U.S. Announces Public-Private Investment Program to Purchase Toxic Assets

April 8, 2009

The U.S. Department of the Treasury ("Treasury"), in conjunction with the Federal Reserve Board ("Federal Reserve") and the Federal Deposit Insurance Corporation ("FDIC"), recently announced another effort to improve conditions in the U.S. financial markets: the Public-Private Investment Program ("PPIP"). The PPIP, created under the Emergency Economic Stabilization Act of 2008 ("EESA"), will focus on removing "toxic assets" or, as Treasury describes them, "legacy assets" from financial institutions' balance sheets in order to improve each institution's ability to raise capital and enhance their willingness to increase lending. Treasury anticipates that the PPIP, by facilitating price determination and creating demand, will boost overall private market activity by increasing investor confidence in purchasing legacy assets.

Treasury focused on three basic principles in designing the PPIP:

- ***Maximizing the Impact of Each Taxpayer Dollar*** – Direct investment of Troubled Assets Relief Program ("TARP") funds alone would be an inefficient means of cleansing balance sheets of legacy assets. Accordingly, a recovery program should be designed to maximize the purchasing power of TARP funds through equity and debt co-investing relationships among taxpayers, private investors, lenders and government agencies.
- ***Shared Risk and Profits with Private-Sector Participants*** – Taxpayers should not be burdened with a disproportionately large share of the risk and private investors should not receive a disproportionately large share of the potential investment reward. A recovery program should be designed to have taxpayers and private investors share both profits and losses proportionately.
- ***Private-Sector Price Discovery*** – Taxpayers should not overpay for legacy assets. A recovery program should prevent overpayment through price determination driven by private investors in market-driven competition.

The PPIP has two basic components, the Legacy Loans Program and the Legacy Securities Program, which relate, respectively, to real estate loans ("legacy loans") and securities backed by real estate loans ("legacy securities"). The cornerstone of each program is the creation of Public-Private Investment Funds ("PPIFs"), which will use public and private capital to acquire legacy assets from various financial institutions. Together, the two programs will use $75 billion to $100 billion in public TARP funds for investments of up to 50% of the equity in several PPIFs. Private investors will provide the remaining equity invested in the PPIFs. The combined public-private equity will be supplemented with public or private debt either financed directly or guaranteed by the FDIC or the Federal Reserve, depending on the program. Treasury projects that the PPIP initially will be able to purchase $500 billion in legacy assets, with the potential to expand to $1 trillion.

On April 6, 2009, Treasury announced various changes and clarifications to the Legacy Securities Program, which are reflected in the discussion of that program below. Several commentators believe that the new guidance is designed to increase participation by prospective fund managers, which commentators perceive as being significantly fewer than Treasury anticipated. These commentators have suggested that prospective fund manager participation has been lighter than anticipated, due to the Legacy Securities Program's initial prequalification criteria, which have excluded many smaller fund managers, as well as prospective managers' general concerns about entering into financial relationships with the U.S. government under TARP.

Legacy Loans Program

Under the Legacy Loans Program, Treasury and private investors will invest in PPIFs that will purchase pools of eligible legacy loans from selling financial institutions ("Legacy Loans PPIFs"). The FDIC will provide primary oversight for the Legacy Loans Program, including formation, approval, funding and operation of the PPIFs, for which it will be paid an administration fee by the PPIFs.

At present, there appears to be no limit to the number of Legacy Loans PPIFs that may be created. Treasury's guidelines imply that a new PPIF will be formed for each pool of legacy loans that is sold, and that no single PPIF will acquire additional pools of legacy loans after its initial investment. Also unclear at present are guidelines regarding PPIF managers, except that the managers will be private and will be responsible for asset management (subject to the FDIC's "rigorous oversight").

Assets eligible for sale under the Legacy Loans Program will be determined by Treasury, the FDIC and financial regulators. Treasury anticipates that various types of investors, including financial institutions, insurance companies, mutual funds and individuals, will participate. The FDIC must approve each investor. There appear to be few qualifications for eligible investors, except that investors cannot be affiliates of selling institutions.

Each PPIF will be funded through a combination of direct equity investments by Treasury and private investors and FDIC-guaranteed debt financing by private lenders. Unlike investors in the Legacy Securities Program, private investors in the

Legacy Loans Program will be permitted to make direct investments into each PPIF. Treasury anticipates that private investors and Treasury each will contribute 50% of the PPIF's total equity, although private investors are authorized to contribute a greater proportion. In any case, Treasury's equity investment may not exceed 50%. In return for its equity investment, Treasury will receive warrants from each PPIF. Treasury has provided few details regarding the warrants it will receive, other than to state that the warrants will be "as required by EESA to protect the interests of taxpayers." In addition to equity financing, the PPIF may obtain debt financing through private lenders. The FDIC will guarantee the PPIF's debt financing, subject to payment of a guarantee fee by the PPIF.

