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Because of the rapidly changing conditions in the financial markets, we have established this special series of Client Alerts to advise you of the newest economic and legal developments and their wide-ranging business implications.

WHAT BANKS, FINANCIAL INSTITUTIONS, INVESTORS AND SERVICE PROVIDERS NEED TO KNOW ABOUT THE EMERGENCY ECONOMIC STABILIZATION PROVISIONS OF H.R. 1445*

What is It?

The historic “economic rescue” bill began as a 2 ½-page proposal from the U.S. Treasury to provide immediate liquidity to troubled financial markets and grew to a nearly 450-page enactment consisting of three separate laws: (i) the Emergency Economic Stabilization Act of 2008 (“EESA”), (ii) the Energy Improvement and Extension Act of 2008, and (iii) the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. President Bush signed the bill yesterday within moments of its passage in the House of Representatives. Whether Congress made immediate implementation of the “rescue” provisions of the bill unwieldy remains to be seen.

In the course of this week, the Senate assumed leadership for the passage of a “rescue” bill after the financial markets swooned on the news that the House did not pass the initial bill. The Senate added a comprehensive tax bill and provisions expanding basic FDIC insurance coverage to \$250,000 to the failed rescue bill and on Wednesday October 1 passed the broader rescue/tax package. The tax package includes a one-year patch for the Alternative Minimum Tax (AMT), extensions of expiring tax relief for businesses, energy tax credits and provisions ensuring that mental health benefits are on par with medical and surgical benefits. The change in heart of members of the House who had opposed the rescue bill on Monday may be attributed to a number of factors, including the addition of tax relief, expansion of FDIC coverage, mental health parity and evidence that the current economic crisis could get much worse without urgent Congressional action. The focus of this summary is on EESA. EESA is expected immediately to affect the outlook of banks and their investment bank affiliates and other financial services providers. The impact of EESA, however, is not limited to financial institutions desiring to sell assets, as the new law creates significant opportunities for service providers, contractors and investors interested in assets that will be available for purchase at the “back end” of the process. Even though much of the implementation of the EESA provisions is left to the Treasury Department, in our flagging economy there will be great pressure on Treasury to make the EESA programs operational just as soon as possible. It is possible, for example, that certain liquidity-enhancing asset sales could take place very soon, even before Treasury establishes final guidelines or rules.

Look Before You Leap - Oversight and Oversight of Oversight

The signature operational feature of EESA is government agency and Congressional oversight. While “hot button” issues such as executive compensation and government ownership of participating financial institutions dominated the headlines in the past two weeks, the extent of oversight provided in EESA likely will have an impact equal to those constraints on the willingness of financial institutions and others to participate in the TARP. Any financial institution wishing to sell assets into the TARP, any third party service provider or contactor to the TARP and any significant purchaser of TARP assets from the Treasury will fall under the authority and supervision of powerful government agencies, with the degree depending on the scope and level of participation.

Ultimately, there are layers of oversight, with Congress having the final say. One of legislative branch's major criticisms of the initial Treasury proposal was the tremendous authority and discretion granted to the Treasury Secretary. Now, over one-third of EESA is related directly or indirectly to administrative or Congressional review and auditing, reporting and other oversight. The layers of administrative and Congressional oversight consist of:

- The newly-created Financial Stability Oversight Board, which is responsible for reviewing the exercise of authority under TARP, making recommendations to the Secretary regarding the use of such authority and reporting fraudulent activity. Additionally, the Oversight Board is charged with ensuring that the policies implemented by the Secretary are in compliance with the Act, protect taxpayers and are in the economic interest of the United States. The Oversight Board is comprised of the Chairman of the Board of Governors of the Federal Reserve System, the Treasury Secretary, the Director of the Federal Housing Finance Agency, the Chairman of the Securities and Exchange Commission and the Secretary of the Department of Housing and Urban Development.
- The Comptroller General's expanded authority to conduct ongoing oversight and annual audits of TARP and to provide reports to Congress every 60 days.
- Establishment of the Office of the Special Inspector General for TARP to conduct, supervise and coordinate audits and investigations of the purchase, management and sale of assets under TARP and of the management of any insurance provided under TARP. The Special Inspector General is required to submit a quarterly report to Congress summarizing its activities and the activities of the Treasury Secretary under TARP.
- The appointment of a Congressional Oversight Panel that must review (i) the current state of financial markets and the regulatory systems and (ii) among other things, the Secretary's use of authority under TARP. The Oversight Panel must report to Congress every 30 days and submit a special report on the regulatory reform prior to January 20, 2009.

Increase in FDIC Insurance Coverage – Section 136

There is a temporary increase in the basic amount of FDIC deposit insurance coverage from \$100,000 to \$250,000, effective on the date of enactment of the bill (October 3, 2008) and ending on December 31, 2009. This increase is not to affect FDIC assessments on insured institutions. EESA contains similar provisions for deposits in credit unions.

