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Enlisting Private Equity to Rescue "Legacy Assets": Treasury Announces Public-Private Investment Funds Structures

Introduction

The Department of the Treasury has unveiled more details about a set of programs intended to remove troubled assets from financial institutions. In October 2008, Congress enacted the Emergency Economic Stabilization Act ("EESA"), which was premised on pursuing this objective. As we suggested at the time, the plan appeared to face two significant hurdles. First, direct negotiated purchases by the government ran the risk of claims of favoritism and assertions that the government had overpaid for troubled assets. Second, auctions of troubled assets ran the risk of triggering large asset write-downs across the financial services industry. *See* *Emergency Economic Stabilization Act Offers Opportunities for Sellers, Contractors and Purchasers*, 21st Century Money, Banking & Commerce Alert® (Oct. 6, 2008). Shortly after EESA was enacted, the Treasury abandoned this strategy and initiated the Capital Purchase Program, under which it has purchased approximately $200 billion in preferred stock of financial institutions.

The Administration has now decided to move forward with its financial institution stabilization plan on two additional fronts. The first is a new round of stock purchases through the Capital Assistance Program, under which the Treasury will purchase mandatorily convertible preferred stock issued by financial institutions. *See* *Reading Between the Lines of the Financial Stability Plan, Part II*, 21st Century Money, Banking & Commerce Alert® (Mar. 6, 2009).

The second, which was announced on March 23, 2009, uses government funds to prime the investment pump to facilitate the transfer of troubled assets from the balance sheets of financial institutions. It attempts to rely on competitive bidding by private sector parties to cut the Gordian Knot of determining the values for these assets by using what are referred to as Public-Private Investment Funds ("PPIFs") to purchase them. There is, however, a very substantial, although not yet fully defined, role to be played by the government in the selection and management of PPIFs.

There are significant issues that private equity investors will need to evaluate as the details of the PPIF program are released. They include:

1. The extent to which investors can trust that the terms of the arrangement with the government, once identified and negotiated, will not be retroactively modified if events change, or if Congress views some aspect of the program as unfair to taxpayers;

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2. The willingness of private investors to provide capital when management decisions and work-out plans are developed by, or subject to modification by, the government;

3. The resources of government agencies to administer these programs;

4. The authority of various branches of the government to take these actions (*e.g.,* setting up special purpose vehicles to facilitate transactions, providing the related financial assistance, *etc.*) when multi-billion dollar deals are being arranged and disappointed bidders and competitors may challenge them;

5. The extent to which private sector managers or investors are considered to be subject to executive compensation or other bailout-related restrictions or requirements;

6. The extent to which private sector managers or investors become government contractors covered by federal acquisition regulations or other government contract principles; and

7. The economic returns that are produced relative to the various risks and other financial factors, such as warrants to be issued to the Treasury in the transaction, and the extent to which current or future government loan modification programs will apply to the operation of a PPIF.

The highlights of the PPIF initiatives are set forth below.

FDIC Legacy Loans Program

The FDIC will use its considerable expertise to administer a program under which it will oversee the establishment, funding and operation of PPIFs for the purpose of purchasing troubled "legacy loans" from insured depository institutions. The initial outline of the program includes the following:

- The equity will be targeted to be provided 50/50 by private investors and the Treasury, but other structures may be considered. The Treasury, however, will not have control rights. Private investors and the Treasury will share profits and losses proportionally. The Treasury also will receive warrants in each PPIF in an amount to be determined.

- Private investor groups must be approved by the FDIC. Asset managers for the PPIFs must work within parameters set by the Treasury and the FDIC. It is not clear how asset managers will be selected.

- The FDIC, with the assistance of a third-party valuation firm, will oversee the process by which (i) banks and thrifts are selected, (ii) eligible pools of assets are identified, (iii) initial due diligence is performed, (iv) asset pools are marketed, and (v) financing terms are established. There are no specific parameters yet established for the types of assets that will be eligible to be included in this program. Asset pools will be offered at auctions conducted by the FDIC. A participating institution will have the option whether to accept the winning bid.

- The FDIC will set the amount of financing it will provide for each class of assets it auctions, up to an anticipated maximum debt-to-equity ratio of 6-to-1. A PPIF will pay for purchased assets with cash, or cash and debt issued by the PPIF. Such debt will be guaranteed by the FDIC, for which the PPIF will pay a fee. The FDIC's guarantee will be collateralized by the assets purchased by the PPIF and will be treated as senior debt of the PPIF. The selling institution will be permitted to transfer the FDIC-guaranteed debt of the PPIF to third parties. It appears that the debt issued by the PPIF will be non-recourse.

- Although it appears that the Treasury will treat a PPIF as a financial institution from which it is purchasing assets for purposes of requiring the PPIF to issue warrants, the initial information released on the program indicates that executive compensation restrictions will not apply to "passive private investors" in PPIFs. There is no guidance on when an investor in a PPIF would or would not be considered to be passive.

It is important to note that the final requirements and structure of this program will be subject to public notice and comment rulemaking by the FDIC.

Treasury Legacy Securities Program

The Treasury will also provide matching capital to PPIFs for the purpose of purchasing troubled "legacy securities," consisting of securitized loans, from a large variety of financial institutions in addition to banks and thrifts, such as insurance companies, pension funds, and mutual funds. Eligible legacy securities will initially be residential mortgage-backed securities ("MBS") and commercial MBS that were issued prior to 2009 and originally AAA-rated without any ratings enhancement. The Treasury's initial outline includes the following:

- In contrast to the FDIC program, this program will be based on the selection of a limited number of fund managers by the Treasury.

- The application deadline for parties wishing to be selected as fund managers is April 10, 2009, with selections expected to be made by May 1, 2009. The selection criteria include having similar securities with a market value of at least $10 billion currently under management and the demonstrated ability to raise at least $500 million for a PPIF. Smaller parties may join together or join with larger applicants to meet these criteria.

- PPIFs will predominantly follow a long-term buy and hold strategy, but the Treasury will consider proposals from fund managers that involve limited trading. A PPIF would not generally have a term beyond 10 years.

- The equity for a PPIF will be provided 50/50 by private investors and the Treasury. The Treasury also will offer non-recourse debt financing, generally up to 50% of the total equity capital, but in some cases up to 100%. Certain types of private debt financing may also be permissible.

- Subject to restrictions established by the Treasury, fund managers will control the selection, pricing, and disposition of assets. Private investors and the Treasury will share profits and losses proportionally. The Treasury also will receive warrants in the PPIF in an amount to be determined.

- The initial information released on the program indicates that executive compensation restrictions will not apply to passive private investors.

TALF Program Expansion

The Treasury and the Federal Reserve also announced an expansion of the Temporary Asset-Backed Securities Loan Facility ("TALF"), under which the Federal Reserve Bank of New York makes non-recourse loans to eligible investors to fund purchases of eligible asset-backed securities ("ABS"). As part of the program to encourage private investors to purchase legacy securities, the classes of eligible assets under TALF are to be expanded to include non-agency residential MBS that were originally AAA-rated and

commercial MBS and ABS that are currently AAA-rated. Interest rates, haircuts, minimum loan size, and loan duration for TALF loans to purchase legacy securities have not been announced.

- The categories of eligible securities are not identical under TALF and the Treasury program. However, where those categories may coincide, such as with regard to certain non-agency residential MBS, a PPIF receiving Treasury funding may also obtain TALF loans.

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