

Buying Distressed Real Estate Assets from Financial Institutions

By Brian W. Smith and Melissa R. H. Hall

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The current economic climate has placed financial institutions under a great deal of stress. Distressed assets, especially residential and commercial real estate loans, put increasing pressure on bank balance sheets. Securitization of such loans, a useful tool for banks in the past, may no longer be as practical an option, as current investor interest in securitization pools has all but disappeared and many of the existing pools are either under ratings pressure or are being restructured.

As with previous downturns, there is much interest in the investment community in purchasing distressed real estate assets (the properties themselves or the loans related to the properties) from financial institutions or the Federal Deposit Insurance Corporation (FDIC) and reworking such assets or holding them until the market improves. Current investors remember that in the past, particularly during the savings and loan crisis of the early 1990s, certain investors were able to realize significant financial returns from buying distressed real estate assets from failed and failing banks.

In today's market and unlike prior crisis periods, only a handful of ways to obtain distressed real estate assets from financial institutions have emerged. This article focuses on two new methods for obtaining distressed assets from banks: FDIC-structured loans transactions and transactions conducted through the Treasury's Public Private Investment Program (PPIP). These transactions are increasingly attractive to investors since they involve types of loss sharing and other incentives for private-sector participation that are typically not available outside of whole-bank purchase transactions.

It should be noted, however, that PPIP is just starting up (and only really on the Legacy Securities

Program side) and there have been only a relative handful of structured loan transactions to date. Therefore, one cannot predict with any certainty that either structured loan transactions or PPIP transactions will be the models that the FDIC uses moving forward, nor is there any certainty that there will be a significant volume of these transactions in the future. Furthermore, there have been no recent transactions involving the disposition of assets with FDIC involvement from open banks. Accounting issues, among other factors, present significant roadblocks to the willingness of open banks to sell portfolios of distressed real estate assets.

FDIC-Structured Loan Transactions

The FDIC has conducted structured loan sales for certain assets of a handful of failed banks. Structured loan sales are a type of private-public partnership whereby the FDIC retains a participation in all future cash flows and the asset manager/purchaser receives the benefit of some sort of FDIC assistance as well as deep discounts on the acquisition value of the assets. Structured loan transactions have so far been more attractive to potential purchasers of the assets of failed banks due to the FDIC loss-sharing arrangements that are part of structured loan transactions. The FDIC does not

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provide guarantees or loss sharing for other types of FDIC loan sales.¹

Only a handful of FDIC-structured loan transactions have been done in the past 18 months or so. The first transaction in May 2008 involved the sale of single-family construction and lot loans from Market Street Mortgage Corporation, a subsidiary of Net Bank (which had failed in September 2007), to Gulf Coast Bank & Trust. Since then, the FDIC has entered into structured loan transactions with respect to acquisition, development and construction loans from ANB Financial, N.A.; three groups of loans (single-family residential, residential construction and commercial construction) from First National Bank of Nevada; and consumer construction, home-builder construction and lot loans from IndyMac.² Most recently, the FDIC announced the proposed sale of performing and nonperforming construction loans and real estate owned assets from Corus Bank, N.A., to a consortium led by Starwood Capital Group and, in somewhat of a hybrid approach, entered into complex loss-sharing arrangements in connection with the sale of nine banks (former subsidiaries of FBOP Corporation) to U.S. Bank, N.A.³

The FDIC-structured loan transactions follow the same basic structure. The transactions have quite a few details, a full discussion of which is far beyond the scope of this brief article, but the broad overview follows:

- The FDIC as receiver for the failed bank forms a limited liability company (LLC) to which the receivership conveys the loans intended to be sold and in exchange receives the sole membership interest in the LLC.
- The LLC and the receiver also enter into a participation and servicing agreement, pursuant to which the receiver is granted a participation interest in the loans (usually around 80 percent), and the LLC agrees to enter into an agreement to service the loans with a qualified servicer.
- Once the bidding process is opened, bidders must be prequalified by the FDIC and demonstrate the financial capacity and ability to manage and dispose of the loan portfolios.
- Qualified bidders are allowed to do limited due diligence based on information posted on the FDIC's online data room and during a one-day on-site diligence session. The documents for the transaction are FDIC forms and are nonnegotiable.