Economic Stabilization

EESA provides up to \$700 billion to the Secretary of the Treasury to buy mortgages and other assets from financial institutions. Congress and the Administration believe that this will unlock liquidity not only in the global financial markets but for consumers, small businesses and other companies. EESA also establishes a program that would allow companies to insure their troubled assets. Some aspects of the bill apply more broadly to financial institutions, but the core of the legislation is the Troubled Asset Relief Program (to be known as the "TARP"). The law, through conduct-related proscriptions, establishes potentially burdensome regulation on any financial institution that desires to avail itself of the Treasury's largesse and on any other parties desiring to provide services to the TARP or purchase assets from it. In short, the trade may be liquidity or other financial gain in exchange for serious regulatory and legal oversight. No one will be able to take advantage of EESA without a careful cost-benefit analysis, based on analysis of unprecedented laws, guidelines and regulations.

The "Considerations" – Section 103

The actions of Treasury under EESA are to be guided by a set of considerations, set forth in Section 103. These are general principles, such as protection of interests of taxpayers and providing stability to financial markets, and notable specific considerations that may form a roadmap for how the TARP is implemented. It appears likely that the "considerations" in effect will create priorities and favored purchase mechanisms for Treasury as the TARP becomes operational.

- A specific consideration is aimed at smaller institutions. Treasury is to provide assistance to financial institutions that have assets less than \$1 billion that were well or adequately capitalized as of June 30, 2008 and that will drop one or more capital levels as a result of devaluation of Fannie Mae and/or Freddie Mac preferred stock. Treasury is to do this “in a manner sufficient to restore the financial institutions to at least an adequately capitalized level.” This means that Treasury may be considering the direct purchases of GSE preferred stock as part of TARP.
- Another significant specific consideration (and presumably, priority) for Treasury relates to the nature of asset sales but actually demonstrates that the Treasury may be more willing to engage in direct asset purchases (as opposed to market-mechanism purchases) with troubled banks. This is because Treasury it to take into consideration the “long-term viability” of the selling financial institution in determining whether to engage in direct asset purchases rather than otherwise-favored market-based purchases from particular financial institutions.
- Treasury is to take into consideration the long-term viability is protecting retirement security by purchasing “troubled assets” held by or on behalf of eligible retirement plans as defined in the Internal Revenue Code. It is not clear how retirement plans would sell assets into the TARP; presumably this will depend on whether the plan is a “financial institution” as defined in EESA (see below).

How Much?

EESA (in Section 115) provides “graduated authorization” for the purchase of “troubled assets” – first, upon enactment, up to \$250 billion, then, if the President submits to Congress a certification of the Treasury Secretary, up to \$350 billion, and then up to \$700 billion if the President submits to Congress a detailed written report from Treasury and Congress does not within 15 days issue a “joint resolution disapproving the plan.” The procedures for the submission and consideration of the “last \$350 billion” are lengthy, and appear to be designed to provide Congress with as much political cover as possible. It is hard to predict just how much Treasury will wind up spending on the TARP; the eagerness of financial institutions to accept immediate liquidity injections from the TARP will be tempered by the consequences of accepting the medicine. Further, the hope that the U.S Government somehow will “profit” from the purchase and sale of loans, securities and derivatives by the TARP seems farfetched, if it is assumed that these assets were of little intrinsic value when made or issued.

Basic Coverage – Section 101

Under TARP, the Treasury Secretary is empowered to purchase or fund commitments to purchase “troubled assets” from “financial institutions.”

- “Financial institution” is defined as any institution established and regulated under state, federal or territorial law having significant operations in the United States, including any bank, savings association, credit union, security broker or dealer, or insurance company, but *not including* any foreign central bank or institution owned by a foreign government. Under this definition, subsidiary or affiliate institutions owned or controlled by foreign companies are included, as long as such subsidiaries or affiliates otherwise meet the definition.
- “Troubled assets” are defined in two categories, mortgages and related assets requiring only an informal pre-purchase determination by the Treasury and “other financial instruments” as to which the Treasury and the Federal Reserve Board must first determine the purchase of which is necessary to promote financial stability. Specifically, “troubled assets” means (i) residential or commercial mortgages, and securities, obligations, or other instruments that are based on such mortgages (e.g., RMBS and CMBS), in each case *originated or issued on or before March 14, 2008* and the purchase of which the Treasury Secretary determines promotes financial market stability, AND (ii) “any other financial instrument that the Treasury Secretary, after consultation with the Federal Reserve Board, determines the purchase of which “is necessary to promote financial market stability” (but only upon transmittal of notice to certain Congressional Committees). It follows that the first category of troubled assets will be more readily marketable than the second category, but this will depend on how quickly Treasury and the Fed can make the additional showing and report it out to Congress.

