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Anticipating PPIP: Watching and Waiting

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Ever since the outlines of the Public-Private Investment Program were announced a couple of months ago, banks and the investment community have been anticipating the possibilities that the program might present. In the meantime, editorial commentators and other pundits have held forth about the likely success (or not) of the announced program in helping to restore the health of the financial community in the United States. In addition, comments have been made by various governmental agencies which have begun to shed some light on the "hot button" issues and the bureaucratic struggles under way in the run-up to the official announcement of the Programs' details. It is worth pausing to revisit some of these issues as they relate to the so-called "Legacy Loans" aspect of the Program.

Potential Purchasers of Legacy Loans

The FDIC has stated clearly that it wants a broad and as open as possible participation by individuals, private equity investors, mutual funds, pension plans, insurance companies and other pools of capital. A number of well- known names have issued statements that they have formed alliances with a view to being purchasers of these assets. At the same time, the Special Inspector General for the Troubled Assets Relief Program ("SIGTARP") has been very vocal about how the Program is inherently vulnerable to fraud, waste and abuse and that this vulnerability requires special rules for transparency and oversight, particularly since private equity groups essentially are unregulated.

SIGTARP has recommended that all beneficial owners of private equity stakes in the Program and the transactions undertaken by

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them be publicly disclosed. Moreover, SIGTARP is pushing for periodic public disclosure of all transactions and asset valuations as well as access by SIGTARP to the books and records of these purchasing entities, as a way of identifying and reducing possible conflicts of interest in the Program and other possible improper conduct. Moreover, SIGTARP wants the FDIC and Treasury to impose "know your customer" rules on the purchasing entities to prevent money laundering and other systemic abuses.

Since the FDIC will have oversight responsibility over the investing entities, some of these recommendations are likely to find their way into the final structure of the Program. This is particularly the case because the Financial Stability Oversight Board, mandated by the original TARP legislation, contemplates at least some of these recommendations.

Executive Compensation Restrictions

These restrictions were first enacted as Section 111 of the Emergency Economic Stabilization Act of 2008 (the original TARP legislation) and were amended by the American Recovery and Reinstatement Act of 2009 (the Stimulus package). That said, concerns have been raised about the extent, if at all, that these restrictions would apply to investors who participate in the Legacy Loans Program. Both Secretary of the Treasury Geithner and the FDIC have stated that these executive compensation restrictions will not apply to "passive" investors, leaving open the question of the extent to which they may be made applicable to a manager or controlling partner or member of a purchasing entity. The FDIC has acknowledged that since these rules emanate from the Treasury, the FDIC has little control over how these restrictions may be made to apply.

In early February of this year, the Treasury announced a proposed rule called the "Compensation Guidelines," designed to ensure that public funds are directed towards the public interest and not toward inappropriate private gain. Thus, the Treasury has the final authority over the application of the Compensation Guidelines to active (as opposed to passive) participants in the Legacy Loans Program.

Treasury Equity Participation and Warrants

The Legacy Loans Program contemplates that the Treasury will contribute 50 percent of the equity in the purchasing entities, which, coupled with the leverage offered by the FDIC loan guarantee, will make the opportunity to purchase these assets more attractive and thus encourage pricing that sellers would view as more acceptable. The expectation is that the Treasury will do well in its ultimate recoveries for its 50 percent investment.

At the same time, however, consistent with the original TARP legislation, the Treasury will be entitled to receive "warrants" (or their equivalent) in the purchasing entity, which has the potential to change the economics for the investors, if not ultimate control of the purchasing entities and the contemplated decision-making apparatus.

This aspect of the Program is wholly within the control of the Treasury, not the FDIC.

Management and Decision-Making by the Purchasing Entity

The FDIC takes the position that even though the private equity-Treasury equity split is contemplated to be 50-50, nevertheless, the private investor is intended to be the "driving force in major decision-making" with the controlling partner or member of the purchasing entity deciding the best resolution or restructuring that results in the best return. That said, the FDIC and the Treasury are expected to provide the ground rules of how this is to work, together with governmental oversight and reporting requirements. The Financial Stability Oversight Board has indicated that the FDIC and the Treasury will enter into an agreement allocating costs and responsibilities with respect to the purchasing entities.

SIGTARP has recommended that the managers of the purchasing entities acknowledge that they owe both the private investors as well as the Treasury a fiduciary duty in respect of their management of the purchasing entities.

Servicing Rights

The FDIC has indicated that the goal is to have the Legacy Loans sold to the purchasing entity "servicing released." With that in mind, it is expected that there will be a sub-servicing agreement between the purchasing entity and the selling institution.

At the same time, the FDIC expects to issue certain guidelines on the basic standards expected to be followed by the sub-servicers, as well as other appropriate conditions to be placed on their activities.

Deal Documents

As anticipated in some circles, the FDIC is expected to adopt some fundamental concepts that were employed in the early to mid-nineties in the Resolution Trust Corporation partnership transactions, as well as the structured sales employed by the FDIC in disposing of assets acquired from failed institutions subject to an FDIC receivership.

Apart from these generalities, it is hard to predict whether some of the "as is" form documents which impose heavy burdens on the purchasers of receivership assets will find their way into the form documents to be offered through the Legacy Loans Program. In particular, if the lack of representations and warranties with no protections from "trailing liabilities" and imposing numerous risks on the purchaser of the assets were to find their way into the deal documents, purchasers would have significantly greater difficulties in offering acceptable pricing.

Implementation of the Program

The FDIC has not yet publicly announced whether the program details will be promulgated by regulation. If that route is taken, there would be a further comment period before implementation becomes effective. Nevertheless, it is expected that the FDIC will use the pilot process approach initially to "debug" the system as much as possible before full implementation.

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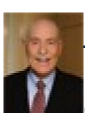

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