CLIENT ALERT

FDIC TESTS INVESTOR INTEREST IN LEGACY LOANS PROGRAM

In an effort to determine the level of investor interest in the Legacy Loans Program (LLP), Federal Deposit Insurance Corporation (FDIC) is asking investors to respond to an online survey published on FDIC’s Web site. Access to the survey may be obtained at www.fdic.gov/llp/investorInterest.html. FDIC has indicated that responses to the survey will remain confidential.

FDIC intends to begin contacting interested investors to determine their eligibility to participate in the LLP as soon as a definitive structure for the program has been announced. Although investor eligibility requirements have not yet been determined, FDIC has stated that investors must demonstrate their ability to manage purchased assets with an eye to maximizing their value and minimizing risk to FDIC, as the guarantor of debt used to purchase the assets, and the U.S. Treasury, as an equity participant in the purchasing public-private investment fund (PPIF).

KEY CONCERNS EMERGE IN PUBLIC COMMENTS ON LEGACY LOANS PROGRAM

Last week, FDIC published the public comments it had received thus far regarding the LLP. The key areas of concern expressed in these comments related to (i) incentives to attract investors, (ii) how best to conduct the auction process to assure integrity in the pricing of loans by investors, and (iii) post-sale management of PPIFs.

Investor Incentives to Participate in the LLP

Based on the public comments, it is evident there is popular concern that investors will be hesitant to participate in LLP auctions if the selling bank (“participating bank”) has the option to reject the winning bid. The solution to this issue that is most often mentioned by those who submitted comments to FDIC is to require participating banks to sell assets offered for sale to the winning bidder selected by FDIC. Although this is a fundamental change in the LLP as proposed by FDIC and Treasury, requiring the participating banks to sell assets to the winning bidder is consistent with the government’s stated objective of cleaning up the balance sheets of FDIC-insured banks, providing liquidity to the banking system and accomplishing these purposes as expeditiously as possible.
Another incentive suggested is for Treasury, as a passive co-investor, to provide a standard promotional return to the private party investor on the PPIFs’ investment. Commenters suggest that management of properties that secure (i) loans with outstanding balances exceeding the market value of such properties or (ii) non-performing loans is anticipated to require considerable time and expertise for which private managers should be compensated.

_Auction Process_

Commenters expressed concern that a participating bank may evade FDIC’s proposed ban on purchasing its own loans or loans of its affiliates by colluding with unrelated banks to purchase each other’s legacy loans using taxpayer dollars provided through TARP. They also urged FDIC to adopt “bad boy” provisions such as those used by the Resolution Trust Corporation when liquidating assets of failed savings banks in the 1990’s. Under such provisions, investors who have created losses for banks (whether actively or passively) would be banned from participating in the LLP.

Opinions differed on the best type of auction to use in the LLP. Some suggested that FDIC, with the assistance of private valuation firms, establish an independent valuation price for all assets that would be provided to participating bidders. In this proposal, selling banks would be required to sell at the independent valuation price. Alternatively, the independent valuation price could be set by holding a Dutch pre-auction, to be followed by a standard auction in which the selling bank would be required to sell at the price set at the pre-auction.

_PPIF Management_

PPIFs may need to advance additional capital to cover unanticipated expenses that may arise in connection with purchased loans. Some commenters suggest that investors should have the option to cover Treasury’s share of any capital calls, either as a loan to be repaid from Treasury’s share of profits or by diluting Treasury’s equity share in the PPIF.

FDIC and Treasury may want to retain some management control in PPIFs. Sales of interests in the PPIF could be subject to Treasury approval, and Treasury could be protected with a right of first refusal to purchase the investor’s PPIF interest and/or drag along rights to sell its interest on the same terms as the investor’s proposed sale.

