

October 2008

## Emergency Economic Stabilization Act of 2008: The U.S. Government's Attempt to Rescue the Financial Industry

In response to the recent historic turmoil in the financial markets, Congress passed, and on October 3, 2008 President Bush signed, the Emergency Economic Stabilization Act of 2008 (the "Act"). The Act provides authority for the U.S. Treasury to purchase or guarantee up to \$700 billion of mortgages and mortgage-backed and other securities held by eligible financial institutions in order to provide liquidity and stability to the U.S. financial system and prevent further disruption in the economy.

### Purchases of Troubled Assets

- **Definition of Troubled Assets.** Troubled assets consist of:
  - residential or commercial mortgages and any securities, obligations or other instruments based on or related to these mortgages, in each case originated or issued on or before March 14, 2008, if the Treasury Secretary determines that their purchase would promote financial market stability; and
  - any other financial instrument if the Treasury Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines that its purchase is necessary to promote financial market stability.
- **Eligible Sellers of Troubled Assets.** Troubled assets generally can be purchased only from financial institutions

that are established and regulated under the laws of the U.S. and its territories and that have significant U.S. operations, and not from central banks of, or institutions owned by, foreign governments.

- **Exception.** The Act allows the purchase of troubled assets held by foreign financial authorities or central banks if the troubled assets are held as a result of extending financing to U.S. financial institutions that have failed or defaulted on that financing.
- **Purchase Mechanisms.**
  - **Auctions.** The Act contemplates that the Treasury Secretary would purchase troubled assets through market mechanisms, including auctions or reverse auctions, where appropriate.
  - **Direct Purchases.** If the Treasury Secretary determines that use of an auction is not feasible or appropriate, the Treasury Secretary may engage in direct purchases of troubled assets, subject to additional safeguards to ensure the prices paid for the troubled assets are reasonable and reflect the underlying value of the assets.
  - **Maximum Purchase Price.** In making purchases, the Treasury Secretary must prevent unjust enrichment of financial institutions, including by not purchasing a troubled asset at a price higher than the seller paid to purchase the asset.

- **Equity/Debt Issuance Requirements.**

- **Generally.** Participating financial institutions that sell troubled assets under the TARP must issue to the Treasury Secretary:
  - in the case of financial institutions that are publicly traded in the United States, a warrant for (1) non-voting common or preferred stock or (2) voting stock if the Treasury Secretary agrees not to exercise voting power; or
  - in the case of other financial institutions, a warrant for common or preferred stock or a senior debt instrument containing a reasonable interest rate.

The equity or debt instruments must provide additional protection for taxpayers against losses from sales of assets by the Treasury Secretary and administrative expenses of the TARP.

- **Warrant Requirements.** Any warrant issued to the Treasury Secretary must:
  - provide for reasonable participation in equity appreciation;
  - be convertible into senior debt, or contain protections to ensure the Treasury is appropriately compensated for the warrant, if the applicable financial institution ceases to be publicly traded in the United States; and
  - contain anti-dilution provisions to protect the value of the warrant from market transactions such as stock splits, stock distributions, dividends, other distributions, mergers, reorganizations and recapitalizations.
- **Exceptions.**
  - **De Minimis.** No equity or debt instrument need be issued if the total amount of all troubled assets sold by a financial institution to the Treasury Secretary is below a de minimis

amount to be established by the Treasury Secretary, which amount may not exceed \$100 million.

- **Other.** The Treasury Secretary will also establish other exceptions and appropriate alternative requirements for any participating financial institution that is legally prohibited from issuing equity and debt instruments.
- **Broad Authority of Treasury Secretary.** The Act provides the Treasury Secretary with broad authority to establish and implement the TARP, including authority to acquire, manage and resell troubled assets.
  - **TARP Program Guidelines.** By November 17, 2008, or sooner if troubled assets are acquired sooner, the Treasury Secretary must publish program guidelines for the TARP, including:
    - 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.
  - **Public Disclosure of Transactions.** To facilitate market transparency, within two business days of any purchase, trade or other disposition, the Treasury Secretary must make public in electronic form a description, amounts and pricing of troubled assets acquired under the Act.

### Guarantee of Troubled Assets

The Act also provides for the establishment of an insurance program to guarantee troubled assets held by financial institutions

that were originated or issued before March 14, 2008.

- The program allows the Treasury Secretary to:
  - guarantee the timely payment of up to 100% of the principal of, and interest on, troubled assets on terms and conditions determined by the Treasury Secretary; and
  - establish and collect premiums for the guarantees based on the credit risk associated with the troubled assets guaranteed.

The premiums must be set at a level necessary to create reserves sufficient to meet anticipated claims.

