DechertOnPoint

August 2009 / Issue 24

A legal update from Dechert's Finance and Real Estate Group

Purchasing Assets of Failed Financial Institutions from the FDIC

During 2009, more than 80 depository institutions have failed, presenting an investment opportunity each time the Federal Deposit Insurance Corporation (the "FDIC") steps in to act as a receiver. In fulfilling its mandate to maintain the stability of the nation's financial system, the FDIC works to limit the effect a bank or thrift institution's failure has on the economy and the U.S. financial system, often by exercising its power to act as a receiver or a conservator[1] for failed depository institutions. As a receiver, the FDIC is able to sell the assets of the failed institution.[2] While the FDIC recently announced[3] that it is postponing the commencement of the Legacy Loans Program and recently issued[4] a final policy statement with regard to bidder eligibility standards for the acquisition of deposit liabilities and assets of failed depository institutions, the FDIC has made it clear that it intends to move forward with sales of receivership assets this month with a public-private partnership funding mechanism developed from concepts employed by the Resolution Trust Corporation of the 1990s as well as more recent structured loan sales transactions.[5] This *DechertOnPoint* will (i) review the key terms of the current FDIC direct loan, real estate, and structured sales programs and provide a "how-to guide" for clients interested in purchasing assets available through such programs, and (ii) describe the test funding mechanism that the FDIC launched this month.

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1 The FDIC's responsibilities as a receiver or a conservator are defined by the Federal Deposit Insurance Act of 1950 (the "FDI Act"). Under the FDI Act, the FDIC serves (i) as a receiver in order to liquidate or wind up the affairs of a failed depository institution while giving regard to the conditions of credit in the applicable locality; or (ii) as a conservator to "preserve and conserve the assets and property of a [failed depository] institution" and return such institution to "sound and solvent condition." 12 U.S.C. § 1821 (2008). Depository institutions include any bank, savings bank, mutual savings bank, credit union, Federal Home Loan Bank member, and savings association, provided that each such entity is insured or eligible to become insured. 12 U.S.C. § 1841(n) (2006).

2 "The FDIC must be [and commonly is] appointed as receiver for insured federal savings associations and national banks." For state chartered and Federal Reserve member banks, the chartering authority has the option of appointing the FDIC as a receiver, although rarely is another entity appointed. In certain instances, the FDIC may appoint itself as receiver. FDIC, FDIC Resolution Handbook, at 85, available at http://www.fdic.gov/bank/historical/history/index.html.

3 The Legacy Loans Program is a joint program with the Treasury and the Federal Reserve intended to remove real estate related assets from bank balance sheets through the use of public-private investment funds. FDIC Statement on the Status of the Legacy Loans Program, June 3, 2009, available at http://www.fdic.gov/news/news/press/2009/pr09084.html; see also *DechertOnPoint*, An Analysis of the Department of Treasury's Public-Private Investment Program, Apr. 2009, available at http://www.dechert.com/library/Finance_and_Real_Estate_04-09_17_An_Analysis_of_the_Department_of_Treasury.pdf.

4 FDIC Final Statement of Policy on Qualifications for Failed Bank Acquisitions, August 26, 2009, available at http://www.fdic.gov/news/board/Aug26no2.pdf.

5 See FDIC Statement on the Status of the Legacy Loans Program, *supra* n.3; See also Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, and Chairman of the Federal Deposit Insurance Corporation Sheila Bair, July 8, 2009, available at http://www.fdic.gov/news/news/press/2009/pr09121.html.

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Asset Sales Overview

Loans that the FDIC obtains from failed financial institutions are generally aggregated into pools by certain characteristics such as loan size, quality, type, collateral, and location, and usually include performing and non-performing loan products.[6] These pools are then sold by the FDIC through an agent to investors through a sealed bid sale or an English outcry auction[7] at a direct sale. The FDIC also has a program to auction real estate assets and has utilized a structured sales framework to sell receivership assets.

