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# FDIC DELAYS THE PPIP LEGACY LOAN PROGRAM TO FOCUS ON PUBLIC-PRIVATE PROGRAMS TO SELL ASSETS FROM FAILED BANKS

On June 3, the Federal Deposit Insurance Corporation (the "FDIC") announced that a pilot sale of assets under the Legacy Loans Program component of the Public-Private Investment Program ("PPIP"), initially scheduled for June, will be postponed indefinitely. The FDIC indicated it will continue to work to develop the Legacy Loans Program as banks take "additional time to assess the magnitude and timing of troubled asset sales." It appears that the FDIC's focus will turn to developing and applying the funding mechanisms of the Legacy Loans Program for sales of failed bank assets held by the FDIC, as receiver.

## RECEIVERSHIP PUBLIC-PRIVATE PARTNERSHIPS

The FDIC, as the receiver of failed depository institutions, has the obligation to structure a "least cost" resolution. Many banks have failed, and the FDIC has had to take, for later sale, a large amount of the failed banks' loans and other assets. The FDIC traditionally sells pools of loans with similar characteristics to the highest bidders through outside financial advisors such as First Financial Network and DebtX, and potentially others.

In May 2008, the FDIC launched a public-private partnership structure (the "Receivership PPP") by selling a pool of loans from the NetBank receivership in a "structured sale transaction." The FDIC has completed five Receivership PPP transactions to dispose of loans acquired from failed banks, and it has sold $681 million of interests in loans to private purchasers for a total sales price of $156 million. The total par value of the underlying loans in these transactions was $3.2 billion. The Receivership PPP has its origins in the Resolution Trust Company ("RTC") equity partnership program.

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## RESOLUTION TRUST COMPANY EQUITY PARTNERSHIP PROGRAM

In the 1990s, the RTC developed an "equity partnership program" to dispose of assets that it held as a result of failed thrifts. The RTC established numerous joint ventures, in which it was the limited partner, and according to *Managing the Crisis* (FDIC, August 1998), a private-sector investor, typically a joint venture between an equity investor and an asset management company, was the general partner. The RTC contributed asset pools (typically subperforming loans, nonperforming loans, and other real estate owned ("OREO")) and arranged financing for the partnership. The general partner contributed equity capital and performed asset management services. These equity partnerships required that cash proceeds generated from the liquidation of assets be applied first to the retirement of bonds held by the RTC, and then to the partners, *pro rata* according to each partner's percentage interest in the partnership. Unlike a direct asset sale, the RTC retained an interest, which entitled it to receive proceeds at closing and a percentage of subsequent income from the assets, including sales of the assets.

The FDIC has stated that the RTC equity partnerships were established to increase the present value of recoveries by capturing the management efficiencies and expertise of the private sector, while reserving for the RTC potential profit from improvements in inefficient or illiquid markets or unexpected events. This strategy also enabled the RTC to successfully move a large number of assets off of its books.

The RTC created 72 equity partnerships between December 1992 and October 1995, with assets having a total book value of $21.4 billion. Similarly, the FDIC was a partner in two partnerships with $3.7 billion of assets based on book values under Asset Management and Disposition Agreements.

The RTC and FDIC measured sales results using the net rate of recovery on the book value (the "Recovery Rate") of the assets. The Recovery Rates achieved by equity partnerships holding commercial and multifamily real estate assets produced better results than other disposition strategies employed by the RTC. Interestingly, the RTC equity partnerships had substantially poorer results than auctions of loans with riskier, illiquid assets such as construction and land loans. The average collections as a percentage of book value was 54 percent by equity partnerships holding commercial and multifamily real estate assets, compared to 45 percent using auctions, 43 percent using multiasset sales transaction seller financing, and 42 percent using sealed bids. In contrast, the average collections as a percentage of book value by equity partnerships was lower than most other strategies when the underlying assets were land and construction assets, which was 27 percent compared to 47 percent using auctions, 30 percent using sealed bids. Only multiasset sales transaction using seller financing had a lower collection rate at 26%.

*Managing the Crisis* assessed the effectiveness of the equity partnerships. The FDIC's conclusions included, among other things, that:

- Recoveries were generally higher for smaller pools.
- Recoveries were also higher where the assets were identified in advance of bidding as opposed to blind pools.
- Equity partnership structures can transfer large volumes of assets to the private sector quickly.
- The receiver's and the investors' and managers' interests need to be aligned in the structure.
- Financing provided by the RTC promoted and speeded sales, reduced financing costs, and increased competition, demand, and pricing for the assets held as receiver.

## LEGACY LOANS PROGRAM AND THE RECEIVERSHIP PPP

We believe that the Receivership PPP and the RTC equity partnership programs may provide a roadmap for how the Legacy Loans Program ultimately will be structured and utilized.

## GENERAL RECEIVERSHIP PPP TERMS

Key terms of the Receivership PPP include the following:

- **Legal Entity.** The FDIC, as the receiver of a failed depository institution, forms a limited liability company (the "LLC") and contributes loans from the failed depository institution. In exchange for the contributed loans,

the LLC issues the FDIC 100 percent of the membership interests in the LLC.

