

REAL ESTATE CAPITAL MARKETS ADVISOR

An informational newsletter from Goodwin Procter's Real Estate, REITs & RE Capital Markets Group

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Opportunities for Real Estate Funds in Troubled Assets Program

This week, the U.S. Treasury announced the much-anticipated details of the Public Private Investment Program (“PPIP”) that was introduced in summary form by Treasury Secretary Timothy Geithner last month.¹ The program, which is part of the Obama Administration's broader “Financial Stability Plan,” focuses on the purchase of what were described as “troubled assets” under the Troubled Assets Relief Program (“TARP”), part of the Emergency Economic Stabilization Act of 2008 (“EESA”) enacted last October. Although the TARP was originally proposed as a purchase program for troubled loans and mortgage-backed securities, the Bush Administration applied the first portion of the TARP proceeds toward direct capital infusions into banking institutions. The objectives of the PPIP are much closer to the original objectives of the TARP: to thaw the nation’s credit markets by moving legacy assets off the balance sheets of financial institutions so those financial institutions can expand their lending activities.

The PPIP consists of two core programs – the Legacy Loans Program and the Legacy Securities Program. Both are built around the same basic concepts: pricing established by private investors and credit support provided by the government. Treasury, using TARP funds, will create a series of joint venture Public Private Investment Funds (“PPIFs”) to purchase pools of loans and asset-backed securities. Treasury’s initial investment will be \$75 to \$100 billion, which when combined with private capital and a series of leverage mechanisms is expected to generate at least \$500 billion in purchasing power for the PPIP that may be expanded to as much as \$1 trillion. As part of the Legacy Securities Program, Treasury also announced an expansion of the Federal Reserve’s existing Term Asset-Backed Securities Loan Facility (“TALF”) to support purchases of legacy asset-backed securities, including legacy RMBS and CMBS.

The details of the PPIP are discussed in Goodwin Procter’s [March 24, 2009 Financial Services Alert](#). In this Advisory, we address potential opportunities for real estate investors in each of the two types of PPIFs. We also present our thoughts on the planned expansion of the TALF as part of the Legacy Securities Program.

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Legacy Loans Program

The Legacy Loans Program is a joint program established by Treasury and the FDIC to enable domestic banks and savings institutions to sell pools of distressed loans in portfolio auctions run by the FDIC. It is expected that bidders will include pension funds, mutual funds, hedge funds, private equity funds, insurance companies and other long-term real estate investors. Successful bidders will get equity co-investment from

Treasury using TARP funds and debt guarantees provided by the FDIC. Although the detailed requirements of the Legacy Loans Program will be subject to notice and comment rulemaking (comments will be accepted until April 10, 2009), Treasury has laid out the following basic structure.

FDIC and Treasury will establish minimum requirements for loan pools that participant banks must demonstrate they meet. Eligible assets and any collateral supporting the assets must be situated predominantly in the United States. The loan pools that go to auction will be determined by the participant banks, their primary regulators, the FDIC and Treasury. Each bidder must be prequalified by the FDIC and must post a deposit equal to 5% of its bid value, which is refundable if the bid is rejected. Bidders cannot cooperate with one another once the auction process begins, in order to maintain fairness. The winning bidder will form a PPIF with Treasury to acquire the loan pool. Thus, there will be a separate PPIF for each loan pool sold.

The FDIC will engage independent valuation firms to advise it on the valuation of loan pools, appropriate leverage and the structure and value of bids. The FDIC will oversee initial due diligence, preparation of marketing materials and conduct the auction process, including review of bids and selection of winning bids. The participant banks that submitted loan pools for auction will have the final say on accepting bids within a pre-established timeframe. While the FDIC has not yet established its pre-qualification, diligence and bidding procedures, auction theory suggests that there will be similarities to the formal processes many investors have encountered in bidding contests for portfolio property acquisitions a couple of years ago at the peak of the real estate market, but less opportunity to cherry-pick or make complex bids.

