

Client Advisory

Summary of Final Legislation — Emergency Economic Stabilization Act of 2008 (EESA) / Troubled Asset Relief Program (TARP)

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the Act) was enacted, giving the Secretary of the Treasury (Secretary) the authority, among other things, to implement the Troubled Asset Relief Program (TARP). The TARP allows the Secretary to purchase and insure troubled assets from a range of financial institutions, including, but not limited to, insurance companies and securities brokers and dealers, in order to restore liquidity and stability to the U.S. financial system. The Secretary has published the first requests for proposals for financial agents to perform services to administer the TARP, and the first asset purchases are expected to occur soon. More recently, the Secretary has indicated that Treasury will use the Act to invest in financial institutions to bolster their capital levels in order to boost confidence in the stability of the U.S. financial system. The following is a summary of some key provisions of the Act and the TARP. Unless otherwise specified, all section references relate to the Act.

Purchase, Insurance, Management and Disposition of TARP Assets

Key Defined Terms. Under the Act, the Secretary has the authority to purchase “troubled assets” from “financial institutions.” Section 3 defines “troubled assets” to include (i) residential or commercial loans, (ii) “securities, obligations, or other instruments that are based on or related to such mortgages” (in each case, as long as those assets were originated or issued on or before March 14, 2008), or (iii) any other financial instrument that the Secretary in consultation with the Chairman of the Board of Governors of the Federal Reserve System (Fed Chairman), determines is necessary to purchase to promote financial stability. Section 3 also defines “financial institution” to include a broad range of different types of financial institutions organized and regulated under the laws of the U.S., or any state, territory or possession of the U.S., and having “significant operations” in the U.S., and specifically excludes any “central bank of, or institution owned by, a foreign government.”

Office of Financial Stability. Section 101 requires the Secretary to administer the TARP through a new Office of Financial Stability (OFS), established within the Office of Domestic Finance of the Treasury Department, headed by an Assistant Secretary of the Treasury. On October 6, Neel Kashkari was appointed the interim head of the OFS.

Authority to Purchase Assets and Take Related Actions. Section 101 gives the Secretary authority to purchase, and to make and fund commitments to purchase, “troubled assets” from any “financial institution”. Under Section 115, initially the Secretary has immediate

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¹ A number of provisions unrelated to the TARP program were included in the final Act, including many tax and energy provisions and the Wellstone-Domenici Mental Health Parity Act. These provisions are not summarized or discussed in this Client Advisory, but clients may call any member of the TARP Task Force with questions related to those provisions.

access to \$250 billion. The Secretary may gain access to an additional \$100 billion upon a Presidential certification of need. The remaining \$350 billion is authorized if, after a Presidential request, Congress, using fast track procedures, does not pass a joint resolution of disapproval within 15 days.

Section 101(c) gives the Secretary the authority to accomplish the goals of the program by (i) hiring employees, (ii) entering into contracts, (iii) designating financial institutions as financial agents to perform all reasonable required duties, (iv) establishing vehicles that are authorized, subject to supervision by the Secretary, to purchase, hold, and sell troubled assets and issue obligations, and (v) issuing regulations and guidance to carry out the Act's purposes.

On October 6, the Secretary requested proposals, which were due on October 8, for financial agents to provide custodial, accounting, auction management and other infrastructure services, as well as whole loan and securities asset management services.

Acquisition, Management and Disposition of Assets. Section 113(b) directs the Secretary to use market mechanisms to effect purchases of assets at the lowest price that the Secretary determines to be consistent with the purposes of the Act, including auctions or reverse auctions, when appropriate. It should be noted that one of the main purposes of the Act is to stabilize the financial system, and that purchases of assets at the lowest possible price might be deemed to conflict with that goal. If the Secretary determines the use of market mechanisms is not appropriate or feasible, Section 113(c) allows the Secretary to purchase assets directly from financial institutions, while pursuing "additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset." The Act does not specify what such "additional measures" might include, but presumably they might include expert valuations of assets.

After assets are purchased, Section 106 authorizes the Secretary to (i) exercise any rights received with respect to the assets, (ii) manage the troubled assets, including revenue and portfolio risks, and (iii) dispose of the assets through sales, securities loans, repurchase transactions or other financial transactions.

