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April 10, 2009

VIA E-MAIL

Mr. Robert E. Feldman
Federal Deposit Insurance Corporation
Executive Secretary
550 17th Street, NW
Washington, D.C. 20429

Attention: Comments

Via Email: LLPComments@FDIC.gov

Re: Legacy Loans Program — Request for Comment

Dear Mr. Feldman:

The law firm of Sonnenschein Nath & Rosenthal LLP is pleased to submit the following comments regarding the Legacy Loan Program (the "LLP") proposed by the Federal Deposit Insurance Corporation (the "FDIC") in conjunction with the United States Treasury (the "UST"). We appreciate the opportunity to address this important effort of the FDIC and the UST to assist U.S. depository institutions (referred to herein as "banks" and "Participating Banks") to divest problem loans and other assets that have adversely affected the balance sheets, earnings potential and market perception of these institutions.

The lawyers at Sonnenschein collectively possess a broad range of experiences assisting financial institutions with their varied capital and balance sheet needs, as well as advising investors and other market participants in the secondary markets for residential and commercial loans and related securities and the FDIC and UST on various aspects of their efforts to address the financial crisis facing the banking and other industries. In reviewing the materials on the LLP, we note the importance of having a program that not only works in theory but creates incentives for the potential bank and investor participants to actively engage with the FDIC and UST to create successful transactions that achieve the purpose of the LLP. However, careful balancing is required so that the American taxpayers are not having their hard earned tax dollars placed at risk in order to yield windfall gains to either Participating Banks or participating investors.

We recognize that the LLP would serve to supplement the current reluctant secondary market for problem assets. We also recognize that the driving forces behind the reluctance are primarily economic — the inability of willing buyers and sellers to agree on a fair price on an identified pool of assets. However, we believe a disorganized market has evolved from the displacement of traditional market participants and the overall concern of investors as to whether distressed assets can be priced properly as the market is in a downward spiral. The efforts of the FDIC and UST to introduce the LLP have the potential to provide a certain degree of order for a more efficient matching of potential sellers and investors and allow for transaction efficiencies that will benefit all participants.

Our comments below are organized by substantive issues and we have, where appropriate, noted the relevant question from the FDIC's Program Description and Request for Comment that our comments address.

A. Eligible Asset Categories and Management Strategy

Response to Request for Comment questions 1, 7 and 8.

We recommend that the LLP be primarily focused on real estate related assets. This asset category contains a very large portion of unrealized losses embedded in bank assets, and stands to gain from increased market liquidity that the LLP can provide. In addition, real estate assets are amenable to a medium term "hold and workout" strategy that would benefit from financing available under the LLP.

We generally recommend that Eligible Assets be defined as broadly as possible within the real estate asset sector, in order to permit the sale of a wide range of asset types of varying levels of quality. We are concerned that if eligibility is defined too narrowly, then the higher quality assets could be stripped out of Participating Banks, leaving the worst assets behind. The increased risks related to lower quality assets can be addressed by permitting lower debt leverage, and requiring higher guarantee fees.

In particular, we recommend that Eligible Assets include the following asset types within the categories below:

Residential:

- all property types (including condos, coops and manufactured housing);
- first and second lien loans;
- HELOCs;
- primary and second homes, and investor properties.

Commercial and Multifamily:

- include permanent and construction loans;

- include mezzanine loans.

Furthermore, we recommend that Eligible Assets include loans in all performance categories, including: performing, previously modified (whether or not performing), delinquent, in foreclosure, in bankruptcy, and real estate owned ("REO").

It is important to move sub- and non-performing assets off of banks' books. The LLP can encourage the sale of these assets to distressed asset buyers, even at comparatively low leverage ratios. Placing such assets into public-private investment funds ("PPIF") will encourage the dedication of resources needed to workout these assets and thereby maximize recoveries. Losses to the FDIC on these assets can be minimal, given appropriate pricing, leverage and guarantee fee rates.

Given this proposed broad range of Eligible Assets, it is important to consider the appropriate management strategy for a PPIF and to take that into consideration in structuring. We believe that the LLP should not contemplate either a hold to maturity strategy or a trading strategy. Rather, the strategy should be to hold the assets and maximize recovery over a medium term horizon (for example, 2 to 5 years). For performing assets, it will take time to realize their embedded value, which is not reflected in current market prices due to illiquidity. For sub- and non-performing assets, it will take time to modify or restructure the assets, to determine which can be brought to performing status and sold, and to recover on those which cannot re-perform. This will require a very active management approach.

Regarding the requirement that the loans or collateral be located "predominantly" within the United States, we recommend that this be clarified in two ways. First, for real estate loans, this should be based solely on where the mortgaged property is located. Second, a percentage should be specified for "predominantly" in this context — for example 95%, which is the percentage specified for the corresponding requirement under the TALF program.

The suggested focus on real estate related assets should not be to the exclusion of other assets. As the LLP moves forward and transactions on real estate related assets are contemplated, other asset categories should be addressed, including non-real estate related asset based loans and unsecured commercial business loans.

B. <u>PPIF Structure</u>

Response to Request for Comment questions 3 and 12.

This section addresses legal issues related to the structuring of a PPIF. We are addressing these issues at the outset, because they give rise to various types of constraints which in turn are relevant in addressing the questions on which the FDIC requested comment.

