

U.S. Treasury Public-Private Investment Program for Legacy Assets

On March 23, 2009, the United States Department of the Treasury, in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve, announced the Public-Private Investment Program under the Treasury's Financial Stability Plan. The Public-Private Investment Program is designed to improve the health of financial institutions via the formation of Public-Private Investment Funds (PPIFs) that will purchase "legacy assets." The Public-Private Investment Program is divided into two parts—the Legacy Loans Program and the Legacy Securities Program—to address, respectively, real estate loans (Legacy Loans) held by banks and residential and commercial mortgage backed securities (Legacy Securities) held by banks and other financial institutions eligible for assistance under the Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008 (EESA).

The latest versions of documents relating to the Public-Private Investment Program may be found [here](#). Among others, these documents include the Legacy Loans Program Summary of Terms (Legacy Loans Summary of Terms) and frequently asked questions (Legacy Loans FAQs), the Legacy Securities Program Summary of Terms (Legacy Securities Summary of Terms) and frequently asked questions (Legacy Securities FAQs), the Application for Treasury Investment in a Legacy Securities Public-Private Investment Fund (Fund Manager Application) and the Public-Private Investment Program White Paper (White Paper).

Below is a summary of key provisions relevant to asset managers considering participating in the Public-Private Investment Program. As is the case with the other programs under the Treasury's Financial Stability Plan, the Public-Private Investment Program is a work in progress. We will continue to monitor developments and provide updates as information becomes available and we develop experience in this area. Please consult the Legacy Loans Summary of Terms, Legacy Loans FAQs, Legacy Securities Summary of Terms, Legacy Securities FAQs, Fund Manager Applications and White Paper for additional information on the Public-Private Investment Program.¹

THE LEGACY LOANS PROGRAM

I. Fund Structure

Under the Legacy Loans Program, the FDIC and the Treasury will coordinate the formation, funding and operation of PPIFs that will purchase pools of troubled and illiquid loans and other assets in substantially sized pools from insured depository institutions (Participant Banks). The Treasury information does not specify a target size for these pools other than to say that they will be substantial.

The exact requirements and structure of the Legacy Loans Program will be subject to notice and comment rulemaking. This is expected to proceed expeditiously, but a date for the first offering of investments under this program has not been set.

The purchase price for each pool will be set by auction to the highest bidder as described below and will be paid by a combination of debt guaranteed by the FDIC and cash contributed as equity by private investors and by the Treasury.² The terms of the FDIC-guaranteed debt for each asset pool will be announced before each auction.

¹ Sample documentation for the Legacy Loan Program and for the Legacy Securities Program is not yet available. Potential investors should anticipate that such documents may contain new elements, such as representations, indemnities and administrative requirements, that may be material, as well as additional details on the elements of the programs described in the Treasury's initial information releases.

² It appears that the program contemplates a separate PPIF for each pool of assets purchased at auction.

The Treasury intends to provide 50% of the equity capital of each PPIF, but private investors may choose to take less of Treasury's equity investment, subject to a minimum to be determined. The Treasury's equity contributions will be under TARP, and the Treasury will receive warrants in the PPIFs, the terms of which are not stated.³

Private investors are expected to include an array of different investor classes including, but not limited to, financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, pension funds, foreign investors with a headquarters in the United States, private equity funds and hedge funds. Private investor groups must be approved by the FDIC, and cooperation between private investor groups will be prohibited once the auction process begins. The Treasury and the FDIC will encourage participation by small, veteran-, minority- and women-owned firms. Investing in Legacy Loan pools will not subject investors to executive compensation restrictions.

Private asset managers will manage the assets of the PPIF, with servicing to be within parameters to be established by the FDIC and the Treasury, and subject to reporting to, and strict oversight by, the FDIC. Procedures and criteria for selecting the private managers are not set forth in the available information.

The PPIFs will be responsible for the fees of the private manager, an administrative fee payable to the FDIC for its oversight, reimbursement of expenses incurred by the FDIC in connection with the auctions and an annual guarantee fee payable to the FDIC, as well as the warrants to be issued to the Treasury. It is expected that servicing of the mortgage loans in each pool will be provided by the Participant Bank.

II. FDIC-Guaranteed Debt

The purchase of pools of Legacy Loans from Participant Banks will be financed in part through debt issued by the PPIF and guaranteed by the FDIC (FDIC Guarantee).