- The winning bidder obtains the FDIC's sole membership interest in the LLC and must provide a guaranty of its and the LLC's obligation by a substantial entity that owns a majority interest in the bidder.
- Cash flows from the loans (minus certain deductions for management fees, taxes, insurance, *etc.*) are allocated between the receiver and the LLC based on the participation interests set forth in the participation and servicing agreement.
- The transactions also typically include a threshold where the participation interests of the receiver drop and those of the winning bidder increase once a stated dollar amount of cash distributions is received.⁴

As of the date this article is being written, the documents for the Corus/Northwest Investments LLC-structured loan transaction have not been finalized for public viewing, but according to information released by the FDIC, that transaction has a couple of additional features not seen in earlier deals. First, there is reportedly an equity kicker that increases the FDIC's equity stake in Northwest to 70 percent from 60 percent once certain returns on Northwest's investment are achieved. Also, the FDIC is providing an advance facility of up to \$1 billion to fund construction of incomplete buildings, operating deficits in completed buildings and other asset-related working capital needs.

The expectations in the lead-up to the Corus transaction garnered a great deal of interest in the financial and investor communities and demonstrate the evolving thinking of the FDIC regarding structured loan transactions (for example, providing the advance facility to fund the completion of construction projects). It remains to be seen whether and, if so, under what circumstances, the FDIC will enter into future structured loans transactions and whether they will contain features such as the advance facility.

PPIP

PPIP, announced in March 2009, is one of the components of the Treasury's economic stabilization program. PPIP is intended to induce the private sector to purchase certain troubled assets such as mortgage-backed securities and distressed loans on bank balance sheets that otherwise are difficult

to sell or can only be sold at deep discounts that are unattractive to the seller. PPIP consists of two programs: the Legacy Securities Program, a Treasury-run securities purchase program designed to address liquidity issues in the secondary markets for mortgage-backed securities, and the Legacy Loans Program, an FDIC loan purchase program designed to address distressed loans on the balance sheets of U.S. financial institutions. Both programs are designed to use public-private investment funds (PPIFs), which are newly formed investment funds capitalized by private investors and the Treasury with attractive components such as Treasury direct loans or debt guarantees. A full discussion of the various aspects of the Legacy Securities Program and the Legacy Loans Program is beyond the scope of this article, but a brief summary of each demonstrates the various approaches of the Treasury and the FDIC to addressing distressed assets.

As originally announced, under the Legacy Securities Program, the Treasury was to choose around five prequalified fund managers. The fund managers would raise private capital for their respective PPIF, and the PPIF would receive matching equity funds from the Treasury based on the amount of private capital raised. The Treasury would receive warrants in the PPIFs pursuant to Section 113(d) of the Emergency Economic Stabilization Act of 2008 (EESA). PPIF managers would have the ability to obtain debt financing from the Treasury in an amount up to 50 percent of total equity capital in the fund. Eligible assets were limited commercial-mortgage-backed securities and residential-mortgage-backed securities issued prior to 2009 that were originally rated AAA or an equivalent and that were situated predominantly in the United States.⁵

As originally announced, under the Legacy Loans Program, the FDIC was to provide oversight and staffing for the formation, funding and operation of PPIFs that would purchase distressed loans and other assets from depository institutions. The FDIC would determine asset pools and conduct asset portfolio auctions. The FDIC would also provide a debt guarantee to the PPIF, and the Treasury would provide equity to the PPIFs to match private-sector

equity. As with the Legacy Securities Program, the Treasury would receive warrants in the PPIF pursuant to the requirements of EESA.⁶ Eligible assets under the Legacy Loans Program were limited to loans and other depository institution assets situated predominantly in the United States under guidelines to be established by the FDIC.