Sales proceeds to the selling bank will be cash or cash and non-recourse debt issued by the applicable PPIF that is credit-enhanced by an FDIC guaranty. For each loan pool that is auctioned, the FDIC will conduct underwriting to determine the extent of the FDIC debt guaranty that will be provided (not to exceed a 6 to 1 debt to equity ratio), and will disclose proposed financing terms and leverage ratios to investors prior to the start of the bidding process. The FDIC will receive an annual fee for providing the guaranty and the guaranty will be secured by the loan pool. The amount of the fee is not yet known. It is contemplated that the selling bank may then sell the guaranteed PPIF debt to raise cash.²

The initial target for the amount of equity to be contributed by Treasury to the PPIF is 50%, although investors may choose to take less Treasury equity subject to a minimum to be determined. Treasury has also stated that in order to comply with Section 113(d) of EESA, Treasury (and not the private investors) will receive warrants in the PPIF. The public and private equity contributions and profits and losses are otherwise to be treated on a *pari passu* basis (and there does not appear to be an opportunity for a promoted interest), although Treasury states that it will “consider alternatives for its capital contribution that do not diminish the *pari passu* sharing of profits and losses, the collateral protection securing the FDIC guarantee, and capital neutrality compared with the currently contemplated investment.” Based on the design of the Legacy Loans Program and the precedent established by Treasury’s conduct of the capital infusion program for banks under the TARP, we do not expect Treasury to entertain much

negotiation of the PPIF documents. Although the private investors, not Treasury, will have management control of the PPIF, Treasury states that management, servicing, financial and operating reporting, and exit timing and alternatives are to be within parameters established by the FDIC and Treasury and governed by standard documentation to the extent practicable.

Treasury has also stated that executive compensation restrictions will not apply to passive private investors in the PPIFs. Fund sponsors and managers that will not be considered passive will want to watch this issue carefully as the more detailed program rules are promulgated. Additionally, as evidenced by the experience of TARP-recipient banks, Congress could impose executive compensation restrictions on PPIF private investors in spite of Treasury's objections.

There has been speculation that participant banks may try to use the Legacy Loans Program to game the system in one way or another, and the FDIC and Treasury can be expected to impose rules to prevent that. One of the already announced limitations in this vein is that private investors may not participate in any PPIF that purchases assets from sellers that are affiliates of such investors. Thus funds that want to bid will need to be able to determine that their investors won't trip this limitation.

Assuming that the Legacy Loans Program is successful in bringing distressed debt to market, whether by design or by the influence of the FDIC and other regulators over the selling banks, many investors will find the program attractive as a source of deal flow and (presumably) low-cost financing. The program also provides qualified firms with the opportunity to apply to the FDIC to become third-party valuation advisors.

Legacy Securities Program

The Legacy Securities Program focuses on "legacy securities" (*i.e.*, RMBS and CMBS originally issued prior to 2009) and consists of two parts. On the equity side, Treasury will select a small number of top tier asset managers with which it will co-invest in PPIFs to acquire legacy securities. In addition, Treasury announced an expansion of the TALF to provide credit support for purchases of legacy securities, which is addressed in the next section of this Advisory.

The Legacy Securities portion of the PPIF will utilize qualified fund managers to form PPIFs in which Treasury will invest TARP funds to acquire legacy securities.³ Treasury expects to select approximately five fund managers to form PPIFs initially, but more may be added.

Each selected fund manager would be given a limited period of time to raise private equity capital and form a private investment vehicle. The private investment vehicle and Treasury would then form a PPIF in which Treasury would invest TARP funds matching the private equity on a dollar-for-dollar basis. As with the Legacy Loans Program, Treasury has stated that in order to comply with Section 113(d) of EESA, Treasury (and not the private investors) will also receive warrants in the PPIF, and otherwise the public and private equity contributions and profits and losses are to be treated on a *pari passu* basis. There does not appear to be an opportunity for a promoted

interest. Also, as with the Legacy Loans Program PPIFs, it is not yet known how each PPIF will be structured or documented, but to the extent permitted by the application process, there may be greater opportunity for negotiation than in the Legacy Loans Program. Private investors may be given withdrawal rights with respect to the private investment vehicle, subject to limitations to be agreed upon with Treasury (in no event will withdrawal be permitted before the third anniversary of the first investment). ERISA plans will be accommodated as investors in the private investment vehicles.

