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How to Buy Loans Originated by Failed Financial Institutions from the FDIC

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Introduction

The Federal Deposit Insurance Corporation ("FDIC") was created by The Banking Act of 1933 at the height of The Great Depression. While the FDIC has other corporate and regulatory powers (for example, the provision of deposit insurance), one of its most public powers is that of receiver, or conservator, for failed depository institutions (i.e. banks and thrifts).[1] In sum, the FDIC has been acting as the receiver for failed banks for over 75 years and, hence, has a long history of engaging in the post-failure sale of the assets of these institutions in order to recover the maximum amount possible to settle the claims of the institution's creditors, including the FDIC.[2]

The FDIC's Division of Resolutions and Receiverships, located in the FDIC's Washington, D.C. and Dallas offices, coordinates the sale of these assets. Of course, the assets of the failed banks which are sold by the Division of Resolutions and Receiverships are numerous and varied. By way of example, a visit today to the FDIC's on-line auction website reveals that one could currently bid on a camper, a barbecue grill, various desks and furniture, and art of questionable aesthetic value,[3] all previously owned by failed financial institutions.

The largest single category of assets held by failed financial institutions are its performing and non-performing loans. The FDIC, as receiver, also sells these loans to the private sector through various programs managed by its Division of Resolutions and Receiverships. While the FDIC has great latitude in how it structures its loan sales programs, whatever method the FDIC chooses to sell assets must support the FDIC's statutory obligations to resolve all receiverships in the "least-cost" manner.[4] As further discussed below, while these efforts have typically involved the direct sales of loan pools comprised of similar loans to various qualified purchasers, the FDIC has also begun to utilize a relatively new structure that permits the FDIC to participate in the future revenue stream from pooled loans alongside investors, thereby potentially increasing the total amount recovered by the FDIC.

In the balance of this Stay Current, we will discuss how the FDIC has previously sold loans originated by failed financial institutions to the private sector, the current FDIC loan sales programs, a relatively new loan sales structure, and finally, how one can participate in the FDIC's loan sales process.

Prior Loan Sales Programs

While the FDIC first began selling whole loans acquired from failed institutions for which it was appointed as receiver as early as 1976, it established its first formal loan sales program,

the Asset Marketing Program ("AMP"), in 1984. The AMP was conducted by the FDIC staff through various locations throughout the country, and while initially focused on the marketing of performing loans, the program was later expanded to emphasize the sale of non-performing loans. Up to that point, the FDIC had typically retained non-performing loans and attempted to work them out itself by assigning specific FDIC officers tasked with negotiating repayment, restructuring or settlement of the debt with individual borrowers. However, as the volume of non-performing loans increased, the FDIC was limited in its ability to continue its in-house workout efforts, and therefore began to market these loans as well. All loans were packaged for sale in pools based primarily upon size, asset quality, asset type and geographic location, following which the FDIC assigned values based on projected cash flows and established minimum reserve prices for each package.

Similarly, following its establishment in 1989, the Resolution Trust Corporation ("RTC") implemented a Bulk Sales Program ("BSP") to dispose of the assets of failed savings institutions which adopted many of the characteristics of the AMP. Both the AMP and BSP utilized the same basic marketing process, whereby each agency would (i) pool and value the loans, (ii) develop a bidder's information package containing the procedures, terms and conditions of the sale, including such things as the availability of loan information for review by the bidders and the requirements that each bidder must meet to bid on and purchase the loans, (iii) require potential bidders to complete and return certification statements and forms through which each bidder detailed its qualifications and acknowledged that it had no ethical conflicts in purchasing the assets, (iv) require each person having access to or reviewing loan data to execute a confidentiality agreement, and (v) sell the loans through auctions or a sealed bid process.

As the volume of loans processed through both programs increased, the FDIC and RTC were forced to delegate significant portions of the sales process to third parties, with each agency then providing oversight of the process.