Neither part of PPIP has developed as originally envisioned. The Legacy Loans Program has not been fully implemented. In June 2009, the FDIC announced that it was postponing the Legacy Loans Program, citing a change in the financial markets that has allowed banks to raise capital without selling

bad assets.⁷ In July 2009, the FDIC held a pilot sale of an ownership interest in an LLC to which the FDIC would convey a portfolio of residential mortgage loans from the failed Franklin Bank, SSB,

with an unpaid principal balance of around \$1.3 billion, and would provide funding using an amortizing note with either four-to-one or six-to-one leverage, depending on certain bidder elections.⁸ The winning bidder of the pilot sale was Residential Credit Solutions, which bid around \$64 million in cash for a 50-percent equity stake in the LLC and chose the six-to-one leverage option. The LLC will issue a note of around \$728 million to the FDIC as receiver, and the FDIC will guarantee the note in its corporate capacity. The FDIC stated that it would review the pilot sale and see whether a similar mechanism could be used to help open depository institutions sell troubled assets.⁹

The Legacy Securities Program part of PPIP is now smaller than originally anticipated (total Treasury commitments are estimated to reach \$30 billion, down from the initial plan of \$75 billion to \$100 billion), but the Legacy Securities Program has successfully established PPIFs and those PPIFs have reportedly started buying eligible assets. Under the Legacy Securities Program, the Treasury selected nine fund managers to establish and manage PPIFs.¹⁰ The investors were given 12 weeks to raise at least \$500 million of capital from private investors. By mid-October 2009, Invesco, TCW Group, Alliance-Bernstein, BlackRock and Wellington Management Company completed initial closings of their respec-

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tive PPIFs. The closings totaled around \$3 billion in commitments from private investors, with the Treasury matching equity and debt commitments to a total of around \$9.2 billion.¹¹ The closings for the remaining four PPIFs are expected to occur before the end of 2009. It remains to be seen how successful the PPIFs will be in obtaining eligible assets and whether they have any effect on the mortgage-backed securities markets.

Where Does This Leave Interested Buyers of Distressed Bank Assets?

Investors interested in financial institution distressed assets can attempt to acquire assets from open banks or from the FDIC as receiver of failed banks. Buyers interested in the assets of failed banks should engage in early talks with the FDIC and should attempt to become a prequalified bidder.¹² Although structured loan transactions are very attractive to potential buyers, it is unclear how many more structured loans transactions the FDIC will be willing to undertake. That said, given the high level of exhibited interest in the Corus Bank portfolio and the expectations of increased numbers of failing banks, it is possible that the FDIC will offer more structured loan transactions in the future, if for no other reason than to relieve ongoing pressure on its own financial resources. Interested observers have speculated that a hybrid form of transaction might emerge, taking the most successful elements of the past FDIC transactions and combining them in a new approach. This remains to be seen.

Buying assets from open banks continues to be a far more difficult task. Although the Legacy Securities Program may have some success in creating a market for mortgage-backed securities, neither the FDIC-structured loan transactions nor PPIP resolve the issue of how open banks dispose of distressed assets. Although there are many interested buyers for distressed loans, particularly distressed real estate loans, many banks are reluctant to sell the loans at current market prices (which are generally

highly discounted) and take the associated write-downs and attendant capital loss. There is, to date, no program that has enabled open banks to sell off or work out distressed loans without negatively affecting bank capital.

Significantly, ongoing pressures from regulators and the marketplace may be creating an environment in which banks' write-downs reach levels of near equilibrium with potential purchasers. In such event, if the banks are able to couple asset sales with capital injections, more fluidity might enter the scene.

