

# LOWENSTEIN SANDLER PC CLIENT ALERT

## GLOBAL FINANCIAL CRISIS

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### PUBLIC-PRIVATE INVESTMENT PROGRAM

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Today, the United States Department of the Treasury ("**Treasury**") announced the details of its long-awaited Public-Private Investment Program (the "**Program**"). The Program is designed to complement Treasury's existing Term Asset-Backed Loan Facility ("**TALF**") by providing loans to qualifying investment funds to enable them to purchase eligible loans and securities created prior to January 1, 2009. The Program consists of two key elements: a Legacy Loans Program (the "**Loan Program**"), which combines Federal Deposit Insurance Corporation ("**FDIC**") guaranteed debt financing with private and Treasury equity capital to support the purchase of troubled loans from insured depository institutions, and a Legacy Securities Program (the "**Securities Program**"), which combines financing from the Federal Reserve System and Treasury through an expanded TALF program with private and Treasury equity capital to purchase eligible real estate-related securities. The Program will be executed through the establishment of "Legacy Public-Private Investment Funds"

(each, a "**Fund**") which will be capitalized with a combination of private equity capital and equity capital provided by Treasury.

Today's announcement does not indicate the exact amount that Treasury intends to invest through the Program. However, the announcement does indicate that the combination of private equity capital and equity capital provided by the Treasury will generate between \$500 billion and \$1 trillion in purchasing power for legacy assets.

#### Loan Program

Under the terms of the Loan Program, the FDIC will oversee the establishment of Funds that will purchase pools of eligible assets primarily through an FDIC-sponsored auction process. The assets will consist of loans and other assets from insured depository institutions under criteria to be established by the FDIC. Private investors will bid for equity stakes in each Fund established by the FDIC and will be required to make a refundable deposit of 5% of the bid value at the time of the bid. Each Fund will be capitalized with equity provided by private investors (the amount of which will be determined through the bidding process) and the Treasury

(initially expected to be provided on a 50-50 basis) and will issue non-recourse debt guaranteed by the FDIC up to a 6-to-1 debt to equity ratio. Proposed financing terms and leverage ratios for each Fund will be established by the FDIC with assistance from third party valuation firms and disclosed to potential investors as part of the auction process. The FDIC will charge a fee for its guarantee, which will be secured by the eligible assets purchased by the Fund. Participating depository institutions will have the right to accept or reject a winning bid and, if accepted, will receive either all cash or a combination of cash and FDIC guaranteed debt for the assets sold. The institution will have the right to resell any debt it receives in connection with the sale of an eligible asset pool.

Treasury's equity investment in each Fund will be counted against the Treasury's \$700 billion cap under the Emergency Economic Stabilization Act ("**EESA**"). As required under the EESA, Treasury will receive warrants in each Fund in connection with its investment. The amount and terms of the warrants have not yet been specified. The

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announcement indicates that Treasury will consider alternatives to a direct investment that do not diminish its ability to participate in profits and losses on a pro rata basis and do not otherwise alter the structure of the Loan Program.

Potential private investors will be pre-qualified by the FDIC to participate in an eligible asset pool auction. Today's announcement of the Loan Program does not indicate what criteria the FDIC will use to pre-qualify interested investors. However, the announcement indicates that investors are expected to include financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, pension funds, foreign investors with U.S. headquarters, private equity funds and hedge funds. Importantly, "passive" private investors who participate in the Loan Program will not be subject to restrictions on employee compensation. Again, today's announcement does not indicate what criteria will be used to determine whether an investor is "passive."

Funds will be established by the FDIC and will be managed within parameters to be established by the FDIC and Treasury. Investors will be subject to restrictions on purchases of assets from affiliated institutions and certain other restrictions to be specified. However, Treasury will not have control rights over the Funds.

The specific requirements and structure of the Loan Program will be subject to FDIC rulemaking after notice and opportunity for public comment.

The Loan Program assumes that, with the government funding, private investors will be willing to purchase distressed assets at prices that will be acceptable to participating depository

institutions. However, given the disruptions in the existing system, it is unclear whether market-clearing transactions will occur even with significant government support and sponsorship.

#### **Securities Program**

Pursuant to the Securities Program, Treasury expects to approve approximately five private Fund managers, each of whom will be required to raise at least \$500 million in committed equity capital shortly following Treasury approval. That amount will be matched by the Treasury on terms described more fully below. Although Treasury anticipates approving only five Fund managers, the Treasury announcement indicates that the number of managers may be increased depending on the level of applications received.