Investment purchases will be made through auctions of pools of legacy loans. The process will begin with selling institutions submitting a proposed pool of legacy loans to the FDIC for approval. After approval, the FDIC will engage a third-party firm to perform a valuation of the assets. Based on the valuation, the FDIC will determine the amount of private debt financing that it will guarantee, which may be any amount up to the maximum debt-to-equity ratio of 6:1. For example, the FDIC could guarantee up to $6 million of debt financing for an asset pool that is valued at $7 million and has $1 million equity invested. After the conclusion of the auction, the selling institution must accept or reject the winning bid within a pre-established time frame. After acceptance of the bid, the winning bidder will form the PPIF, obtain funding from the various sources discussed above and purchase the pool of assets from the selling institution using a combination of cash and debt.

Legacy Securities Program

The Legacy Securities Program contains two related parts. The first part is the formation of PPIFs similar in structure to Legacy Loans PPIFs. These PPIFs ("Legacy Securities PPIFs") will purchase legacy securities from selling financial institutions. The second part is an expansion of the Term Asset-Backed Securities Loan Facility ("TALF") program operated by the Federal Reserve Bank of New York to allow investors to use TALF funds to purchase legacy securities. Such TALF funds will be available for use not only by investors in connection with Legacy Securities PPIFs, but also by private investors for independent purchases of legacy securities.

The structure of the Legacy Securities Program is somewhat different from the structure of the Legacy Loans Program. Treasury will invest directly, but private investors will invest indirectly through private investment vehicles (*e.g.*, limited partnerships). In addition, the number of PPIFs that will purchase eligible legacy securities from selling financial institutions will be limited initially. Eligible legacy assets will also be more limited – initially only residential mortgage-backed securities that were originally rated AAA and commercial mortgage-backed securities and asset-backed securities that are rated AAA will be eligible. Furthermore, PPIF managers may not use debt to purchase eligible securities.

Each Legacy Securities PPIF will be managed by a private PPIF manager prequalified by Treasury as having a demonstrated ability to purchase legacy securities. Treasury expects to prequalify five PPIF managers initially, although it may approve more. Eligibility criteria are expected to include:

- A demonstrated capacity to raise at least $500 million of private capital.
- Demonstrated experience investing in eligible assets, including through performance track records.
- A minimum of $10 billion (market value) of eligible assets currently under management.
- A demonstrated operational capacity to manage PPIFs in a manner consistent with Treasury's investment objectives while also protecting taxpayers.
- Headquarters in the United States.

In its April 6, 2009 release, Treasury clarified that the foregoing criteria "will be viewed on a holistic basis" such that failure to satisfy one criterion "will not necessarily disqualify" a prospective manager from being approved. In addition, Treasury indicated that, after the initial pre-approval process, it would consider approving smaller prospective managers who do not satisfy the requirement for having $10 billion of assets under management.

Prospective PPIF managers are required to submit an application to Treasury via email no later than 5:00 p.m. ET on April 24, 2009. Treasury anticipates announcing prequalified PPIF managers on or before May 15, 2009.

Approved PPIF managers will have a limited period of time (which Treasury expects to be 12 weeks) to raise a minimum of $500 million in private capital, which will be matched by an equivalent Treasury investment. Unlike the Legacy Loans Program, private investors in the Legacy Securities Program will not have the option to invest greater than 50% of the total equity of the PPIF – private and Treasury equity will be equal. In addition to equity financing, PPIFs meeting certain guidelines to be established by Treasury will be able to obtain senior nonrecourse debt financing from Treasury in an amount of up to 50% of the PPIF's total equity capital. Treasury will also consider requests for additional senior nonrecourse debt in an amount of up to 100% of the PPIF's total equity capital, subject to additional restrictions on the PPIF to be determined by Treasury. Private equity, Treasury equity and Treasury debt will be required to be drawn down together in lockstep tranches, with the same proportion being drawn from each at the same time. Taking the foregoing sources of capital together, for each $1 of private investment, each PPIF can have $4 in total capital. In addition to Treasury funding, Legacy Securities PPIFs may also obtain TALF funds from the Federal Reserve Bank of New York, any other Treasury program or through private lenders. Details regarding the availability of TALF funds have not yet been made available. In return for its investments, Treasury will receive warrants from the PPIF. As with the warrants under the Legacy Loans Program, Treasury has provided few details regarding the warrants it will receive.

Subject to the requirements for the types of assets that may be purchased, each PPIF manager has full discretion in investment decisions. However, Treasury has indicated that it expects investments to be made with a long-term horizon.

For Further Information

Duane Morris stands ready to assist firms interested in participating in one or more of these programs. We will continue monitoring and commenting on the regulations, guidance and interpretations concerning the PPIP and EESA, as they become available.

If you have any questions regarding EESA or any of the programs described in this Alert, including how they may affect your company or its executives, please contact anymember of the Corporate Practice Group, any member of the Business Reorganization and Financial Restructuring Practice Group or the attorney in the firm with whom you are most regularly in contact.