This section also addresses structuring considerations for a PPIF where the private equity is held by sophisticated or institutional investors only (not retail investors). As discussed below, the most likely structure for such a PPIF is either a limited partnership in which a private entity serves as the general partner and the UST and other private investors are limited partners with correspondingly limited control rights or, alternatively, a limited liability company in which management and control is more equally weighted among the investors with a private investor as managing member. The choice of entity between a limited partnership and limited liability company involves a variety of business considerations that are more likely to be of greater concern to the investors in the PPIF than to the UST or FDIC. This assumes that the role of the UST is intended to be that of a passive investor similar to the Capital Purchase Program under TARP and the role of the FDIC is of general oversight which would be established in connection with the terms of the FDIC guarantee. Accordingly, we recommend that the choice of entity be left to the direct private investors(s) in any PPIF, subject to the governing documents for those entities being subject to either standardization or review and approval by the UST and FDIC. For ease of drafting and not with any intent to suggest a preferred structure, the remainder of this letter assumes that the LLP will utilize a limited partnership structure, though the bulk of the commentary applies equally to limited liability companies.

1. <u>Securities law issues</u>

a) *Debt*

An important structuring goal for all PPIFs is to minimize any legal constraints on transferability of the PPIF debt. In order to provide a proper incentive to utilize the debt structure, the debt should be freely tradable in the hands of either the sellers or the investors. We suggest that the FDIC clarify that the FDIC-guaranteed debt issued pursuant to the LLP will be structured in the same manner as the FDIC-guaranteed debt issued under the Temporary Liquidity Guarantee Program ("TLGP"), and thus will be exempt from registration under the Securities Act of 1933 (the "1933 Act"), as set forth in the Securities and Exchange Commission ("SEC") Response Letter dated November 24, 2008 with respect to the TLGP debt.

As an exempt security, and assuming no transfer restrictions result from reasons other than the 1933 Act, the FDIC-guaranteed debt could potentially trade among dealers on their government desks, which would afford a very high degree of liquidity and therefore result in the lowest possible yields. Furthermore, we believe that the FDIC-guaranteed debt would be appropriate for retail investors, and could therefore could be purchased in small denominations.

Please see the discussion in Section H. regarding the terms of the FDIC-guaranteed debt. As discussed in greater detail, there are important considerations about the terms of the debt which would bear on the depth of the trading market and the nature of any disclosure.

b) *Equity and Entity Level Issues*

Because any PPIF will be an entity that issues securities and that primarily invests in a pool of mortgage loans, the PPIF would be required to be registered as an investment company under the Investment Company Act of 1940 (the "1940 Act"), absent an exemption. Registration would not be generally feasible for an investor group bidding on a particular asset pool.

Private equity funds that are created to invest in distressed loans and securities are generally formed as limited partnerships, and are structured to rely on the exemption under Section 3(c)(7) of the 1940 Act. The principal constraints of this exemption are that there can be no public offering of any securities of the issuer, and that all investors in all classes of securities of the issuer must be "Qualified Purchasers" (as defined in the 1940 Act). Qualified Purchasers include natural persons with at least $5,000,000 in investments, as well as other persons (corporations, trusts etc.) with at least $25,000,000 in investments. These constraints are not in any way problematic for the anticipated typical non-retail investors in the equity of a PPIF. However, it would be very unfortunate to prohibit public offerings of the PPIF issued FDIC-guaranteed debt, or to have to restrict the debt to Qualified Purchasers.[1]

For PPIFs that are formed primarily for the purpose of investing in mortgage loans and real estate loans, we would recommend that strong consideration be given to structuring the fund to rely on the exemption to investment company registration under Section 3(c)(5)(C) of the 1940 Act. This is available to persons that are "primarily engaged in…purchasing or otherwise acquiring mortgages and other liens on and interests in real estate."[2] There is no restriction on the public offering of securities by such issuers, and no requirement that investors in those securities meet certain criteria. Therefore, reliance on this exemption would not result in any restriction on transfers of the PPIF issued FDIC-guaranteed debt.

Under either exemption, the equity interests in a non-retail PPIF would have to be offered and sold pursuant to an exemption from registration under the 1933 Act. Typically, equity in a fund of this type would be offered under a private placement under the 1933 Act, with investors also limited to Qualified Purchasers (as well as "Knowledgeable Employees" as defined in the 1940 Act Rules) in reliance on Section 3(c)(7) of the 1940 Act. Transfers of equity interests would

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[1] There are other exceptions under the 1940 Act that could be considered, but are similarly not desirable. Section 3(c)(1) contains an exception for issuers the securities of which are held by not more than 100 persons and who is not making a public offering. The 100 holder limit would be an undesirable constraint on the transferability of the PPIF issued FDIC guaranteed debt. Rule 3a-7 under the 1940 Act excepts certain issuers of asset-backed securities, but contains limitations on management of the assets that are unduly restrictive for this purpose.

[2] There are a number of SEC no-action letters that define "primarily engaged" in this context in terms of a specified percentage of the assets that must consist of mortgage loans and real estate related assets. We would be happy to provide a summary of these requirements upon request.

typically: (1) require consent of the general partner in the partnership, (2) be restricted to Qualified Purchasers, (3) be subject to typical 1933 Act private placement transfer restrictions, and (4) be further restricted if necessary to U.S. persons depending on the tax structure.

For PPIFs that rely on Section 3(c)(5)(C) and are therefore not required to be limited to Qualified Purchasers, consideration should be given to generic criteria for the types of investors who should be able to invest directly in PPIF equity. These criteria must include restrictions consistent with the PPIF equity being not publicly offered in accordance with the 1933 Act. Please see Section E. below for a discussion of transfer consent provisions.

2. Tax issues

The private sector investment in the LLP can be structured in a few forms but each form has some tax constraints that need to be addressed. We recommend that the FDIC coordinate with the UST to determine which vehicle will encourage the greatest participation by private investors and meets the objectives of the LLP. In particular, the UST should consider temporary relief specifically for the LLP.

Under current law, as noted above, we believe that the best and most likely tax structure for a non-retail PPIF is a partnership or another legal entity characterized as a partnership for federal income purposes (e.g. a limited liability company). Private investment in the LLP can be achieved through an investment in a U.S. partnership. Because the Eligible Assets included in the PPIF are all real estate assets, investment in a U.S. partnership presents different tax concerns for U.S. investors then it does for non-U.S. investors and tax exempts.

