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Clients&FriendsMemo

The Public-Private Investment Program For Legacy Loans: Unanswered Questions For Loan Sellers and Investors and Request For Comments by the FDIC

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On March 23rd, The U.S. Department of the Treasury ("Treasury") and the Federal Deposit Insurance Corporation ("FDIC") jointly announced a new program under the Troubled Assets Relief Program ("TARP") called the Public-Private Investment Program ("PPIP").[1] The program is divided into two components, one for "Legacy Loans" and another for "Legacy Securities". The structures of the two components are very different and this memorandum will address only the Legacy Loans Program ("LLP")

On March 26th, the FDIC posted a series of questions on their website, inviting comment on the questions posted for consideration as well as all other aspects of the Legacy Loans Program[2] and hosted a conference call for bankers.[3] During the call, Chairman Bair made it clear that the PPIP terms would not be finalized until comments have been received.[4] On several occasions during the call, FDIC staff referred questioners back to the comment process, saying "We're seeking comment on that." Comments will be accepted until April 10th, and may be submitted by email, mail or courier, as set forth at http://www.fdic.gov/llp/progdesc.html and in the attached Appendix B. Comments will be posted without edits, including any identifying information, on the FDIC website at http://www.fdic.gov/llp/LLPcomments.html.

Brief Review of the Legacy Loan Program Process

The Legacy Loans Program is a six-step process:[5]

1. IDENTIFY ASSETS: FDIC-insured banks or savings associations ("Selling Banks") identify to the FDIC the assets on their books they want to sell. The FDIC has provided little guidance regarding the definition of eligible assets. It has only indicated that the collateral supporting such assets must be situated predominantly in the United States.[6] For the LLP, there is no minimum Selling Bank size. It is still unclear whether banks or savings associations owned or controlled by a foreign bank or company are ineligible.[7]

2. DETERMINE LEVERAGE: The FDIC will use a third-party consultant to determine the debt leverage the FDIC will guarantee on the pool, up to a maximum leverage of 6-to-1. This leverage determination will be disclosed in the auction process.

3. AUCTION: Pools of eligible assets will be auctioned off to the highest bidder in a public auction conducted by the FDIC. Potential private investors must be pre-qualified by the FDIC to participate and must provide a refundable five percent (5%) deposit of their bid value. There is no minimum investor size; however, investor groups must be approved by the FDIC and cooperation between groups will be prohibited once the auction process has begun. Banks may reject the final bid within a pre-established timeframe.

4. DEBT GUARANTEE: Financing will be provided through an FDIC guarantee of debt issued by a Public-Private Investment Fund ("PPIF") created by the private investor under FDIC oversight. Private investors must create one PPIF for each pool of assets with the assistance of the FDIC. An annual guarantee fee will be charged for this service by the FDIC. The debt initially will be placed with the Selling Bank, which may resell the debt.

5. EQUITY MATCH: Treasury will provide 50% of the equity (non-controlling) required to purchase the assets. The private investor supplies the remaining 50% equity to the PPIF to complete the purchase. Private investors may not participate in a PPIF that purchases assets from affiliated sellers and investors may choose to take less than 50% equity from Treasury, subject to a minimum.

6. MANAGEMENT: The private investor manages the asset pool and chooses the timing of any disposition, using managers approved and subject to oversight by the FDIC.[8] Servicing will be provided by the Selling Bank initially. It is expected that the pools will be sold servicing-released. FDIC and Treasury will establish servicing parameters and governance procedures. Ongoing administration fees will be paid to the FDIC. The PPIF must make certain representations, warranties and covenants with respect to the conduct of business and compliance with applicable law, provide reports to the FDIC and allow access to information required by the Special Inspector General of the TARP and the Government Accountability Office.

If you would like more information on the Legacy Loans Program, it is covered in detail, along with the Legacy Securities Program, in our Clients & Friends Memo entitled "The Public-Private Investment Program; Treasury's Plan to Cleanse Legacy Assets from Banks' Balance Sheets" at http://www.cwt.com/assets/client_friend/032609The_Public-Private_Investment_Program.pdf.

WHAT WE DO KNOW, WHAT WE DON'T KNOW.

