer finance lenders have captive insurance or reinsurance subsidiaries providing insurance products and services related to the company's lending activities. Depending on the type of lender, these insurance products can include credit life and disability insurance, unemployment insurance, mortgage insurance and, in the case of auto lenders, gap insurance. In addition to reviewing the insurance operations for compliance issues (such as how insurance products are marketed and whether borrowers are required to purchase insurance), a prospective buyer also must understand the regulatory approvals required in connection with the change in control of the insurance company.