What About “Hard” Assets?

The definition of “troubled assets” includes financial assets only and not “hard” assets such as OREO, even though Treasury is directed (in Section 103(9)) to consider the utility of purchasing OREO and multi-family CMBS. The Treasury’s purchase of troubled commercial mortgages and commercial mortgage-backed securities may well result in Treasury itself coming to own significant OREO arising from ongoing or subsequent foreclosures. If the purchase of commercial mortgage assets is given priority and facilitated through the TARP, Treasury conceivably could become one of the larger owners of commercial real estate in this country. In this sense, TARP will resemble RTC. Folks with memories of those days understand that there likely will be meaningful opportunities for property managers, default specialists and “distressed” purchasers of real estate in the commercial real estate arena.

Insurance Program – Section 102

EESA also establishes an insurance program for “troubled assets,” including RMBS. Development of the details of the insurance program, such as premium amounts, is delegated to the Treasury. Section 102 was added to the original House bill at the behest of members of Congress who favored a “rescue” solution not aimed at Wall Street-issued securities but at the performance of the underlying assets, i.e., mortgage loans. The extent of the guarantee may be up to 100% of the payments due under a troubled asset. The insurance program will be subject to certain of the same basic requirements and guidelines as the TARP, such as Section 103 (considerations by the Treasury Secretary) and Section 104 (Financial Stability Oversight Board). The insurance program is to be established after the TARP and important questions surround Treasury’s willingness to implement the insurance program with due haste. This summary covers the TARP provisions in greater detail than the insurance program portions of EESA, because the TARP is expected to be implemented quickly while the insurance program may evolve in the coming weeks or months.

Commencement of TARP: Treasury’s Authority

Congress included various implementing provisions in Section 101, but stated that establishment of policies and procedures and “other similar administrative requirements imposed [by Congress] on the Secretary [of the Treasury] by the Act are not intended to delay the commencement of the TARP.” This means that Treasury should be able to begin buying mortgages and mortgage-related assets (“MAMRA’s”) relatively quickly. In fact, the Treasury’s responsibility to publish TARP guidelines is triggered by Treasury’s first purchase of troubled assets. *See* § 101(d). It is not clear whether Treasury must promulgate all troubled assets purchase guidelines for both categories of troubled assets based on this aggressive timeframe. Rather, we could expect Treasury first to publish purchase guidelines for MAMRA’s and then later do so for the other category of “troubled assets” (which may be described as “stability-promoting purchased financial instruments” (“SPPFI’s”)).

It appears that Treasury will be establishing one or more TARP vehicles that are authorized to purchase, hold and sell troubled assets and issue obligations backed by the assets. *See* § 101(c)(4). These vehicles likely are to be special purpose entities, such that Treasury will have the flexibility inherent in this structure (not to mention limitation of liability). One of the key legal determinants early in the life of TARP will be establishing and funding these anticipated TARP vehicles. In this regard, it is possible that Treasury already has evaluated “pre-arranged” purchases of substantial quantities of MAMRA’s (or even SPPFI’s), keeping in mind that MAMRA’s include RMBS. It is notable that early sellers to the TARP could be subject to stricter regulation of executive compensation, which should weigh on whether a particular financial institution wants to participate in the TARP right away (if at all). Finally, under Section 120, Treasury’s authority with respect to the TARP and the insurance program expires on December 31, 2009, unless the Treasury Secretary provides written justification to Congress of why continued effectiveness of the TARP and the insurance programs is necessary, in which case these programs will live on for two more years.

Treasury is to implement its duties through a newly-created Office of Financial Stability (“OFS”) within the Office of Domestic Finance. The OFS is to be led by an Assistant Secretary. The Treasury Secretary may appoint an Interim Assistant Secretary immediately. The regulations and guidelines establishing the TARP and the operation of the TARP will be the responsibility of the OFS.

TARP Purchase Guidelines

EESA establishes TARP program guidelines (Section 101(d)) very generally, in starkly spare language. Significantly, the promulgation of these guidelines, the very driver of the TARP, will not be subject to notice and comment under the Administrative Procedure Act. Nonetheless, the ability of industry participants to provide feedback on these guidelines likely will exist, particularly because Treasury is to consult with the federal banking agencies at this stage. The guidelines are to include: (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.