Direct Loan Sales Program

Direct loan sales are primarily marketed through the websites of the advisors appointed by the FDIC—First Financial Network, Debt-X, The Debt Exchange, Mission Capital Advisors, Eastdil Secured, and Garnet Capital Advisors.[8] The steps in a typical direct loan sale transaction are as follows:

- **Step One (Registration)**: A prospective bidder registers with an FDIC direct loan sale advisor by completing a brief identification questionnaire on the advisor's website. Once the questionnaire is complete, a confirmation email is sent to validate the registration email address and then the bidder's user name and password is emailed. Once registered, a prospective bidder will be able to access information on the prequalification process, receive information regarding loan sales, and participate in the bidding process.[9] It should be noted that the FDIC recently released a Final Statement of Policy on Qualifications for Failed Bank Acquisitions.[10] This policy statement provides that certain bidders[11] that are also acquiring the deposit liabilities of a financial institution would be subject to several additional qualification requirements[12] prior to becoming eligible bidders for any FDIC asset sale.

- **Step Two (Qualification)**: Once registered, a prospective bidder may access documents that must be submitted for qualification through the advisor's website. The prospective bidder will submit (i) an executed confidentiality agreement covering information disclosed during due diligence of a loan pool for sale[13] and (ii) a pur-

6 Loan Sales FAQs, available at http://www.fdic.gov/buying/loan/loan/index.html.

7 In a Sealed Bid Sale, all bidders simultaneously submit sealed bids so that no bidder knows the bid of any other participant and the highest bidder pays the price they submitted; while in an English outcry auction participants bid openly against one another, with each subsequent bid higher than the previous bid.

8 First Financial Network, www.firstfinancialnet.com; DebtX, The Debt Exchange, www.debtx.com; Mission Capital Advisors, www.missioncap.com; Eastdil Secured, www.eastdilsecured.com; Garnet Capital Advisors, www.garnetcapital.com.

9 See *id*. A general announcement of an FDIC loan sale will appear on the website of the loan sale advisor responsible for that particular sale.

10 *Supra* n.4.

11 The policy statement applies to private investors in a company that is proposing to acquire the liabilities and assets of failed depository institutions and does not apply to (i) investors in partnerships or similar ventures (excluding shell companies) where the holding company has a strong majority interest in the resulting bank or thrift; (ii) investors with 5% or less of the total voting power of an acquired failed insured depository institution or its bank or thrift holding company provided that there is no evidence of concerted action by these investors; and (iii) an investor in a bank, a thrift or a bank or thrift holding company that has an ownership structure that is consistent with the objectives of the statement of policy and has maintained a composite camels 1 or 2 rating for at least 7 years. *Id*. at 36.

12 Specifically, these investors must (i) cause the resulting depository institution to be well capitalized (i.e., maintain a Tier 1 common equity to total assets ratio of at least 10% for the first 3 years and remain well capitalized afterward); (ii) pledge the stock of commonly owned banks or thrifts if one or more investors own 80% or more of 2 or more banks or thrifts; (iii) not extend credit by an insured depository institution acquired by the investors to any investor or its investment fund or any affiliates of either; (iv) be domiciled outside of a bank secrecy jurisdiction, unless the subsidiaries of the company are subject to consolidated comprehensive supervision as recognized by the Federal Reserve Bank and the company executes agreements on the provision of information to primary regulators about the non-domestic operations and activities; (v) not sell any interest acquired for a period of at least 3 years, absent FDIC approval; (vi) not hold any more than 10% or more of the equity of a bank or thrift in receivership; and (vii) be prepared to submit additional information to the FDIC about the investors and all entities of ownership, such as size of a capital fund(s), its diversification, the return profile, the marketing documents, the management team and the business model. *Id*. at 37-39.

13 Confidentiality Agreement, available at http://www.fdic.gov/buying/loan/confidentiality/confidentiality.pdf. A prospective bidder's submission of the executed confidentiality agreement, without modification, is a pre-condition to it being able to access diligence materials. *Id*.

chaser eligibility certification,[14] which is used to identify prospective bidders who are not eligible to purchase assets of failed financial institutions, such as FDIC employees or officers or directors of failed institutions. A prospective bidder typically is approved as a qualified bidder in approximately 48 hours. The approval period may last longer if additional references are requested. Approval notification is delivered to the email entered during the registration process.

- **Step Three (Diligence)**: Once approved, the qualified bidder will be permitted to (i) view instructions for accessing information for assessing whether loan pools are a worthwhile investment[15] and (ii) bid on available loan pools any time after the auction is opened through the advisor's website, in accordance with the bid instructions associated with each sale. The bid instructions are available online in the storeroom and access to the bid room is permitted once all requirements in the bid instructions for a particular sale are met.