The questions posed by the FDIC in its request for comment[9] reflect an attempt to solicit the views of a broad constituency that will be affected by the program. The following chart summarizes what is known regarding topics that are relevant to potential loan sellers and investors and sets forth key unanswered questions on the same topics.

Asset Sale		
Question	What we do know	What we don't know
What can be sold?	▪ "Eligible Assets": Collateral supporting such assets must be situated predominantly in the United States.[10] ▪ Selling Bank must select assets in consultation with their primary federal regulators, FDIC and Treasury.[11] ▪ Initially the pools of assets must all be held at a single Selling Bank; however, larger pools may be created from multiple sellers in the "second phase" of the program.[12]	▪ What are the other eligible asset criteria? ▪ Will there be a maximum or minimum pool size? ▪ Will asset pools be able to mix types/quality of assets? ▪ Will only legacy whole mortgage loans be eligible or will syndicated notes, A/B notes, mezzanine loans or participation interests qualify? ▪ Can investors "cherry-pick", i.e., exclude assets from pools based on due diligence? ▪ What influence will the primary federal regulator have over which assets are sold? ▪ Will the government expand the asset types beyond real estate loans?
Who can sell?	▪ "Eligible Asset Sellers" are FDIC-insured U.S. banks or U.S. savings associations;[13] however, this may or may not include foreign-owned banks chartered in the United States.[14]	▪ Will FDIC-insured banks with foreign owners be included? ▪ Will sellers be comforted that they are not "TARP beneficiaries" by virtue of the TARP equity used to buy the assets? ▪ Must sellers have originated all loans in the sale pool? ▪ Will Treasury and the FDIC be open to expanding eligible asset sellers to include investment banks, real estate debt funds, insurance companies, pension funds and other entities that previously have been major sources of commercial real estate financing and currently hold many of these assets?
Who can buy?	▪ Purchaser cannot be an affiliate of seller and seller cannot represent more than 10% of the aggregate equity in the PPIF.[15] ▪ Purchaser must be "prequalified" by the FDIC.[16]	▪ Will investors be subject to ongoing reporting obligations or audit rights? ▪ What are the prequalifications? ▪ Will sovereign wealth funds or other foreign-controlled investors be able to participate?
Due diligence: Who? What? When? Where?	▪ Due diligence will be performed by a vendor selected by the FDIC.[17] ▪ Some diligence will be in a virtual data room, other diligence will only be available on-site.[18] ▪ Buyers and sellers will negotiate sellers' asset-level representations and warranties on a case-by-case basis.[19]	▪ When and for how long will diligence be made available? ▪ Will there be post-bid or post-award diligence available? ▪ What is the scope of due diligence to be provided by the Selling Banks and performed by FDIC-selected vendors? ▪ Will direct purchaser diligence in addition to the "vendor diligence" be permitted or available? ▪ Will the due diligence extend beyond confirmation of basic loan terms to include current asset-level diligence such as title updates, ground lessor or tenant estoppels or environmental reviews? ▪ Will review by potential bidders be subject to

		confidentiality agreements? ▪ Will sellers be required to provide representations and warranties regarding the assets? If so, what will be the consequence of a breach?
How will the sale be conducted?	▪ Auction run by a financial advisor selected and managed by the FDIC.[20]	▪ What kind of auction? Dutch? English? Sealed bid? ▪ How many rounds? ▪ Will online bidding be available? ▪ Who will reimburse the FDIC for costs of the auction, buyer or seller? ▪ Will Selling Bank be responsible for any brokerage commission of the financial advisor?
How will the FDIC/Treasury respond if the bid-ask spread remains wide?	▪ One possibility FDIC Chairman Bair suggested as an incentive for Selling Banks is an equity position in the PPIF for the bank.[21] ▪ Failed auctions will not constitute a further mark-to-market.[22]	▪ Will there be a change to loss recognition requirements to incentivize banks?
Can banks reject winning bids?	▪ Yes.[23]	▪ What are the conditions under which banks will be able to reject winning bids? ▪ Will the banks be required to set a reserve price, and take all offers above the reserve? If so, will the reserve be published before the auction? ▪ Will the banks have to cover costs of a winning bidder in case of rejection?