U.S. investors investing directly in the PPIF, while not concerned about being engaged in a U.S. trade or business, will have other tax concerns because of the nature of the Eligible Assets. The PPIF would be expected to generate significant amounts of phantom income (that is, taxable income resulting from transactions that do not generate cash to be used to distribute income), resulting from: a) the purchase of loans with substantial market discount, which causes the holder to recognize that discount over time as income, and b) certain loan modifications which would give rise to the recognition of gain at the time of the modification.

Typically non-U.S. investors and tax exempts are not as concerned about phantom income as they generally are not subject to U.S. federal income tax on these amounts. However, direct investment in the U.S. partnership by non-U.S. investors and tax exempts may cause some tax concerns. While foreign investors are generally permitted to own mortgage loans, the ownership of REO and any workout activities may pose “U.S. trade or business” tax concerns for non-U.S. investors. If the U.S. partnership uses debt financing (clearly contemplated under the LLP) there will be concerns regarding unrelated business taxable income (“UBTI”) for tax exempt investors and pension plans (both government and ERISA). Interest payments on mortgage loans will not have the benefit of the portfolio interest exemption because mortgage loans are not in registered form. Placing the loans in a grantor trust will satisfy the registered form requirement. If these concerns cause foreign investors and tax exempt investors to invest through a blocker U.S. corporation to minimize the tax consequences of Foreign Income Real Property Tax Act ("FIRPTA") or trade or business concerns, those classes of investors may choose not to participate because of the tax inefficiencies. We recommend that FDIC consider working with the Internal Revenue Service towards making some meaningful accommodation for non-U.S. investors, in order to permit maximum participation from a world-wide base of investors in the LLP.

Traditionally, the principal vehicle used to hold a pool of mortgage loans is a real estate mortgage investment conduit ("REMIC") which is a pass-through entity that issues securities to investors which entitle the investors to the underlying cashflow on the mortgages. The benefit to using a REMIC to hold a pool of securities is that all investors own debt for federal income tax purposes regardless of any equity characteristics of the REMIC securities issued. Thus, foreign investors can own REMIC securities free of any withholding on interest payments on the mortgage loans and without worry of being subject to the FIRPTA. Tax-exempt investors in REMIC securities do not have any UBTI. U.S. investors may have timing issues on recognition of income from converting market discount into original issue discount ("OID") but a REMIC alleviates the need to file any state income tax returns. However, REMICs were created by Congress to be a passive investment in current mortgages and the LLP will include delinquent or non-performing mortgage loans and such assets are not eligible for inclusion in a REMIC. Furthermore, the LLP anticipates an aggressive workout plan to modify mortgage loans and keep borrowers in their houses, and the REMIC rules were not enacted to allow "workout factories." The FDIC and the UST should consider some relief under the REMIC rules for participation in the PPIP if a REMIC would meet the other objectives to encourage foreign investment.

The second investment vehicle that is often used to own mortgage loans is a real estate investment trust ("REIT"). We note that REITs are typically structured to qualify under exemption 3(c)(5)(C) of the 1940 Act and may be offered publicly under the 1933 Act. REITs are also designed to be passive investments in real estate. The inclusion of delinquent or non-performing mortgage loans will result in adverse tax consequences upon a sale of the related REO. Furthermore, under the REIT rules, REITs are required to distribute 90% of their income annually in cash. Presumably, these mortgage loans are going to generate a significant amount of phantom income due to market discount and gain resulting from loan modification, thus the income distribution requirements will be difficult to comply with. REITs may also not be an appropriate investment vehicle since REITs are generally subject to a 100% prohibited transaction tax on gain resulting from the sale of mortgage loans or REO that have been held for less than 2 years. These rules may make investments in the LLP by a REIT extremely inefficient.

The traditional entities that invest in real estate all have some tax inefficiencies that may need to be addressed to encourage the broadest base of investors to participate in the LLP.

3. Government Equity Participation

The concept of the UST and private investors sharing in the equity investment in a PPIF allows for a significant extra cushion of equity support for the PPIF from the government while providing the private investors a significant economic incentive to invest in the PPIF and manage the assets acquired by the PPIF to maximize the economic return. We believe a maximum 50% investment by the US government is appropriate as we perceive a greater participation by the government may be a disincentive to attract private investors. Moreover, we suggest that the FDIC and UST consider providing greater clarity as to the ability of private investors to own greater than 50% of a PPIF. The FDIC may wish to consider allowing potential private investors to bid on a higher percentage of their choosing up to a maximum percentage determined by the FDIC and UST. Doing so would likely create an even greater incentive for private equity investment and minimize the use of taxpayer funds as part of the LLP. In evaluating the minimum and maximum UST percentage investment, consideration should be given to any warrants that may be received by the UST. Further, if warrants are distributed only to some investors, there may be implications requiring analysis under tax and securities laws, particularly for issuers relying on exemptions under the 1940 Act.

4. Reserves

With respect to the Debt Service Coverage Account, we recommend that the LLP contemplate the need for additional reserves, or even the possibility of making capital calls on investors. For some residential REO properties, it may be necessary to incur net carrying costs pending ultimate sale, even if the property is rented. Operating reserves may also be needed for loans on multifamily and commercial properties.

5. Licensing

Entities that purchase and hold mortgage loans secured by residential one- to four- family properties are required to be licensed in a number of states. Each PPIF would have to be licensed, or would have to acquire and hold the mortgage loans through an entity that is exempt from licensing requirements. Complying with licensing requirements could slow down the process of closing the sale to the PPIF. In light of the significant equity ownership interest that the UST will have in the PPIFs, we suggest that the FDIC and UST consider whether the PPIPs should be deemed exempt from these licensing laws by virtue of federal preemption.