Based on a third-party valuation of each asset pool, the FDIC will determine the amount of purchase debt it is willing to guarantee. It is anticipated that the ratio of debt to equity in each purchase will not exceed 6 to 1. The obligation of the PPIF to reimburse the FDIC for any payment on an FDIC Guarantee will be secured by the asset pool and will be without recourse to the private investors. In exchange for the FDIC Guarantee, as noted above, the FDIC will charge the PPIF an annual guarantee fee based on outstanding debt balances.

Each PPIF will be required to maintain a Debt Service Coverage Account (DSCA) to ensure that the working capital for each PPIF is sufficient to meet anticipated debt service and operating expenses. A portion of the cash proceeds from asset sales will be retained until cash flow from the asset pool has fully funded the DSCA, at which point the escrowed cash will be released to the Participant Bank and, presumably, applied to the debt included in the purchase price for the pool.

III. Eligible Banks

Each Participant Bank must be a bank or savings association organized under the laws of the United States or any State of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa, or the Virgin Islands.

³ The warrant provisions, in both the Legacy Loans Program and the Legacy Securities Program, appear to be intended to satisfy indirectly the requirement of Section 113(d) of EESA that the Treasury not purchase troubled assets from any financial institution eligible for assistance under TARP unless the Treasury receives either warrants for common or preferred stock of the selling financial institution or senior debt of the selling financial institution. The descriptions of the legacy programs published by the Treasury do not say whether under either program a selling financial institution would be required to provide warrants or senior debt under EESA.

Each Participant Bank will work with its regulator to determine which assets, usually a pool of loans, should be sold in the Legacy Loan Program. After identifying the pool of assets to sell, Participant Banks and regulators should contact the FDIC to express interest in participating in the Legacy Loan Program. Legacy Loans to be included in a pool and any collateral supporting those assets must be situated predominantly in the United States.

IV. Auctions of Legacy Loan Pools

Eligible asset pools will be purchased from Participant Banks at prices determined through an auction process conducted by the FDIC for the private capital component of the PPIF. The Treasury will provide a parity investment providing up to 50% of the equity amount bid by the highest bidder among the private investors.

As part of the auction process and prior to bid submission, the FDIC will disclose to potential investors the proposed financing terms and leverage ratios for each PPIF. The sale of equity stakes in the PPIFs to private investors (in conjunction with the allowed leverage) will determine the total price of a specific asset pool.

Potential private investors must be pre-qualified by the FDIC to participate in an auction. For a bid to be considered in the auction process, the bid must be accompanied by a refundable cash deposit for 5% of the bid value.

Once a bid(s) is selected, the Participant Bank will have the option of accepting or rejecting the bid within a pre-established timeframe.

V. Sample Investment under the Legacy Loans Program

- Step 1: A bank approaches the FDIC with a pool of residential or commercial mortgages with \$100 face value that it is seeking to divest.
- Step 2: The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a debt-to-equity ratio of up to 6-to-1.
- Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bidder from the private sector—in this example, offering \$84—would be the winner and would become an equity investor in a Public-Private Investment Fund to purchase the pool of mortgages.
- Step 4: Of the \$84 purchase price, the FDIC would provide guarantees for \$72 of financing, leaving \$12 of equity.
- Step 5: The Treasury would provide 50% of the equity investment on a side-by-side basis with the investor. In this example, the Treasury and the private investor each would invest \$6 in the PPIF.
- 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 LEGACY SECURITIES PROGRAM

I. Eligible Assets

The Legacy Securities eligible for purchase in the Legacy Securities Program initially will be securities meeting the following criteria:

- commercial mortgage-backed securities or residential mortgage-backed securities;
- issued prior to 2009;
- originally rated AAA or an equivalent rating by two or more nationally recognized statistical rating organizations without ratings enhancement; and
- secured directly by the actual mortgage loans, leases or other assets and not other securities (other than certain swap positions, as to be determined by the Treasury).

The loans and other assets underlying any eligible Legacy Securities must be situated predominantly in the United States.

The Legacy Securities may be purchased solely from financial institutions from which the Secretary of the Treasury may purchase assets under TARP pursuant to Section 101(a)(1) of the EESA and may not be purchased from the Fund Manager, any other Fund Manager or their respective affiliates or from any private investor that has committed 10% or more of the aggregate private capital raised by the Fund Manager.

Although eligible Legacy Securities are initially limited to mortgage-backed securities, it is foreseen that, based on market demand, the program may evolve to include other asset classes.

