

Client Alert

A report
for clients
and friends
of the Firm

October 2008

The Emergency Economic Stabilization Act of 2008

On October 3, 2008, Congress passed, and the President signed into law, the Emergency Economic Stabilization Act of 2008 (the “Act”). The Act’s purposes are to provide immediate authority and facilities for the Secretary of the Treasury (“Secretary”) to restore liquidity and stability to the U.S. financial system and to ensure that such authority and facilities are used in a manner that protects home values, college funds, retirement accounts, and life savings; preserves home ownership and promotes jobs and economic growth; maximizes overall returns to U.S. taxpayers; and, provides public accountability for the exercise of such authority by the Secretary.

The Act is divided into three parts – Troubled Assets Relief Program (Title I), Budget (Title 2), and Tax (Title 3). We summarize here only the key elements of Title I of the Act.

- **Troubled Assets Relief Program.** The core component of the Act is the “Troubled Assets Relief Program” (or “TARP”) under which the Secretary may purchase, or make and fund commitments to buy, “troubled assets” from any “financial institution” on such terms and conditions as the Secretary determines are appropriate, and in accordance with policies and procedures to be promulgated by the Secretary.
 - *“Troubled Assets.”* Troubled assets subject to purchase by the TARP include (1) residential and commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial
- market stability, and (2) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability.
- *“Financial Institutions.”* Financial institutions eligible to participate in TARP include any bank, savings association, credit union, security broker or dealer, or insurance company having “significant operations” in the U.S., but excluding any central bank of, or institution owned by, a foreign government.
- *Pension Plans.* Although not listed among the entities that qualify as a “financial institution,” in exercising the authorities granted under the Act the Secretary may purchase troubled assets held by or on behalf of an eligible retirement plan.
- *Graduated Availability of TARP Funds.* Up to \$700 billion may be made available to purchase troubled assets from financial institutions, but the funds will be distributed in three stages: (1) the Secretary has immediate authority to purchase up to \$250 billion of troubled assets through TARP; (2) upon written certification by the President to Congress, such funding authority will be increased to \$350 billion; and (3) upon a further submission by the President to Congress, such funding authority will be increased to \$700 billion, unless Congress passes a joint resolution disapproving the increase within fifteen days after receipt of the President’s submission. The Secretary’s authority under the Act to buy and guarantee troubled assets ends on December 31, 2009, although Congress may extend that authority until October 3, 2010. To accommodate the availability of the \$700 billion, the public debt level will be raised to \$11.3 trillion.

- *Taxpayer Benefits and Protections.* The Act contains provisions to protect U.S. taxpayers in connection with TARP. Specifically, the Secretary is directed to use his authority under the Act to minimize any potential long-term negative impact on taxpayers, taking into account a number of considerations, including the direct outlays, potential long-term returns on purchased troubled assets, and the overall economic benefits of the program. To that end, the Secretary is required to:

- (1) hold the assets to maturity or for resale until such time as the Secretary determines that the market is optimal for selling such assets, to maximize the value to taxpayers; and
- (2) sell such assets at a price that the Secretary determines, based on available financial analysis, will maximize return on investments for the Federal government.

The Act also directs the Secretary to “encourage” private sector participation in purchases of troubled assets and investment in financial institutions.

The Secretary’s authority to purchase troubled assets may include the use of “market mechanisms,” such as auctions or reverse auctions, where appropriate. If the Secretary determines that use of market mechanisms is not feasible or appropriate, the Secretary may make use of direct purchases from individual financial institutions which would further the purposes of TARP.

The Secretary’s power to purchase troubled assets is conditioned upon the Secretary’s receipt from any selling financial institution that is publicly-traded of a warrant to receive either non-voting common or preferred stock, or in the case of a non-publicly traded financial institution, a warrant or a senior debt instrument from the institution. The warrant must provide for the Secretary’s reasonable participation in equity appreciation or a reasonable interest rate premium. The Secretary shall set the exercise price for any such warrant, in the interest of the taxpayers. The Act further provides that any warrant representing securities to be received by the Secretary must contain an anti-dilution provision to protect the value of the securities from market transactions such as stock splits, stock distributions, dividends, and other distributions, mergers, and other forms of reorganization or recapitalization.

- *Office of Financial Stability.* TARP is to be implemented by a newly created Office of Financial Stability (“OFS”) within the Office of Domestic Finance of the Treasury Department. The OFS will be headed by an Assistant Secretary of the Treasury who is appointed by the

President with the advice and consent of the Senate. To aid in TARP’s implementation, the Secretary also may hire new personnel and retain independent asset managers to manage troubled assets. Pursuant to the Act, Secretary Paulson yesterday designated Neel Kashkari as the Interim Assistant Secretary of the Treasury for Financial Stability. In this capacity, Kashkari will oversee the OFS, including the TARP. In addition, the Treasury Department posted three solicitations for the provision of services necessary for the effective implementation of the TARP. The services being solicited are:

- (i) custodian, accounting, auction management, and other infrastructure services for a portfolio of troubled mortgage-related assets;
- (ii) asset management services for a portfolio of mortgage whole loans; and
- (iii) asset management services for a portfolio of troubled mortgage-related securities.

