LLB&L Client Alert

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Treasury Releases Details on Public-Private Investment Plan

The United States Department of the Treasury ("UST") announced on Monday, March 23, 2009, details of its much-heralded Public-Private Investment Plan ("PPIP") to remove the problem assets currently weighing down banks' balance sheets. The root of the current financial crisis lies with such problem, or "legacy," assets, as banks are compromised in their ability to raise capital and boost lending while such assets remain "on the books." The UST's new PPIP program incorporates joint efforts from the UST, Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC") to work with private investors to create a market for troublesome assets using Public-Private Investment Funds ("PPIF's"). Drawing on funds available under the Troubled Asset Relief Program ("TARP"), UST plans to utilize up to $100 billion in funds with matching capital from private investors, to generate several hundred billion dollars in purchasing power to buy problem assets. It is expected the PPIP could expand to $1 trillion over time, depending on participation levels and the program's success.

One concern of potential investors with the PPIP is risk-allocation. The PPIP is designed to allocate risk of purchasing problem assets between the private sector and the government, with the government bearing much, though not all, of the investment risk. As UST Secretary Timothy Geithner ("Geithner") stated, "we don't want the government to assume all the risk. We want the private sector to work with us."

The Obama administration views the PPIP as a public/private *investment*, as opposed to a publicly subsidized purchase of whole loans at above market prices. It is envisioned that the loans purchased will be held for a long term, and eventually sold once the market for loans revives. Thus, if the value of such assets increases in the future as markets return to normal trading volumes, the government will not only be repaid, but taxpayers may even earn a profit. The idea of actually earning a profit certainly appeals to investors, making the PPIP preferable compared to a strategy where banks slowly work these problem assets off their books.

As Secretary Geithner wrote in an opinion piece on Monday, March 23, 2009, for *The Wall Street Journal*, the efforts of the PPIP should assist in providing a "normal" price for problem assets, which UST states are currently undervalued. "The ability to sell assets to this fund will make it easier for banks to raise private capital, which will accelerate their ability to replace the capital investments provided by the Treasury." If as a result of the PPIP, the value of troubled assets increases, this would mitigate the effect of the forthcoming "mark to market" revisions expected in early April, increasing the value/price of the PPIP assets from their current low valuation.

In addition to finalizing various details of the PPIP, UST must also work to encourage investor participation in this program. Investors in the current environment are wary of participating in a program without final details, expressing concern that rules could change throughout the course of their involvement. Clearly, the current outburst of Congressional outrage with insurance giant AIG's bonus payments and the resulting confiscatory tax proposals on compensation have undermined the confidence of the investor community in doing business with the government.

Press reports have announced that compensation restrictions commonly associated with TARP "will not apply to passive [p]rivate [i]nvestors." This same approach was taken last month for participants in the Federal Reserve's consumer-lending facility, which provided loans to investors who agreed to purchase asset-backed securities. The Congressional climate with respect to honoring contracts with companies receiving government subsidies may cause government interference with the terms of the PPIP relating to the sharing of profits and losses. Obama administration officials, however, have stated their hope that the public draws a distinction between financial firms that receive government "bail-out" money, and hedge funds and private equity firms participating in government programs as "passive investors." Notwithstanding the Obama administration's statements, there is anxiety that Congress, in the future, could enact confiscatory measures which would affect the level of profits permitted to investors.

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With the intent to build on earlier programs structured to inject capital into banks, restart consumer and small-business lending, and assist homeowners in paying mortgages, UST identified two categories of problem assets which will be the focus of the PPIP, legacy loans and legacy securities, backed by mortgages on residential and commercial properties. By assisting banks in clearing their books of problem legacy loans and problem legacy securities, UST aims to instill confidence in banks to spur lending.

Implementation of Legacy Loan and Legacy Securities Programs

As outlined by UST, there are three basic principles around which the PPIP is designed: (i) the creation of substantial purchasing power by utilizing government financing in partnership with private sector investors; (ii) UST would be an equal investor in the partnerships created, thus sharing losses as well as profits on the equity investment; and (iii) the decreased likelihood of overpayment for assets due to private sector participation in the auction process used to establish the price of the assets purchased. In order to purge both problem legacy loans and problem legacy securities from the balance sheets of investors, UST, under the PPIP, will utilize one of three avenues to sell problem assets: (i) loan auctions for problem assets; (ii) the creation of investment funds to manage risky securities; and (iii) the expansion of Term Asset-Backed Securities Loan Facility ("TALF").