- **Participation Agreement.** The LLC enters into a Participation and Servicing Agreement with the FDIC and issues a participation interest to the FDIC (the "Participation Interest") in the loans. The Participation Interest is typically 80 percent, but the actual amount varies by transaction. The LLC services the loans through a Servicing Agreement with a qualified servicer. The LLC also enters into a Custodial Agreement with a qualified document custodian.
- **Eligibility to Bid.** The FDIC auctions its 100 percent membership interest in the LLC to pre-qualified bidders ("Eligible Buyers"). Eligible Buyers must have demonstrated financial capacity, the ability to manage and dispose of similar loans, and be eligible generally to purchase FDIC receivership assets.
- **Membership Interest.** The winning bidder (the "Private Purchaser"), acquires 100 percent of the LLC's membership interests, subject to the FDIC's Participation Interest in the LLC's loans. The Private Purchaser is entitled to the income from the loans other than the FDIC's Participation Interest.
- **Guaranty.** The Private Purchaser is required to guarantee its and the LLC's obligations as the sole managing member of the LLC.
- **Management Fee.** The LLC is entitled to a monthly management fee in an amount determined by the FDIC prior to the bidding process.
- **Distributions.** Cash flows from the loans, after deducting the monthly management fee and advances for taxes, insurance, and property protection expenses, are distributed monthly to the FDIC and the Private Purchaser based on their Participation Interests.
- **Reduced FDIC Interest.** Upon the later of the date (i) on which the aggregate distributions (including the initial purchase price paid by the Private Purchaser) to the FDIC reach a certain threshold, specific to each transaction and established and disclosed by the FDIC prior to the bid date, and (ii) which is one year after the closing date of the transaction, the FDIC's participation interest is reduced by a specific percentage and the participation of the Private Purchaser increases by an equivalent percentage.
- **Clean-up Call.** The FDIC has the right to require the liquidation and sale of any remaining loans held by the LLC at any time after the earlier of (i) seven years (10 years for single-family residential loans) after the date of the Participation and Servicing Agreement, and (ii) the date on which the unpaid principal balance has been reduced to 10 percent of the balance at closing of the sale of the LLC Membership Interests.
- **Assignment and Resale.** The FDIC may sell or assign all (but not part) of its participation interest in the loans. The Private Purchaser may dispose of all (but not part) of its membership interest (or permit any change in control) only if, among other things, the transferee (i) is a special purpose entity with (a) a net worth of more than $5 million, (b) has the licenses and other governmental approvals necessary to perform its obligations as a sole member of the LLC, (c) has knowledge and experience in the origination, servicing, sale, and/or purchase of performing and nonperforming or distressed loans, and (d) the ability to bear the economic risks of the investment (including a total loss); (ii) the transferee is acquiring the membership interest for its own account and not with a view toward resale; and (iii) the transferee has obtained the prior written consent of the FDIC.

To date, the FDIC has engaged two primary outside financial advisors to market the LLC membership interests to potential bidders, GlassRatner and Keefe, Bruyette & Woods.

## COMPARISON OF THE RECEIVERSHIP PPP TO LEGACY LOAN PROGRAM

The Receivership PPPs, which have been operating since May 2008, with the enhanced funding and leverage contemplated by the FDIC, now are expected to provide even more clues to how the FDIC will structure and fund the PPIP's Legacy Loans Program. We have highlighted below certain key terms of both programs. The FDIC may make significant changes to the Legacy Loans Program based on its experiences with the Receivership PPPs.

| | Receivership PPP | Legacy Loans Program |
|---|---|---|
| Legal Entity/ Vehicle | The LLC that will hold loans the FDIC decides to sell. The 100 percent membership interest will be sold to a private purchaser. | The type of entity to be used by the public-private investment funds ("PPIFs") has yet to be determined. PPIFs will finance the purchase of eligible asset pools by issuing debt guaranteed by the FDIC, and half of the equity stakes in the PPIFs will be sold to private investors, and the other half will be funded by the Treasury from TARP. |
| Eligibility of Private Investors | Qualified bidders must have demonstrated financial capacity and the experience in managing and disposing of similar loan portfolios. Bidders must be eligible generally to purchase from the FDIC, as receiver. | The specific eligibility requirements for private investors have not been delineated, but the FDIC has indicated that prospective bidders will need to qualify separately for each individual loan purchase transactions.<br><br>Private investors are expected to include an array of different investors, including, but not limited to, financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, and pension funds, including private investor groups. The FDIC chairman recently indicated that banks may not be eligible to be purchasers in the Legacy Loans Program.<br><br>Private investors may not participate in any PPIF that purchases assets from sellers that are affiliates of such investors or that represent 10 percent or more of the aggregate private capital in the PPIF.<br><br>For a bid to be considered in the auction process, the bid must be accompanied by a refundable cash deposit for 5 percent of the bid value. |
| Servicing | The LLC is obligated to service the loans by entering into a servicing agreement with a qualified servicer and a custodian agreement with a document custodian for a monthly management fee. | Servicing initially will be provided by the bank that sells the legacy loans to the PPIF, unless otherwise provided.<br><br>The PPIF will control servicing, subject to relevant agreements. |
| Management and Governance | The Private Purchaser will become the sole member and manager of the LLC and have full and exclusive power and discretion to manage the business and affairs of the LLC under an Operating Agreement. | PPIFs will be managed (by the private purchaser or a manager retained by the private purchaser) within parameters to be established by the FDIC and the Treasury, with reporting to the FDIC and oversight by FDIC. The FDIC will be responsible for providing information required by the Treasury. |

