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Partner With The Government? Buyer Considerations For Participating in the New FDIC PPIP Program

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As the markets anxiously await further details of the FDIC's new Public-Private Partnership Investment Program (PPIP), a few institutional players have tentatively indicated their willingness to participate. Many other potential participants are uncertain whether they can or should participate due to the absence of details as to how the program will work. Further, many potential buyers remain wary of co-investing with the federal government on a 50-50 basis, despite promises of government-guaranteed loans offering up to 6:1 leverage, citing concerns such as potential regulatory scrutiny over asset management practices.

Our recent experience representing buyers and sellers of portfolios of distressed debt suggests that potential participants would be wise to watch how the FDIC addresses several key issues, because these issues will have a direct and substantial impact on the risks potential bidders will be asked to assume and thus the way potential bidders will price the assets. These issues include:

REPRESENTATIONS AND WARRANTIES

While the asset sales offered by the Resolution Trust Corporation in the early '90s came with fairly reasonable representations and warranties in the sale agreements, which allowed bidders to assume certain key matters affecting the assets that would otherwise have been difficult or impossible to ascertain through due diligence (such as the enforceability of the loan documents, the presence or absence of funding obligations, etc.), the FDIC has

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so far taken a very conservative and (in our view) unreasonable position. In fact, very little protection is provided to buyers in the more recent asset sales offered by the FDIC (as receiver for various failed financial institutions, through DebtX and First Financial Network), and contractual conditions precedent render largely illusory those few protections that are afforded.

The absence of reasonable representations and warranties is of critical importance because potential buyers will need to satisfy themselves by other means (i.e., due diligence) with respect to issues that are not "protected" in the loan sale agreement, or simply decide to accept the risk and reflect it in their bid. Even this approach is problematic, as many of the issues (e.g., the absence of defenses, counterclaims, or offsets on the part of the borrower) would be expensive, if not impossible, to diligence, and the risk presented is not always readily ascertainable or quantifiable.

It remains to be seen whether the federal government will encourage a different approach on the part of private sellers participating in PPIP. Will the FDIC insist upon a standardized sale agreement form with limited representations, or permit individual sellers to negotiate these types of provisions? Will the FDIC encourage reasonable, market-standard representations, or force private sellers to adopt the approach currently maintained by the FDIC? If the latter approach is taken, due diligence investigations and downward pricing adjustments may be the only mechanisms available to mitigate risk.

Complicating the process even further is uncertainty about how the FDIC will manage pool sales where multiple sellers are involved. Prospective purchasers should consider how much, if any, discretion will be given to individual sellers to manage the sales process, such as qualifying potential bidders, managing due diligence materials, drafting loan sale agreements, and setting closing deadlines. Moreover, prospective purchasers should also consider how risk under the purchase and sale agreement (or agreements) is allocated among the sellers and what implication that may have on the exercise of rights and remedies by the buyer.

WHO IS ON THE TEAM?

Many potential buyers that lack expertise in buying and managing distressed real estate assets will likely be turning to strategic alliances with seasoned real estate professionals to "vertically integrate" the due diligence process and prepare for eventual ownership. For example, buyers of commercial real estate debt need valuation expertise and underwriting skills as part of the acquisition process, as well as legal expertise to handle such tasks as loan document review, title review, environmental review, and bankruptcy risk assessment. Once the portfolio is purchased, a completely new skill set is required, namely, people who can service the debt, manage workouts and bankruptcies, and otherwise implement exit strategies such as discounted payoffs or REO asset sales.

For buyers of residential debt, valuation expertise on the front end is critical, but servicing capability is less critical, since most sellers have the capability (and often the desire) to continue servicing these assets. If fact, we anticipate that many pools in the PPIP program could be sold on a "servicing retained" basis (i.e., seller retains the servicing rights), which would eliminate the need for the buyer to maintain a conventional servicing platform, but would still require that the buyer employ personnel to oversee the servicing process and make key decisions. In contrast, servicing capability is critical for buyers of commercial debt. In any event, selection of an experienced operating partner may well be the key element in how well the portfolio ultimately performs.

TRAILING LIABILITIES

Even with an experienced team in place, the very nature of a government-sponsored sale process carries with it significant potential ongoing legal risks. These risks could result in liabilities in excess of the mere loss of the buyer's investment, and therefore must be carefully considered. For example, unlike with private sales, the FDIC contracts we've reviewed give the buyer no protection against lender liability claims. In other words, the buyer takes subject to the misdeeds of the originating lender (as well as the FDIC in its capacity as an interim receiver, if applicable), which could result in potential borrower claims over issues such as ongoing funding obligations, commitments to modify the loan terms, and even potential environmental liability arising out of lender control over remediation decisions.

A second area of potential ongoing liability is title risk. The due diligence materials often include the original lender's title policy, but no recent title update has been done. It is up to the buyer to obtain a new title report and look for any new matters that could potentially impair its lien. For example, mechanic's liens can potentially gain priority over a deed of trust as well as delinquent property taxes. Certain title matters may be covered by the originating lender's title policy, but further legal due diligence must be done to properly assess that risk.

Other areas of risk, such as undisclosed and ongoing funding obligations, are not adequately mitigated by the FDIC in the recent transactions we have been involved with. Even if these trailing liabilities are addressed in a sale agreement through seller indemnities, one must question the continuing viability of the seller to even perform under such indemnities, and the same reasoning would equally apply to representations and warranties.

The PPIP program may very well attract a large number of interested buyers, but the ultimate returns generated by the assets they acquire will not only be a function of price but also the buyers' ability to assess and manage risk.

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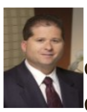
Adam Salis Mr. Salis' practice focuses on real estate, commercial leasing, acquisitions, sales, financing, development and new company formation.


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