



TEAM

.....
 ...
 Please contact any of the Venable lawyers named below if you have any questions about the Act or the guidelines and regulations implementing it.

Legislative Group:

William J. Donovan
 202.344.4939

John J. O'Neill
 202.344.4548

Robert L. Smith, II
 202.344.4077

Banking and Financial Services Group:**Partners**

Ronald R. Glancz
 202.344.4947

John B. Beaty
 202.344.4859

Overview of the Emergency Economic Stabilization Act of 2008

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008 ("EESA", or the "Act") and the President quickly signed it into law.¹ The Act provides broad discretion to the Secretary of the Department of the Treasury (the "Secretary") to implement a program for the purchase, in tranches, of up to \$700 billion in troubled assets. Venable's legislative and financial services practice attorneys have been closely following the negotiations that have resulted in the Act, and provide the following Alert for our clients and other friends.² Our Alert discusses the following topics:

- **Troubled Assets Program**
- **Homeownership Preservation**
- **Increase of FDIC and NCUA Borrowing Authority and Insurance**
- **SEC Mark-to-Market Issues**
- **Prohibited False Advertising of FDIC Insurance**
- **Tax Treatment of Gain or Loss on GSE Preferred Stock**

I. Troubled Assets Program

The Act authorizes the Secretary "to purchase . . . troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary."³

Three Key Definitions

- **TARP.** "TARP" is an acronym for the "Troubled Asset Relief Program" established under the Act, authorizing the Secretary to purchase troubled assets from financial institutions.⁴

¹ The Act comprises Division A of H.R. 1424. Division B is the "Energy Improvement and Extension Act of 2008" and Division C is the "Tax Extenders and Alternative Minimum Tax Relief Act of 2008." Divisions B and C generally are not relevant to the issues discussed in this Alert.

² A copy of the Act, and the policies and guidelines issued by the Treasury to date, are attached.

³ H.R. 1424, § 101(a)(1).

⁴ H.R. 1424, § 3(8).

John F. Cooney
202.344.4812

Peter E. Heyward
202.344.4616

Bruce O. Jolly, Jr.
202.344.4818

Joseph T. Lynyak, III
310.229.9660

Ralph E. Sharpe
202.344.4344

D. Ed Wilson, Jr.
202.344.4819

Associates

Suzanne F. Garwood
202.344.8046

John D. VanEtten
202.344.4816

- **Financial Institutions.** A financial institution is “any institution, including but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any state, territory, or possession of the United States, . . . and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.”⁵

- **Troubled Assets.** There are two basic categories of troubled assets.⁶
 - The first category consists of “residential or 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.”⁷
 - The second category of troubled assets consists of “any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve Board, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.”⁸ Thus, the EESA grants the Secretary, in consultation with the Federal Reserve Board (the “Federal Reserve”), the authority to deem non-mortgage securities and assets, such as automobile loans or credit card receivables, to be “troubled assets” that may be purchased under the TARP.

Office of Financial Stability

The day-to-day operations of the TARP will be run through a newly established office of the Treasury, the Office of Financial Stability (the “Office”). The President must appoint an Assistant Secretary of the Treasury to head this office, subject to Senate confirmation. It was reported on October 6 that Secretary Paulson had selected Neel Kashkari, currently the Treasury’s Assistant Secretary for International Economics and Development, as the interim Assistant Secretary for Financial Stability. Mr. Kashkari, like Secretary Paulson, is a veteran of Goldman Sachs. In carrying out its authorities, the Office must consult with the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (“OTS”), the National Credit Union Administration (“NCUA”) and the Secretary of the Department of Housing and Urban Development (“HUD”).

⁵ H.R. 1424, § 3(5).

⁶ H.R. 1424, § 3(9).

⁷ H.R. 1424, § 3(9)(A).

⁸ H.R. 1424, § 3(9)(B)(emphasis added).