Legacy Loan Program

The Legacy Loan Program is targeted to real estate whole loans held directly on the books of banks. Under the Legacy Loan Program, UST intends to participate with individual investors, pension plans, insurance companies and long-term investors to create a market for these assets through the creation of PPIF's established to own and manage pools of assets. Private investor groups must be approved by the FDIC, and in order to maintain fairness, collusion between private investor groups is prohibited once the auction process, as discussed below, begins.

Creation of Investment Funds

The activities of the fund managers will be subject to oversight by the FDIC as to formation, funding and operation of the newly-created investment funds purchasing pools of assets, with the scope of the "strict oversight" of such funds by the FDIC yet to be determined. UST has not yet addressed the terms and procedures for liquidating assets held in investment funds. Each PPIF must agree to waste, fraud and abuse protections, as defined by the UST and FDIC, to provide taxpayer protection. Further, in addition to oversight of PPIF's by the FDIC, each PPIF must agree to provide access to information required by the Special Inspector General of the TARP, and the Government Accountability Office.

Once formed, the PPIF's will finance the purchase of eligible asset pools with debt, guaranteed by the FDIC, and secured by the eligible assets comprising such pools. Equity in the PPIF's will come from private investors and the UST. Private investors may not participate in PPIF's that purchase assets from sellers that are affiliates of such private investors, or that represent 10 percent or more of the aggregate private capital in the PPIF. UST will remain involved in such investment funds as a co-investor, sharing the costs of managing such funds equally with private investors, and sharing in losses, and gains, equally. In addition, the UST shall receive warrants in the PPIF, consistent with requirements under the Emergency Economic Stabilization Act of 2008 ("EESA"). UST will maintain responsibility for overseeing and managing UST's equity contributions to the PPIF's, while the FDIC will maintain responsibility for overseeing and managing its debt guarantees to the PPIF's. The FIDC is to be reimbursed for its expenses incurred in providing such oversight and management, though the question remains as to which party is responsible for such fee to the FDIC, or whether there is a distinction in the event of a failed auction.

The PPIF's are expected to be run by approximately five major private fund managers which meet certain to-be-determined UST criteria (such as experience in managing similar assets). UST may consider adding additional asset managers depending on the experience and quality of applicant managers. Managers whose application and proposals are approved by UST will have an unknown period of time to raise private capital to "target" the designated pools of assets, and will receive matching UST funds under the PPIP program. Asset managers will have the ability, if their investment fund structures meet requirements and guidelines set forth by UST, to apply for senior debt for the PPIF from UST, in an amount initially targeted at 50 percent of the total equity capital of the subject investment fund.

In order to determine eligible asset pools, interested banks are encouraged to work with their primary bank regulators to identify and evaluate asset pools, and the corresponding financial impact on the seller bank if such asset pools are sold to the PPIF. It is anticipated that the agencies will make a determination of eligibility in conjunction with the application of the "stress test" as outlined by UST in its February 25, 2009 press release issued regarding the terms of the Capital Assistance Program. Eligible seller banks include any insured U.S. bank or U.S. savings association (banks controlled or owned by a foreign bank or company are not eligible). Assets to be pooled and any collateral supporting those assets must be situated predominantly in the United States.

In consultation with an outside appraiser, the FDIC will use an internal analysis to determine the amount of funding it is willing to guarantee, with parameters not yet specified, other than that the leverage will not exceed a 6–1 debt-to-equity ratio. Such outside appraiser is also expected to provide information about the structure and value of bids during the auction process. The critical feature of the plan involving the FDIC guarantee of the debt of the investment fund's purchases of eligible assets is unprecedented use of FDIC authority, in that the FDIC is guaranteeing non-deposit accounts in companies not affiliated with banks. It remains to be seen what structures and procedures the FDIC will employ to clarify the validity

and enforceability of its guarantee of investment funds' debt.

In addition, the plan provides that a selling bank can withdraw assets from a sale at the conclusion of the bidding process, which creates uncertainty for investors and risk as to whether the expense of participating in a bid process will be justified. This risk is real because banks holding troubled assets would be reluctant to sell such assets where the bids for such assets are not satisfactory to avoid write-offs necessary to remove problem assets from institutional books. Clearly, the more attractive the bid price is to the investor, the less attractive it is to the selling bank. After presentation of eligible assets from participants, the FDIC will oversee the initial due diligence, preparation of required marketing materials, and commencement of the auction process.

Loan Auction

The FDIC will work with participating financial institutions, the UST, private investors and third-party contractors (including private auctioneers) to administer the auctions of eligible asset pools, with the FDIC reimbursed for all expenses relating to conducting such auctions. Additional fees payable to the FDIC include ongoing administration fees, and a guarantee fee charged annually for guaranteeing debt issued to the PPIF's as consideration for eligible asset pool purchases.