- **Step Four (Bidding Process):** When making a bid, the qualified bidder must pay an Initial Deposit (defined in the bid instructions associated with each loan pool sale), which must be received by wire transfer the business day prior to the bid deadline. Only one Initial Deposit is required from each bidder regardless of the number of bids submitted.[16] In addition, the qualified bidder must complete and execute a bid form.[17]

- **Step Five (Notification of Winning Bid and Final Deposit):** Upon notification that a bidder is the winning bidder,[18] the bidder must submit a Final Deposit via wire transfer within one business day of the bid award. The Final Deposit equals 10% of the sum of all bid amounts for loan pools and loan pool combinations awarded to the winning bidder less the amount of the bidder's Initial Deposit.

- **Step Six (Closing):** Successful bidders will receive an executed Bill of Sale, Assignment and Assumption Agreement, and Loan Sale Agreement at closing, which typically occurs within 20 business days after the bid has been awarded. The closing documents are executed upon receipt by the FDIC of the balance of the purchase price due from the purchaser.[19] The remaining pertinent loan documentation, such as the notes, collateral documents, and loan files, is delivered to the successful bidder within a reasonable time after closing. The FDIC does not guarantee or make any representations or warranties in connection with any of the loans in a direct sale. A buyer's remedies or recourse, if any, are addressed in the sale documentation.

Real Estate Sales Program

The FDIC also has a program for the sale of real estate assets it has obtained as the receiver for failed financial institutions. Information regarding FDIC-owned real estate assets available for sale can be found through the FDIC website and the websites of its primary real estate advisors, CB Richard Ellis Inc. and Prescient Asset Management.[20] Interested purchasers can obtain additional information about a particular property in a given sale from the contact person assigned to that property as indicated on the website of the primary real estate advisor assigned to that property. The contact person is either a representative from a FDIC office, or an individual associated with the sales initiative (e.g., an auction company or a real estate broker), who is responsible for the sale of the property. All properties are sold on an "as is" basis and without any guarantee,

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14 Purchaser Eligibility Certification, available at http://www.fdic.gov/buying/loan/purchaser/purchaser.pdf.

15 While information for each loan pool varies, the FDIC has previously provided electronic copies of all available loan documentation, including credit files and servicing records. *Supra* n.6.

16 In past sales, bidders have been permitted to bid multiple times. *Id.*

17 See Failed Financial Institution Bid Documents, available at http://www.fdic.gov/about/freedom/biddocs.html.

18 Note that the winning bidder is not necessarily the highest bidder, but rather is the bidder the FDIC and the loan sale advisor determine is the winning bidder. See CNBC Interview with Bliss Morris, CEO of First Financial Network, June 19, 2009, available at http://www.firstfinancialnet.com.

19 Closing occurs either by mail or is conducted in person at a place designated by the seller, at the seller's option. *Supra* n.6.

20 FDIC Real Estate For Sale, available at http://www2.fdic.gov/drrore/; CB Richard Ellis Inc., http://orelistings.cbre.com/; Prescient Asset Management, http://www.fdiclistings.com/.

representations, or warranties from the FDIC. The steps in a typical real estate sale transaction are as follows:[21]

- **Step One (Registration):** All prospective purchasers must complete a confidentiality agreement and a purchaser eligibility certification (similar to those documents described in the direct loan sales section above) as well as a resume and Term and Conditions Agreement. In addition, certain prospective purchasers that are also acquiring the deposit liabilities of a failed institution will have to meet the eligibility requirements outlined in the FDIC's Final Statement of Policy on Qualifications for Failed Bank Acquisitions described in the direct loan sales section above. The specific sale terms and conditions associated with each property offered for sale vary and can be obtained from the contact person for the property or by accessing the website of a primary real estate advisor. Following review of qualification information, an email will be sent alerting the prospective bidder that it has been certified and providing information on how to activate the username and password to access information regarding the real estate sale.