Graduated Purchase Authority

Rejecting Treasury's initial proposal for carte blanche authority to purchase \$700 billion of troubled assets,⁹ the Act "tranches" Treasury's authority to purchase troubled assets above a specified ceiling¹⁰ at any one time, as follows:

- **\$250 Billion Cap.** Effective upon enactment on October 3, 2008, the Secretary was authorized to purchase assets up to \$250 billion outstanding at any one time.¹¹
- **\$350 Billion Cap.** Effective upon certification by the President to Congress, the Secretary's authority to purchase assets can be raised to \$350 billion outstanding at any one time.¹²
- **\$700 Billion Cap.** After a certification by the President to raise the cap to \$350 billion, the Secretary's authority to purchase assets may be raised to \$700 billion outstanding at any one time, if the President transmits a written report to Congress detailing the Secretary's plan to exercise the authority.¹³ However, this increase in the cap is subject to Congressional disapproval by a joint resolution within 15 days of transmission of the written report. Nevertheless, the President retains the authority to veto this joint resolution.¹⁴

Required "Upside"

To provide taxpayers with an opportunity for an "upside" and additional protection against losses, the Secretary, prior to purchasing or making any commitment to purchase any troubled assets, must obtain from the selling financial institution warrants for nonvoting common stock, preferred stock or voting stock as deemed appropriate by the Secretary or, in certain circumstances, senior debt instruments. Any warrants obtained under this authority must contain anti-dilution provisions. The Secretary is authorized to exempt certain *de minimis* asset purchases from this requirement, provided that the exempt amount may not exceed \$100 million.¹⁵

Managing Assets

The Secretary has the authority to manage the troubled assets purchased under the Act and may, at any time and at a price determined by the Secretary, sell,

⁹ Section 6 of Treasury's Legislative Proposal to Purchase Trouble Assets stated simply: "[t]he Secretary's authority to purchase Troubled Assets under this Act shall be limited to \$700,000,000,000 outstanding at any one time."

¹⁰ This ceiling is calculated by aggregating the purchase price of all troubled assets held. H.R. 1424, § 115(b).

¹¹ H.R. 1424, § 115(a)(1).

¹² H.R. 1424, § 115(a)(2).

¹³ H.R. 1424, § 115(a)(3).

¹⁴ H.R. 1424, § 115(c).

¹⁵ H.R. 1424, § 113(d).

enter into securities loans, repurchase transactions or other financial transactions regarding any troubled asset purchased under the auspices of the Act. Revenues from any such sale, however, must be paid to the general fund of the Treasury to pay down the national debt.¹⁶

It is expected that the Secretary will hire private sector asset management firms to assist it.¹⁷ In addition to outside asset management firms, the Act provides that the FDIC is eligible to serve and must be considered for the role of asset manager. On October 6, the Secretary issued Interim Guidelines for Conflicts of Interest, a Process for Selecting Asset Managers pursuant to the Act, and Procurement Authorities and Procedures, as well as bid solicitations for Securities Asset Management Services, Whole Loan Management Services and Infrastructure Services. Responses to the solicitations are due by 5PM on October 8th.¹⁸

The Act requires the Secretary, in managing the assets and preparing them for sale, to maximize the economic benefits. To accomplish this, the Secretary must hold the assets to maturity or for resale until such time as the Secretary determines is optimal for selling such assets. The Secretary also must "encourage" the private sector to participate in purchases of troubled assets and to invest in financial institutions.¹⁹

Guidelines for Valuation

The Secretary must issue guidance valuing troubled assets at the earlier of the end of the second business day beginning on the date of the first troubled asset purchase or 45 days from the date of enactment (mid-November). The guidelines must address: (i) mechanisms for purchasing troubled assets; (ii) methods for pricing and valuing troubled assets; (iii) procedures for selecting asset managers; and (iv) criteria for identifying troubled assets for purchase.²⁰

One overarching prohibition, however, is that the Secretary is prohibited from purchasing a troubled asset at a price higher than what the seller paid for it. This prohibition, however, does not apply to any troubled assets acquired in a merger, acquisition or a purchase of assets from a financial institution in conservatorship or receivership or that has initiated a bankruptcy proceeding.²¹

To facilitate market transparency, the Secretary must make available to the public a description, amount and pricing of assets acquired under the Act within two business days of purchase, trade or other disposition.²²

¹⁶ H.R. 1424, § 106.

