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April 16, 2009

DISTRESSED ASSET LAW @MANATT

NEWSLETTER OF THE DISTRESSED ASSET PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

**Selling with the government?**
***Seller considerations for participating in the new PPIP***

**By Ellen R. Marshall and Clayton Gantz**

As the markets anxiously await further details of the new Public-Private Partnership Investment Program (PPIP), banks are wondering if this will be their salvation or another sideshow. Even those who are wary of participation wonder if this program will be successful in reestablishing a market and, if so, whether that market will have acceptable pricing, from the seller's point of view. Will the 50 percent equity investment and up to 6:1 leverage that the federal government is making available serve to buoy prices? Will a rush of buyers gleefully accept the government's financial support? Or will the potential buyers collectively beat down the prices or walk away?

Several major elements of the program that are not yet known will greatly affect the answers to these questions. They relate to the selection of assets, the direction of the sale strategy, the selection of the sell-side team of professionals, the ability to control the bidders, and the forms of asset purchase agreements.

**SELECTION OF ASSETS**

Under the PPIP, the regulators will identify which pools of assets should be sold and the amount of leverage that will be available for each such pool. As yet the regulators have not indicated how they will make those determinations. Will they do so in consultation with management? Will they prioritize the most "toxic" of the assets, or those that are likely to fetch the highest price? Will it matter which regulator is involved? Will the selection process be used to help the bank's capital, or eliminate operational headaches?

Indications are that these decisions may be driven by, among

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other things, (1) the regulators' subjective and objective views on the long-term quality of management, and (2) the extent to which the assets reflect credit risk, as opposed to market and interest rate risk.

**DIRECTION OF SALE STRATEGY**

Once the sellers and asset types are selected, who picks the sale strategy? For example, will the immediate regulator or the FDIC dictate whether particular assets will be sold in bulk or in individual transactions? Will they dictate the extent of seller representations and warranties, the auction process, and the time frames? Or will the seller control some or all of these decisions?

Many of these decisions will directly affect the pricing of the assets and, thereby, the financial statement impact of the sale. For that reason alone, it seems unlikely that the regulators will prescribe only a narrow type of transaction structure. They could, however, limit the range of choices for transactions conducted under the program, and they might choose to do so in the interest of transparency or expediency.

Ultimately, control of the sale strategy will rest with the potential sellers, in the sense that they are not going to be literally forced into deals through the PPIP. If the range of permitted sale strategies is not suitable, in the seller's view, for the sale of one asset or all assets, the seller need not use the program. For the program to succeed at its goal of cleansing balance sheets of a variety of asset types, though, a reasonable array of options needs to be permitted.

**SELECTION OF TEAM**

Depending on the asset type, there may be an array of professionals who need to be involved in the selling process - lawyers and accountants; financial analysts; perhaps title, environmental and land use experts; providers of electronic data rooms; and perhaps technical or management specialists. Will sellers be permitted to hire their providers of choice? Will the transaction structures permit these costs to be financed with government-guaranteed financing, and if so, will the government seek to control costs through control of the selection?

In a similar vein, will the sellers or the regulators control the content and presentation of due diligence files that are made available to potential investors?

The FDIC has a history of practice in their sales of assets from receiverships. Will that regulatory body seek to conform the private-sector to these procedures when selling under the PPIP? The industry press has been abuzz with references to the old processes that were used by the RTC in the liquidation of closed savings institutions in the early 1990s. If, however, the PPIP seeks to tether transactions too closely to that or any other pattern, there will be a reduction in opportunities for creative structuring, and that will inherently reduce competition in the asset sales.

In the RTC asset sales, the government imposed requirements about the use of minority and women-owned businesses (MWOBs) to provide many professional services. Whether this will again be a requirement, or merely an encouraged practice, remains to be decided. Already, though, some savvy mainstream professionals are scouting around for MWOB firms with whom they can partner on a mutually beneficial basis.