Troubled Asset Insurance Financing Fund. Under Section 102, the Secretary is required to establish a Troubled Asset Insurance Financing Fund to guarantee troubled assets whereby the Secretary would set risk-based premiums to sufficiently cover anticipated claims. The total amount of guaranteed obligations, minus premiums collected, would reduce the amount of the \$700 billion purchase authority granted under the TARP.

Encouraging Private Sector Participation. Section 113(a)(3) requires the Secretary to encourage the private sector to participate in the TARP, and also requires the Secretary to "invest in financial institutions", in each case, consistent with the provisions of Section 113. There are various ways the Secretary might comply with these provisions, including forming joint public-private ventures with government-provided seller financing, or through the direct investment of funds in distressed financial institutions. (Recent reports have indicated that the Secretary will consider buying preferred stock or perhaps subordinated debt of financial institutions.)

Publishing Program Guidelines. Section 101(d) requires the Secretary, on the earlier of 2 business days following the first purchase of troubled assets or 45 days from enactment, to publish program guidelines that include mechanisms for purchasing troubled assets, methods for pricing and valuing troubled assets, procedures for selecting asset managers and criteria for identifying troubled assets for purchase.

Termination. Section 120 sets the TARP expiration date as December 31, 2009, but provides that the program can be extended, to a date no later than two years from the date of enactment, if Treasury certifies such an extension is necessary.

Contracting Procedures and Conflicts of Interest

Under Section 107, when contracting with private institutions, the Secretary is permitted to waive provisions of the Federal Acquisition Regulation if urgent and compelling circumstances exist, in which case a report must be made to Congress within 7 days. If any minority contracting regulations are waived, alternate procedures must be developed to encourage the participation of minorities and women in the TARP.

Section 108 requires the Secretary to take affirmative steps to manage conflicts of interest in the hiring of contractors, advisors and asset managers; the purchase and management of troubled assets; and other areas. On October 6, the Secretary published a press release covering the interim guidelines for handling conflicts of interest among contractors performing services in conjunction with the Act. The press release states, among other things, that (i) Treasury may require non-

disclosure and conflict of interest (COI) agreements in advance of supplying an offeror a solicitation; (ii) solicitations should instruct prospective offerors to disclose any actual or potential COIs and describe related mitigation plans to address such conflicts to the Treasury's satisfaction; (iii) solicitations must include criteria and minimum standards to help Treasury assess the potential for effective COI mitigation; (iv) where applicable, solicitations must include a statement affirming that the contractor will owe a fiduciary duty to Treasury; (v) solicitations should state that Treasury will oversee and enforce the proposed mitigation plan as part of the contract; (vi) COI evaluations will be case by case; and (vii) the Treasury Senior Procurement Executive will review and approve all provisions related to COIs prior to issuance of the solicitation.

Homeowner Assistance

Foreclosure Mitigation. Section 109 requires the Secretary to (i) implement a plan to maximize assistance for homeowners, including encouraging servicers to utilize the HOPE for Homeowners refinance program to avoid foreclosures, (ii) to coordinate with the FDIC to improve the modification and restructuring process and (iii) to consent to reasonable loan modification requests. In addition, the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.

Section 110 applies similar requirements to any “federal property manager”, which includes the FHFA as conservator of Fannie Mae and Freddie Mac, the FDIC and the Federal Reserve Board, all to the extent that they hold, own or control mortgage loans, mortgage-backed securities or related assets.

HOPE For Homeowners Expansion. Section 124 expands the number of borrowers eligible to participate in the HOPE for Homeowners Program (which conceivably will be the target for the vast majority of whole loans acquired by the Treasury) by loosening the debt-to-income ratio requirement and providing the HOPE for Homeowners Board with the authority to increase the maximum loan-to-value ratio permitted under the program, which is currently set at 90%.

Protection of Taxpayers

Use of Proceeds from Sales of Purchased Assets. Under Section 106(d), revenues of and proceeds from the sale of troubled assets purchased are required to be paid into the general fund of the Treasury for reduction of the public debt.

Equity Sharing Through Warrants. Section 113(d) requires that the Treasury receive warrants from participating financial institutions giving the Treasury the right to purchase either non-voting common or preferred stock, or senior debt instruments, in order to share in any equity appreciation in those institutions, and to protect taxpayers against losses.

Preventing Unjust Enrichment. Section 101(e) requires the Secretary to take steps to prevent unjust enrichment of participating financial institutions, including selling troubled assets to the TARP at a price higher than the amount that the seller paid to purchase the asset (unless the assets were acquired in a merger or acquisition or purchased from an institution in conservatorship, receivership or bankruptcy).