¹⁷ The Secretary may solicit and award contracts to asset managers, servicers, property managers and other services providers and waive the usual Federal Acquisition Regulation upon a determination of urgent and compelling circumstances. H.R. 1424, § 107. Information regarding the Secretary's selection process is available here: <http://www.ustreas.gov/>, a copy of which is attached.

¹⁸ H.R. 1424, § 108. Copies of these guidelines and the bid solicitations are attached.

¹⁹ H.R. 1424, § 113.

²⁰ H.R. 1424, § 101(d).

²¹ H.R. 1424, § 101(e).

²² H.R. 1424, § 114.

Insurance For Troubled Assets

The Secretary is also tasked with the creation of a program to guarantee troubled assets that were originated or issued prior to March 14, 2008, with risk based premiums for such guarantees. Any fees that the Secretary collects must be deposited into a "Troubled Assets Insurance Financing Fund."²³

Oversight

The Act establishes multiple oversight mechanisms with respect to the TARP.²⁴

First, the Act creates a Financial Stability Oversight Board ("FSOB").²⁵ The FSOB is responsible for reviewing any exercise of authority under the Act, including policies issued by the Secretary, to ensure that such exercise is consistent with the goals of the law, such as protecting the taxpayer, paying down the national debt, etc.. The FSOB must report any suspected incidents of fraud to the United States Attorney General or a Special Inspector General for the TARP.²⁶

The FSOB is comprised of many of the same entities with which the Office is required to consult on its use of powers granted under the Act: the Chairman of the Federal Reserve, the Secretary of Treasury, the Director of the Federal Housing Finance Agency,²⁷ the Chairman of the Securities and Exchange Commission ("SEC") and the Secretary of HUD. The FSOB must meet every two weeks after the first purchase under the Act and must file a report with Congress every quarter.²⁸

Second, the Comptroller General (the GAO) also is tasked with oversight of the TARP, particularly as it regards meeting goals of foreclosure mitigation, cost reduction, providing stability to the marketplace and protection of tax payers.²⁹ The GAO also is tasked with evaluation of the asset management contracts that the Secretary enters into and must submit reports on its findings every 60 days.

²³ H.R. 1424, § 102.

²⁴ The Act also creates the Congressional Oversight Panel to review and provide periodic reports to the Congress on the current state of the financial markets and the regulatory system. One of the required reports, due January 20, 2009, must address the current state of and the effectiveness of the United States financial regulatory system. H.R. 1424, § 125.

²⁵ H.R. 1424, § 104.

²⁶ Section 121 creates a new Office of the Special Inspector General for the Troubled Asset Relief Program.

²⁷ The Federal Housing Finance Agency is itself a new agency created under the Housing and Economic Recovery Act in July 2008. <http://www.fhfb.gov/>

²⁸ In addition to these quarterly reports from the FSOB, Section 105 of the Act sets forth in detail the topics that the Treasury must cover in its reports to Congress, including a "tranche" report that includes a description of all transactions occurring during that period, impact on the financial system, benchmarks achieved, etc.

²⁹ H.R. 1424, § 116. In addition, the GAO is tasked with determining to what extent leveraging and sudden deleveraging of financial institutions caused the current credit crisis. *Id.* § 117.

Third, the Act creates a new Office of the Special Inspector General for the Troubled Asset Relief Program, whose head is to be appointed by the President with the advice and consent of the Senate.³⁰

In addition, actions taken by the Secretary are subject to judicial review over federal government agencies as set forth in Chapter 7 of Title 5 of the United States Code.³¹ The Act sets certain limits on the equitable relief available. However, notwithstanding this, the terms of any residential mortgage loan purchased by the Secretary remain subject to all claims and defenses that otherwise would apply.