- **Step Two (Bidding Process)**: After certification is complete, prospective purchasers may obtain property information packages and bid on real estate assets available for sale in accordance with bid instructions through the websites of the primary real estate advisors. Bid instructions associated with each sale vary.[22] The FDIC updates its online listing of properties for sale by the close of business each Monday.[23]

- **Step Three (Bid Evaluation and Purchase Financing):** The FDIC evaluates the bids from prospective purchasers, using criteria such as net funds received after deducting brokerage commission and sale expenses, and payment terms in light of the applicant's credit worthiness and ability to perform. Seller financing may be available to qualified buyers on all commercial and land properties regardless of price, as well as on residential properties with a minimum purchase price of $500,000 or those sold as affordable housing. While reviewing offers, the FDIC reserves the right to continue its sales efforts, including responding to any inquires or offers to purchase the property. Furthermore, the FDIC reserves the right to accept, reject, or counter any submitted bid.

- **Step Four (Closing):** The timing of the closing and documentation associated with each real estate sale will vary according to the terms and conditions of the real property sale. Documentation involved in some real estate sales can be obtained from the FDIC's advisor's website.[24]

Structured Loan Sales Program

The FDIC has recently offered opportunities to purchase loan pools through a private placement structure, which may be instructive with respect to the FDIC's plans for the Legacy Loans Program, discussed further below. Since May 2008, the FDIC has held six structured sales of interests in loan pools totaling $209,809,666; the value of the interests sold equaled $1,011,592,190. The loan pools from which interests were sold had a total book value of $4,912,321,069 and consisted primarily of real estate or construction loans. The sales used public-private partnership structures where a private investor acquired the rights to certain future cash flows and assumed asset management and servicing obligations as sole membership interest holder in a newly formed limited liability company while the FDIC retained a participation interest in future cash flows.[25] The sales were marketed through two financial advisors appointed by the FDIC—GlassRatner and Keefe, Bruyette & Wood. The steps in a typical structured loan sale transaction are as follows:

- **Step One (Loan Contribution and Assignment):** The FDIC in its capacity as receiver (the "Receivership") contributes a pool of loans to a newly established limited liability company (the "LLC"), in exchange for the sole membership interest in the LLC.[26]

- **Step Two (Creation of the FDIC Participation Interest):** The LLC enters into a Participation and Servicing Agreement with the Receivership, in

21 See Real Estate Sales FAQs, available at http://www.fdic.gov/ buying/owned/real/index.html.

22 See e.g., Terms and Conditions - Bidder Instructions available at http://www.prescientore.com/forms/Terms_and_Conditions.pdf.

23 FDIC: Real Estate Sales, available at http://www.fdic.gov/buying/owned/index.html.

24 See e.g., Closing Documents for Download, available at http://www.prescientore.com/closing_docs.aspx.

25 FDIC: Structured Loan Sales, available at http://www.fdic.gov/buying/historical/structured/index.html.

26 FDIC Receivership Public/Private Partnership Transaction Fact Sheet, available at http://www.fdic.gov/buying/historical/structured/factsheet.html.

which the Receivership retains a participation interest in the future cash flows of the loan pool and servicing mechanics are described.[27]

- **Step Three (Servicing Arrangements):** The LLC enters into (i) a servicing agreement and (ii) a custodial agreement, each of which delegates responsibilities to a qualified servicer as required by the Participation and Servicing Agreement.

- **Step Four (Qualification):** Bidders are qualified using the same procedure used for direct sale qualification described above through the websites of the structured loan sales advisors. In addition, certain bidders interested in purchasing LLC membership interests must satisfy the eligibility requirements outlined in the FDIC's Final Statement of Policy on Failed Bank Acquisitions described in the direct loan sales section above, if applicable and must complete and submit a bidder qualification questionnaire, which establishes that the bidder is an accredited investor under federal securities laws and has the requisite (i) knowledge and experience in financial and business matters to assess the risks associated with the purchase of the membership interest and (ii) resources to acquire the membership interest.[28]

- **Step Five (Bidding Process):** Qualified bidders may bid on available loan pools by submitting an Earnest Money Deposit (as defined in the bid instructions associated with each loan pool sale) any time after the auction is opened and in past sales have been permitted to bid multiple times. Bids are solicited from qualified third-party bidders from the private sector for purchase of a 100% membership interest in the LLC from the Receivership, which entitles the bidder to the remaining future cash flows of the loans not retained by the Receivership as part of its participation interest.

