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MAXIMIZING PROFITS THROUGH DUE DILIGENCE

(or, How to Stay Out of the Troubles
my Co-panelists are Talking About)

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PAUL H. SCHIEBER is chairman of Blank Rome LLP's Consumer Financial Services/Retail Banking Group. Mr. Schieber's lending clients include major banks, thrift institutions, credit unions, mortgage companies, finance companies, mortgage insurance companies, universities, secondary market investors, real estate companies and other financial services providers. He concentrates his practice on all aspects of residential mortgage, consumer loan and credit sale transactions, including the development and documentation of consumer products and programs such as second mortgage, installment sale, home equity, student loan, automobile sale and leasing, and credit card programs. Mr. Schieber advises clients on state and federal consumer compliance and regulatory issues, as well as warehouse lending, loan sales and securitizations, mergers and acquisitions, government relations, strategic planning and other business law matters. His Group provides clients with litigation defense and prosecution in state and federal courts throughout the United States.

Mr. Schieber has lectured and prepared educational materials for numerous organizations. Mr. Schieber is author of the newly released Allregs© State Law Compliance Module; co-author of the 6 volume, Pratt's State Regulation of Second Mortgages and Home Equity Loans; and co-author of A Lender's Guide to Consumer Compliance and Anti-Discrimination Laws: Complete Coverage of CRA, ECOA and HMDA, published by the Mortgage Bankers Assn. of America. His more than 30 articles have appeared in the ABA Banking Journal, Origination News, Risk Management Assn. Journal, Pennsylvania Law Journal, Loyola Consumer Law Review, Mortgage Banking Magazine, and other publications. His monograph, Federal Regulation of Second Mortgage Lending, 2nd Ed. was published by the National Home Equity Mortgage Association. Mr. Schieber has spoken extensively on consumer finance matters before the Mortgage Bankers Association, America's Community Bankers; Consumer Bankers Association; Bank Administration Institute; Motor Vehicle Leasing Association; Pennsylvania Bankers Association; National Home Equity Mortgage Association; Mortgage Insurance Companies of America; Pennsylvania and New Jersey Financial Services Associations; National, Pennsylvania, New Jersey and Delaware Associations of Mortgage Brokers; Pennsylvania Association of Realtors, and other groups. Mr. Schieber is Chairman of the Pennsylvania Bar Association Consumer Law Committee and past Chairman of the Philadelphia Bar Association Consumer Financial Services Committee.

BLANK ROME LLP, a full-service law firm, has offices in New York City, Cherry Hill and Trenton, New Jersey, Philadelphia, Allentown and Media, Pennsylvania, Washington, DC, Wilmington, Delaware, Baltimore, Maryland, Cincinnati, Ohio and Boca Raton, Florida. The firm's Consumer Financial Services/Retail Banking Group has counseled and represented lenders and others involved in the consumer financial services industry for over two decades. The firm includes over 450 attorneys who practice in the areas of real estate, corporate, litigation, government relations, financial services, health services, labor and employment, international trade, tax and estate law.

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**MAXIMIZING PROFITS THROUGH DUE DILIGENCE:
THE ACQUISITION AND SALE OF MORTGAGE/FINANCE
COMPANIES AND/OR THEIR PORTFOLIOS**

**Paul H. Schieber
Blank Rome LLP**

Recent consolidations in the residential mortgage marketplace have highlighted the need of both acquirers and sellers of mortgage and finance companies and their portfolios to focus carefully on the due diligence that must go into such transactions. Buyers must have a full and global appreciation for their target asset. Merely kicking the tires is no longer sufficient. Class action and individual lawsuits, combined with heightened state and federal supervision and enforcement make it imperative that acquirers be fully aware of not only the potential profits that can result from merger synergies, larger market shares and new market opportunities, but also the lurking liabilities and risks which invariably accompany such acquisitions.

Equally, if not more important to keep in mind is that a careful due diligence review, which entails interviewing QC/compliance personnel and senior managers, as well as file reviews, will identify strengths and weaknesses that can be translated into powerful pricing negotiation tools.

Sellers need to know that prospective buyers will be looking very carefully at for sale operations and sellers need to be ready for these reviews and be prepared with answers to questions which will result from comprehensive due diligence visits. Carefully prepared for, a due diligence review can help sellers maximize sales prices. Failure by sellers to prepare properly can afford purchasers with additional support for lowering purchase prices.