Executive Compensation

Any financial institution that sells troubled assets to the Secretary pursuant to the TARP is subject to the following executive compensation limitations:³²

- **Direct Purchase.**³³ In instances where the Secretary directly purchases the assets (i.e., there is no bidding process and no market prices available), and the Secretary receives a "meaningful" equity or debt position in the financial institution, the Secretary must require that the financial institution meet "appropriate standards for executive compensation and corporate governance." These standards will apply for the period that the Secretary holds the equity or debt position.
- **Compensation Criteria.** The compensation standards created by the Secretary must include: (i) limits on compensation that exclude incentives for senior executive officers³⁴ to take "unnecessary and excessive risks that threaten the value of the financial institution;" (ii) 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 later proven to be materially inaccurate; and (iii) prohibition on golden parachute payments.
- **Auction Purchase.** Assuming that the purchase via auction in the aggregate exceeds \$300 million, the Secretary must prohibit any new employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership.³⁵ Additionally, these institutions cannot take a tax deduction for remuneration above \$500,000 for the Chief Executive Officer, Chief Financial Officer or any of the three most highly paid executives during, or after, any tax year in which the threshold is

³⁰ H.R. 1424, § 121.

³¹ H.R. 1424, § 119.

³² H.R. 1424 § 111. Section 302 of the Act contains additional provisions on executive compensation and limits tax deductions available for the compensation of certain covered executives.

³³ In determining whether to engage in a direct purchase from an individual financial institution, the Secretary must consider the long term viability of the financial institution and whether the purchase represents the most efficient use of funds under the Act. H.R. 1424, § 103.

³⁴ "Senior executive officer" is an individual who is one of the top five highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and any regulations issued thereunder, and non-public company counterparts.

³⁵ These executive compensation limitations apply only to those arrangements entered into during the period during which the TARP is in effect. H.R. 1424, § 111(b)(1) and (d).

reached that also overlaps with the period during which the TARP is in effect.

II. Homeownership Preservation

In keeping with the Act's directive to the Secretary to take into consideration "the need to help families keep their homes and to stabilize communities"³⁶ the Secretary must implement a plan to encourage servicers of mortgages underlying any troubled assets acquired by the Secretary to take advantage of any available plans to minimize foreclosures.³⁷ This directive contemplates modification and restructuring processes pursuant to which a bona fide tenants who are current on their rent would be permitted to remain in their homes under the terms of the lease. Loss mitigation measures include term extensions, rate reductions, and principal write downs.

Similar requirements are placed on "federal property managers," which term refers to the Federal Housing Finance Agency in its capacity as conservator of Fannie Mae and Freddie Mac; the FDIC respecting any residential mortgage loans and mortgage backed securities held by a bridge institution; and the Federal Reserve regarding most mortgages or mortgage-backed securities or pools of securities held, owned or controlled in connection with open market operations.³⁸

III. Increase of FDIC and NCUA Authority and Insurance

Effective October 3, 2008 and expiring as of December 31, 2009 (unless made permanent by Congress), accounts that were eligible for FDIC³⁹ or NCUA⁴⁰ insurance of \$100,000 are insured for \$250,000.⁴¹ Neither the FDIC nor the NCUA is permitted to take this increase into account when setting insurance assessments or premium charges. The borrowing limits for both agencies are also temporarily removed, but the expanded borrowing authority is scheduled to sunset along with the new insurance cap on December 31, 2009.

IV. SEC Mark-to-Market Issues

Section 132 of the Act gives the SEC the authority to suspend the application of FASB 157 with respect to any class or category of transaction the SEC determines is "necessary or appropriate in the public interest." The SEC also must study the effects of FASB 157 and provide a report to Congress within 90 days of October 3,

³⁶ H.R. 1424, § 103(3).

³⁷ H.R. 1424, § 109; *See, e.g.*, HUD's Help for Homeowners Program: <http://www.hud.gov/offices/hsg/sfh/econ/econ.cfm>; HOPE NOW Alliance: <http://www.hopenow.com/>. The Act amends the recently enacted HOPE for Homeowners program to allow for broader eligibility. H.R. 1424, § 124.

³⁸ H.R. 1424, § 110.