Considering the potentially wide array of asset types in the PPIP, it is unlikely that the government will be able to dictate all of these details. Conceivably, though, it could require all of the professionals on the team to be selected from a pre-approved list.

**SELECTION OF BIDDERS**

Since the structure of the PPIFs (public-private investment funds) themselves are not yet entirely clear, the way they will interface with sellers is at least equally unclear. Based on regulatory arrangements of the past, it is likely that sellers will not be forced to do business with particular counterparties, at least if they have a good reason for declining to do so. For example, a seller will likely be permitted to exclude from the bidding direct competitors as to whom access to the data files might confer a competitive benefit outside the asset purchase itself. The sellers will also probably have some ability to set minimum financial metrics, so as to assure the ability to close, and minimize execution risk.

Whether sellers will be permitted to limit the total number of bidders is not clear. The government seeks to promote robust competitive bidding, so it may have an incentive to allow large numbers of potential buyers to sniff around. Also, the government does not wish to be seen as favoring a limited group of buyers.

**FORMS OF SALE AGREEMENTS**

Our recent experience representing buyers of portfolios of distressed debt from the FDIC’s receiverships causes us to be concerned that the FDIC might seek to impose its standard agreement onto PPIP sellers. The FDIC standard form sale agreement for its receiverships includes no representations or warranties and no protection for trailing liabilities. Essentially, the sales are on an "as is" basis, with numerous risks allocated to buyer which are difficult, if not impossible, to identity, quantify and price. While limited asset "put-back" rights are provided, stringent conditions precedent render these rights largely illusory.

This approach, while superficially appealing, is sure to result in a rock-bottom price. A more customary set of representations, warranties and indemnities – especially as to those matters that would be difficult for a buyer to diligence, and about which the seller has actual knowledge – will better achieve a fair price by allocating risks more appropriately.

If and to the extent that seller representations, warranties and indemnities are given, though, the financial condition of the seller will become an issue for the buyer and its pricing. If we have learned anything from the subprime meltdown, it is the vulnerability of the entire system to counterparty risk. Unless the government is prepared to stand behind the seller's financial commitments, the buyers will likely discount the value of the seller's promises unless the financial stability of the seller is unquestioned.

**MULTIPLE SELLER POOLS**

Complicating the process further is uncertainty about how the FDIC will manage pool sales where multiple sellers are involved. Prospective sellers should consider how much if any discretion will be granted to the individual sellers to qualify potential bidders, manage due diligence and asset-level disclosures, draft loan sale agreements and set closing deadlines. What would happen if not all sellers want to proceed with the high bidder for any reason, or if individual sellers want to establish reserve prices to manage their losses? Moreover, prospective sellers should also consider how risk under the purchase and sale agreement (or agreements) is allocated among the sellers and whether the practices of other sellers could give rise to a claim by the buyer or another person or entity against all sellers as a group.

**SERVICING RETENTION**

The current financial distress of potential sellers is, in many cases, a result of external circumstances, but not the quality of the sellers operations. Many potential buyers lack expertise in managing distressed real estate assets. While some of them may align themselves with third-party real estate professionals to manage the assets, many are likely to be agreeable to retain the current management as the servicer. The retention of servicing can create an income stream for the future of the selling bank, but only if it is priced in a way that is profitable. For portfolio lenders that have never really focused on the servicing as a separate profit center, there can be great risk of underpricing the distressed asset administration function. In addition, the legal and operational structure of the servicing relationship can greatly affect the outcome. The current owner of the assets is in the best position to anticipate the cost of future servicing, but if this element of the arrangement is not given careful attention, a seller can let a favorable purchase price eclipse the realistic evaluation of the aggregate package deal.

The PPIP may very well attract a large pool of interested buyers, but the ultimate returns generated by these pools will be a function not only of price competition, but also of the seller's ability to facilitate the buyers' assessment and management of risk.

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