II. Fund Structure

The Treasury and a vehicle controlled by the applicable Fund Manager (Private Vehicle), operating in a manner similar to a feeder fund, will be the sole investors in each Legacy Securities PPIF. Each will hold 50% of the equity of each PPIF on a parity basis, except that the Treasury will also receive warrants to comply with EESA. Private investors will invest in a PPIF by investing in the applicable Private Vehicle. Subject to certain exceptions, the Treasury and the Private Vehicle will indirectly invest in and divest assets proportionately at the same time and on the same terms and conditions.

The Treasury will provide debt financing to each PPIF equal to 50%, or in some instances up to 100%, of the equity amount of the PPIF, as described below.

Asset managers desiring to participate in the Legacy Securities Program as Fund Managers must submit applications to the Treasury pursuant to the Fund Manager Application not later than April 10, 2009. The Fund Managers receiving initial approval by the Treasury will have a certain period of time to raise private capital to target the designated asset class.

Proceeds received by a PPIF will be divided between the Treasury and the applicable Private Vehicle based on equity contributions, except that the Treasury will take warrants as required by the EESA. The terms and amounts of such warrants will be determined in part based on the amount of Treasury Debt Financing taken.

PPIFs will be structured to terminate within ten years, subject to extension with Treasury's consent. No private investor may have the right to voluntarily withdraw from a Private Vehicle prior to the third anniversary of the first investment by such Private Vehicle.

The Treasury expects to define final terms and conditions for the PPIFs prior to fundraising.

III. Debt Financing

A. Treasury Debt Financing

Each Fund Manager will have the option to obtain, for each PPIF, secured non-recourse loans from the Treasury (Treasury Debt Financing) in an aggregate amount of up to 50% of a PPIF's total equity capital. Treasury Debt Financing will not be available to any PPIF with respect to which the private investors have voluntary withdrawal rights (apparently, even after the third anniversary of the first investment, although that is not stated explicitly).

The Treasury will consider requests for Treasury Debt Financing of up to 100% of a PPIF's total equity capital subject to restrictions on asset-level leverage, withdrawal rights, disposition priorities and other factors the Treasury deems relevant.

Treasury Debt Financing will be secured by the Legacy Securities held by the applicable PPIF. (It is not clear whether the non-recourse loans will be cross-collateralized to other non-recourse loans to the same PPIF.) Treasury Debt Financing will mature at the termination of the PPIF, expected to be in ten years.

Treasury Debt Financing will be structurally subordinated to any financing extended by the Federal Reserve Bank of New York (FRBNY) to the PPIF via the TALF (as defined below).

B. Financing through Expanded TALF Program

In November 2008, the Federal Reserve Board established the Term Asset-Backed Securities Loan Facility (TALF) to provide financing by the FRBNY to eligible borrowers owning eligible asset-backed securities.

Together with the announcement of the Public-Private Investment Program, the Treasury and the Federal Reserve announced their plans to expand the TALF to include financing for purchase of securities tied to residential and commercial real estate and consumer credit. Borrowers will need to meet eligibility criteria in accordance with TALF. Haircuts will be determined at a later date and will reflect the riskiness of the assets provided as collateral. Lending rates, minimum loan sizes, and loan durations have not been determined.

C. Other Sources of Financing

PPIF may also obtain financing from any other Treasury program or debt financing raised from private sources; *provided* that Treasury equity capital and Private Vehicle capital be leveraged proportionately from such private debt financing sources.

IV. Fund Management

A. Fund Management

The PPIFs will be managed by Fund Managers, who will control the process of asset selection, pricing, asset liquidation, trading and dispositions.

Fund Managers will be required to present monthly reports to the Treasury on assets purchased, assets disposed, current valuations of assets and profits/losses on assets included in each fund.

The Treasury will also retain the right to cease funding of committed but undrawn Treasury equity capital and debt financing in its sole discretion.

B. Pre-qualification of Fund Managers

Private asset managers interested in participating in the program as Fund Managers may apply to be pre-qualified to raise private capital to invest in joint programs with the Treasury by submitting an application by 5:00 p.m. on **April 10, 2009** in accordance with the Funds Manager Application. The Treasury expects to approve approximately five asset managers with a demonstrated track record of purchasing Legacy Securities. The number of Fund Managers may be increased depending on the Treasury's evaluation of the applications received. The Treasury also will consider expanding the program in the future.