³⁹ Information regarding FDIC insurance is available here: <http://www.fdic.gov/news/news/financial/2008/fil08102a.html>. Retirement accounts, which currently are insured up to \$250,000 are not affected.

⁴⁰ Information regarding NCUA insurance is available here: <http://www.ncua.gov/ShareInsurance/Index.htm>. Retirement accounts, which currently are insured up to \$250,000 are not affected.

⁴¹ H.R. 1424, § 136.

2008.

On September 30, FASB staff and the SEC Office of the Chief Accountant issued a joint press release to provide clarifications on fair value accounting in disorderly or inactive market conditions, and on October 3, FASB staff proposed to amend FASB Statement No.157, to clarify its application in an inactive market. Initial reactions indicate that the clarifications are being interpreted as granting greater flexibility to financial institutions with respect to the valuation of assets sold at a “fire sale” price in an inactive market. Comments on the proposed FASB amendment must be received in writing by October 9, 2008.⁴²

V. Prohibited False Advertising of FDIC Insurance

EESA prohibits any person from representing or implying that any deposit, obligation, certificate or share is FDIC-insured when it is not.⁴³ The appropriate banking agency (i.e., OCC, OTS, FDIC, Board) has enforcement authority for any violation of this prohibition; however the FDIC has authority to enforce this prohibition if the appropriate banking agency does not.

VI. Tax Treatment Of Gain or Loss on GSE Preferred Stock

Section 301 of the Act generally provides that a financial institution must treat as ordinary income or loss the gain or loss from the sale or exchange of any preferred stock in Fannie Mae or Freddie Mac that was: (i) held on September 6, 2008; or (ii) sold or exchanged on or after January 1, 2008 and before September 7, 2008. For purposes of the above, a "financial institution" includes most banks, any small business investment company operating under the Small Business Investment Act of 1958, and any business development corporation and bank holding companies.⁴⁴

VII. Effective Dates

Most provisions of the Act became effective upon the President's signing on October 3, 2008 and sunset on December 31, 2009 (with the exception of the Troubled Assets Insurance Financing Fund and the creation of the Office).⁴⁵ One exception to the effective date applies to standards for executive officer compensation: the Secretary has two months from the date of enactment to issue guidance (not necessarily regulations) detailing appropriate standards for senior executive officer compensation for financial institutions participating in the TARP. The guidance will be effective upon publication.

⁴² <http://www.fasb.org/>

⁴³ 12 U.S.C. § 1828(a).

⁴⁴ H.R. 1424, § 301; 26 U.S.C. § 582(c)(2); 12 U.S.C. § 1813(w)(1).

⁴⁵ This sunset may be extended at the discretion of the Treasury until October 2010.

Venable office locations

BALTIMORE, MD

750 E. PRATT STREET
NINTH FLOOR
BALTIMORE, MD 21202
t 410.244.7400
f 410.244.7742

LOS ANGELES, CA

2049 CENTURY PARK EAST
SUITE 2100
LOS ANGELES, CA 90067
t 310.229.9900
f 310.229.9901

NEW YORK, NY

ROCKEFELLER CENTER
1270 AVENUE OF THE
AMERICAS
TWENTY-FIFTH FLOOR
NEW YORK, NY 10020
t 212.307.5500
f 212.307.5598

ROCKVILLE, MD

ONE CHURCH STREET
FIFTH FLOOR
ROCKVILLE, MD 20850
t 301.217.5600
f 301.217.5617

TOWSON, MD

210 ALLEGHENY AVENUE
TOWSON, MD 21204
t 410.494.6200
f 410.821.0147

TYSONS CORNER, VA

8010 TOWERS CRESCENT DRIVE
SUITE 300
VIENNA, VA 22182
t 703.760.1600
f 703.821.8949

WASHINGTON, DC

575 SEVENTH STREET NW
WASHINGTON, DC 20004
t 202.344.4000
f 202.344.8300

Economic crisis team alert

Economic Crisis Team Alert is published by the Financial Services Group of Venable LLP. Venable publications are not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations. This newsletter may be reproduced without the express permission of Venable LLP, so long as it is reproduced in its entirety including the Venable name and logo.