While every deal is unique and requires that unique issues be addressed, the following outline is designed to introduce many of the legal issues which beg due diligence in connection with company or portfolio sales and acquisitions and which, based on the results, could drastically increase or reduce the target's sale price.

PRELIMINARY DUE DILIGENCE CHECKLIST

Documents or Information to Be Provided/Reviewed

A. Corporate Partnership Documents

1. Articles of Incorporation (partnership agreement) (including any amendments)
2. By-Laws (including any amendments)
3. Minute Book
4. Stock Transfer Records
 - a. Most recent list of shareholders (partners)
5. Certificates of Authority to do business as a foreign corporation (if applicable); multiple states
6. Fictitious or trade name filings (if any)
7. Current list of Directors and officers and key employees
8. Organizational chart

B. Contracts and Licenses

1. Licenses and sublicenses from third parties and granted to third parties
2. Sales or distribution contracts (form)
3. Subscriber and customer contracts and purchase contracts (form)
4. Supply contracts
5. Other material contracts or agreements, including, without limitation, agreements relating to sales of any significant assets or properties, software agreements, related party agreements, stock sale agreements and any other agreements regarding the issuance of stock options, warrants and any other equity interest in the company (including third party consents to the issuance of the same and letters of intent) and agreements regarding business combinations, marketing and franchise agreements, and finder or broker fee arrangements.

C. Corporate Loans and Financing

1. Loan agreements and mortgages
2. Security agreements
3. Notes, including promissory notes and subordinated convertible notes
4. Lines of credit/warehouse lines
5. Note purchase agreements
6. Any other material agreements or understandings regarding financial arrangements

D. Regulatory Compliance

1. State or federal law interest rate lending authority
 - a. Maximum rate permitted to subject institution
 - b. Variable rate authority and limitations: prohibitions? ceilings? maximum increments? index restrictions? frequency limits?
 - c. State or federal law parity statutes - any available? are they needed? any disclosures required?
 - d. Interest rate authority of purchaser - does it cure problems, if any, with originator's rate structure?
 - e. Credit limit ceilings relevant to rate authority
 - f. State law interest rate disclosures
 - g. Predatory lending restrictions
 - h. First and junior lien loans - federal preemption? other limits?

2. Fees and charges: state or federal authority
 - a. Are fees and charges authority tied to source of rate authority or do independent sources of rate authority exist applicable to originator?
 - b. Authorization and limits on following fees, if charged:
 - 1) credit report
 - 2) appraisal
 - 3) application fee
 - 4) title search/insurance
 - 5) recording fee
 - 6) satisfaction fee
 - 7) notary fee
 - 8) attorney closing fee
 - 9) document preparation
 - 10) points
 - 11) survey fee
 - 12) overdraft charge
 - 13) credit insurance
 - 14) annual fee
 - 15) check reorder fee (HELOC's)
 - 16) late charges
 - 17) transaction fee

- 18) bounced check charge
 - 19) flood search
 - 20) prepayment penalties
 - 21) other
 - c. Timing of collection of certain fees - limited to closing or at application?
 - d. Financing of fees permitted vs. cash payments
 - e. State law fee disclosures
 - 1) Predatory lending rules
3. Open-end loan lien priority; state law issues
- a. Compliance with lien priority statutory disclosure requirements, if any
 - b. If no statute, review agreement and security document for case law obligatory advance doctrine, if applicable
 - c. Interruptions in lien priority arising from draw period renewal procedures, if any?
 - d. Need to disclose credit limit in loan documents?
4. Credit insurance products: state law compliance
- a. Compliance with state law disclosure requirements
 - b. Disclosures approved/required by applicable state authority
 - c. Product types available in particular state:
 - 1) credit life
 - 2) credit accident & health
 - 3) joint credit products
 - 4) credit unemployment
 - d. Premium refund requirements (if any for open-end)
 - e. License required?
5. Other state law issues
- a. Plain language law compliance?
 - b. Limits on attorneys fees and costs of collection?
 - c. Record retention laws
6. Federal disclosure
- a. Sequence of required disclosures
 - b. RESPA

- 1) Early
- 2) Final
- 3) Escrow
- 4) Annual
- 5) Servicing transfers (2)
- c. TILA
 - 1) Early
 - 2) Final
 - 3) ARM
 - 4) Open-end
 - 5) Advertising
 - 6) Rescission
- d. Regulation AA/credit practices
- e. ECOA/Fair Housing Act
 - 1) Adverse action
 - 2) Spousal signatures
 - 3) Appraisals
 - 4) Written applications
 - 5) Race/sex/other data collection
 - 6) Second reviews
 - 7) Overages/underages