Joint Venture with the Government

Question	What we do know	What we don't know
How will the Joint Venture be structured?	▪ Treasury and the private investor(s) will contribute equity to a Private-Public Investment Fund (PPIF).[24] ▪ One PPIF must be set up for each asset pool purchased.[25]	▪ What legal structure will the PPIF take? LP? LLC? ▪ Will the form of JV agreement be negotiable? ▪ Will there be buy-sell rights? Will they only be available when there has been a failure to resolve a dispute? ▪ Will managers be able to pledge, sell or transfer interests in the PPIF? ▪ Will particular joint venture terms expose private investors to claims that they are not "passive" private investors that qualify for the exemption from EESA restrictions on executive compensation?
What control rights will the government have?	▪ Treasury "will not have control rights,"[26] however, the PPIF must be managed within parameters set by the FDIC and Treasury, with reporting to the FDIC and oversight by the FDIC.[27] ▪ Treasury is to be granted warrants.[28]	▪ No parameters for management have yet been specified by Treasury or the FDIC. (See other questions below under "How will assets be managed and serviced?") ▪ Will Treasury have consent or veto rights over specified joint venture decisions ("major decisions")? ▪ What are the parameters of the warrants? How will

		they be priced since the PPIFs are not publicly traded? ▪ Does reservation of rights by the FDIC and Treasury to modify or withdraw the LLP at any time effectively eliminate any limits on Treasury's control rights?
What credit support will be given by the government? How will this support be provided?	▪ The FDIC will provide up to a maximum of 6-to-1 leverage.[29] ▪ Leverage will be determined in the FDIC's sole discretion, with the input of a third party valuation consultant, on a per-asset-pool basis.[30] ▪ Purchase will be supported by FDIC guarantees on debt issued by the PPIF that is to be placed initially at the Selling Bank and can be sold later.[31] ▪ Consideration paid to Selling Banks will be in the form of cash or cash and debt issued by the PPIF.[32]	▪ Will the formula for determining the ratio be published? Will diligence results be factored in? ▪ Will the diligence of the third-party valuation consultant hired by the FDIC be public? ▪ What is the term of the guarantees? ▪ What is the guarantee fee and will it be charged on Treasury's portion of the debt? ▪ What are the parameters of the debt sale? ▪ Will debt be freely tradeable or will institutional investors or investors satisfying other criteria be the only permitted holders? ▪ Will Selling Banks have to hold the debt for a specified time? ▪ Will there be other support besides the debt guarantees?[33]
What equity will the government provide? How will additional capital be handled after the asset pool purchase?	▪ Treasury's investment will not exceed 50% of the equity required, although a lower amount of equity participation, subject to a minimum, may be requested by the private investor.[34]	▪ What is the minimum percentage of equity provided by Treasury that the private investor can request? ▪ How will additional capital infusions be handled? Will emergency capital calls be funded solely by the private investor and dilute Treasury's interest or will the government be subject to capital calls? ▪ Will additional capital contributed by the private investors (and the government) after the closing of the sale of the asset pool be repaid *pari passu* or through a preferred payment from cashflow and proceeds of capital transactions?
How will the assets be managed and serviced after purchase?	▪ The private investor will manage the assets subject to FDIC parameters, which initially will be serviced by the Selling Bank.[35] The guidelines suggest that only "approved" asset managers will be able to manage the assets,[36] although on the March 26th teleconference, FDIC staff indicated that private investors would be able to service assets directly.[37] ▪ The FDIC anticipates selling the assets on a servicing-released basis, allowing the private investor to control servicing arrangements.[38] ▪ Residential loans are subject to the U.S. Government Loan Modification Program, among other as-yet-unspecified restrictions.[39]	▪ Will there be asset management and servicing fees chargeable by the Selling Bank or private investor? ▪ What are the parameters on such fees, and when can they be charged? ▪ What administrative fees will the FDIC charge? ▪ Will there be incentive fees? ▪ How will servicing work? Will the investor be in charge of special servicing? ▪ How will the economics of servicing work? ▪ Will the investor have to be separately approved as an asset manager in order to service the assets of a PPIF in which it invests? ▪ Will there be any restrictions on the private investor's ability to work out or restructure loans or exercise remedies? ▪ How will day-to-day decisionmaking be handled? In the case of any decisions that require Treasury approval, will Treasury be deemed to approve a decision after a specified period in which it fails to