The FDIC intends to disclose proposed financing terms and leverage ratios for each PPIF to potential investors as part of the auction process, prior to bid submission. The sale of equity stakes in the PPIF's to private investors will determine the total value of specific eligible asset pools. Potential private investors must be pre-qualified by the FDIC to participate in an eligible asset pool auction. Bids made during the auction process must be accompanied by a refundable cash deposit for 5 percent of the bid value. Unsuccessful or rejected bids will result in the cash deposit refunded to the unsuccessful bidders.

Once a bid is selected, the seller bank has the option of accepting or rejecting such bid, within a time frame to be established. If the selected bid is accepted, consideration paid to the seller bank by the highest bidder at such auction will be in the form of cash or cash and debt issued by the government through the PPIP and invested proportionately at the same time as private capital. Certain details remain to be determined, such as the timing for determining the amount of guarantee provided by the FDIC, the amount of government investment, the FDIC's fee schedule for providing guarantees, and method of the government's receipt of interest payments on the money loaned to the PPIF's.

The PPIF purchasing an eligible pool of assets will be required to maintain a debt service coverage account to ensure that working capital for each PPIF is sufficient to meet debt service obligations. A portion of cash proceeds from the sale at auction of eligible asset pools will be retained until cash flow from eligible asset pools has fully funded the required debt service coverage account, upon which the retained cash will be released to the seller bank.

The PPIP does not address if the seller of the troubled assets does not accept the purchase price of the highest bidder at auction (for instance, if a seller bank declines a bid and withdrawals eligible assets out of the auction process, can the seller bank submit the same assets for bid at a later date). Further, the FDIC and UST are in the process of establishing governance procedures on the management, servicing agreements, financial and operating reporting requirements of the PPIF's, exit timing and alternatives for each eligible asset pool.

With the announcement of the PPIP, UST and the FDIC also announced no obligation to reimburse or otherwise compensate seller banks or private investors for expenses or losses incurred in connection with the proposed summary of PPIP terms, or application to participate in the PPIP. UST and the FDIC also reserve the right to: (1) modify the requirements of the proposed summary of PPIP terms; (2) decide not to choose any seller bank or private investors for participation in the PPIP; (3) reject applications for participation without inviting the seller bank or private investors to submit new applications; (4) negotiate with and select any seller bank or private investors considered qualified; (5) request, orally or in writing, clarification of or additional information on an application to participate; (6) waive minor informalities or irregularities, or any requirements of the proposed summary of PPIP terms; (7) accept any application in part or in total; and (8) reject an application that does not conform to the specified format of the application as set forth by the UST and the FDIC.

Legacy Securities Program

The Legacy Securities Program is designed to allow the UST and the Federal Reserve, with investment from private capital, to make non-recourse loans to investors to fund purchases of securities backed by loan portfolios, such as non-agency residential mortgage-backed securities (not including derivatives) on residential and commercial properties as originated prior to 2009 with "AAA" ratings at origin. Additionally, eligible assets must be situated predominantly in the United States, and purchased solely from financial institutions from which the Secretary of UST may purchase assets pursuant to the EESA.

The Legacy Securities Program has two components, with the first aspect of the Legacy Securities Program designed to form funds to acquire pooled legacy securities. The second component of the Legacy Securities Program is for UST to match on a one-for-one basis, the private capital raised by major investors for funds targeting the purchase of legacy securities and to provide debt financing through the TALF. Proceeds received by funds formed as described below will be divided between UST and the fund based on equity contributions, with the exception that UST will take warrants as required by EESA.

UST has not yet determined the scope of assets eligible for purchase by investors under the Legacy Securities Program. Further, investors will be required to meet eligibility criteria. Additional requirements to be set forth by UST include

lending rates, minimum loan sizes, and loan durations. Further clarification is needed from UST as to the statement that "Haircuts will be determined as a later date and will reflect the riskiness of the assets provided as collateral." UST intends to finalize the terms of the Legacy Securities Program by discussions with market participants.

Creation of Investment Funds

The first component of the Legacy Securities Program is a cooperative investment program between private asset managers and the UST. UST will work with the approximately five fund managers to form a vehicle through which private investors will invest in selected funds. UST and private investors will share profits or losses on a pro-rata basis in accordance with equity capital investments.