C. <u>Structure for Indirect Retail Investment</u>

Response to Request for Comment question 5.

This section explores the possibilities for a structure which would allow indirect retail equity participation in a PPIF. It should be noted that retail investors may have the opportunity to indirectly invest in PPIFs through traditional indirect vehicles that otherwise have the inclination and ability to invest in the investment vehicles established by the private investors who would be eligible to invest in PPIFs. For example, certain mutual funds, insurance companies, pension funds or other ERISA funds which hold and manage money and investments for retail investors may be direct or indirect clients of the private investors eligible and interested in investing in PPIFs. Apart from these traditional existing indirect vehicles, new vehicles could be created specifically for the purpose of facilitating indirect retail investment in PPIFs, which is discussed below.

Any direct retail equity participation in the bidding process under the LLP would require a public offering of the equity interests, registered under the 1933 Act. We believe this would be effectively impossible at the 'front-end' of any bidding process, although a subsequent broader syndication of the interests held by investors in the PPIF is something that may be considered after some period of time. Except in the case where an investor's interest is subsequently syndicated to retail investors, any retail equity participation could only be effected through an investment vehicle to be established prior to starting the bidding process, and intended for use in connection with bids on multiple Eligible Asset Pools. The vehicle would bid as part of a bidding group, and in the event of a successful bid the vehicle would be one of the equity investors in the related PPIF.

One structure that could be considered for such a vehicle is a closed end fund ("CEF"), registered as an investment company under the 1940 Act. We believe that a CEF could be established for the purpose of investing in the equity of various PPIFs. The CEF shares would not be redeemable, would be registered under the 1933 Act, and may or may not be traded on an exchange. The CEF would have to publish its net asset value per share on a regular basis, which would present some challenges in terms of valuation given the illiquidity of its investments. However, the SEC registration process takes several months, and the ability to bring a fund to market will depend upon underwriter participation and broad investor interest.

A CEF structure would require careful analysis of the tax issues. A CEF would have to qualify as either a Regulated Investment Company ("RIC") or a partnership, in order to avoid an entity level tax. RICs are defined under federal income tax law. The RIC alternative is problematic because of the requirement to distribute 90% of taxable income to investors in cash. (Alternatively, a REIT could be used, but REITs are subject to the same requirement to distribute 90% of taxable income in cash.) It would appear that where a RIC invests in equity of a non-retail PPIF as contemplated in Section B. above, the RIC would look through the PPIF to the characterization of the underlying income and assets. The PPIF would be expected to generate significant amounts of phantom income (that is, taxable income resulting from transactions that do not generate cash to be used to distribute income), resulting from: a) the purchase of loans with substantial market discount, which causes the holder to recognize that discount over time as income, and b) certain loan modifications which would give rise to the recognition of gain at the time of the modification. To the extent that the RIC did not have cash from operations to meet the requirement to meet the distribution requirement, that shortfall would have to be covered from reserves, borrowings or capital contributions. Also, RICs are subject to limits as to the percentage of total assets that may consist of REO, and the percentage of gross income that may be derived from operation of or disposition of REO. These limits, particularly the latter, may be problematic in the context of a PPIF that invests in distressed mortgage loans.

One possibility would be to seek relief from the Internal Revenue Service from the 90% of taxable income distribution requirement, for RICs (or perhaps REITs) that are used to invest in PPIFs under this program. Similar relief has been granted recently for specific situations, but only on a temporary basis (for example, Rev. Proc. 2009-15). In order to encourage use of a RIC (or REIT) as a vehicle for indirect investment in PPIFs, we believe that any such relief would have to be permanent.

Alternatively, it appears that such a CEF could be characterized as a partnership for income tax purposes, and that it would not be disqualified by the publicly traded partnership rules.[3] However, investors in the CEF would have allocated to them shares of phantom income generated by the underlying PPIFs, as described above. In other words, the vehicle could generate significant tax liability to retail investors that would not be covered by cash distributions. We believe that this may not be appropriate for some retail investors. The same issue applies, of course, to equity investors in the PPIFs, but those investors are institutional or sophisticated investors who can be expected to understand these issues and comply with the related tax liability.

In addition to the foregoing issues, it may be difficult to find interest in the launch of a public CEF (or REIT) until it is clear that a regular stream of assets will be made available for sale under the LLP.

[3] A "publicly traded partnership" is taxed as a corporation if (i) interests in such partnership are traded on an established securities market, or (ii) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof); unless 90% or more of the gross income of such partnership for such taxable year consists of qualifying income. "Qualifying income" means interest, dividends, real property rents or gain from the sale or other disposition of loans or real property. We believe that substantially all income of a CEF investing in PPIF equity would be qualifying income.

D. Seller Concerns

Response to Request for Comment question 13.

The LLP presents a number of challenges and concerns for Participating Banks that may present barriers to entry to the program. These challenges and concerns range from initial asset identification to the consideration for the loan sale and are set forth below.

1. Asset Identification and the Bidding Process

The process for the identification of the Eligible Assets any Participating Bank would desire to sell and that investors are willing to bid presently places the burden on the Participating Banks and raises some accounting concerns. The LLP Summary of Terms provides that interested banks are to work with their primary bank regulators to identify assets to be sold. One potential concern for the interested bank is that by identifying assets for sale through the LLP they may be required to designate those assets as "held for sale" for accounting purposes resulting in market value accounting before the assets are put to auction. Many of the assets considered eligible for sale, particularly at the community banks, may not yet have been subject to mark-to-market accounting but for the commencement of a sale process. Given that there is uncertainty as to whether the proposed auction process will result in actual sales due to the potential for mismatched pricing between the investors and the interested banks, these banks may be reluctant to even explore the LLP if there is a possibility for a change in accounting treatment of the otherwise eligible assets. We suggest that the principal accounting firms be requested to provide guidance as to how to avoid "held for sale" treatment for loans evaluated for eligibility but not actually auctioned or auctioned but withdrawn from the auction process. We believe that to address this concern it would be helpful if the bidding and auction procedure were structured to allow several methods for identifying assets for inclusion in the LLP, including allowing the primary bank regulator for the Participating Bank to request the bank to offer up a specified pool of assets, which would allow the Participating Bank to have a more passive role in the process with the FDIC, and not the seller, organizing and leading the bidding and auction process.