That said, there are clearly opportunities for investors who have the capability to purchase and work out financial institution distressed assets. With the predictions of increasing bank failures over the next year (likely to be mostly community banks saddled with worsening commercial real estate loans), and

in light of the strain the 140 bank failures in 2009 has placed on the FDIC and the Deposit Insurance Fund,¹³ it is possible that both the FDIC and open banks will begin to think creatively about disposing of distressed assets.¹⁴

It remains to be seen whether PPIP, structured loan transactions or any other methods achieve notable success. So far, the FDIC has had limited success in connecting interested buyers with distressed assets. Although there is much interest in the investment community in acquiring distressed real estate assets, it is not yet clear how many acquisition transactions will be done.

We continue to advise that potential buyers make their interest and abilities known to the FDIC so that they can qualify as a bidder and get the opportunity and information to bid. After all, you can't win a raffle unless you buy a ticket.

Endnotes

¹ The FDIC is also conducting, as it has in the past, periodic sales of loans or loan pools. The loan sales are managed by third parties hired by the FDIC to manage the bid or auction process. The current form of these loan sales, unlike structured loan transactions, typically does not involve any sort of FDIC loss sharing or guarantee. Information regarding loan sales

and qualification requirements is available at www.fdic.gov/buying/loan/index.html.

- ² A list of structured loan sales is available on the FDIC's Web site at www.fdic.gov/buying/historical/structured/index.html.
- ³ Although the U.S. Bank transaction has aspects of other structured loan transactions (*e.g.*, FDIC loss sharing on various asset pools) it is not a typical structured loan transaction since it involved investor purchase of distressed assets in connection with the acquisition of the failed banks themselves.
- ⁴ For example, under the IndyMac Venture LLC Participation and Servicing Agreement, the receiver is entitled to 80 percent of all loan proceeds until the later of the receipt of the stated threshold amount or one year after the closing date, after which the receiver is entitled to 60 percent of the loan proceeds.
- ⁵ See *Legacy Securities Public-Private Investment Program Frequently Asked Questions*, available at www.treas.gov/press/releases/reports/legacy_securities_faqs.pdf (July 8, 2009).
- ⁶ See *Public-Private Investment Program for Legacy Loans Frequently Asked Questions*, available at www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf; *Legacy Loans Program Summary of Terms*, available at www.treas.gov/press/releases/reports/legacy_loans_terms.pdf.
- ⁷ *FDIC Statement on the Status of the Legacy Loans Program*, available at www.fdic.gov/news/news/press/2009/pr09084.html (June 3, 2009).
- ⁸ *Legacy Loans Program—Test of Funding Mechanism*, available at www.fdic.gov/news/news/press/2009/pr09131.html (July 31, 2009).
- ⁹ *Legacy Loans Program—Winning Bidder Announced in Pilot Sale*, available at www.fdic.gov/news/news/press/2009/pr09172.html (Sept. 16, 2009).
- ¹⁰ The nine approved fund managers are AllianceBernstein; Angelo, Gordon & Co. and GE Capital Real Estate; BlackRock; Invesco; Marathon Asset Management; Oaktree Capital Management; RLJ Western Asset Management; TCW Group; and Wellington Management Company.
- ¹¹ *Treasury Department Announces Initial Closings of Legacy Securities Public-Private Investment Funds*, available at www.ustreas.gov/press/releases/tg304.htm (Sept. 30, 2009); *Treasury Department Announces Additional Initial Closings of Legacy Securities Public-Private Investment Funds*, available at www.ustreas.gov/press/releases/tg311.htm (Oct. 5, 2009).
- ¹² More information on the FDIC prequalification process is available at www.fdic.gov/buying/financial/.
- ¹³ Eric Dash, *Failures of Small Banks Grow, Straining F.D.I.C.*, N.Y. TIMES, Oct. 11, 2009.
- ¹⁴ For example, the FDIC is increasingly interested in sharing in any economic benefits deriving from transactions in which it participates (*see, e.g.*, the cash participant instrument allowing for an equity interest in New York Community Bank acquired by the FDIC in connection with the December 4, 2009, AmTrust Bank purchase and assumption agreement).

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