FDIC'S STRUCTURED LOAN PORTFOLIO SALES FROM FAILED INSTITUTIONS ON THE RISE

Nearly 100 financial institutions have failed this year. The Federal Deposit Insurance Corporation (FDIC) is typically appointed receiver for a bank or thrift when it fails (failed institution). The FDIC is required by statute to maximize the recovery on the assets of the failed institution and minimize the impact on the Deposit Insurance Fund (DIF). In most cases, the FDIC, as receiver, markets and sells a portion of the assets of the failed institution to another financial institution immediately upon its failure or directly sells the loan portfolios to the public through selected brokers. In some cases, however, the FDIC retains some of the assets in the receivership and subsequently sells them through structured transactions, including joint ventures and FDIC-provided seller financing.

I. STRUCTURED LOAN TRANSACTION PROGRAM

During the past year, the FDIC has begun implementation of its structured transaction program to sell shares of loan portfolios out of failed institution receiverships to third parties in a joint venture format. The FDIC has consummated six structured transactions to date and selected the winning bidders for two other recent deals, both of which are structured to include FDIC financing: (1) a consortium managed by Starwood Capital Group was selected as the winning bidder to purchase assets from the receivership of Corus Bank, N.A., Chicago, Illinois, which failed on September 11, 2009; and (2) Residential Credit Solutions (RCS) was selected as the winning bidder to purchase assets from the receivership of Franklin Bank, S.S.B., Houston, Texas, which failed on November 7, 2008.

The transactions thus far have ranged from approximately US$500 million to US$5 billion and have included performing and nonperforming loans from one of the following categories: single family, acquisition and development construction, residential construction, commercial construction, commercial real estate, and hotel. The cost to the winning bidder has ranged from US$0.09 on the dollar of unpaid principal to US$0.39 cents on the dollar. There are currently five more structured transactions slated for auction consisting of a total of approximately US$6–7 billion in assets. In addition, the FDIC anticipates yet another wave of transactions to begin this month.

The number of structured transactions is expected to rise given the large number of recent failures, which have led to a substantial decrease in the size of the DIF. The

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

Financial Regulatory Reform

For more information and access to Arnold & Porter's latest resources on this topic including advisories, upcoming events, publications, and the Financial Regulatory Chart, which aggregates information on US government programs, please visit: http://www.arnoldporter.com/FinancialRegulatoryReform.

FDIC is trying to bolster the DIF, which from June 2008 to June 2009 lost nearly US$35 billion leaving it with just over US$10 billion remaining as of June 2009. The structured transaction program is one approach by which the FDIC can minimize the impact of bank failures on the DIF.

The FDIC recently instituted a pilot program to test the funding mechanism for the Legacy Loan Program, a program aimed to help banks remove troubled loans and other assets from their balance sheets. The Legacy Loan Program was announced by the Secretary of the US Department of the Treasury, the Federal Reserve, and the FDIC on March 23, 2009, as part of the Public-Private Investment Program, and is described in Arnold & Porter LLP's advisory at: http://www.arnoldporter.com/resources/documents/CA_TreasurysPublic-PrivateInvestmentProgram_040709.pdf. As part of the pilot program, the FDIC sold a US$1.3 billion loan portfolio from the receivership assets of Franklin Bank, S.S.B., Houston, Texas (Franklin Bank transaction), a US$4.9 billion asset bank which failed on November 7, 2008.

The Legacy Loan Program, as originally announced, was designed to facilitate the sale of toxic assets by open financial institutions, however, the FDIC has decided to test the viability of the program using assets held by the FDIC in receivership. Unlike the previous structured transactions, the Franklin Bank transaction gave bidders the opportunity to opt for FDIC financing with debt-to-equity ratios of six-to-one or four-to-one, or consistent with the previous structured transactions, to submit a cash bid for a 20% ownership interest. The FDIC has indicated that it anticipates that the Franklin Bank transaction will be followed by similar deals for failed institution assets and could serve as a model for open-bank deals.

While the basic framework for each of the structured transactions is generally consistent, the details may vary from transaction to transaction. The following is a brief description of the basic framework of the structured transactions.