In addition to the equity co-investment provided by Treasury, each Legacy Securities Program PPIF will be eligible to apply to Treasury for “senior” debt⁴ (“Senior Loans”) in an amount equal to between 50% and 100% of the PPIF’s total equity contributions. The business terms for these loans have not yet been determined, but it is expected that they will be repaid on a pro-rata basis with equity as the PPIF realizes operational or disposition proceeds. As described in the next section of this Advisory, TALF funds are expected to be made available to finance legacy securities purchases by the PPIFs. Senior Loans will be structurally subordinated to the TALF financing, and the TALF financing, not the Senior Loans, will take the underlying securities as loan security.

The private fund managers will have full discretion in the PPIF’s investment decisions, although a long-term buy-and-hold (as opposed to loan-to-own by strategically buying tranches or a trading strategy) is the expected course of action.

One significant negative feature is that Treasury reserves the right to cease funding of committed but undrawn Treasury equity and debt capital at any time. This may reflect the fact that TARP funds are dwindling.⁵

Fund managers that are interested in being selected to form Legacy Securities PPIFs have until April 10, 2009 to submit applications, and Treasury expects to make preliminary selections by May 1, 2009. Applicants must be headquartered in the United States and be able to demonstrate (i) the ability to raise at least \$500 million of private capital, (ii) experience investing in comparable assets, (iii) a minimum of \$10 billion in comparable assets under management (based on market value) and (iv) the ability to follow Treasury’s guidelines. As with Legacy Loans Program PPIFs, the executive compensation restrictions will not apply to passive investors, but fund sponsors and managers that will not be considered passive will need to watch this issue.

The private fund managers may charge private investors fees within their discretion, but those fees will be considered part of the bidding process. Fixed management fees on Treasury equity may be charged on a percent of equity contributed basis. Such fees and Treasury’s share of fund expenses are to be paid solely out of distributions with respect to Treasury equity capital. It appears that any other fees are to be shared *pari passu* based on equity capital.

For fund managers that meet the qualifications to be selected and have a predominantly buy-and-hold strategy, the government debt and equity financing provided may make the Legacy Securities PPIF program an attractive opportunity.

Expansion of TALF for Legacy Securities

The TALF was established in an effort to help restart the securitization market by providing favorable financing to purchasers of asset backed securities. However, the TALF in its current form provides little immediate help to the commercial real estate industry. Investors can only access the TALF by pledging certain types of newly issued AAA-rated asset-backed securities, a list which currently includes certain types of auto, student, credit card, small business and equipment loans, as well as certain residential mortgage servicing advances. In February 2009, Treasury announced that the TALF will be expanded to include both RMBS and CMBS.⁶ However, we anticipate that this will not be implemented for at least another two months.⁷ Furthermore, expanding the TALF for newly issued CMBS would currently be of limited practical effect. Regardless of asset class, the TALF can only be used for newly issued AAA-rated securities backed by relatively new loans (a restriction which varies somewhat by asset class, but does not extend earlier than mid-2007). Given the overall deterioration in real property values, the dearth of recent CMBS offerings, and the time and effort needed to create new CMBS pools, few CMBS are likely to meet this high standard for some time.

As part of the Legacy Securities Program, Treasury intends to expand the universe of TALF-eligible collateral to include certain non-agency RMBS that were originally AAA-rated, and outstanding CMBS that are AAA-rated, thereby enabling PPIFs purchasing legacy securities to apply for TALF financing. However, given the timing involved in rollouts of successive TALF program expansions (as noted in endnote 7), it is likely that the expansion of the TALF to support purchases of legacy securities will not occur until mid-2009 at the earliest. The lending rates, minimum loan sizes and loan durations have not been determined for legacy securities, but Treasury notes that the Federal Reserve is working to ensure that the duration of these loans takes into account the duration of the underlying assets (e.g., CMBS typically have a 10-year maturity period, whereas TALF loans have a three-year term). Additionally, there is some question as to whether downgraded legacy securities will be eligible for TALF loans. Although Federal Reserve Bank of New York President William Dudley⁸ has indicated that the TALF may be extended to lower-rated legacy securities, in more recent Congressional testimony, Federal Reserve Chairman Bernanke indicated that the TALF would only be used for AAA-rated securities.⁹ Recent downgrades have reduced the number of legacy securities that continue to be rated AAA, and further downgrades may well occur. Thus, TALF financing will not be available for these legacy securities, unless the Federal Reserve decides to accept downgraded securities as TALF-eligible collateral. Assuming there is a compelling need for government financing to support purchases of legacy securities, a change of Fed policy in this regard may be a more palatable alternative than seeking additional TARP funds.¹⁰ Unless such a policy change occurs, fund managers considering applying to form Legacy Securities PPIFs will have to consider the implications of TALF financing not being available for downgraded securities.