Here Congress admonishes the Treasury Secretary, in purchasing troubled assets, to avoid unjust enrichment to financial institution participants in TARP, including preventing the sale of a troubled asset at a higher price than what the seller paid to purchase the asset. Section 101(e). In effect, this means that financial institutions or intermediaries will not be able to purchase distressed mortgage-related loans, securities and derivatives first and then sell them to the TARP at amounts in excess of the purchase price. This does not include the purchase of assets from a financial institution in conservatorship (i.e., Fannie Mae, Freddie Mac) or receivership (i.e., failed bank in FDIC receivership). Sellers of troubled assets may need to be sure, as a practical matter, that there is an established purchase or issue price of such assets before offering them for sale to the TARP.

In purchasing troubled assets under the TARP, Treasury first is to utilize “market mechanisms” such as auctions or reverse auctions. *See* Section 113(b). If Treasury determines that such “market mechanisms” are not feasible or appropriate, Treasury may engage in direct purchase of troubled assets. Direct purchases will be subject to “additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset” to be imposed by Treasury. Congress is showing here and throughout EESA a preference for auction sales (presumably, in bulk) of troubled assets rather than direct bulk or asset-by-asset sales to the Treasury.

Bank Regulators in the TARP

Bank regulators are given little authority regarding the TARP, though the Treasury Secretary must consult, in exercising his or her authority under the TARP, with the Fed, FDIC, OCC, OTS, OTS and HUD. Section 101(b). The Federal Housing Finance Agency (“FHFA”), HUD and the Fed are to participate in the Financial Stability Oversight Board, under Section 104. In addition, the FDIC is to be considered for selection as an asset manager for TARP residential mortgage loans and RMBS. Section 107(c). Because of the impact of EESA on bank capital, the FDIC can be expected to take a meaningful role in monitoring of the impact of EESA on insured depository institutions.

Federal Deposit Insurance Act Changes – Section 126

Besides the increase in basic deposit insurance coverage, EESA amends and modifies other parts of the Federal Deposit Insurance Act. EESA amends and extends FDIC’s authority to prohibit false advertising related to the availability or status of deposit insurance and misuse of the FDIC name. The FDIC is granted new authority to involve other bank regulators in the enforcement of these provisions. It makes sense for all insured depositories to review Section 126 in detail to confirm that internal controls are sufficient to ensure compliance with this part of EESA. Section 126 also extends FDIC’s agreement avoidance authority to any existing or future standstill, confidentiality or other agreement that limits the acquisition or offering of all or any part of a depository institution in connection with the FDIC’s exercise of its receivership powers.

Management and Disposition of Troubled Assets – Section 106

The Treasury Secretary is authorized to “exercise any rights received in connection with troubled assets” purchased under the TARP. Presumably, this means Treasury is empowered to enforce the terms of any agreements, contracts, instruments or obligations that constitute or are related to troubled assets purchased under the TARP. The extent of Treasury’s immunity to liabilities to or claims of other parties who may be liable on troubled assets is not fully articulated in EESA. Congress has assured that Treasury’s rights and privileges are not absolute, and Treasury could even be liable for damages or subject to material enforcement and foreclosure defenses asserted by consumer borrowers who are obligated on troubled assets (see below).

Treasury is authorized to manage and dispose of troubled assets purchased under the TARP. The Treasury is entitled to revenues and proceeds from the sale of troubled assets and from senior debt or preferred equity it takes in financial institution sellers to the TARP. These sums are to be deposited in the General Fund for reduction of the public debt. The Treasury's authority to hold and dispose of troubled assets does not expire upon the termination of the TARP under Section 120 (see below).

Roles for Third-Party Service Providers?

EESA contemplates (in Section 101) that Treasury will be entering into third party agreements or arrangements with financial institutions that are "financial agents" to the U.S. Government and with other third-party service providers. Service providers, contractors and agents will be needed at every stage of TARP's lifecycle, from initial establishment of TARP vehicles through evaluation, purchase, servicing, management and ultimate disposition of "troubled assets." EESA mentions or contemplates asset managers, loan servicers, portfolio specialists, property managers and expert consultants. This latter category may include attorneys, accountants, data processing firms and other automated solutions providers, quantitative experts, valuation specialists, auction firms, economists and financial forensics experts. Opportunities for these parties may be enormous in coming weeks and months, but the chance to work for Treasury in connection with the TARP comes with oversight and risk. For example, the appointment of financial agents will be subject to review by the Financial Stability Oversight Board [*see* § 104(a)(1)(a)] and, as discussed below, third-party arrangements will fall under the scrutiny of the Comptroller General and the TARP Special Inspector General.

Section 107 sets forth streamlined contracting procedures, which include Treasury's ability to waive any identified Federal Acquisition Regulation ("FAR") upon Treasury's determination of "urgent and compelling circumstances" that make compliance with the regulations "contrary to the public interest." If Treasury waives a FAR related to minority contracting, the Treasury Secretary must implement special back-up standards and procedures.