2. Contract Process

With respect to the contract process, a potential concern for a Participating Bank is the retention of any significant degree of recourse due to breach of asset level representations and warranties, especially since the loans are likely to be sold at a discount. On the other hand, absent traditional representations and warranties, pricing for the loans could be further discounted to the detriment of the Participating Bank resulting in a failed auction. In addition, the FDIC, as guarantor of the PPIF's debt collateralized by the loans being sold, will, in essence, be relying on the asset level representations and warranties of the sellers on a pass-through basis. These conflicting concerns over representations and warranties could result in extensive negotiations that could hinder the auction process. To balance the conflicting concerns, the FDIC should consider utilizing a standardized set of documents with market standard loan origination and compliance with law representations and warranties, which would vary only depending on the asset class. The standard documents would be "bid upon" as part of the bid for the asset pool. This would allow bids to be evaluated on a level playing field and reduce transaction costs.

Further, FDIC may wish to consider the range of appropriate remedies for the breach of a representation or warranty. To address the concerns described above, we suggest that in the event of a breach the Participating Bank be given a reasonable period of time to cure the breach prior to any other remedy being made available to the PPIF.

3. Financing Flexibility

Currently, the Summary of Terms for the LLP provides that consideration will be paid to the Participating Banks in the form of cash or cash and debt issued by the PPIFs and guaranteed by the FDIC without providing clarity as to how the decision regarding the form of consideration for each Participating Bank will be made. The FDIC-guaranteed debt can be viewed as an attractive asset for a Participating Bank because the addition of the FDIC-guaranteed debt in exchange for the problem asset is likely to result in an improvement in the Participating Bank's risk-based capital ratios under the applicable rules and would constitute a performing and earning asset on the balance sheet. However, acquiring such debt may not fit a particular bank's balance sheet strategy and capital situation. As a result, imposing a requirement that the Participating Bank take back the debt instead of cash might be viewed as a disincentive to participation in the program. Therefore, it is suggested that the program should afford the Participating Banks adequate flexibility for their particular balance sheet and capital situation by providing them with the option to take back either FDIC-guaranteed debt, or cash (in which case the FDIC-guaranteed debt would be sold directly to investors and the proceeds would be applied as part of the purchase price).

4. Equity Participation Interest

As a general matter, the pricing discounts resulting from the auction process might be too significant to attract certain sellers. To provide an incentive for the sellers to participate in the LLP, the FDIC should consider an alternative structure to provide for an upside sharing by the sellers, such as equity participation. One possibility, assuming a limited liability company structure for the PPIF, is the creation of a special class of membership interest which will allow the sellers to participate in the final returns. Further, the FDIC should clarify that the Participating Banks are eligible to participate in the PPIF subject to the 9.9% equity limitation.

5. Broad Participation

We note that, on its face, the LLP is intended to include financial institutions of all sizes. We strongly encourage the FDIC to encourage participation in the program by financial institutions on the regional and community bank levels. To facilitate such participation, we suggest the FDIC or the primary bank regulator for a particular bank take the lead in pooling together loans from smaller financial institutions to be sold in the auction process. In doing so, the FDIC might want to consider identifying specific banks or specific regions which the investors might be interested in. In addition, the FDIC may wish to consider hiring an asset manager for this purpose. We note, however, that no risk-sharing arrangement among institutions that pool their loans together is being suggested and each institution should remain solely responsible for the loans it includes in the pool by executing separate agreements.

In addition, smaller banks might be less inclined to participate in the program due to the perceived transaction costs, a lack of prior experience with complex financial transactions or a possible fear of being taken advantage of by the more sophisticated investors. The use of a standardized set of streamlined contracts suggested above will help to alleviate some of these fears.

6. Expenses

Currently, the Summary of Terms for the LLP provides that the FDIC will be reimbursed for all expenses related to conducting the auctions without clarification as to which party will ultimately bear the auction expenses. In cases of the successful auctions, the expenses presumably will and should be reimbursed by the PPIF. However, the FDIC should clarify who would bear the auction expenses in any failed auctions and might consider not seeking reimbursement for such expenses from the interested banks in order to facilitate broader participation in the program.

E. Investor Concerns

Response to Request for Comment questions 2 and 4.

Private investors in a fund should have the right to pledge, sell or otherwise transfer their interests in such fund, subject to the requirements described in Section B.1, including the approval of the general partner (or other controlling person) of the PPIF. We believe this approval right should rest with the general partner or other representative of the management of the PPIF, and should not rest with the UST or any other government entity. Moreover, we do not believe that transferees that are passive equity investors should be limited to persons that satisfy the criteria established to be a qualified bidder. The bidder criteria should address a person’s ability to perform as bidder in an auction, and to execute on its commitment to purchase as a winning bidder, as these criteria are essential to the credibility of the auction process. Once a

PPIF is established, however, the same criteria need not apply to a passive equity investor. In some cases, there may be additional criteria that are appropriate for transferees in certain PPIFs, such as the ability to fund capital calls if those may be required under that PPIF. However, we believe that any such additional criteria should be objective, and should be spelled out in the terms of the governing documents.

Permitting a private investor to transfer its interest in a fund will (i) provide for a broader range of potential private investors since certain investors would be unwilling or unable to invest if no right of transfer existed and (ii) increase the value of the investments and thus increase bidding. The transfer of any private investor's interest in a fund should be accompanied by a certification that the related transferee meets the criteria of a qualified bidder or such other criteria that may be established for subsequent holders.