		respond? ▪ How will REO be handled following foreclosure? Will the private investor have complete control of all actions subject to limited veto rights of Treasury?
Do the executive compensation limits apply to LLP participants?	▪ The executive compensation limits are not applicable to passive investors in a legacy loans PPIF.[40]	▪ Are the limits applicable to asset managers or investors in PPIF who are actively managing assets, or sellers or holders of FDIC-guaranteed PPIF debt? ▪ What are the criteria delineating "active" and "passive" investors?

As the preceding chart makes clear, there are many questions that remain unanswered about the Legacy Loans Program. As additional information is made available by the FDIC and Treasury, it will shape the legal and business strategies of loan sellers and investors. Careful legal analysis and guidance is a must to protect your interests, and we welcome the opportunity to help you navigate this process.

There is still an opportunity to provide comments to the Legacy Loan Program until April 10th. We would welcome the opportunity to assist potential loan sellers and investors with their participation in the comment process for the Legacy Loan Program.

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Appendix A

Resources

FDIC Web Site on the Legacy Loans Program

- http://www.fdic.gov/llp/

Legacy Loans Summary of Terms

- http://www.treas.gov/press/releases/reports/legacy_loans_terms.pdf

Legacy Loans Fact Sheet

- http://www.fdic.gov/llp/LLPFactSheet.pdf

Legacy Loans FAQ

- http://www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf

Program Description and Request for Comment

- http://www.fdic.gov/llp/progdesc.html

Conference Call for Bankers

- audio -- http://www.vodium.com/goto/fdic/legacyloans.asp
- transcript -- http://www.fdic.gov/llp/transcript033009.html

Expression of Interest Form for Interested Investors

- http://www.fdic.gov/llp/InvestorInterest.html

Appendix B

FDIC Questions for Comment and Comment Instructions[xli]

The FDIC is requesting comment from interested parties on all aspects of the proposed LLP. In particular it has formulated the following questions for interested parties to consider:

1. Which asset categories should be eligible for sale through the LLP? Should the program initially focus only on legacy real estate assets or should any asset on bank balance sheets be eligible for sale? Are there specific portfolios where there would be more or less interest in selling through the LLP?

2. Should the initial investors be permitted to pledge, sell or transfer their interests in the PPIF? If so, how should the FDIC ensure that subsequent investors meet the program's criteria for investors?

3. What is the appropriate percentage of government equity participation which will maximize returns for taxpayers while assuring integrity in the pricing by private investors? How would a higher investment percentage on the part of the government impact private investment in PPIFs? Should the amount of the government's investment depend on the type of portfolio?

4. Is there any reason that investors' identities should not be made publicly available?

5. How can the FDIC best encourage a broad and diverse range of investment participation? How can the FDIC best structure the valuation and bidding process to motivate sellers to bring assets to the PPIF?

6. What type of auction process facilitates the broadest investor participation? Should we require investors to bid on the entire equity stake of a PPIF, or should we allow investors to bid on partial stakes in a PPIF? If the latter, would a Dutch auction process or some other structure provide the best mechanism for bridging the potential gap between what investors might bid and recoverable value? If multiple investors are allowed to bid through a Dutch auction, or similar process, how should asset management control be determined?

7. What priorities (i.e., types of assets) should the FDIC consider in deciding which pools to set for the initial PPIF auctions?

8. What are the optimal size and characteristics of a pool for a PPIF?

9. What parameters of the note and its rate structure would be essential for a potential private capital investor to know at the time of the equity auction to provide equity?

10. Would it be preferable for the Selling Bank to take a note from the PPIF in exchange for the pool of loans and other assets that it sells? Alternatively, what would be the advantages

and disadvantages of structuring the program so that the PPIF issues debt publicly in order to pay cash to the Selling Bank? Would a public issuance of debt by the PPIF limit its flexibility compared to the issuance of a note to a Selling Bank?

11. In return for its guarantee of the debt of the PPIF, the FDIC will be paid an annual fee based on the amount of debt outstanding. Should the guarantee fee be adjusted based on the risk characteristics of the underlying pool or other criteria?