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Both the Legacy Loans Program PPIFs and the Legacy Securities Program PPIFs present attractive opportunities for appropriately situated real estate investors. Although the details announced this week by Treasury were well received by the stock market, more specifics remain to be delineated, accommodations may be necessary to meet the tax and regulatory needs of pension funds and other investors, and the availability of TALF financing for downgraded legacy securities remains a question.

¹ Addressed in Goodwin Procter's [February 13, 2009 Real Estate Capital Markets Advisor](#).

² Presumably the alternative of allowing the PPIF to issue debt to third parties and pay all cash to the selling bank was at least for now deemed unattractive in the context of an auction due to the timing and risk associated with necessitating an additional transaction.

³ These would include residential mortgage-backed securities, commercial mortgage-backed securities and asset-backed securities, in each case if rated AAA at issuance and backed by the actual mortgage loans, leases or other assets and not other securities (other than certain swap positions, as determined by Treasury). The loans and other assets underlying the securities must be situated predominantly in the U.S. Legacy securities may only be purchased from financial institutions eligible to sell troubled assets to Treasury, under EESA.

⁴ This debt financing will also be provided from the TALF, once TALF is expanded to include legacy securities.

⁵ *The Wall Street Journal* estimated this week that, including Treasury's announced commitment to the PPIP programs, TARP may have as little as \$82 billion in uncommitted funds remaining (*see*, Sudeep Reddy and Michael R. Crittenden, "Rescue Agencies Now In Scramble," March 24, 2009, at A14).

⁶ See Goodwin Procter's [February 13, 2009 Real Estate Capital Markets Advisor](#).

⁷ The TALF timetable set forth in the Treasury White Paper "The Consumer and Business Lending Initiative," dated March 3, 2009, stipulates that TALF fundings will be held monthly. Beginning with the April TALF funding, subscriptions are required to be recorded on the first Tuesday of each month, with the details of each subscription to be announced two weeks prior, and disbursement to occur one week subsequent: e.g., the details of the April TALF funding were announced on March 24, the subscription will be closed on April 7 and the disbursement will be made on April 14. Prior to adding any new asset-backed securities to the list of TALF-eligible assets, both the Treasury and the Federal Reserve Bank of New York must determine the appropriate terms and conditions for accepting such asset-backed securities (e.g., the interest rate and haircut amount). Based on the well-publicized lack of staffing at Treasury, and the fact that CMBS are not included in the April TALF funding, CMBS terms could not be announced until April 21 at the earliest (i.e., as part of the May funding of the TALF).

⁸ William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, Remarks at the Council on Foreign Relations Corporate Conference 2009, New York City (March 6, 2009).

⁹ Oversight of the Federal Government's Intervention at American International Group: Hearing Before the House Committee on Financial Services and General Government, 111th Congress (March 24, 2009).

¹⁰ See note 5 above regarding depletion of TARP funds. Given the long odds of a further Congressional bailout, at least in the next few months, Treasury has a clear incentive to use TALF loans (which are funded by the Federal Reserve on a 10 to 1 ratio against credit support provided by Treasury with TARP funds) in lieu of Treasury matching funds, to conserve its TARP proceeds.

For further information about the issues raised in this newsletter, please contact your usual Goodwin Procter attorney or any of the attorneys listed below.

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