A. BASIC FRAMEWORK OF STRUCTURED TRANSACTIONS

The FDIC's basic framework for its structured transactions has been to set up a limited liability company (LLC), contribute loans to it, and serve as the sole member of it. The FDIC (or one of its financial advisors) markets the assets to qualified bidders through a sealed bid auction process. The LLC enters into a Participation and Servicing Agreement with the winning bidder (Managing Member) and the FDIC as receiver. That agreement typically grants the FDIC an 80% participation interest in the loans and the Managing Member a 20% interest in the loans. Thus far, the transactions have included a threshold of distributions to the LLC, upon which the participation interest of the FDIC decreases (for instance, from 80% to 60%) and the interest of the Managing Member increases by a corresponding percentage (for instance, from 20% to 40%).

The Managing Member must provide a guaranty of its and the LLC's obligations by a "substantial entity that owns a majority interest in" the Managing Member, or such other guarantor as the FDIC deems acceptable. It appears that the guaranty may not be made by a shell company, but rather must be made by a credit-worthy entity. Based upon the FDIC's formula for calculating the guaranty limit, the maximum amount of the guaranty works out to twice the bid amount.[1]

The LLC receives a monthly management fee (e.g., 50 basis points) that is specified prior to the bid date. The Managing Member is responsible for servicing or arranging for the servicing of the loans. Cash flows from the loans, after

1 Nearly all of the previous structured transactions contain the following guaranty formula (or a variation on that formula that is essentially the same since it would result in the same guaranty limit):

> The aggregate amount for which the Guarantors shall be liable under this Guaranty (such amount, the "Guaranty Limit") shall be the greater of (a) an amount equal to (i) the Unpaid Principal Balance as of the date of the calculation of the Guaranty Limit, *multiplied by* (ii) the Participant's Share expressed as a fraction, *multiplied by* (iii) 0.50, *multiplied by* (iv) a percentage, expressed as a decimal, equal to (x) the Bid Amount (as defined in the Contribution Agreement), *divided by* the aggregate Adjusted Unpaid Principal Balance (as defined in the Contribution Agreement), *divided by* (y) the percentage obtained by subtracting the Participant's Share from 100%, and (b) $5,000,000.

deducting the monthly management fee and advances for things such as taxes, insurance, and property protection expenses, are allocated between the FDIC and the Managing Member, each according to their percentage interest. The FDIC typically retains the right to require the sale of all the remaining assets of the LLC when the aggregate unpaid principal balance of the loans has been reduced to 10% of the balance at closing or at the seventh anniversary of the participation agreement for commercial loans (or the 10th anniversary for single-family loans), whichever comes first.

Transactions with affiliates of the Managing Member, any servicer or subservicer, or any affiliate of any servicer or subservicer are restricted by the Participation and Servicing Agreement, absent prior written consent by the FDIC as receiver. Arnold & Porter understands that the FDIC will strongly discourage any such transactions with respect to the assets of the LLC.

B. PREQUALIFICATION / BIDDING PROCESS

In order to bid on the assets in an FDIC structured transaction auction, a potential bidder must become prequalified to receive materials about specific sales. To complete the prequalification process for each asset sale, a potential bidder must fill out a Pre-Qualification Request, a Purchaser Eligibility Certification, and a Contact Information Form (collectively, prequalification materials).

In addition to the prequalification materials, a potential bidder must submit a Bidder Qualification Application (Application), which is used by the FDIC to determine whether a potential bidder has the requisite financial resources, asset management capabilities, and ability, either on its own or through its servicer, to service the loans. The FDIC does not require that a servicer be rated by a nationally recognized statistical rating organization, so long as the bidder can provide evidence that the servicer has relevant experience servicing loans. The FDIC also uses the Application to ensure that the potential bidder does not have a recent bankruptcy, criminal conviction, or obligation to the FDIC that is delinquent.

Each auction requires separate prequalification and a separate Application. Nevertheless, a bidder interested in participating in multiple asset sales may maintain a current application profile with the FDIC. The bidder can submit an affidavit certifying to the continued validity of previous Application responses, and thus avoid resubmitting the entire Application each time, although it still must complete certain sections of the Application for each auction. Prospective bidders should update their prequalification materials every six months. Bidders are required to submit a refundable monetary deposit, typically US$250,000, before being provided access to transaction due diligence materials.

The FDIC has used various financial advisors to market the assets to potential bidders. An interested bidder should submit the prequalification materials to the FDIC as well as each financial advisor to ensure that it receives announcements of upcoming auctions.