With respect to the identity of the equity investors, we recommend that the LLP contemplate that the identities of all persons (or all persons over a specified percentage) who are direct investors in each PPIF be disclosed or available for disclosure, after the time when a binding agreement to purchase the related pool has been entered into. We do not believe there should be a requirement to disclose the identity of the owners of each person directly owning PPIF equity, except to the extent otherwise legally required.

F. <u>Asset Diligence and Valuation</u>

Response to Request for Comment questions 5 and 17.

The qualifications of firms providing valuation and due diligence services in connection with the assets proposed to be sold to a fund will need to be disclosed.

Due diligence results should be made available to the bidders to enable the bidders to evaluate the quality of the assets. If more information is made available to bidders it should result in more accurate pricing for the assets and potentially shorter time frames for completing transactions since bidders may only need to perform limited additional due diligence or possibly no additional due diligence. The type of information that bidders would need to see should be solicited from potential bidders to understand what information bidders want.

There may be variances in the type of due diligence performed. Bidders for distressed assets may expect more complete due diligence and not rely on sampling results. Certain offerings may need to rely on sampling simply due to the number of assets included in a particular offering. In this regard, we note that diligence standards for the purchase of mortgage assets are evolving. Several of the major nationally recognized statistical rating organization have published guidelines for diligence that go beyond prevailing practices from before the subprime crisis. The new guidelines require greater efforts to verify current income and property value, and require a statistically significant sampling of loan data. In order to bring uniformity to the process, we recommend that the LLP establish diligence criteria to be used for various types of asset pools.

Allocation of the cost for the due diligence services should also be clarified. Imposing diligence costs on the Participating Bank would be a disincentive to entry and asset buyers would typically bear their own diligence costs in normal markets. The primary alternatives would then be for the FDIC to pay the diligence costs or for such costs to be passed on to all bidders for the particular assets or perhaps solely to the winning bidders. It will be necessary for the parties to understand how these costs will be paid in order to evaluate pricing. Please see discussion of expenses in Section D.6.

Valuation information may not need to be disclosed to bidders, and only shared with the selling banks, unless a minimum bid amount is desired to be established based on the resulting valuations. Each bidder should perform its own valuation of the assets based on the due diligence materials available and any other diligence the bidder desires to perform. The type of valuation performed would be expected to vary with the particular assets offered. For example, performing assets may utilize a valuation methodology based on the assumption of the assets remaining performing. However, non-performing assets are likely to be valued with the assumption that the assets will become further delinquent and thus need to be viewed from a liquidation perspective.

In order for bidders to have confidence in the due diligence results obtained by the particular due diligence provider, such providers will need to be industry established parties that are known to the bidders. Valuation providers should also be industry established parties that are known to the Participating Banks and bidders.

G. Auction Procedures

Response to Request for Comment question 6.

Ideally assets which are sold would be packaged in amounts which would be large enough to attract interest in the investing community, but not too large to prohibit or discourage all but the largest investors. Assets should be segregated by product type, and also divided into performing and distressed groups within product type. Potential investors or groups of investors should be required to bid on an entire pool, although nothing should prohibit them to join with others in making a bid if they do not have sufficient interest or ability to purchase assets at the full amount.

We do not believe that a Dutch auction would be suitable for this program. In a Dutch auction, individual bidders submit bids for a specified amount at a specified price, and the clearing price is determined by reference to the highest bid price such that bids at or above that price cover a quantity equal to the entire amount offered. The essential problem in this context is that bidders would be bidding individually for part of the equity, rather than individually for the entire equity or as part of a group bidding for the entire equity. Thus, winning bidders would end up as co-owners of PPIF equity with other winning bidders that they did not select or agree to. We believe that in the PPIF program, direct equity investors will generally wish to co-invest only with other investors that they had selected or agreed to.

H. <u>FDIC-Guaranteed Debt</u>

Response to Request for Comment questions 9, 10 and 11.

As indicated in our comments in Section B. above, we believe that the FDIC-guaranteed debt should be freely tradable and exempt from registration under the securities law. Further, to provide maximum liquidity, the debt should be DTC eligible, or be able to become DTC eligible, if negotiated by the parties involved.

While match term financing should be an essential goal of the LLP, it may be desirable to achieve this through debt terms such as laddered maturities[4] and prepay and extension options, rather than by tying paydown of the debt directly to the related pool performance. To the extent that principal payment terms of the FDIC-guaranteed debt are generic and not tied directly to the assets in the related PPIF, it may be possible for the trading market to effectively extend to all FDIC-guaranteed debt issued under the LLP program, as opposed to the trading market for the debt issued by each PPIF being somewhat limited to the debt issued by that PPIF. On the other hand, to the extent debt paydown is directly tied to pool performance, there may be more of a need to provide investors in the FDIC-guaranteed debt with detailed information about the pool, both initially and over time. These two different approaches are explored below. We recommend that the FDIC consider allowing either approach to be used under the program.

<u>Generic terms</u>

Under this approach, the maturity of the debt and the length of the FDIC guarantee would be fixed and bear a reasonable relationship to the expected life of the underlying asset pool. Consideration should be given to provisions allowing the debt to be prepaid in part or in whole prior to maturity, or for the maturity to be extended, at the option of the issuing PPIF. In order to provide enhanced funding flexibility and interest rate risk management, we would expect the PPIFs may desire to have debt in serial classes with laddered maturities (each of which may have prepay or extension options exercisable by the issuing PPIF), with the possibility that the debt of any class would need to be replaced during the life of the PPIF. In this circumstance, the FDIC may consider clarifying that it will guarantee any replacement debt issued during the expected life of the PPIF. This concept is similar to the existing TLGP Debt Guarantee Program in that the FDIC would establish a maximum amount of debt issued over a fixed period that would be guaranteed.