| | Receivership PPP | Legacy Loans Program |
|---|---|---|
| Change in Public Participation Interests | Upon the later of the date (i) on which the aggregate distributions (including the initial purchase price paid by the Private Purchaser) to the FDIC reaches a certain threshold, specific to each transaction and established and disclosed by the FDIC prior to the bid date, and (ii) which is one year after the closing date of the transaction, the FDIC's participation interest will be reduced by a specific percentage, and the participation of the Private Purchaser will increase by the corresponding percentage. | The Treasury will have a fixed equity participation throughout the term of the PPIF.<br><br>The Treasury will receive warrants as part of the PPIF transaction. The issuer and terms of the warrants have yet to be determined. |
| Due Diligence and Evaluation | Each Private Purchaser is responsible for making its own independent investigation and evaluation of the LLC membership interest and the loans held by the LLC.<br><br>Permissible leverage to be developed by the FDIC, based in part on the PPIP Legacy Loans Program. | A third-party valuation firm selected by the FDIC will provide independent valuation advice to the FDIC on each eligible asset pool. Upon determination of an eligible asset pool for sale by a participant bank, the FDIC will oversee initial due diligence, preparation of required marketing materials and conduct the auction process. It is unclear whether the information collected by the FDIC will be made public to the eligible bidders in connection with the auction process.<br><br>The FDIC will make its own determination as to available leverage, not to exceed 6 times the PPIF's equity. |
| Management Fees | The LLC will charge a monthly management fee. Cash flows from the loans will be used to pay the monthly management fee and advances for taxes, insurance, and property protection expenses before distribution. | The FDIC will be reimbursed for all expenses related to conducting auctions.<br><br>The PPIFs will pay ongoing administration fees of a currently unknown amount or percentage to the FDIC for oversight functions performed by the FDIC. |
| Guaranties | The Private Purchaser needs to provide a guaranty of its and the LLC's obligations as the sole managing member of the LLC. | The FDIC will guarantee debt issued by the PPIFs to participant banks or in the market as consideration for eligible asset pool purchases. In exchange for the debt guarantee, the FDIC will charge the PPIFs an annual guarantee fee. |
| TARP | Not subject to TARP or PPIP restrictions or oversight. | TARP monies were expected to be used, but TARP executive compensation limits will not apply to passive investors.<br><br>Subject to FDIC oversight and to the Public-Private Investment Program Improvement and Oversight Act of 2009 (the "PPIP Oversight Act"), including conflict of interest rules, periodic reporting to Treasury, inspection of books and records by SIGTARP, fiduciary duties to public and private investors, ethics policies, investor screening, and indemnification of 10 percent or greater interest in the PPIF. |

## CONCLUSIONS

Receivership PPPs, organized by the FDIC alone without TARP funding, may provide an investment alternative for sophisticated investors interested in investing in legacy loans that the FDIC has acquired through resolving failed depository institutions. Receivership PPPs may help reduce the estimated $21 billion of assets held by the FDIC as receiver of failed banks and thrifts. The Receivership PPP structure and administrative process, which have been used since last May and trace their origins to the RTC equity partnership program, may be useful in determining the way in which the FDIC and the Treasury will structure and operate the PPIP's Legacy Loans Program.

It is not surprising that the Legacy Loan Program has been deferred. The PPIP Oversight Act increases the complexity of, and the conditions to, the Legacy Loan Program. Any use of TARP funding in the Legacy Loan Program includes the uncertainty of accompanying regulation, which reduces the appeal of this Program to sellers, investors, and asset managers. It is possible that a more market-driven Legacy Loan Program that does not utilize TARP, and is more attractive to asset sellers and investors, may result. We hope that the FDIC will consider using the Legacy Loan Program to assist banks in funding good bank/bad bank structures.

For more information on the PPIP, please see our *Jones Day Commentary,* "The Public-Private Partnership Investment Program," at www.jonesday.com/pubs/pubs_detail.aspx?pubID=S6070, and for more information on the PPIP Oversight Act, please see our *Jones Day Commentary,* "The Helping Families Save Their Homes Act of 2009 Significantly Changes the TARP, PPIP and TALF Programs and FDIC Insurance," at www.jonesday.com/pubs/pubs_detail.aspx?pubID=S6303. Jones Day will continue to update you as further developments occur.

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