**TREASURY PROVIDES MORE GUIDANCE ON LEGACY SECURITIES PROGRAM**

Based on initial feedback from potential fund managers, on April 6, 2009, Treasury issued updates to the Legacy Securities Program to extend the application period and provide flexibility with respect to the qualifications of fund managers of public-private investment funds (PPIFs). Treasury’s modifications also seek to ensure broader participation in the program by encouraging fund managers to partner with small minority- and women-owned businesses in innovative ways. Treasury also clarified how the Legacy Securities Program will interact with the Federal Reserve’s Term Asset-Backed Securities Lending Facility (TALF). Treasury has clarified the basis for issuing warrants to Treasury, as well as how PPIFs are to be structured.

_Selection of Fund Managers_

Fund Managers now have until 5 p.m. on Friday, April 24, 2009, to submit their applications via e-mail. Treasury anticipates informing applicants on or before May 15, 2009, whether they meet preliminary qualifications. Treasury expects to make public the names of pre-qualified fund managers. After selection of initial fund managers, Treasury will
consider opening the Legacy Securities Program to additional fund managers, including firms currently managing pre-2009 mortgage-backed securities having a market value of less than $10 billion. The initial group of pre-qualified fund managers will be expected to raise a minimum of $500 million of private capital within no more than 12 weeks after their selection. PPIFs that fail to meet this capital requirement will not be eligible to receive equity or debt financing from Treasury.

Although Treasury has not changed its five previously announced criteria for fund managers (see Akin Gump March 27, 2009 client alert, “FDIC Clarifies Legacy Loans Program”), it now states that failure to satisfy any one of them will not necessarily disqualify an applicant. Treasury urges applicants to submit innovative proposals—either with their fund manager applications or after the application deadline—that incorporate smaller firms owned by veterans, minorities and/or women. Without limiting applicants as to how they can achieve this goal, Treasury suggests including these smaller firms as asset managers, equity partners and/or fund-raising partners.

Legacy TALF and the Legacy Securities Program

Treasury is administering two separate programs for the purchase of eligible mortgage-backed securities: Legacy TALF and Legacy Securities. Legacy TALF participants must satisfy the Federal Reserve Bank’s lending requirements. Fund managers pre-qualified by Treasury for the Legacy Securities program may also participate in Legacy TALF. Treasury will not provide any debt financing to a PPIF in which private investors have voluntary withdrawal rights. (Private investors at the private vehicle level may have the right to voluntarily withdraw from the private vehicle after the third anniversary of its first investment.) Treasury is considering offering the following three financing alternatives to PPIFs for the purchase of eligible securities—

- debt financing limited to Legacy TALF or any other Treasury program or private lenders
- debt financing limited to senior secured loans made by Treasury in an amount not to exceed 100 percent of a fund’s total equity, subject to restrictions on asset level leverage, withdrawal rights, disposition priorities and other factors deemed relevant by Treasury
- debt financing from unsecured loans made by Treasury in an amount not to exceed 50 percent of a fund’s total equity and additional loans from TALF, any other Treasury program or private lenders, subject to compliance with Treasury’s leverage requirements and covenants to be determined.

Unless Treasury otherwise agrees, Treasury equity will be drawn in tranches at the same time and in the same proportion as private equity, and debt financing will be funded concurrently with equity draws. Treasury will retain the right to cease funding committed equity and debt financing at its sole discretion.

Treasury Warrants

Treasury will determine the amount and terms of warrants that it will require PPIFs to issue to Treasury on a case-by-case basis. One consideration in making this determination will be the amount of debt financing provided to the fund by Treasury.
Other Restrictions on PPIF Fund Managers and Private Vehicles

PPIFs will have two investors: Treasury and a private vehicle controlled by the fund manager. Fund managers may not acquire eligible assets from, or sell eligible assets to, its affiliates, any other fund manager or any private investor that has committed at least 10 percent of the aggregate private capital raised by such fund manager. Fund managers are expected to adopt primarily a long-term buy and hold strategy. Treasury will consider, however, PPIF hedging proposals as appropriate on a case-by-case basis.