Traps for the Unwary

McKee Nelson identifies key considerations for making private equity investments in the financial sector

By Reed Auerbach and Keith Krasney

DURING THE PAST 18 MONTHS, private equity (PE) firms have become more prominent as investors in the financial services marketplace, even taking a leading role and displacing commercial banks, investment banks and finance companies (traditional financial institutions) in this space. Indeed, since January 2007, there have been 20 announced private equity investments in traditional financial institutions, most certainly as a result of the credit market disruption. Looking back to the preceding period, there were only 24 such deals announced from 2000 to 2006.

PE firms have purchased financial businesses and financial assets, often bidding against each other in auctions. As traditional financial institutions have reduced headcount, PE firms have been hiring former bankers experienced in the financial services industry. In addition, new funds have been established by former employees of traditional financial institutions, often funded by those same institutions, and PE firms have raised billions of dollars through new placements. PE firms have even formed joint ventures with traditional financial institutions.

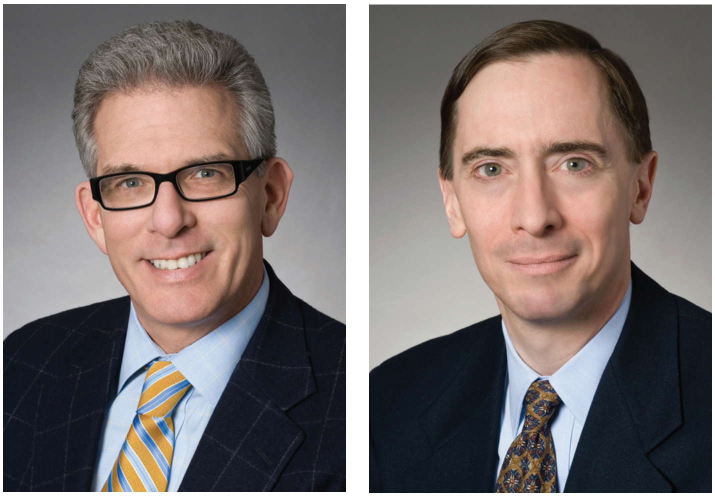
Private equity investment in financial assets can take the form of the acquisition of entire companies, divisions, select operating assets or pools of financial assets or securities issued in securitizations. Origination, servicing and securitization operations may be involved. This article will identify and address some fundamental considerations in the purchase of interests in financial institutions and financial assets and, by implication, will highlight differences from the traditional private equity realm of purchasing interests in operating companies.

The Nature of the Assets

Whether a fund is acquiring shares in a company, divisions or assets of a company, pools of assets or securities representing interests in assets, the object is the same – to acquire directly or indirectly cash flow producing assets. Any acquisition begins with an inquiry into the assets. Financial assets differ from operating assets, in no small part because the former depend on payments from a third-party obligor, directly or indirectly, to produce income. Whether the assets are mortgage loans, student loans, credit card receivables, leases, corporate loans, royalties or securities representing interests in any of the foregoing or dependent on cash flow from any of the foregoing or a derivative based on one or more reference obligations, the assets derive value from an intangible – the obligation to pay – and are dependent on cash flow from obligors (or a counterparty in the case of a derivative) for their value.

A buyer of financial assets must consider several common legal elements such as issues of property law relating to the transfer and assignability of assets, as well as commercial, bankruptcy, tax and securities law issues. For example, acquisitions of mortgage loans involve issues of assignment of interests in real property, specialized tax regulations concerning REMICS, possible environmental problems, foreclosure matters and federal laws concerning origination and servicing practices. On a different playing field, acquisitions of credit cards involve issues of consumer finance law, banking regulation, other specialized tax regulations and often industry class action lawsuits. The acquisition of federally guaranteed student loans requires that legal title to the loans be held in the name of an eligible lender with a Department of Education lender identification number that has entered into guaranty agreements with each guarantor of the student loans in the portfolio. Only banks and insurance companies may qualify as eligible lenders. Failure to comply with these regulations will result in the loss of the 97% Department of Education guaranty of interest and principal, as well as interest subsidy and special allowance payments.

While each asset type is subject to a particular legal framework, sharing some aspects with other financial assets, each financial asset also may be subject to different market custom on transfer. For example, the representations and warranties commonly made with respect to prime mortgage loans are vastly different from the representations and warranties made with respect to auto leases and even different from the commonly accepted rep-



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resentations and warranties made with respect to scratch and dent mortgage loans or REO properties.

As in other acquisition transactions, sellers of financial assets prefer to sell on an 'as is, where is' basis, perhaps only making a representation and warranty as to good title, while the PE firm as buyer will negotiate for an array of representations and warranties. In the secondary market of trading financial assets, representations and warranties are common and serve the purpose of apportioning risk; however, in the context of a sale of a business, sellers will resist representations and warranties to avoid contingent liabilities.

While in secondary market sales an option often exists for a substitution of a financial asset for a defective one, in the context of a sale of a financial services business where the originator is selling its entire business there will not be any remaining assets with which to substitute, so payment will be required. The PE firm will want numerous representations and warranties because its exit strategy may be either to eventually securitize the assets or to sell them in bulk sales. Either the investors in the securitization or the bulk buyers will expect to receive numerous customary representations and warranties. In the private equity context, negotiation of representations and warranties may consume a lot of time and there usually is a trade-off in terms of price.

