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Key Features of the Economic “Bailout” Law

On Friday, October 3, 2008, President George W. Bush signed the Emergency Economic Stabilization Act of 2008 (the “Act”), commonly known as the “Bailout Bill” or the “Financial Rescue Package.” The Act’s sweeping provisions will affect financial institutions, businesses and consumers alike. This alert summarizes the information currently available about the Act’s major provisions.

Executive Summary

The Act:

- authorizes the Secretary of the Treasury (the “Secretary”) to establish the Troubled Asset Relief Program (TARP) to purchase so-called “troubled assets”
- authorizes the Secretary of the Treasury to establish the Troubled Assets Insurance Financing Fund (TAIFF) to guarantee certain troubled assets
- authorizes a total of \$700 billion in funding for TARP and TAIFF, of which \$250 billion is available immediately, \$100 billion will be available in the future upon the President’s approval, and \$350 billion will be available in the future upon the approval of both the President and the Congress
- requires financial institutions that sell troubled assets to TARP to also give the government warrants or another means of reaping upside benefits
- imposes executive compensation limits on financial institutions that sell troubled assets to TARP
- temporarily increases FDIC insurance limits to \$250,000 per account (the limits will revert to \$100,000 unless Congress makes the increase permanent prior to December 31, 2009)
- allows certain financial institutions to treat losses from the sale of Fannie Mae or Freddie Mac preferred stock as ordinary, not capital, losses for federal tax purposes
- authorizes the SEC to suspend the required use of “mark-to-market” accounting under FAS 157

Overview of TARP

The Act gives the Secretary broad latitude with respect to the structure and operation of TARP, subject to a requirement that he consult with other federal financial regulators. Notably, the Act:

- defines “financial institution” as any financial institution, including:
 - U.S. banks, thrifts, credit unions, broker-dealers and insurance companies
 - other financial institutions established under U.S. law and having significant U.S. operations, but excluding foreign central banks and foreign government-owned entities (such as sovereign wealth funds)
- defines “troubled assets” to include:
 - residential and commercial mortgages, and all financial assets “based on or related to” mortgages, and
 - any other financial asset if the Secretary determines (in consultation with the Chairman of the Federal Reserve) that purchasing it will promote stability of financial markets
- requires the Secretary to establish, no later than November 17, 2008, guidelines for purchasing, pricing, managing and selling troubled assets from financial institutions, including the selection of asset managers (the Treasury Department has already issued procedures for the selection of asset managers)
- requires the Secretary to issue guidelines for managing conflicts of interest that may arise in the implementation of

the Act (the Treasury Department has already issued an interim set of guidelines on this issue)

- authorizes the Secretary, in “urgent and compelling circumstances,” to waive provisions of the Federal Acquisition Regulation when engaging private contractors to assist with TARP
- establishes a new “Office of Financial Stability” within the Treasury Department to oversee TARP

Overview of TAIFF

In connection with TARP, the Secretary must also establish TAIFF to guarantee troubled assets originated or issued prior to March 14, 2008. Under TAIFF, the federal government will guarantee the timely payment of principal and interest on covered troubled assets. Financial institutions participating in TAIFF will be required to pay premiums, the amount of which will be set by the Secretary using a methodology based on the credit risk associated with the covered assets. The Secretary is required to publicly disclose the premium methodology.

Participation Requirements

A financial institution wishing to participate in TARP:

- may not be unjustly enriched by selling any troubled asset to TARP at a price higher than the price the financial institution paid to acquire it (excluding assets acquired in mergers and acquisitions, or from financial institutions in conservatorship, receivership or bankruptcy)
- must give the government a means of realizing some upside benefits, as follows:
 - publicly-traded financial institutions must give the Secretary:
 - warrants to purchase non-voting equity (which will convert to senior debt if the institution is later de-listed), or
 - senior debt instruments, but only if the institution is unable to issue warrants due to its capital structure or a lack of shareholder approval
 - privately-owned financial institutions must give the Secretary either warrants for equity or senior debt instruments
 - the Secretary may adopt a de minimis exception from this requirement for financial institutions selling an aggregate of less than \$100 million in troubled assets to TARP
 - in all cases, warrants issued to the Secretary must contain anti-dilution protections “of the type employed in capital markets transactions”
- will be subject to limits on compensation payable to senior executive officers (“SEOs”) – i.e., the top five highest-paid executives and anyone else whose compensation is required to be disclosed under the Securities Act of 1934 – depending on how the financial institution sells troubled assets to TARP:
 - if the troubled assets are sold to TARP in a direct sale, the institution:
 - may not provide SEOs with compensatory incentives for taking excessive risk
 - must recover any bonus or incentive compensation that was paid to SEOs based on criteria that are later proven to be materially inaccurate
 - may not make any golden parachute payments to SEOs while the Secretary holds a debt or equity position in the institution
 - if the troubled assets are sold to TARP in an auction, and if the total amount of troubled assets sold to TARP by the institution exceeds \$300 million (including direct sales to TARP), the institution:
 - will be prohibited from entering into new employment contracts with SEOs that provide for any golden parachute in the event of bankruptcy, insolvency, receivership or other involuntary termination
 - will be subject to new federal excise taxes and income tax deduction limits with respect to golden parachute payments made in the event of bankruptcy, insolvency, receivership or other involuntary termination
 - if it is publicly-traded, will be subject to new limitations on its federal income tax deduction for nonperformance-based compensation paid to certain corporate executives
- will have the adequacy of its public disclosures reviewed by the Secretary with respect to “off-balance sheet transactions, derivatives instruments, contingent liabilities, and similar sources of potential exposure” (the Secretary will make recommendations to appropriate regulators if the disclosures are found to be inadequate)

Assistance to Homeowners

The Secretary:

- is required, with respect to the mortgages underlying troubled assets held in TARP, to encourage homeowners and mortgage servicers to take advantage of programs intended to “minimize foreclosures”
- may use “loan guarantees and credit enhancements” to facilitate loan modifications to prevent “avoidable foreclosures”
- shall consent, “where appropriate” to “reasonable requests for loss mitigation measures, including term extensions, rate reductions, principal write-downs, increases in the proportion of loans within a trust or other structure allowed to be modified, or removal of other limitation[s] on modifications”

In addition, the FDIC, the Federal Reserve and the Federal Housing Finance Agency (as conservator of Fannie Mae and Freddie Mac) are required to implement similar protections with respect to mortgages under their respective jurisdiction.

General Principles

Under the Act, the Secretary must:

- use the authority granted under the Act “in a manner that will minimize any potential long-term negative impact on the taxpayer,” taking into account the direct outlay of funds, potential long-term returns, and broader economic consequences, including credit availability
- use market mechanisms, such as auctions or reverse auctions, to “maximize the efficiency of taxpayer resources”
- hold troubled assets until maturity or until “the market is optimal for selling such assets”
- only sell troubled assets at a price that will maximize return for the federal government
- encourage the private sector to participate in troubled asset purchases and invest in financial institutions

Transparency

In addition to regular reports to Congress, the Act also requires the Secretary to make available to the public, in electronic format, information about assets acquired and sold under the Act, including a description of the assets, the amount acquired or sold, and the purchase or sale price. This information must be made available within two business days after purchase or disposition of the assets.

If you have questions about how the Act, TARP or TAIFF may impact you or your business, please contact us. Venable’s [Business Transactions](#) and [Banking and Financial Services](#) practice groups are available to answer your questions.

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