Section 108 requires Treasury to issue regulations or guidelines necessary to address and manage or prohibit conflicts of interest that may arise under the implementation or execution of EESA. The law says that conflicts of interest may arise in hiring of contractors, purchase of troubled assets, management of assets held, post-employment activities and other situations that the Treasury Secretary may identify. Treasury is directed to issue conflict-of-interest guidelines and regulations "as soon as practicable after the date of enactment" of EESA. These guidelines probably will not be outright prohibitions on all common-party or related-party transactions or contractual arrangements, because to do so very well could make the establishment and operation of TARP unworkable. Rather, the conflicts-of-interest guidelines likely will limit the activities and compensation of financial institutions and their affiliates and impose additional vetting, qualification, reporting and disclosure requirements on financial institutions and their affiliates, as well as on non-affiliated contractors and service providers.

The existence of Section 108 raises the question of how Treasury will deal with the most common method of selling residential mortgages today, that is, the seller-servicer model. Trillions of dollars of residential mortgages, particularly GSE-funded mortgages, rely on sellers of mortgages to service the transferred mortgages over the life of the loans. It seems likely that Treasury will take this basic model into account as the agency establishes purchasing guidelines and particularly conflicts-of-interest regulations or guidelines.

Any contractor or service provider to the TARP may be subject to audit and review by the Comptroller General of the United States. *See* § 116. This will include the Comptroller General's right to have access to the records, reports and communications belonging to or in use by the TARP and the financial advisors and other agents or representatives of the TARP. Perhaps more importantly, any contractor or third party will be under the jurisdiction of the Special Inspector General ("SIG") for the TARP, as per Section 121 of EESA. The duties of the TARP SIG include audits and investigations into the activities of the purchase, management and sale by Treasury of TARP-related assets and the management of the TARP. In this regard, the SIG is directed to create and maintain "a listing of and detailed biographical information on each person or entity hired to manage troubled assets." The SIG is empowered to hire third-party service providers and contractors of its own to conduct audits, analyses or studies.

Treasury's Ownership of Equity and Debt – Section 113

The Treasury Secretary is to hold and sell assets in a manner to reduce costs to the taxpayers, by maximizing return. This is to be done in two ways, through the purchase and sale of troubled assets and by way of compelled sale of non-voting equity or debt in participating financial institutions. As to the latter, Treasury is not permitted to purchase or commit to purchase any troubled asset under the TARP unless the Treasury Secretary receives from the financial institution -

- In the case of publicly-traded financial institutions, warrants for non-voting or preferred stock, which must be subject to anti-dilutions provisions and is exercisable at a price determined by the Treasury Secretary, or
- Otherwise, senior debt. If the financial institution is no longer publicly traded, warrants must be converted to senior debt.

Treasury is given broad power to determine the terms of conversion or sale of these instruments. The financial institution must assure that it has sufficient authorized shares available, and if the financial institution cannot obtain necessary shareholder approval, the Treasury Secretary may accept senior debt on such terms as will provide equivalent value to Treasury. Treasury is required to establish a “de minimis” exception for financial institutions, based on the cumulative dollar amount of purchases of troubled assets, at not more than \$100 million. This exception applies to these specific equity ownership provisions of EESA only, meaning that even small participants may be subject to other TARP duties and burdens.

The Treasury's interests are non-voting, from a corporate law standpoint. It is not known whether Treasury would seek to assert any influence over corporate governance as a result of holding these interests, but the extensive reporting requirements imposed on Treasury and other regulators under EESA as to the operation of the programs in effect will impose a new level of disclosure on financial institutions involved in EESA programs. As discussed below, the oversight of the Oversight Board, the TARP SIG, Treasury itself and Congress must also be factored in by any financial institution participating in the TARP.

Special Roles for the Private Sector?

Treasury must “encourage the private sector to participate in the purchase of troubled assets and in the investment of financial institutions consistent with the provisions of this section.” *See* § 113(a)(3). This special provision may be broken down into two components, *i.e.*, (i) participation by the private sector in the purchase of troubled assets, (ii) investment by the private sector in financial institutions. In each case, Treasury's “encouragement” would appear to be based on the objective stated in Section 113(a)(1) – minimizing potential long-term (negative) impact of the TARP on taxpayers. The scope of this provision, the full implementation of which by Treasury technically is not mandatory, is difficult to discern at this early stage. The possibilities bear close attention not only by financial institutions but by financial investors such as private equity shops, hedge funds and others. Presumably, this “private sector” provision in EESA is intended to facilitate public/private ventures that would purchase troubled assets and perhaps pre-sale of assets to private financial parties out of the TARP. It is less clear what the second component means as a practical matter, because EESA itself does not facilitate, at least directly, the purchase of “investments” in financial institutions.