- *TARP Guidelines.* The Act does not specify how the TARP is to be operated by the Secretary. Instead, within forty-five days after enactment of the Act (or, if earlier, the end of the second business day after the first purchase under TARP), the Secretary is required to publish TARP “program guidelines” including (1) mechanisms for purchasing troubled assets; (2) methods for pricing and valuing troubled assets; (3) procedures for selecting asset managers; and (4) criteria for identifying troubled assets for purchase. The Act specifically provides, however, that the Secretary’s establishment of the policies, procedures and administrative requirements imposed by the Act are not intended to delay the commencement of TARP.

- *Prevention of Unjust Enrichment.* In purchasing troubled assets through TARP, the Secretary must prevent unjust enrichment of participating financial institutions, including the prevention of the sale of a troubled asset to the Secretary at a higher price than what the financial institution paid to purchase the asset. The unjust enrichment provisions of the Act do not apply, however, to troubled assets acquired in a merger or acquisition, or a purchase of assets from a financial institution in conservatorship or receivership or that has initiated federal bankruptcy proceedings.

- *Insurance Program.* The Secretary is required to establish an insurance program to guarantee troubled assets that were issued or originated prior to March 14, 2008. This authority allows the Secretary the option of guaranteeing troubled assets pursuant to the insurance program, rather than purchasing them under the TARP. Under the

insurance program, upon the request of a financial institution, the Secretary may guarantee the timely payment of principal of, and interest on, troubled assets. Financial institutions that participate in the insurance program would have to pay premiums into a newly-created Troubled Asset Insurance Financing Fund. The Secretary may set the premiums based on the credit risk of the particular troubled assets being guaranteed. The Secretary is required to publish the methodology for setting premiums by asset class.

- **Oversight.** The Act contains provisions for oversight and reporting through various mechanisms.

- The Act establishes a Congressional Oversight Panel (“COP”) that will be responsible for reviewing the current state of the financial markets and the regulatory system. The COP also is required to submit periodic reports to Congress with regard to:
 - (i) The Secretary’s use of authority under this Act;
 - (ii) The impact of purchases made under the Act on the financial markets and financial institutions;
 - (iii) The extent to which the information made available on transactions under the program has contributed to market transparency; and
 - (iv) The effectiveness of foreclosure mitigation efforts, and the effectiveness of the program from the standpoint of minimizing long-term costs to the taxpayers and maximizing the benefits for taxpayers.
- The Act creates a new Financial Stability Oversight Board (“FSOB”) that will be responsible for reviewing the exercise of the Secretary’s authority with regard to the TARP and the guarantee program. The FSOB is required to report at least on a quarterly basis to Congress and the COP with respect to the Secretary’s exercise of his authority over the TARP and the guarantee program.
- The Act creates a new Office of the Special Inspector General for the TARP that will be responsible for conducting, supervising, and coordinating audits and investigations of the purchase, management, and sale of assets by the Secretary under the TARP and guarantee program. The Special Inspector General is required to provide to Congress a quarterly report summarizing his activities during the 120-day period ending on the date of such report.

- The Comptroller General of the United States will be responsible for ongoing oversight of the activities and performance of the TARP. The Comptroller General is required to submit periodic reports to Congress and the Special Inspector General on the activities and performance of the TARP.

- **Executive Compensation and Corporate Governance.** Under TARP, any financial institution that sells troubled assets to the Secretary is subject to the executive compensation requirements set forth below:

- Where troubled assets are purchased directly from an individual financial institution (*i.e.*, where the purchase does not include a bidding process or market prices are unavailable), and the Secretary receives a meaningful equity or debt position, the Secretary shall require the financial institution to meet “appropriate standards” for executive compensation and corporate governance. These standards shall include:
 - (i) limits on compensation that exclude incentives for senior executive officers to take unnecessary and excessive risks that threaten the financial institution while the Secretary holds an equity or debt position in the financial institution;
 - (ii) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive based on materially inaccurate financial reporting; and
 - (iii) a prohibition on golden parachute payments for senior executive officers of a financial institution.
- A financial institution that sells more than \$300 million in troubled assets to the Secretary is prohibited from deducting from its federal income tax return more than \$500,000 in annual compensation for each “covered executive” (CEO, CFO, and three other highest paid executives) for those years during which the sale of troubled assets exceeds \$300 million.
- Financial institutions that participate in auctions of troubled assets resulting in purchases of more than \$300 million in troubled assets by the Secretary are prohibited from entering into a new employment contract with a senior executive officer that provides for golden parachute payments in the event of involuntary termination, bankruptcy, insolvency or receivership.

