

LEGACY LOANS PROGRAM UPDATE

On March 26, 2009, officials from the Treasury and the FDIC provided further guidance and information regarding details of the contemplated Legacy Loans Program, which is a portion of the government's new Public-Private Investment Program. As noted in our previous Client Alert containing a summary description of the Legacy Loans Program, this program is still subject to notice and comment rulemaking. As part of this process, the FDIC and the Treasury are soliciting input from the banking, business and real estate investment communities.

The latest guidance and information from the Treasury and the FDIC include the following:

1. Reserve Price and Disclosure

Comments are currently being solicited regarding whether bank sellers will be permitted to establish a reserve price and whether, if established, such reserve price will be required to be disclosed to pool bidders.

2. Auction Manager

The FDIC will select a financial advisor for each auction to oversee the process. The role will include, among other things, advising on the pool asset mix and FDIC guaranteed note terms.

3. Note Terms and Pool Asset Mix

The maturity date, interest rate, payment schedule and other economic terms of the notes to be issued to the seller banks and guaranteed by the FDIC will be determined by the FDIC and the Treasury for each separate asset pool. Such determination for each such pool will be made in consultation with the financial advisor and the third party asset evaluator to be retained by the FDIC for such pool. Factors to be taken into consideration include the quality of the pool assets, the cash flow projected to be generated by the pool assets, and the mix of cash-flowing and non-cash flowing, and performing and non-performing, assets in the pool. In conjunction with the foregoing, when formulating asset pools, consideration will be given to creating an appropriate mix of assets to support note debt service. In addition to current pay notes, note terms may potentially contain pay and accrual features or participation features. Included in the due diligence and bid materials for each pool transaction will be the terms of the financing and the maximum amount thereof (in absolute terms, and/or relative to the purchase price). Comments are being taken by the FDIC and the Treasury on the foregoing aspects of the program.

4. Bidder Qualification

Each bidder's qualifications will be reviewed for each new pool transaction, and prior successful qualification for another FDIC pool will not pre-qualify a bidder for a subsequent pool bid.

5. Auction Format

Comments are presently being solicited for what form of auction will produce a fair price for sellers. Should it be a sealed bid? Dutch auction? English outcry?

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6. Eligible Banks

The Legacy Loans Program allows only open institutions to participate as sellers. Institutions under FDIC receivership will be treated separately.

7. Program Costs; Special Assessment

The costs incurred by the FDIC and the Treasury relating to a pool sale will be deducted from gross sales proceeds payable to the selling bank. The special assessment being imposed upon banks generally for the Legacy Loans Program will be charged to banks whether or not they elect to sell assets through the Legacy Loans Program.

8. Due Diligence Period; Representations and Warranties

Comments are being taken as regards whether a “second” due diligence period will be afforded to a winning bidder after submission of its winning bid but prior to closing. Being considered is whether to allow an asset to be kicked out of the asset pool pre-closing due to a breach of agreed-upon representations and warranties. The FDIC and the Treasury presently expect that there will be a single due diligence period prior to the bid submission date. Weighing in favor of a second due diligence period is the fact that it is often cost-prohibitive for a bidder to conduct thorough due diligence pre-bid, particularly in light of the fact that pool due diligence data rooms often contain limited, incomplete and dated information. The combination of inadequate information, large numbers of assets, an abbreviated due diligence period and scores of competing bidders introduces a significant element of risk and uncertainty to such pool bids.

The totality of these circumstances encourages bidders to under-price their bids to account for such risk and uncertainty, and a second due diligence period may result in better pricing and execution. Indeed, the program would likely produce higher pricing if the FDIC were to take the top few bidders and allow them to conduct further diligence (against representations and warranties or otherwise) pre-closing, with an opportunity to increase, but not decrease, their bids post-bid but pre-closing in a “once-and-final” second bid round.

Interestingly, each seller bank will have flexibility to determine what representations and warranties it wishes to provide with respect to a pool sale. There is not expected to be uniformity among different sellers.

9. Asset Types

No asset types have been excluded from the program as yet. The FDIC is still analyzing how to deal with unfunded liabilities under construction and other loans that have a future funding component. Assets that do not produce cash flow in the near term, such as land and construction loans, will not be excluded, but the lack of cash flow will be taken into account in selecting the mix of assets to be offered in a pool, as referenced above. The FDIC and the Treasury have indicated that the initial pool offerings will come from large banks and focus first on pools of home loan mortgages. Thereafter, commercial real estate and multi-family loans will be offered, followed by “C&I” (commercial & industrial) loans. In “Round I” of the Legacy Loans Program offerings, each pool will have a single selling bank. In “Round II”, there may be multiple banks included as sellers in a single offered pool.

10. Data Room

The data room will appear in a physical “war room” and/or be posted electronically.

11. Post-Pool Acquisition Asset Servicing, and Restructuring Requirements and Restrictions

As to the general scope of servicing, for those pool assets acquired by a public-private investment fund (“PPIF”) consisting of home mortgage loans, there will be a requirement that the loan servicer comply with the federal program requirements recently adopted for the restructuring and modification of home loans. Additionally, with respect to a range of asset types, there may be additional requirements and limitations imposed on the servicing of assets purchased by a PPIF. Comments are currently being solicited in this regard.

As to who will service, following the sale, the seller bank will initially provide asset servicing or subservicing. However, the pool assets will be sold on a “servicing released basis”, which is very important to asset buyers. “Control rights” over asset servicing will be held by the PPIF equity investor. As among the participants in the equity investment (the private equity investor and the Treasury), the rights of each equity investor will be established by contract. The level of delegated decisional authority afforded to the “general manager” of the PPIF will be specified. Such general manager will be granted the discretion as to when to transfer the asset servicing away from the selling bank. Such contract terms and conditions will be included in the due diligence materials made available with respect to the specific asset pool.

We note that the decision to sell assets on a “servicing released basis” is directly responsive to the concern we raised in our initial Client Alert; namely, that some buyers would be unwilling to participate in the Legacy Loans Program if the selling bank, with perhaps multiple relationships with borrowers (and an agenda different than the buyers), retained servicing rights.

12. Seller Participation

Although key program details were just announced this week, some banks have already expressed interest in participating as sellers. Under consideration by the FDIC and the Treasury is what “sweeteners” or incentives will be offered to banks to spur participation if the preponderance of banks are hesitant to sell, whether due to reluctance to incur losses generally, to sell into a depressed market, or due to low prices in the event that bids continue to be below the banks’ expectations, notwithstanding the FDIC debt guaranties under this program.

Banks that participate in the program will not be penalized from an accounting standpoint for participating in the program in that the existing accounting methodology and treatment of “assets held for investments” (as distinguished from “assets held for sale”) remain unmodified by the Legacy Loans Program. ➤

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