Reporting of Purchases of Troubled Assets – Section 114

The Treasury must disclose to the public, in electronic form, a description of troubled assets purchased, including description of the assets, amounts, and pricing, within 2 business days of purchase, trade or other disposition. As a practical matter, this means that the scope and terms of the each sale by a financial institution of troubled assets will be known. The Treasury Secretary must determine whether the public disclosure required of financial institutions for off-balance sheet transactions, derivatives, contingent liabilities and “similar sources of potential exposure” is “adequate to provide to the public sufficient information as to the true financial position of the institutions.” If the Treasury Secretary determines that disclosure is insufficient, then he or she shall make recommendations for additional disclosure requirements to other relevant regulators.

Limits on Executive Compensation – Sections 111 and 302

One of the most contentious aspects of the new law was compensation for executives of participating financial institutions. Congress settled on onerous requirements. At the outset, two sets of standards are imposed on financial institutions, depending on the method of Treasury's purchase of troubled assets. For purposes of the Section 111 compensation restrictions, "senior executive officer" means one of the top 5 executives of a public company whose compensation is required to be disclosed in federal securities filings and counterparts in non-public companies.

- If (i) Treasury determines that direct purchases of troubled assets from a financial institution best carries out the purposes of EESA, (ii) there is no bidding process or market prices are available, and (iii) Treasury obtains a "meaningful debt or equity position" as a result of the transaction, then Treasury may impose criteria that include (x) limits on incentives for executive officers to take risks that threaten the value of the financial institution, (y) recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria "that are later proven to be materially inaccurate," and (z) prohibition on golden parachute payments to the "senior executive officer" (ordinarily, the CEO) during any time period that Treasury holds warrants or senior debt in the financial institution (*see* Section 113).
- When Treasury determines that auction purchase of troubled assets best carries out purposes of EESA, but only when overall purchases exceed \$300 million, then no new employment contract with a senior executive officer may contain a golden parachute.

Tax treatment of compensation to executives is restricted for companies that participate in the TARP, as per the Section 302 amendments to tax treatment of executive compensation. Basically, deductibility of compensation is capped at \$500,000 with respect to "covered executives." Employers become affected if Treasury purchases one or more troubled assets under the TARP in the aggregate of \$300 million over the life of the program, unless the only sale of troubled assets by the employer is by one or more direct purchases by Treasury under the TARP (in which case the \$300 million cap does not apply). The definition of "employer" is qualified by aggregation rules in the Internal Revenue Code. The definition of "covered executive" includes the CEO or the CFO of the financial institution or 1 of the 3 highest compensated officers of the employer. Section 302 also contains rules limiting severance payments and golden parachutes.

TARP-Related Loss Mitigation Efforts for Consumers – Section 109

Treasury is required to implement a homeowners' assistance program with respect to acquired mortgages, RMBS and other assets secured by residential real estate (including multifamily housing). This program is to include encouraging existing mortgage servicers to take advantage of the HOPE for Homeowners Program and "other available programs to minimize foreclosures." The Treasury Secretary is authorized to use loan guarantees and credit enhancements to facilitate loan modifications that prevent foreclosures, presumably from the TARP budget. The Treasury Secretary is directed to coordinate with other federal agencies, including HUD and FHFA, that hold troubled assets (including mortgages, pools of mortgages or RMBS) to identify opportunities to for targeted acquisition of classes of troubled assets that lend themselves to the Treasury Secretary's loan modification mandate. This should facilitate the purchase of troubled assets from Fannie Mae and Freddie Mac (under conservatorship). Under existing investment contracts, the Treasury Secretary *must* consent to reasonable requests for loss mitigation measures, where appropriate and considering net present value to the taxpayer, including term extensions, rate reductions, principal writedowns and increases in the proportion within structured transactions (e.g., MBS) of loans that may be modified.

Assistance to Homeowners Outside of TARP – Section 110

Congress is directing "federal property managers" to engage in extensive loan modification activities for the benefit of consumers. The mortgage-related assets subject to these requirements are not tied to the TARP, so that this broad-ranging consumer protection regime has little or nothing to do with restoring liquidity in the markets. Significantly, the term "federal property managers" includes FHFA as conservator of Fannie Mae and Freddie Mac, the FDIC as receiver and the Fed with respect to RMBS owned by the Federal Reserve Banks outside of open market activities. This means that Fannie Mae or Freddie Mac approved seller-servicers may be affected by Section 110.

As to mortgages, MBS and other mortgage-related assets secured by residential real estate (including multifamily housing), the “federal property manager” must implement a plan that seeks to maximize assistance to homeowners and encourage servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program or other available programs to minimize foreclosures, considering the net present value to the taxpayers. The modifications may include reduction in interest rates, reduction in principal balance and “other similar modifications.” For residential rental properties, tenants are to be protected through the continuance of applicable government housing subsidies and operating reserves.