Fund Managers will be pre-qualified based upon criteria that are anticipated to include:

- Demonstrated capacity to raise at least \$500 million of private capital.
- Demonstrated experience investing in Legacy Securities, including through performance track records.
- A minimum of \$10 billion (current market value) of Legacy Securities under management.
- Demonstrated operational capacity to manage the PPIFs in a manner consistent with the Treasury's stated investment objective of generating attractive returns for taxpayers and private investors through long-term opportunistic investments following predominantly a buy-and-hold strategy.
- Headquartered in the United States.

Please refer to the Fund Manager Application for other criteria applicable to the pre-qualification of Fund Managers.

The Treasury expects to inform applicants of its preliminary approval on or prior to May 1, 2009.

Following the preliminary approval, applications will have a limited period of time to raise at least \$500 million of private capital and demonstrate committed capital before receiving final approval.

C. Certain Points of Particular Interest Relating to the Fund Manager Application

Below are selected points that may be of particular interest to asset managers considering applying to be Fund Managers under the Legacy Securities Program.

- 1) Lack of confidentiality protections. The Fund Manager Application contains strong and broad confidentiality provisions in favor of the Treasury but lacks confidentiality protections for applicants and Fund Managers.
- 2) Interest in including certain investors. The applicant must describe in the application its expectations as to the composition of the private investor base for raising equity capital commitments to the PPIF. Investments must be eligible for benefit plans subject to ERISA. In addition, applicants are asked to consider whether, and how, to include retail investors.
- 3) Possible advantage to co-venturing with minority/women-owned business. The application must state whether the applicant is a small, veteran-, minority- and women-owned business. To ensure a diversity of participation, the Treasury will encourage small, veteran-, minority- and women-owned private asset managers to partner with other private asset managers, if necessary, in order to meet the criteria identified above for assets under management and ability to raise private capital.
- 4) Emphasis on experience with funds that invest primarily in eligible assets. The applicant must demonstrate its experience investing in Legacy Securities, including performance track records for five years showing returns for its accounts or other investment vehicles that invest primarily in Legacy Securities. The applicant should also

include information on (i) its business entities or units that manage portfolios of Legacy Securities, (ii) its personnel that manage funds, accounts or other investment vehicles managing portfolios of Legacy Securities, and (iii) the number of funds, accounts or other investment vehicles it manages and the total assets under management, with particular details on Legacy Securities under management.

- 5) Requirement that applicant identify major investors as references. The applicant must provide reference contacts for the three largest limited partners in aggregate invested in its funds, accounts or other investment vehicles that invest primarily in Legacy Securities over the last three years, including name, title, organization and phone number.
- 6) Covenants regarding allocations/non-competition related to investment opportunities. The applicant must describe proposed covenants relating to allocation of investment opportunities, competing funds and investments away from the PPIF.
- 7) Waste, fraud and abuse rules. The applicant must describe its proposals to minimize waste, fraud and abuse.
- 8) Fee issues. Treasury can be charged only fixed fees (and so presumably will not be subject to incentive fees). Fees and expenses to be paid by the Treasury will be paid solely out of distributions with respect to Treasury equity capital. Fees charged to private investors are not subject to similar limitations.
- 9) Additional fund structuring questions. The terms of the PPIFs for Legacy Securities state that the Treasury will retain the right at its sole discretion to stop making equity contributions and debt advances at any time, while also requiring that all the private investor capital be committed at any early stage and not be subject to voluntary withdrawal. Another feature is that each PPIF be structured to terminate within ten years, although the life of the assets in each pool may exceed that period. These requirements will present structuring and operational challenges, as will the requirement that the Treasury receive warrants in the PPIF.
- 10) Executive compensation restrictions. The terms of the Legacy Securities Program provide that executive compensation restrictions will not apply to passive private investors in PPIFs, but do not specify that the Fund Managers will not be subject to such restrictions.

V. Sample Investment under the Legacy Securities Program

- Step 1: The Treasury launches the application process for managers interested in the Legacy Securities Program.
- Step 2: An applicant submits a proposal by April 10, 2009 and is pre-qualified (on or prior to May 1, 2009) to raise private capital to participate in joint investment programs with the Treasury.
- Step 3: The Treasury 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 PPIF. The Treasury provides commitments for a \$100 equity coinvestment on a side-by-side basis with private capital and for a \$100 loan to the PPIF. The Treasury will also consider requests from the Fund Manager for an additional loan of up to \$100 to the PPIF.
- 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 Legacy Securities.

Step 6: The Fund Manager has full discretion in investment decisions, although it will predominantly 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.

CONTACTS

If you would like to discuss the Public-Private Investment Program further, please feel free to contact any of the following Ropes & Gray attorneys:

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