It is anticipated that the created funds will be structured so that benefit plan investors (within the meaning of Section 3(42) of the United States Employee Retirement Income Security Act of 1974, as amended) will be eligible to participate as indirect investors in the funds. Potential private asset managers must be pre-qualified to raise private capital for investment and in order to receive matching UST equity funding. Pre-qualification requirements include, but are not limited to: (1) demonstrated capacity to raise at least $500 million of private capital; (2) demonstrated experience investing in eligible assets; (3) minimum of $10 billion (market value) of eligible assets under management; (4) demonstrated operational capacity to manage the funds in a manner consistent with UST's investment objective while also protecting taxpayers; and (5) headquarters in the United States. Applications from interested potential fund managers must be submitted to UST no later than April 10, 2009. Upon preliminary approval by UST, applicants will have a limited, to-be-determined period of time to raise at least $500 million of private capital and demonstrate committed capital before receiving final UST approval to act as a fund manager.

Fund managers will be solely responsible for managing the funds, controlling the process of asset selection and pricing, asset liquidation, trading and disposition, and may charge private investors a fee for such management, in the fund manager's discretion. The proposed management fee will be considered by UST during the application process. UST requires such managers agree to waste, fraud and abuse protections for the fund as defined by UST in order to protect taxpayers. Each fund manager may only purchase assets from sellers that are not affiliates of such fund manager, any other fund manager or their respective affiliates, or any private investor that has committed at least 10 percent of the aggregate private capital raised by such fund manager. Private investors may not be informed of potential acquisitions of specific eligible assets prior to acquisition. Fund managers will make proposals to UST for the term of a fund, with the goal to maximize returns for taxpayers and private investors in no longer than 10 years, subject to extension with UST's consent.

UST remains involved in purchased legacy securities funds by receiving monthly reports from the fund managers on assets purchased, assets disposed, current valuations of assets and profits/losses on assets included in each fund. Prices of eligible assets for reporting purposes must be tracked using third party sources, including annual audited valuations by a nationally-recognized accounting firm. Additional reporting requirements include providing access to relevant books and records of the fund for UST, the Special Inspector General of the TARP, the Government Accountability Office and their respective advisors and representative, for oversight purposes.

Expansion of TALF

The second component of the legacy securities program involves the expansion of TALF lending, and securing financing from UST, in a joint venture with the Federal Reserve, to assist in absorption of risky assets that may date back several years. UST intends to make non-recourse loans available to investors meeting to-be-determined eligibility criteria to fund purchases of legacy securitization assets utilizing funds available under TALF. Debt financing provided by UST will be funded concurrently with drawdowns of equity commitments, and will be in an aggregate amount of not more than 50 percent of a fund's total equity capital. UST will consider requests for financing up to 100 percent of a fund's total equity capital subject to factors UST deems relevant, and to be determined (such as asset level leverage restrictions and disposition priorities). However, UST financing will not be available to any fund in which the private investors have voluntary withdrawal rights, and UST equity capital and private vehicle capital must be leveraged proportionately from such private debt financing sources. In addition to the foregoing, private investors may have withdrawal rights no earlier than the third anniversary of the first investment by such fund.

UST financing will be secured by the eligible assets held by the applicable fund. UST financing will accrue interest at an annual rate to be determined by UST, and payable in full on the date of termination of the fund.

Examples

The following example investment under the Legacy Loan Program was released by UST on Monday, March 23, 2009:

Step 1: If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC.

Step 2: The FDIC would determine that they would be willing to leverage the pool at a 6-1 debt-to-equity ratio.

Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – in this example, $84 – would be the winner and would form a PPIF to purchase the pool of mortgages.

Step 4: Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity.

Step 5: UST then provides 50 percent of the equity funding required on a side-by-

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side basis with the investor. In this example, UST would invest approximately $6, with the private investor contributing $6.

Step 6: The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

The following example investment under the Legacy Securities Program was released by UST on Monday, March 23, 2009:

Step 1: UST will launch the application proves for managers interested in the Legacy Securities Program.

Step 2: A fund manager submits a proposal and is pre-qualified to raise private capital to participate in join investment programs with UST.

Step 3: The government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed PPIF.

Step 4: The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. UST provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the PPIF. UST will also consider requests from the fund manager for an additional loan of up to $100 to the fund.

Step 5: As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.

Step 6: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The PPIF, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.

Conclusion

Although the details of PPIP are not entirely clear, this program does seem to create a vehicle by which distressed assets can be purchased through investment opportunities offered at arguably favorable terms. The attorneys of Locke Lord Bissell & Liddell LLP bring unique experience in real estate, distressed assets, fund formation, securities. bank regulatory, and TARP-related disciplines together to provide insightful and effective counsel to our clients in these challenging times. Please contact any of the attorneys identified herein to discuss the opportunities this program may present and the experience Locke Lord offers in this area.

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