Other Significant “Burdens” on Financial Institutions in TARP

No financial institution should consider selling “troubled assets” into the TARP without carefully considering the indirect burdens of the new law, just as no service provider or contactor to the TARP should proceed without a similar analysis. At first glance, these are not provisions aimed in a straight line at conduct of financial institutions and others participating in the TARP. However, these provisions, built into the various oversight mechanisms in EESA, create legal, reputational and operational risks to parties involved with the TARP.

- The Financial Stability Oversight Board (as per Section 104) mainly is charged with oversight of Treasury’s implementation of the TARP. The Board is charged with reporting any suspected fraud, malfeasance or misrepresentation to the TARP SIG and the U.S. Attorney General, and the “level” of this activity is not specified. It follows that the Board could be dealing with institution-level or asset-level matters and there is no “due process” connected with the Board’s reporting under Section 104(a)(3).
- Under Section 116, the Comptroller General is responsible for ongoing oversight of the activities and performance of the TARP and “any agents or representatives of the TARP,” including vehicles established to facilitate the TARP. The Comptroller General’s oversight responsibilities are set forth in detail, and include characteristics of transactions and commitments entered into by the TARP, including “transaction type, frequency, size, prices paid, and all other relevant terms and conditions, and the timing, duration, terms of any future commitments to purchase assets.” This almost certainly means that the details of every institution-specific TARP asset purchase (including identification of the financial institution itself) will be subject to the Comptroller General’s scrutiny. There are like provisions imposed on purchasers of assets *from* the TARP.
- Under Section 121 of EESA, the TARP Special Inspector General will enjoy the same broad-ranging oversight authority as is the case for IG’s of other major government agencies. The TARP SIG’s enumerated EESA duties to conduct, supervise and coordinate audits and investigations in connection with the TARP specifically include, among other things, collecting and examining a listing of each financial institution that sells troubled assets to the TARP.
- Perhaps most significantly, EESA is chocked full of reporting requirements that will result in significant public disclosure of the participation by and specific terms of purchases involving financial institutions participants in the TARP. The full impact of these requirements and related provisions are unknown, but bear close attention by financial institutions and others evaluating TARP-related opportunities. These requirements, which are not imposed directly on financial institution participants, include Section 114’s two-day transaction reporting by the Treasury, but so-called “tranche reports” to Congress under Section 105(b). Under this subsection of EESA, Treasury is to provide written reports to the “appropriate committees of Congress” first upon the amount of TARP purchase commitments reaching \$50,000,000,000 and then upon each additional \$50,000,000,000 in additional commitments thereafter. These reports are to include “a description of all of the transactions made during the reporting period.” It is difficult to envision how Treasury will meet its duties regarding “tranche reporting” without identifying information about specific financial institutions selling into the TARP. In addition to these identified reporting mechanisms, it is possible that the information identifying specific financial institutions or TARP contractors and agents could find its way into other audit reports, written findings and other public information generated by Treasury, the Comptroller General, the TARP SIG and Congressional committees under EESA mandates.

Role of the Courts and Allocation of Legal Liabilities – Section 119

Section 119 imposes another form of “oversight,” one that is all too familiar to financial institutions and others in business – from the courts. The initial Treasury proposal contained immunity for Treasury. EESA as enacted not only removed this immunity, but imposed actionable legal responsibilities on Treasury and preserved potential liabilities on other parties. Thus, claims or causes of actions are sure to arise not only against Treasury or TARP vehicles, but against other participants in the TARP.

Actions by Treasury under EESA are subject to the Administrative Procedures Act, including the familiar standard of review – final actions are unlawful and shall be set aside by the courts if found to be arbitrary, capricious, an abuse of discretion or not in accordance with law. Equitable relief, including injunction, is not available for TARP or insurance fund-related actions, except for violations of the Constitution (for example, under the 14th Amendment, as per Section 1983). Injunctive remedies may be available for other alleged violations, and the proceedings must be conducted on an expedited basis. No party that “divests its assets” under an EESA program may bring an action or claim against the Treasury Secretary, except as provided under the APA provisions in Section 119(1) (discussed above). Whether such claims will be available to financial institutions selling “troubled assets” into the TARP may be unlikely, because asset purchases are completely voluntary and purchases of assets by TARP vehicles may not be “final agency actions.”

Under Section 119, the terms of a residential mortgage loan that is part of any purchase by Treasury will remain subject to all claims and defenses that would otherwise apply. It appears that Treasury or the purchasing TARP vehicle established by Treasury could stand as a defendant, in its capacity as assignee of whole loans, in any case brought by an aggrieved homeowner who is obligated on the purchased loan. The Treasury presumably would be able to avail itself of any defense that an assignee may claim to affirmative liability, but any homeowner would be able to assert his or her own defenses to collection of the loan by the Treasury (for the benefit of the taxpayers).