- **Assistance to Homeowners.** The Act requires a number of steps to assist homeowners who are possibly facing default, including:
 - Where mortgages (or other assets secured by real estate) have been purchased under the Act, the Secretary shall “implement a plan that seeks to maximize assistance” for homeowners and use the authority granted by the Act to “encourage the servicers of underlying mortgages...to take advantage of” programs available to minimize foreclosures, such as HOPE for Homeowners.
 - The Secretary may also use loan guarantees and credit enhancements to facilitate loan modifications, such as a reduction in interest rate or a reduction in loan principal, to prevent avoidable foreclosures.
 - The Secretary is also required to coordinate with the FDIC and other federal government entities that hold troubled assets to identify opportunities for the acquisition of classes of troubled assets that will improve the Secretary’s ability to improve the loan modification and restructuring process.
- **Loss Recoupment under TARP.** Upon reaching five years from the enactment of the ACT, if TARP is running a deficit, the President “shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall” to ensure that TARP does not add to the deficit or national debt.
- **Mark-to-Market Accounting.** Under the Act, if the SEC determines that it is necessary or in the public interest, the SEC has the authority to suspend the Financial Accounting Standards Board Statement Number 157 regarding mark-to-market accounting standards for any issuer or any class or category of transaction.
- **FDIC Increase in Insurance Coverage.** The Federal Deposit Insurance Corporation deposit insurance amount was temporarily increased from \$100,000 to \$250,000, effective until December 31, 2009. During this period, the Board of Directors of the FDIC may borrow from the Treasury in order to meet the deposit insurance amount increase.
- **Gain or Loss from Sale of Certain Preferred Stock.** The gains or losses on the sale of Fannie Mae or Freddie Mac preferred stock that was held on September 6, 2008, or was sold on or after January 1, 2008 and prior to September 7, 2008, can be treated as ordinary income or loss by certain financial institutions or depository institution holding companies.
- **Market Transparency.** The Secretary must publish a description and the pricing of assets that are obtained pursuant to the Act. In addition, for each financial institution that sells troubled assets to the Secretary, the Secretary must decide whether the required disclosures regarding off-balance sheet transactions, derivatives instruments, contingent liabilities, and similar sources of potential exposure are sufficient to inform the public of the true financial position of the financial institution. If the disclosures are insufficient, the Secretary may recommend that further disclosure requirements be established.
- **Over-the-Counter Swaps.** Given the role that credit default swaps played in the recent meltdown, the Secretary is required by April 30, 2009 to submit a report to Congress analyzing the current state of the financial regulatory system and its effectiveness at overseeing participants in the financial markets, including the over-the-counter swaps market and government-sponsored enterprises. The Secretary’s report must provide recommendations for improvement, including (1) whether any participants in the financial markets that are currently outside the regulatory system should become subject to it, and (2) enhancement of the clearing and settlement of over-the-counter swaps, as a guarantee against “fails.”
- **Judicial Review.** Under the Act, any actions taken by the Secretary pursuant to his TARP authority may be set aside by the courts only if such actions are found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law. No other lawsuits or claims may be instituted against the Secretary by any financial institution or person that divests assets as a participant in the TARP or any other program under the Act. Accordingly, there would appear to be no private right of action against the Secretary in the exercise of his authority under the TARP.

The Act severely limits available equitable remedies to which the Secretary may be subjected in connection with implementing TARP, including:

- (1) For actions taken by the Secretary pursuant to the authority conveyed by Sections 101 (TARP), 102 (Insurance Program), 106 (Rights and Management of Troubled Assets), and 109 (Foreclosure Mitigation Efforts) of the Act, no injunction or other form of equitable relief may be issued against the Secretary, other than to remedy a constitutional violation. If any injunction or other form of equitable relief is issued against the Secretary for actions taken pursuant to these sections, such injunction or relief will be automatically stayed.

- (2) For actions taken by the Secretary pursuant to other sections of the Act, any request for a temporary restraining order against the Secretary must be decided within three days of the date of the request. In addition, requests for preliminary and permanent injunctions against the Secretary must be decided on an expedited basis and, whenever possible, a court must consolidate a trial on the merits with any hearing on a request for a preliminary injunction.

Any residential mortgage loan that is part of any purchase by the Secretary shall be subject to all claims and defenses that otherwise would be available to the borrowing homeowner.

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Client Alert

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