12. Should the program include provisions under which the government would increase its participation in any investment returns that exceed a specified trigger level? If so, what would be the appropriate level and how should that participation be structured?

13. Should the program permit multiple Selling Banks to pool assets for sale? If so, what constraints should be applied to such pooling arrangements? How can the PPIF structure equitably accommodate participation by smaller institutions? Under what process would proceeds be allocated to Selling Banks if they pool assets?

14. What are the potential conflicts which could arise among LLP participants? What structural arrangements and safeguards should the FDIC put into place to address or mitigate those concerns?

15. What should the relative role of the government and private sector be in the selection and oversight of asset managers? How can the FDIC most effectively oversee asset management to protect the government's investment, while providing flexibility for working assets in a way which promotes profitability for both public and private investors?

16. How should on-going servicing requirements of underlying assets be sold to a PPIF and paid for? Should value be separately attributed to control of the servicing rights?

17. Should data used by the independent valuation consultant, as well as results of such consultant's analysis, be made available to potential bidders? Should it be made available to potential sellers prior to their decision to submit assets to bid?

Comments on the LLP may be submitted until April 10, 2009.

You may submit comments by any of the following methods:

E-mail: LLPComments@FDIC.gov. Include "Legacy Loans Program" in the subject line of the message.

Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m. (EDT).

Public Inspection: Please note that all comments will be posted generally without change (including any personal information) to the FDIC's website (http://www.fdic.gov/llp/index.html). Paper copies of public comments may be ordered from the Public Information Center by telephone at (877) 275-3342 or (703) 562-2200.

ENDNOTES

[1] See the attached Appendix A for hyperlinks to government resources on the Public-Private Investment Program.
[2] See the attached Appendix B for the list of questions posted for comments by the FDIC, *available at* http://www.fdic.gov/llp/progdesc.html.
[3] March 26th teleconference transcript ("Teleconference"), *available at*: http://www.fdic.gov/llp/transcript033009.html.
[4] *Ibid.*
[5] See generally, Fact Sheet, Public-Private Investment Program ("Fact Sheet"), p. 3-4, *available at* http://www.fdic.gov/llp/LLPFactSheet.pdf.
[6] Legacy Loans Program Summary of Terms ("Summary of Terms"), p. 2, *available at* http://www.fdic.gov/llp/LLPtermsheet.pdf.
[7] Teleconference, *supra* note 3 ("MS. TROYER: ... you refer to eligible banks as being any bank ... organized under the laws of the United States, but then you say that banks that are owned or controlled by a foreign bank or company are not eligible. Can you explain that? ... MS. McINERNEY: This is Roberta McInerney. I'm Acting General Counsel at the FDIC ... and I -- other folks have raised that questions (sic) with me, and I've reached out to the Treasury Department to get clarification on that point. There are some restrictions in existing law on foreign bank participation, and Treasury has indicated, for example, for the TARP capital program, that foreign-owned banks, including those chartered in the United States have not been eligible for that program for the Capital Purchase Program, but I'm working with them to get an answer to that question, but I don't know right now.").
[8] It is unclear whether an investor may redirect servicing to an affiliate servicer, and what requirements or restrictions will be placed on such arrangements.
[9] See the attached Appendix B for the list of questions posted for comment by the FDIC. The questions are also available at http://www.fdic.gov/llp/progdesc.html.
[10] Summary of Terms, *supra* note 6, p. 2.
[11] Fact Sheet, *supra* note 5, p. 3.
[12] Teleconference, *supra* note 3 ("FDIC STAFF MEMBER: Yes, we are anticipating that -- first of all, at least initially, for the earlier funds that are established, there will just be one bank contribution (sic) funds, and it would be later in the program where we'll start pooling assets across financial institutions into a single fund. So, that's really sort of the second phase of the program.")
[13] Summary of Terms, *supra* note 6, p. 2.