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4 If the debt has laddered maturities and amortizes based on payments from an underlying asset pool, then the Taxable Mortgage Pool rules must be considered.

Pool specific terms

Under this approach, the debt of each PPIF would be issued in a single class which would amortize under terms that are tied to the performance of the related asset pool. Given that the FDIC-guaranteed debt essentially will be backed by a pool of mortgages, the FDIC might consider having the debt pay down in a way similar to mortgage-backed securities rather than traditional UST debt with a bullet maturity. A bullet maturity, even with the generic terms discussed above, would have a considerable mismatch with most types of underlying collateral, and may not be as appealing to PPIF equity investors. In addition, the potential paydown rate of many of the types of assets that may be sold under the LLP may be very difficult to predict. Given the discounted price on the assets, a substantial portion of the cash flow to the PPIF may consist of excess coupon, and consideration should be given to applying some portion of the excess coupon to pay down the debt under this approach.

Consistent with the general concept that the LLP should be structured to invite the broadest group of participants, the method of issuance of the FDIC-guaranteed debt should be flexible to allow for public and private issuances as well as issuances to the Participating Bank as seller financing (as discussed in Section D. above). As suggested in Section D. above, the FDIC-guaranteed debt should be structured to have the same exemption from the 1933 Act as FDIC-guaranteed debt under the TLGP Debt Guarantee Program.

I. Asset Administration

Response to Request for Comment questions 15 and 16.

The administration of loans in an investment vehicle is customarily handled by different parties with separate roles. The following parties may be involved in administering loans held in an investment vehicle: primary or sub-servicer, master servicer, special servicer and/or loss mitigation advisor, and particularly with commercial assets, directing holder or controlling class and trustee.

Generally, a master or primary servicer's responsibility is to service the loans in the vehicle unless the borrower defaults, and the master servicer often sub-contracts certain loan administration duties to a primary or sub-servicer. The master or primary servicer is responsible for the flow of payments and information, holding and making any disbursements from escrows, performing routine administration functions and analyzing financial and property information from the borrower. The master or primary servicer is generally required to process all borrower requests and the master or primary servicer's ability to waive, consent or modify terms of any loan is governed by the operative legal documents of the investment vehicle. Many material servicing requests or modifications will also require the consent or approval of the special servicer, and in some cases those decisions are further subject to approval by the directing holder.

Upon the occurrence of certain specified events, primarily a default, administration of the loan is transferred to a special servicer who specializes in dealing with defaulted loans and is usually selected by the directing holder (discussed below). Like the master servicer, the special servicer must act to maximize the recovery on the loan to the investors (as a collective whole) based on an analysis of collection alternatives. Frequently the directing holder also has the ability to direct the special servicer's actions with respect to defaulted loans, subject to a servicing override.

The majority equity investor, or an investor in the most subordinate position, is usually considered to be the directing holder, also referred to as the 'controlling class' or 'B-piece' buyer. The directing holder typically plays an active, and sometimes controlling, role in monitoring the performance of each loan, making decisions on key asset issues and appointing and/or terminating the special servicer. Finally, the trustee's primary role is to hold all the loan documents and distribute payments received from the master servicer to the investors.

In light of all different roles in asset administration, the duties of the servicer(s) and asset manager in the program must be further defined by the FDIC. Will there be multiple roles including a master servicer that aggregates information from primary or sub-servicers, a special servicer that manages, resolves and disposes of non-performing loans and real estate owned, a loss mitigation advisor that would evaluate decisions of the servicer, and a directing holder? Will it be possible for private investors to be servicers and/or asset managers? Alternatively, the program should detail what authority the servicers and asset managers have over defaulted loans, loss mitigation and the management and disposition of REO property. Also, will asset managers be involved in raising capital for the program or in structuring the funds?

The private investors in the fund should have input in the selection of asset managers and in certain cases it may be appropriate for the selling banks to have some input in the selection. Ultimately, the FDIC should define certain criteria, including the appropriate level of experience, that any asset manager would need to satisfy. Such experience would address such institution's history in managing the specific asset types and its general strategies for handling such assets in the current market environment.

The duties of the asset manager for each specific asset type should be identified and the program should compel each such asset manager to perform its duties in accordance with an accepted standard of care. Unless an asset manager is required to be an investor, thereby ensuring that each asset manager shares in the management risk, private investors will want to guarantee that asset managers are performing their defined duties and taking appropriate actions.

As noted below, if the assets are sold to the fund on a servicing retained basis, the private investors will certainly place a greater emphasis on the role of the asset manager, particularly with respect to the ability of the asset manager to manage delinquent assets demonstrating a philosophy that protects asset values. Moreover, if asset servicing under the program is limited to managing the flow of payments and information and performing minor loan administration duties, then the asset manager would presumably assume a more significant role as primary servicer and/or special servicer.

Private investors may prefer the assets be sold on a servicing released basis with the expectation that the private investors will retain a servicer that is acceptable to the private investors and qualified as a servicer for the program. Particularly with delinquent assets, the ability to select the servicer and/or special servicer will have increased value to the private investors. Including the ability to choose servicers may improve the servicers' performance since there would be competition for future opportunities dependent on their performance. Strategies for managing delinquent assets are necessary to implement quickly to avoid further deterioration in the value of the assets. Utilizing a servicer that the private investors have a relationship with may enhance participation of private investors in the program. Those private investors will be familiar with that servicer's practices and comfortable in its ability to manage the assets effectively.