Current FDIC Loan Sales Programs

Today, the FDIC continues to sell pools of loans directly to investors in substantially the same manner described above, and has engaged two primary outside financial advisors, First Financial Network and DebtX, to manage this sales process. It has also begun to sell loan pools under a private placement structure ("LLC Structure") whereby instead of selling the loans directly to investors, it (i) contributes a pool of performing and non-performing loans to a newly established limited liability company ("LLC"), (ii) retains a participation interest in the future cash flows pursuant to a participation agreement with the LLC, and (iii) sells the entire membership interest in the LLC (which represents the remaining interest in the loan revenue stream) to a single investor. As with the direct sales program, the FDIC has engaged two other primary outside financial advisors, GlassRatner and Keefe, Bruyette & Woods, to manage the process. This structure, which offers the potential of providing the FDIC with a higher level of recovery (comprised of the initial sales price received from the bidder and a significant portion of the ongoing revenue stream from the contributed loan pool) in exchange for taking a stepped approach to receiving all amounts associated with disposition of the assets, seems particularly attractive in today's financial climate where the FDIC might otherwise be forced to accept a lower sales price due to the uncertainty in the market, resulting inability to accurately value assets and reluctance of investors to pay anything more than a fire-sale price. To date, there have been five transactions of this type, and while the description below is specific to one of these transactions, we understand that this may reflect the preferred structure for all future sales of this type.

How are loans sold through the LLC Structure?

The FDIC initially establishes a LLC, following which it contributes a pool of loans to such LLC pursuant to a Loan Contribution and Assignment Agreement. The LLC simultaneously enters into a Participation and Servicing Agreement ("Participation Agreement") with the FDIC, pursuant to which the FDIC is issued a "Participation Certificate" representing a certain participation interest in the future loan payments. Bidders are then permitted to bid on a 100% membership interest in the LLC, which will provide the bidder with the remaining interest in the loan payment stream. However, once the FDIC has recovered a pre-determined amount, its participation interest will be reduced, thereby increasing the future amount received by the LLC (and the bidder). For example, in one recent transaction, the FDIC's initial participation interest was set at 60% and will be dropped to 40% upon reaching the pre-determined recovery threshold.

The winning bidder is required to form a special purpose entity ("Purchaser") to purchase the 100% membership interest in the LLC, which will serve as the LLC's sole managing member and will be required to ensure that the loans are properly serviced by a contract servicer ("Servicer") retained by the LLC but approved by the FDIC as part of the bid process. Note that the Purchaser will also be required to provide the FDIC with a guaranty from a financially responsible source in order to guaranty the obligations of the LLC and the Purchaser as the sole managing member of the LLC.

In addition, in instances where the contributed loans involve future advance commitments on performing loans (such as construction loans), the FDIC and the Purchaser will contribute the necessary amounts to funds such obligations in proportion to their initial participation interests, with the funds to be maintained in an interest-bearing account ("Advance Account") and accessed by the LLC to funds the commitments in accordance with their terms.[5] The Advance Account will typically terminate 12 months following the date upon which the Purchaser acquires its interest in the LLC, with any remaining funds to be distributed pro-rata to the FDIC and Purchaser in accordance with their respective cash contributions to the Advance Account.

All costs payable by the LLC pursuant to the servicing agreement between the LLC and the Servicer are the sole responsibility of the Purchaser, as these may not be passed on the FDIC. However, the Purchaser is entitled to a monthly management fee, and all cash advances made by the LLC or the Servicer for items such as foreclosure expenses, property preservation and maintenance costs, property taxes and sale expenses will be reimbursed in accordance with the terms of the Participation Agreement.

The LLC is required to remit to the FDIC its proportionate share of all cash received from the loans on a monthly basis (net of any expenses authorized to be paid or reimbursed under the terms of the Participation Agreement), and may distribute any or all of the remaining cash to the Purchaser as it deems appropriate. The Purchaser is required to provide monthly reports to the FDIC (or its designee) concerning portfolio-level and loan-level activities.

What is required in order to bid on the LLC membership interest?