[14] Teleconference, *supra* note 7.
[15] Summary of Terms, *supra* note 6, p. 3.
[16] *Ibid.*
[17] Teleconference, *supra* note 3 ("FDIC STAFF MEMBER: And we do anticipate, as I mentioned earlier, that we'll have a due diligence process where we will be hiring or retaining a contractor to conduct due diligence and provide that information basically in a data room, probably some of it on a virtual data room, some of it on (sic) a physical location, for investors to review, which will hopefully minimize the cost of the due diligence performance that an investor would have to undertake.").
[18] *Ibid.*
[19] Teleconference, *supra* note 3 ("FDIC STAFF MEMBER: ... It's also contemplated that the seller will be granted certain reps and warrants associated with the asset pool. Those would be determined, of course, on a case-specific basis. We don't anticipate that those would be uniform because they'll vary by seller and by the type of asset pool being contributed.")
[20] Teleconference, *supra* note 3 ("FDIC STAFF MEMBER: Well, right now, we anticipate hiring a financial adviser for each one of these transactions, and the financial adviser would be overseeing the auction process, whatever that is determined to be. MR. GRADIUS: Okay, like, say, who the auction vendor would be, for example? FDIC STAFF MEMBER: Well, the financial adviser would be the party that would be overseeing the actual auction process.")
[21] Teleconference, *supra* note 3 ("CHAIRMAN BAIR: ... I think there was some discussion about whether Selling Banks should be able to take part of the payment back as an equity interest in the PPIF, the bidding on -- the Selling Banks will have assets. So, I think we'd be open to comment on that. And if you think that's something Selling Banks would be interested in, we'd be open to comment on that.")
[22] Teleconference, *supra* note 3 ("MR. CASSIDY: Thank you. In regards to the banks that do decide to participate, the bids come in, and the banks do not to accept the bids because they're too low, will the supervisors and the regulatory exams be able to use that as a guide to require the banks to mark down their assets to those bid prices? MR. STORCH: ... Assuming the loans have been in the held for sale account -- held for investment account prior to the consideration of selling them, the remainder of the loans in the held for investment account really wouldn't be affected by what the price is because they're carried at amortized cost less a loan loss allowances (sic). Depending on how the volume of auctions works and the amount of transparency about prices and so forth, there may come a point in time where there's enough information out there that those data points could be used for valuing other assets that do have to be fair-valued, but the program is not going to change the existing accounting rules about what assets are accounted for at fair value versus an amortized cost basis.")
[23] Summary of Terms, *supra* note 6, p. 3.
[24] *Ibid.*, p. 1.
[25] Public-Private Investment Program for Legacy Loans, Frequently Asked Questions ("FAQ"), p. 1, *available at* http://www.fdic.gov/llp/LLPfaq.pdf.
[26] Summary of Terms, *supra* note 6, p. 4.
[27] *Ibid.*, p. 3.
[28] *Ibid.*, p. 4.
[29] Fact Sheet, *supra* note 5, p. 3.
[30] Summary of Terms, *supra* note 6, p. 4.
[31] Summary of Terms, *supra* note 6, p. 1; FAQ, *supra* note 25, p. 3.
[32] Summary of Terms, *supra* note 6,, p. 1.
[33] On the March 26th conference call with bankers, and in question #10 of the suggested questions posed by the FDIC in its request for comments (available at http://www.fdic.gov/llp/progdesc.html), FDIC staff indicated that the FDIC is also considering providing notes from the PPIFs to the Selling Banks.
[34] Summary of Terms, *supra* note 6, p. 4.

[35] *Ibid.*
[36] Summary of Terms, *supra* note 6, p. 1.
[37] Teleconference, *supra* note 3 ("UNIDENTIFIED SPEAKER: I have a question, if it's possible, in terms of control rights, is the private investor going to control 100 percent of the investment? ... FDIC STAFF MEMBER: Right now, it's contemplated that, as I indicated earlier, that with respect to the servicing of the loans, the servicing will be held by the equity holder, that the loans will be sold servicing-released ...")
[38] *Ibid*.
[39] *Ibid.* ("FDIC STAFF MEMBER: Yes, we do contemplate that there will be certain restrictions. For example, we would expect single-family loans, residential loans, would be subject to the U.S. Government Loan Modification Program, and there are likely to be other restrictions as well.")
[40] FAQ, *supra* note 25, p. 3.
[xli] *available at* http://www.fdic.gov/llp/progdesc.html .