Common consumer claims include actions that either delay or negate the right to conduct foreclosure, so as to each residential mortgage loan that Treasury purchases, it may be questionable whether Treasury would be able to foreclose on (and realize value from) such a loan. Section 119 also states that Treasury’s exercise of its rights under EESA, including purchase of troubled assets, will not affect the claims and defenses that would otherwise apply to parties other than Treasury. This means that a financial institution may well need to defend consumer claims on residential mortgage loans (and claims on commercial real estate loans) even after the loans are purchased by Treasury under the TARP. The path to government liability for the alleged misdeeds of loan originators or intermediate parties is not as straightforward when RMBS are sold into the TARP. This will depend on the legal status of Treasury (or the TARP vehicle created by Treasury) upon purchase of particular assets.

Relaxed Duty on All RMBS Servicers?

Section 119(b)(2) also modifies the legal duties of residential loan servicers and, in particular, RMBS servicers. It does not appear that this subsection is tied to TARP-related assets. This subsection modifies the duty of servicers to investors in RMBS transactions. If the servicing agreement is silent on the issue, by operation of law (EESA) the servicer owes a duty to all investors and holders (but not any particular group of investors or holders) to determine whether the net present value of the payments on the loan, as modified, is likely to be greater from the net recovery from liquidation of the collateral (foreclosure). If the servicer takes appropriate loss mitigation steps, including loan modification or workout as to a particular loan, then the servicer will be deemed to act in the best interest of all classes or investors or holders. This subsection seeks to relax and standardize specific loan modification duties on loan servicers of trouble assets purchased through the TARP, as a means of encouraging loan workouts. The extent of exculpation is not worded strongly, and it appears that a loan servicer still could be challenged on whether its specific actions fit the facts for establishing this very limited safe harbor.

Mark-to-Market – Section 132

The SEC is granted authority to suspend the FASB mark-to-market rule (FAS 157). Under Section 133, the SEC is to conduct a study of FAS 157, which must include consideration of the effects of FAS 157 on financial institution balance

sheets, impacts of such accounting on bank failures in 2008 and even the process that the FASB uses to develop accounting standards.

Pay-Later – Section 134

Five years after the effective date of EESA, the OMB, in consultation with the Congressional Budget Office, must submit a report to Congress on the net dollar amount of the TARP. If there is a shortfall, the President must submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall, in order to ensure that the TARP does not increase the deficit. Whether this provision is even constitutional is open to question, and the taxpayers should not find comfort in a bill that may or may not be introduced five years from now.

Amendments to HOPE for Homeowners – Section 124

EESA contains significant amendments to the HOPE for Homeowners Act (which was enacted as part of the comprehensive Housing and Economic Recovery Act of 2008 (“HERA”). These amendments are intended to permit the FHFB to exercise more flexibility regarding required debt-to-income ratio, insured principal amount and payments on subordinate mortgages.

Tax Provisions that Matter to Banks and Financial Institutions

Section 301 of EESA amends the Internal Revenue so that gain or loss from the sale or exchange of “applicable preferred stock” by any “applicable financial institution” will be treated as ordinary income or loss. Enjoying this treatment are FDIC-insured institutions that held Fannie Mae or Freddie Mac preferred stock on September 6, 2008 or sold or exchanged it on or after January 1, 2008 but before September 7, 2008. There are other special rules in Section 301 that apply to GSE preferred stock.

Parts of the comprehensive law other than EESA cover tax law changes that affect financial institutions, individual taxpayers and investors. The new law provides another one-year patch for the alternative minimum tax to keep it from extending to middle class taxpayers. The bill also includes “extenders” such as extension through 2009 of the Subpart F deferral of tax on the earnings of a foreign subsidiary of a U.S. parent in a banking, financing or similar business, and the research and development tax credit. Other “extenders” to 2009 of provisions set to expire this year include: extending the basis adjustment to stock of an S corporation making charitable contributions of property; extending tax-free contributions from Individual Retirement Account plans to charitable organizations; extending the new markets tax credit; and providing an additional standard deduction for real estate taxes to taxpayers who do not itemize. The new law extends through 2012 the current tax forgiveness on cancellation of mortgage debt that was set to expire in 2009. The bill provides disaster tax relief to individuals and businesses. To partially offset the cost of the tax breaks, the bill requires securities brokers to report the cost basis for transactions involving stock, debt, commodities, derivatives and other items.

If you have any questions about this or another financial services matter, please contact a member of the [Capital Markets Practice Group](#) at Womble Carlyle Sandridge & Rice, PLLC. Readers are urged to consult with their regular contacts at Womble Carlyle.

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