- **Step Six (Closing):** At closing, the successful bidder (the "LLC Interest Holder") must (i) pay the balance of the purchase price; (ii) deliver an executed Limited Liability Company Interest Sale and Assignment Agreement, and (iii) deliver an executed guaranty of its and the LLC's obligations under each of the transaction documents entered in connection with the transaction from the entity that owns the majority interest in the LLC Interest Holder (or another guarantor that the FDIC deems to be acceptable).[29]

- **Step Seven (Management):** Once closing has occurred and the sale is complete, cash flows from loans are allocated between the Receivership (with respect to its retained participation interest) and the LLC Interest Holder, less the monthly management fee paid to the service providers and advances related to expenses, such as taxes, insurance, and property protection made by the servicer. Generally, once the Threshold[30] amount is reached, the participation interest of the Receivership is reduced by a certain percentage specific to the transaction, and the LLC Interest Holder's interest is increased by a corresponding percentage.

- **Step Eight (Winding Up the LLC):** The Receivership has the right to require the sale of all remaining LLC assets when the aggregate unpaid balance of the loans has been reduced to 10% of the balance at closing or upon the 7th anniversary of the effective date of the Participation and Servicing Agreement (or in the case of single-family residential loans, the 10th anniversary), whichever occurs first.

Legacy Loans Program

On June 3, the FDIC announced that it was postponing the pilot sale of assets by open banks under the Legacy Loan Program (the "LLP"). Instead, the FDIC and the Treasury tested a funding mechanism this month in a sale of receivership assets. The LLP is part of the Public-Private Investment Program announced in March by the Secretary of the Treasury, the Federal Reserve, and the FDIC, and was designed to help open banks remove troubled loans and other assets from their balance sheets in order to raise new capital and place themselves in a better position to provide lending to further the recovery of the U.S. economy. The LLP funding mechanism is based on the FDIC's prior experience with the Resolution Trust Corporation of the

27 The actual percentage interest retained is specific to each LLC, however, in the sales conducted thus far, the initial percentage retained has ranged from 60-80%. *Id.*

28 *Id.*

29 For a complete list of the structured loan sales conducted and copies of the related documentation, see *id.*; see also GlassRatner, http://www.glassratner.com/; Keefe, Bruyette & Woods, http://www.kbw.com/.

30 Structured loan sales transactions typically contemplate the FDIC recovering a predetermined amount (the "Threshold"), which includes the sales price received upon sale of the membership interests and is specific to each transaction. The Threshold amount is established by the FDIC and disclosed prior to the bid date.

1990s, as well as the recent structured loan sales the FDIC has completed. On July 31, the FDIC announced that it would commence the testing of the LLP in August with the transfer of a portfolio of residential mortgage loans on a servicing released basis with a similar structure to the structured loan sales program described above.[31] There is also a requirement that the loan servicing conforms to either the Home Affordable Modification Program guidelines or the FDIC's loan modification program.

As part of the LLP test, accredited investors were offered two different options for purchase of an equity interest in the LLC, either an all cash basis or a sale with leverage. Under the cash basis option, there would be an equity split of 80% (FDIC) and 20% (accredited investor). Under the sale with leverage, there would be a 50/50 equity split. The funding mechanism is financing offered by the Receivership to the LLC using an amortizing note. Financing will be offered with leverage of either 4-to-1 or 6-to-1, depending upon the election made in the bid submitted by the private investor. If the bid incorporates the 6-to-1 leverage alternative, then the underlying assets will be subject to certain performance thresholds including delinquency status, loss severities, and principal repayments. If any one of the performance thresholds is triggered over the life of the note then all of the principal cash flows would be applied to the reduction of the note until the balance is zero. The performance thresholds will not apply if the bid is based on the lower leverage option. Additionally, the FDIC will be protected against losses on the note guarantee by the limits on the amount of leverage (both in terms of a maximum ratio and dollar amount), the mortgage loans collateralizing the guarantee, and the guarantee fee.[32]

While the FDIC remains committed to fully developing the LLP,[33] it has demonstrated its flexibility in responding to changing market conditions by shifting its focus toward the development of the funding mechanism of the LLP. If this month's expected sale of receivership assets utilizing such a funding mechanism is successful, another source of investment opportunities may soon be open to investors seeking more stable investments during this period of economic turmoil.

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31 Legacy Loans Program – Test of Funding Mechanism, July 31, 2009, available at http://www.fdic.gov/news/news/press/2009/pr09131.html.

32 *Id.*

33 See *id.*

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