Recouping Losses From Financial Industry. In the event there is a shortfall in the net amount within the TARP after five years, Section 134 requires that the President submit a proposal to Congress that sets forth a plan to recoup from the financial industry an amount equal to the shortfall.

Limits on Executive Compensation

Direct Purchases of Assets. Under Section 111, for direct purchases of troubled assets, if the Secretary receives a “meaningful equity or debt position in the financial institution as a result of the transaction” the Secretary must require the financial institution to have (i) limits on compensation that exclude incentives which encourage senior executive officers (generally, the top five highest paid executives) to take “unnecessary and excessive risk that threatens the value of the institution,” (ii) repayment (i.e., clawback) provisions for bonuses based on earnings figures that are shown to be materially inaccurate, and (iii) prohibition on “golden parachute” payments (generally, severance payments made in connection with certain involuntary terminations) to senior executive officers.

Auction Purchases of Assets. Under Section 111, for auction purchases that in the aggregate (including amounts attributable to direct asset purchases) exceed \$300 million with respect to any financial institution, the Secretary must prohibit new employment contracts with senior executive officers that contain “golden parachutes” in the event of involuntary termination or the failure of the institution. In addition, special deduction limitations apply to all compensation paid to senior executive officers, and such officers may also become subject to a 20% excise tax for receipt of “golden parachute” payments.

Congressional and Regulatory Oversight

Oversight. Section 104 creates the Financial Stability Oversight Board, consisting of the Fed Chairman, the Secretary, the Director of the Federal Housing Finance Agency, the Chairman of the Securities Exchange Commission (SEC) and the Secretary of Housing and Urban Development. The Financial Stability Oversight Board may appoint a Credit Review Committee to evaluate the exercise of authority under the Act and the assets acquired. Under Section 116, the Comptroller General is tasked with providing ongoing oversight of the activities and performance of the TARP, including providing annual audits to Congress.

Required Reports. Under Section 105, an initial report is required to be provided to Congress within 60 days of the first exercise of the authority under the TARP, and every month thereafter. The Secretary is additionally required to report a detailed description of all transactions (including pricing mechanisms used) for every \$50 billion in assets purchased. No later than April 30, 2009, the Secretary must report to Congress, analyzing the current state of the financial market regulatory system and making recommendations to modernize it.

Additional Disclosure. Section 114 requires the Secretary to provide public disclosure in electronic form, within 2 business days of any purchase, trade or disposition of assets, of the description, amounts and pricing of such assets. The Secretary is also required to determine if public disclosures required for participating financial institutions, including with respect to off balance sheet transactions, derivatives and other similar sources of exposure, are sufficient with respect to their actual financial position, and if not, to make recommendations for additional disclosure requirements.

Judicial Review. Although the Treasury's initial proposal did not allow for judicial or administrative review, Section 119 specifies that actions of the Secretary may be reviewed and set aside if they are "found to be arbitrary, capricious, an abuse of discretion, or not in accordance with law." Equitable relief, however, such as injunctions and restraining orders, is substantially limited, and the terms of any residential mortgage loans purchased by the Secretary remain subject to any claims and defenses that would otherwise apply.

Other Provisions

Temporary Increase in FDIC Insurance. Under Section 106, effective through December 31, 2009, the amount of deposits which can be insured by the FDIC is increased from \$100,000 to \$250,000. The \$100,000 limit has been in place since 1980. Related provisions dictate that the increase is not to be taken into account when setting assessments and that the borrowing limit of the FDIC is lifted during this period.

Coordination with Foreign Authorities. Section 112 requires the Secretary to coordinate, as appropriate, with foreign financial authorities and central banks to establish similar programs, and to the extent such authorities or banks hold troubled assets as a result of extending financing to financial institutions (as defined in the proposal) that have failed or have defaulted on such financing, those troubled assets qualify for purchase under the program.

Mark-to-Market Accounting. Section 132 restates the SEC's existing authority to suspend FAS 157 if the SEC determines doing so is in the public interest, and Section 133 requires the SEC to conduct a study of mark-to-market accounting standards under FAS 157 to be submitted in a report to Congress within 90 days of enactment. On September 30, the SEC and the Financial Accounting Standards Board together issued interpretive guidance that allows companies a certain amount of flexibility in determining the fair market value of assets if the trading market for those assets is deemed to be inactive.

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