Under the Securities Program, Treasury and a private investment vehicle controlled by the applicable manager will each invest in a Fund that will invest in legacy securities that will initially include securities backed by mortgages on residential and commercial properties. The securities will initially be commercial mortgage backed securities and residential mortgage securities issued prior to 2009 that were originally rated AAA or the equivalent by two or more nationally recognized statistical rating organizations without ratings enhancement and that are secured directly by the actual mortgage loans, leases or other assets approved by Treasury located predominantly in the U.S. The eligible assets will be purchased from financial institutions from which Treasury is authorized to purchase assets under EESA.

The objective of each Fund will be to

generate attractive terms through long-term opportunistic investments. To achieve this objective, each Fund will follow predominantly a long-term buy-and-hold strategy; however, Treasury will consider other strategies involving limited trading. Each Fund is expected to have a life span of 10 years or less, subject to extension with Treasury consent.

Private asset managers headquartered in the United States can apply to the Treasury to pre-qualify to serve as a Fund manager. Pre-qualification applications must be submitted to the Treasury no later than 5:00 p.m. on April 10, 2009. Treasury expects to inform managers of preliminary approval on or prior to May 1, 2009. Managers wishing to manage a Fund will be required to meet the following criteria:

- Capacity to raise at least \$500 million of private capital
- Experience investing in eligible assets
- Minimum of \$10 billion in market value of eligible assets currently under management
- Operational capacity to manage a Fund

Fund managers will control the process of asset selection and pricing, as well as asset liquidation, trading and disposition of assets. Fund managers may not purchase assets from affiliated sellers or from any investor providing 10% or more of the Fund's private equity capital. Managers will be required to agree to certain other restrictions to be specified.

Fund managers will be entitled to charge private investors fees as determined by the manager. For Treasury equity capital, the Treasury will accept proposals for fixed management fees to apply as a percentage of equity

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capital contributions for invested equity capital. Such fees would be paid solely out of distributions made in respect of Treasury equity capital. Subject to certain conditions, private investors may be given voluntary withdrawal rights from the private investment vehicle but no private investor may voluntarily withdraw prior to the third anniversary of the first investment by the private vehicle. It is expected that the private investment vehicles will be structured so as to permit ERISA benefit plan investors to participate.

Treasury equity capital will be drawn down in tranches to provide for anticipated investments and, unless otherwise agreed, will be drawn down at the same time and in the same proportion as the private capital. Proceeds of asset sales will be divided between the Treasury and the private investment vehicle on a *pro rata* basis. However, as required by EESA, Treasury will also receive warrants on such terms and in such amounts as will be determined in part based on the amount of any Treasury debt financing provided to the Fund. Treasury will request suggestions on structure from potential Fund managers, including with respect

to possible recycling of realized capital.

Fund managers will have the option to obtain secured non-recourse debt from Treasury in an aggregate amount of up to 50% of a Fund's total equity capital and Treasury will consider requests for additional debt financing of up to 100% of equity capital subject to certain leverage and other restrictions. The other terms of any Treasury debt financing will be subject to negotiation between the Fund managers and the Treasury. Funds may also finance the purchase of eligible assets through the TALF program, which is being significantly expanded to cover purchases of assets created prior to January 1, 2009 as well as newly created asset backed securities.

It is worth noting that the Treasury announcement does not state whether restrictions on employee compensation will apply to Fund managers. However, given the proposed structure of the Funds and the fee structures described above, we believe that those restrictions will not be applicable to employees of such Fund managers, although clarification on that point would certainly be welcome in light of recent concerns about potential ex post facto

changes in the terms and conditions of similar government programs.

The Treasury announcement does not indicate how eligible assets will be identified and purchased under the Securities Program. Nor does the Securities Program provide any incentive for sellers to sell eligible assets.

Accordingly, it is unclear whether the Securities Program will actually achieve its goal of increasing liquidity by allowing financial institutions to rid their balance sheets of distressed assets. However, to the extent that the lack of liquidity is due to a dearth of willing buyers, the Securities Program should help to ameliorate current conditions in the secondary market for real estate-backed securities.

As noted above, many of the terms and conditions of the Program have yet to be determined and, in certain instances, will be subject to public notice and an opportunity for comment. As a result, it is not likely that either the Loan Program or the Securities Program will become operational for several months. In the meantime, we will endeavor to keep interested parties informed of material developments in this area.

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