Potential bidders must first be qualified by the FDIC in order to receive information regarding sales and participate in the bid process, which requires the completion and submission of the following documents to the FDIC:

- Confidentiality Agreement
- Purchaser Eligibility Certification – this document establishes that the potential bidder is eligible to purchase assets from the FDIC or any entity controlled by the FDIC.

- Bidder Qualification Request – this document establishes that the potential bidder is an "accredited investor" under the federal securities laws and has (i) the knowledge and experience in financial and business matters so as to be capable of evaluating the merits and risks of purchasing the LLC interest and (ii) the resources to purchase such interest.

Once these documents have been received and approved by the FDIC, the bidder will receive a password and access instructions for the website that provides sale information, and will be eligible to submit bids in any future sales. Each bid submitted must be final, non-contingent, and submitted on an "all or nothing basis," meaning that no bid will be accepted for fewer than all of the loans to be contributed to the LLC or in any sale structure other than that proposed by the FDIC. It is our understanding from prior transactions that each bidder may submit multiple bids.

How can a potential bidder conduct due diligence on the loan pool to be contributed to the LLC?

While the information available for each pool of loans may vary, the FDIC has previously provided electronically scanned copies of all available loan documents, including credit files and servicing records, for review by bidders and their representatives on the sale website.[6] Note that each agent or representative of the bidder will be required to execute a Confidentiality Agreement, if one is not on file with the FDIC or its financial advisors, and provide appropriate identification prior to commencing any due diligence review.

Can the FDIC require the LLC to sell the loans at any point?

The FDIC does retain the right to require the liquidation and sale of any loans or other assets remaining in the LLC, and liquidate the FDIC's participation interest, upon the earlier of (i) the seventh anniversary of the date upon which the Purchaser acquires its interest in the LLC, or (ii) the date upon which the aggregate unpaid principal balance of the loans is reduced to 10% of the loan balance as of a set date (which has previously fallen at some prior point during the due diligence period but before bids are due).

Conclusion

While, given the time and expense involved, this new LLC Structure is likely to be used only to dispose of relatively large loan portfolios, it does provide an interesting and seemingly effective way for investors to take advantage of significant profit opportunities at a reasonable price, while at the same time furthering the FDIC's ability to recover more in its disposition of assets, thereby potentially providing greater liquidity for the FDIC's Deposit Insurance Fund.

Of course, if we can be of assistance to you as you determine (a) whether to bid on certain loan assets, or (b) how to structure such a bid please do not hesitate to contact any of our lawyers below.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Interestingly, the FDIC is not the mandated receiver for all federally-insured financial institutions: "The FDIC must be appointed as receiver for insured federal savings associations [i.e. thrifts chartered by the Office of Thrift Supervision] and national banks [chartered by the Office of the Comptroller of the Currency]. For state chartered and Federal Reserve member banks, the chartering authority has the option of appointing the FDIC as receiver, although rarely has another entity been appointed." FDIC: The Resolution Handbook, at 85.

[2] Further information regarding these asset sales can be found at: http://www.fdic.gov/buying/index.html.

[3] We note the truism that beauty (and, in turn, art) is in the eye of the beholder.

[4] See CCH's Federal Banking Law Reporter, Volume 8, at ¶68-221:

> The FDIC is charged with using the "least-cost" method of resolving cases, in order to keep the expense to the Deposit Insurance Fund at a minimum. Specifically, the Corporation may not exercise any authority unless: (1) such action is necessary to fulfill the obligation of the Corporation to provide insurance coverage, and (2) the total amount of FDIC expenditures and obligations incurred "is the least costly to the Deposit Insurance Fund of all possible methods for meeting the Corporation's obligation."

[5] A previous transaction required the FDIC to fund all required amounts in cash, with the Purchaser being required to deposit cash or otherwise demonstrate its ability to fund its proportionate share.

[6] In certain instances, the FDIC has also made physical copies available for review in a designated location (such as an FDIC regional office). However, as the availability of these items may vary between transactions, bidders may not always be given the option to physically examine documents.