Bidders who are prequalified for an auction will receive a package of information or access to a database in order to conduct due diligence on the assets. Bidders are usually given approximately one month to conduct due diligence before bids are due. Closing usually occurs one month after the winning bidder is selected.

II. FRANKLIN BANK TRANSACTION—LEGACY LOAN PROGRAM PILOT

In the Franklin Bank transaction, the FDIC modified its standard terms for closed-bank structured transactions to allow bidders to opt for FDIC financing. On September 16, 2009, the FDIC as receiver for Franklin Bank signed a bid confirmation letter with RCS on a US$1.3 billion residential loan portfolio. The total bid was US$856 million or about 70% of the unpaid principal balance in the portfolio. Under the modified program, if a bidder opts for FDIC financing, as RCS did, it must pay for a 50% equity stake in the LLC (the FDIC would retain the other 50% equity stake), and the seller, being the FDIC as receiver of the bank, would lend US$4 or US$6 for every dollar of equity for the acquisition of the loan portfolio.

In the Franklin Bank transaction, RCS opted for a six-to-one leverage ratio (being about an 85% loan-to-bid ratio). Thus, RCS will pay US$64.215 million in cash for its 50% equity stake. The financing will come in the form of a US$727.77 million amortized note issued by the LLC to the FDIC as receiver and guaranteed by the FDIC in its corporate capacity. The FDIC, as lender, anticipates selling the note at a future date.

Based on the results of this pilot program, the FDIC is examining whether the Legacy Loan Program model is a viable way for open institutions to remove toxic assets from their balance sheets. In the future, the FDIC may apply the Legacy Loan Program model to both the assets of failed institutions and those of open institutions.

The FDIC has already announced a second deal involving FDIC financing. On October 6, 2009, the FDIC as receiver for Corus Bank signed a bid confirmation letter with a consortium managed by Starwood Capital Group that also includes TPG Capital, Perry Capital, and WLR LeFrak. The portfolio of assets placed in the LLC will consist of predominantly performing and non-performing construction loans and real estate owned assets with an unpaid principal balance of approximately US$4.5 billion. Starwood Capital Group will receive a 40% managing equity interest in the LLC and the FDIC as receiver will retain a 60% equity interest. In addition, the transaction is structured to include a debt-to-equity ratio of one-to-one and an advance facility that will fund up to US$1 billion of financing for the construction of incomplete buildings, operating deficits in completed buildings, and other asset-related working capital needs.

III. OPPORTUNITIES

The FDIC's structured transaction program and the Legacy Loan Program will present numerous opportunities for financially substantial entities with loan workout expertise to purchase assets from the FDIC or partner with private equity to purchase such assets. Arnold & Porter has a multidisciplinary team assisting clients, including private equity and real estate groups, with the purchase of assets from the FDIC as receiver. The team consists of attorneys in our financial services, real estate, and hedge and private equity fund groups.

Our attorneys are familiar with the staffs within the FDIC tasked with asset sales and asset management, the bidding process, the forms of documentation used by the FDIC, and the ongoing requirements applicable to firms that do business with the FDIC as receiver. Furthermore, many of our attorneys have experience representing clients in the purchase of toxic assets from the Resolution Trust Corporation in the late 1980s and early 1990s.

Arnold & Porter maintains a list of the FDIC's financial advisors, as well as the size, geography, and categories of loans in the FDIC's upcoming structured transactions. We can assist you in becoming prequalified, performing due diligence and bidding on transactions with the FDIC with respect to loan portfolios of failed institutions or, if and when applicable, open financial institutions.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

A. Patrick Doyle
+1 212.715.1770
Patrick.Doyle@aporter.com

David F. Freeman, Jr
+1 202.942.5745
David.Freeman@aporter.com

Michael D. Goodwin
+1 202.942.5558
Michael.Goodwin@aporter.com

Jennifer Perkins
+1 202.942.5350
Jennifer.Perkins@aporter.com

Kenneth L. Schwartz
+1 202.942.5595
Kenneth.Schwartz@aporter.com

Carey W. Smith
+1 202.942.5538
Carey.Smith@aporter.com

Jeremy W. Hochberg
+1 202.942.5523
Jeremy.Hochberg@aporter.com