Financial assets involve more than receivables and securities. For example, rights to reimbursement for liquidity features, such as servicing advances, advances of delinquent principal and interest, or for the funding of a reserve fund, among others, also may be purchased by a PE firm.

Structuring the Purchase

The structure of the purchase transaction will reflect the expectations of the parties and the business bargain negotiated. If the goal is to acquire the entire origination business of the seller, then purchasing shares of the target originator may be easiest since the assets and liabilities of the target become assets and liabilities of the purchaser by virtue of the purchase. However, a subset of assets may be the subject of the acquisition. In either case, specified assets or liabilities may be included or excluded. Other factors may argue against a transfer of shares; for example, if the current owner of the assets has net operating losses, a sale of its shares will make the net operating losses unavailable to the other members of the seller's corporate group.

Buyers acquiring consumer assets in particular must be wary of the pitfalls of various state licensing issues. In addition, in some jurisdictions mere ownership of financial assets requires an appropriate license under the view that the acquirer is stepping into the place of the originator. States may impose liability on both the seller of financial assets and the buyer if the buyer is not licensed. While mortgage assets are most heavily regulated, in general, other assets involve particular technical licensing issues. If a servicing platform is being acquired, additional licensing issues are implicated, since different licenses are required to service assets than to originate or hold assets. If shares of the financial institution are acquired, application for a new license must be made because of the change of control, even though the original license was granted to the institution. Purchases of securities representing interests in financial assets, in general, will not involve state licensing issues.

One approach used to minimize licensing issues is for the purchaser to establish a Delaware statutory trust with a national bank as trustee. Title to the assets is taken in the name of the national bank. Since the national bank has title, the acquirer may be able to rely on the doctrine of federal preemption to avoid state licensing requirements.

Many other issues need to be considered as well. One often overlooked is whether the PE purchaser will be permitted to continue to use the name of the originator with respect to existing assets or securitizations. With respect to securitizations, the seller may desire to have its name removed from the securities and the issuer because, in the event of a future downgrade of the securities when 'ownership' of the securitization trust lies with the PE firm, the taint would otherwise be associated with the seller.

Underlying Documentation Issues

One pitfall often encountered in transferring servicing is obtaining appropriate consents from interested parties. While the Uniform Commercial Code favors transfers of property interests, in cases where an obligation must be performed (such as in servicing financial assets), it permits the parties to restrict assignment. In a securitization or a third-party servicing arrangement for financial assets, the servicing agreement often restricts the ability to freely transfer servicing. There will be eligibility criteria for the successor servicer requiring a minimum net worth or satisfaction of other financial tests, minimum servicing ratings, specified servicing experience or servicing portfolio size, among others.

Some securitization servicing agreements require a letter from the rating agencies that rated the securities governed by the servicing agreement that the servicing transfer will not result in a downgrade or withdrawal of any rating before a transfer may occur. However, usually there is an exception to obtaining consent in the case of a successor to the business by merger, consolidation or a successor to substantially all the business of the servicer. If less than all the business of a particular line of servicing is being transferred, counsel must determine if the transaction can be characterized as involving substantially all the assets of the subject business.

Challenges will arise if there is third-party credit enhancement. If any securities were insured by a bond insurer or if there is a pool mortgage insurance policy, the relevant insurance agreement also may contain restrictions on transfer of servicing. If there are reserve funds covered by third-party enhancement, there may be obstacles to transfer. In addition, derivatives may be part of the securitization transaction, either in the form of a swap, cap or other derivative, or the financial institution may have hedged its portfolio. In all cases, the derivative documentation will need to be reviewed for termination procedures or to determine how best to unwind or offset them.

Where assets have been financed by private asset-backed commercial paper facilities or other warehouse financing facilities, care must be exercised. Often there are change of control provisions that are triggered upon a transfer of assets. In the alternative, consents will be required to the transfer. Documentation for such facilities must be reviewed and a decision made as to whether or not it is economic to attempt to retain the facilities.

Many originators purchase pools of assets in addition to originating them directly. These purchases are made pursuant to a flow or stand-alone purchase agreement. Upon a breach of a representation and warranty made by the seller that materially and adversely affects the asset, the purchaser has the right to demand that the seller repurchase the financial asset, sometimes for a limited period of time. This remedy for a material breach of a representation and warranty has real value and the PE firm as purchaser will want this right assigned to it. However, the agreement between the original seller of the asset and the financial institution may not permit assignment or may require advance notice, making consent of the original seller necessary.

Even the purchase of securities issued in a securitization presents challenges for PE firms. The underlying securitization documentation may prohibit the transfer of securities to foreign investors, particularly if these securities are not REMIC regular interests or treated as 'debt' for tax purposes. While a structure for the purchase transaction often can be designed to avoid these issues, the economic inefficiency inherent in some of these structures should be factored into the purchase price of the securities. The underlying documentation also may contain certain liabilities associated with these securities, such as the obligation of the holder to pay ongoing expenses of the securitization vehicle, or to indemnify third-party service providers, such as trustees. Finally, holders of certain structured securities may have certain rights, such as a call right on the underlying assets or consent rights, that a PE firm may need to acquire to successfully execute its strategy.

Conclusion

Purchases of financial service firms or financial assets involve a myriad of legal and practical issues that do not exist in transactions involving operating companies. These issues derive from the nature of the assets, the transaction structure, the documentation for the underlying financial assets and the numerous laws that govern financial assets and institutions, as well as market practice. PE firms should consult legal, accounting and financial advisors with particular expertise in the related financial assets to avoid the many traps for the unwary investor.

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