7. Mortgage or deed of trust; property insurance; appraisals

- a. Recordability under particular state law
- b. Compliance with priority of lien law, if any
- c. Assure that future advances are secured
- d. Assure that loan agreement is properly identified
- e. Review for inclusion of basic mortgage protections involving payment of taxes, insurance, waste, etc.
- f. Review to assure mortgage remedies do not violate Regulation Z termination and freeze limitations
- g. Property insurance loss payee documentation
- h. First liens loans: monitoring of property tax payments?
- i. Other collateral permitted?
- j. If title insurance required, is binder included?
- k. Appraisals - compliance with federal and state laws
- l. Permitted fees to release lien

8. Collection procedures
 - a. State law notice and foreclosure procedure compliance
 - b. Federal homeownership counseling notice procedures
 - c. No confessions of judgment - unfair trade practice/state law

9. Interstate sales: buyer's compliance with seller's state's laws
 - a. Do laws of seller's state or other states in which properties are located require seller to obtain permission to sell loans?
 - b. Do laws of seller's or other applicable states prohibit buyer from purchasing and/or servicing loans in that (those) state(s)?
 - c. Must seller qualify as a foreign corporation?
 - d. Does servicing trigger tax liability in seller's or other applicable states?
 - e. Does servicing trigger collection law licensing?
 - f. Which law will govern loan agreements? Will contractual choice of law continue to apply?
 - g. For rate, fee, disclosure and related issues identified above, does seller's or buyer's state law apply?

10. Selected Subprime Issues
 - a. Interagency Guidelines on Subprime Lending
 - b. § 32 loans and state/local predatory lending laws
 - 1) § 32 loans impossible to cure
 - 2) If broker has charged extra (un- or underdisclosed) fees, could be subject to § 32 without knowing it
 - 3) Extra disclosures, state and federal
 - 4) Pattern or practice of lending on collateral
 - 5) Extra damages
 - 6) State/local rate and fee thresholds

11. Fair Lending
 - a. Risk of disparate treatment and disparate impact by targeting low income/minority communities
 - 1) ECOA
 - 2) Fair Housing Act
 - 3) State civil rights laws

- 4) Overages/underages
- 5) Liability for broker behavior

12. Insurance Products

- a. Credit insurance
 - 1) Licensing
 - 2) Insurance packing
- b. Forced place insurance

13. Wall Street

- a. Prepayments, litigation concerns and other market fluctuation factors
- b. Bankers Trust and similar litigation

14. Prepayment penalties

- a. Federal preemption for certain institutions
- b. Parity Act (change effective 1/1/03)

15. State unfair trade practices statutes

- a. Bait and switch advertising
- b. Loan flipping
- c. Home improvement loans
- d. Broker/correspondent activities (RESPA Policy Statement 1999-1 on broker compensation)

16. State usury and fee restrictions

- a. Predatory lending limits

E. Personal Property

- 1. Equipment or capital leases
- 2. Service or maintenance contracts
- 3. Automobile and equipment titles
- 4. Securities owned by the company

F. Real Estate Owned

1. Deeds
2. Mortgages
3. Leases
4. Surveys
5. Title Reports
6. Zoning
7. Appraisals

G. Insurance

1. Comprehensive and general liability
2. Worker's compensation
3. Property damage
4. Health
5. Directors' and officers' liability
6. Auto
7. Other

H. Employment Matters

1. Employment agreements
2. Welfare plans (not included under Insurance above)
3. Fringe benefits
4. Incentive plans
5. Other employee benefit agreements (including stock options, bonuses and profit-sharing)
6. Union or collective bargaining agreements
7. Consultant or independent contractor agreements
8. Termination or severance agreements
9. Manual(s)/policies
10. Religious/sexual/racial harassment policies
11. Non-competes

I. Legal

1. Prior or pending lawsuits or proceedings; lawyer and accountant reports regarding the same
2. Investigations, governmental or otherwise

3. Reports, notices or correspondence relating to any violation or infringement of government regulations, and all other material correspondence with federal, state and local authorities or regulatory agencies

J. Trademark

1. Trademark registrations or applications