If the assets are sold on a servicing retained basis, the program should consider incorporating a right granted to the equity investors (the directing holders) to direct any delinquent assets to a special servicer of their choice, subject to established criteria, that would have more specialized abilities to service such delinquent assets. This special servicer could be the asset manager, an investor or the selling bank, and the equity investors may want to preserve the ability to direct the special servicer's actions with respect to defaulted loans (provided the servicing standard discussed below is maintained). As noted previously, time is of the essence when handling delinquent assets and having parties that have demonstrated an ability to manage such assets should be part of the eligibility criteria for the program as such parties would increase the probability of obtaining the best value for the fund.

From a pricing perspective, the sale of assets on a servicing released basis has historically correlated with a higher price for such assets. The decision on whether assets should be sold to the funds on a servicing released or retained basis should consider this pricing factor. The program could provide for the option of having an auction on a servicing released or retained basis.

The relationship between borrowers and servicers is accentuated for commercial loans. Because of the complex nature of most commercial loans, servicing requires a more hands-on approach with the borrowers and their businesses. Most originating lenders have good rapports with their commercial borrowers and a collective servicing knowledge about the loan. On the other hand, investors bidding on a pool of commercial loans will likely be proficient in dealing with commercial assets and familiar with commercial loan servicing. In deciding how servicing and asset management is going to be further defined and whether servicing should be sold on a released or retained basis, the FDIC should consider the additional diplomacy required with commercial borrowers.

The program indicates that the FDIC will be responsible for formation, funding and operation of the funds, but the FDIC will need to detail oversight of the program. Standardized reporting can be developed for servicers and asset managers to report to the FDIC. The FDIC could also have the right to periodic inspections of the servicers and asset managers and the ability to meet with management and discuss the status of the assets. Such day-to-day involvement would need to be tempered with the goal of allowing each asset administrator to perform its job with the confidence that it was a qualified participant for the program.

The program would need to provide more detail as to what loan modification programs and other workout strategies, if any, would apply to asset pools. It is expected that the Obama administration will provide further guidance with respect to the terms of its Home Affordable Modification program (the "Obama Plan") announced in March 2009. To the extent the Obama Plan would be applied to the program, some additional clarification would be needed regarding certain aspects of the Obama Plan, such as (i) how servicer and investor incentive fees should be allocated, (ii) what is the compensation schedule for servicers and the parameters with respect to certain loss mitigation strategies such as short sales and deeds in lieu of foreclosure, and (iii) what incentives would be provided to extinguish junior liens. Participants in the program will need more information on the terms of the agreements required to be entered into by the servicer under the Obama Plan. The program should provide guidelines for reporting and monitoring of loan modifications and instruction regarding the authority of program participants to implement loss mitigation strategies and whether certain consents will be required. The FDIC may want to consider permitting flexibility in choosing the applicable modification program for an asset pool. For instance, some loans in an asset pool may have already been modified or subject to a specific trial modification, requiring that such modifications be continued under the program. The ability to choose among various modification programs and other workout strategies in addition to the Obama Plan may affect the ability to maximize proceeds on the assets and impact the pricing and future value of the asset pool. In addition, depending on the structure of the program, clarification may be needed as to whether the servicing discretion involved in making loan modifications and implementing other workout strategies creates any trade or business issues for foreign investors and tax exempt entities as previously described.

J. Affiliation/Conflict Issues

Response to Request for Comment question 14.

Affiliations among various program participants may raise conflict issues that will need to be addressed or mitigated. Affiliations particularly among the sellers and the private investors and the multiple capacities they may have with respect to a PPIF present issues regarding manipulation of the program. Some of these conflict issues can be addressed by establishing ethical walls between affiliated service providers or otherwise barring certain affiliations, such as between the asset manager and the seller. There have also been concerns raised about the various roles of the government in the program. We believe it is essential to the success of the program that the FDIC and UST outline clear divisions between their roles as investor in the asset pool, as moderator of the program and as regulator of the seller institutions.

The program appears to place limitations on affiliations between sellers and private investors in the PPIF. According to the initial terms of the program, no PPIF can purchase assets from a seller that is affiliated with any of its private investors or from private investors that represent 10% or more of that PPIF. However, as discussed in Section D.4, there may be reasons for permitting the seller to be a private investor in an asset pool that it sells. The seller may be compelled to sell at a relatively low price but could hope to experience some future upside that the asset pool may realize over time. If the asset pool is being sold or offered on a servicing retained basis, the seller institution who has an investment in the PPIF may be further incentivized to maximize the return on that asset pool.

The program's limitations on the percentage interest held by any affiliated seller or other investor should be weighed against how those limitations would impact the investor pool and whether such limitations address potential conflict issues appropriately. For instance, placing restrictions on sellers investing in asset pools or portions thereof that they did not sell or in an asset pool sold by multiple sellers may be counter to the effort to obtain broad participation in the LLP. Any conflict concerns could be addressed by placing a limitation on the percentage invested or the assets sold, but such limitations shouldn't be so restrictive that they limit wide participation in the program. The FDIC could impose certain guidelines on the divesting of an affiliate seller's or a private investor's interest in the PPIF. The FDIC could also create a waiver procedure whereby specific affiliation issues that may be contrary to any published percentage ownership limits could be addressed.

K. Executive Compensation Issues

With respect to the executive compensation issues, Chairman Bair's comments as expressed during the Press and Technical Briefing Conference Call on Legacy Loans Program on March 23, 2009 to the effect that banks selling loans and investors participating in PPIF will not be subject to any limitations on executive compensation merely by participating in the LLP would be a suggested approach. It is our sense that potential market participants are concerned about these issues based on recent experience under the TARP and recent legislative efforts. A joint statement from the FDIC and the UST regarding this matter would provide clarity and allay certain fears from potential participants.

Conclusion

We thank you for the opportunity to comment on the Legacy Loans Program. If there are any questions or comments, please do not hesitate to contact either Stephen S. Kudenholdt at 212-768-6847 or skudenholdt@sonnenschein.com, or Robert C. Azarow at 212-768-5371 or razarow@sonnenschein.com.

Sincerely,

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