### Limits on Program Funds

- **\$250 Billion Initial Limit.** The Treasury Secretary's authority to purchase troubled assets is initially limited to \$250 billion outstanding at any one time.
- **Additional \$100 Billion.** The purchase authority limit will be raised to \$350 billion outstanding at any one time upon submission by the President to Congress of a certification that the Treasury Secretary needs increased authority.
- **Additional \$350 Billion.** The purchase authority limit may be raised to \$700 billion outstanding at any one time if the President sends to Congress a report detailing the plan of the Treasury Secretary to exercise the increased authority unless, within 15 days after the President sends the report, Congress enacts a joint resolution disapproving the Treasury Secretary's plan.
  - The Act provides a fast track procedure for this joint resolution.

- **Calculation of Limit.** In determining whether any applicable limit is reached, the amount of purchased troubled assets outstanding at any one time will be determined based on the aggregate purchase prices of the troubled assets held by the Treasury Secretary.
- **Reduction for Insurance Program.** The purchase authority limit will be reduced to take into account troubled assets guaranteed under the insurance program.

### Termination of Purchase and Insurance Programs

The authority of the Treasury Secretary to purchase or guarantee troubled assets will terminate on December 31, 2009.

- The termination date may be extended until no later than October 3, 2010 if the Treasury Secretary certifies to Congress the rationale and expected cost to taxpayers of the extension.
- The authority of the Treasury Secretary to hold troubled assets purchased before the termination date, and to purchase troubled assets under a commitment entered into before the termination date, will remain in effect after the termination date.

### Recoupment of Shortfall From Financial Institutions

- **Five-Year Report.** Following October 3, 2013, the Director of the Office of Management and Budget must submit a report to Congress on the net amount of troubled assets within the TARP.
- **Shortfall Recoupment.** To ensure that the TARP does not add to the deficit or national debt, if there is any shortfall noted in the five-year report, the President

will submit to Congress a legislative proposal that recoups from the financial industry an amount equal to this shortfall.

### **Executive Compensation, Corporate Governance and Other Requirements Imposed on Participating Financial Institutions**

The Act imposes certain requirements on financial institutions that sell troubled assets to the Treasury Secretary.

- **Executive Compensation and Corporate Governance Restrictions – Direct Purchases.** If the Treasury Secretary purchases troubled assets directly from a financial institution (where no bidding process or market prices are available) and the Treasury Secretary receives a “meaningful” equity or debt position in the financial institution, the financial institution must meet “appropriate standards for executive compensation and corporate governance” for so long as the Treasury Secretary holds an equity or debt position. These standards will include:
  - **Limits on Certain Incentive Compensation.** A requirement that compensation for senior executive officers exclude incentives that encourage these officers to take unnecessary and excessive risks that might threaten the value of the financial institution;
  - **Clawback of Certain Incentive Compensation.** Provisions allowing the financial institution to recover any incentive compensation paid to a senior executive officer based on financial or other criteria later proven to be materially inaccurate; and
- **Prohibition on Golden Parachute Payments.** Prohibitions on any golden parachute payment to a senior executive officer while the Treasury Secretary holds an equity or debt position in the financial institution.
- **Golden Parachute Restrictions – Auction Purchases.** If the Treasury Secretary purchases troubled assets from a financial institution through auction purchases and total troubled asset purchases (including direct purchases) from that financial institution exceed \$300 million, the financial institution will be prohibited from entering into any new employment contract with a senior executive officer that provides for a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership.
- **Definition of Senior Executive Officers.** A senior executive officer is one of the “top 5” executives of a public company whose compensation is required to be disclosed under U.S. securities rules (i.e., the CEO, the CFO and the three other highest compensated officers) and the non-public company counterparts of these individuals.
- **Scrutiny of Public Disclosure.** The Treasury Secretary must determine, for each type of financial institution that sells troubled assets to the Treasury Secretary, whether the public disclosure required for these financial institutions with respect to off-balance sheet transactions, derivative instruments, 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 the disclosure is not adequate, the Treasury Secretary must make recommendations to relevant regulators for additional disclosure requirements.
- **Waivers of Claims.** Participants that divest troubled assets under the Act may not bring any action or claim against the Treasury Secretary with respect to its participation, except to the extent the Treasury Secretary's actions are found to be unlawful or as expressly provided in a written contract with the Treasury Secretary.

### Foreclosure Mitigation Efforts

- The Act includes several provisions designed to mitigate foreclosure risks.
- To the extent the Treasury Secretary acquires mortgages, mortgage-backed securities or other assets secured by residential real estate, the Treasury Secretary must implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program or other available programs to minimize foreclosures.
- The Treasury Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.
- The Treasury Secretary must consent, where appropriate and taking into account net present value to taxpayers, to reasonable requests for loss mitigation measures, including term extensions, interest rate reductions and loan principal reductions.

- The Treasury Secretary must coordinate with other federal agencies that hold troubled assets to attempt to identify opportunities for the acquisition of classes of troubled assets that will improve the Treasury Secretary's ability to improve the loan modification and restructuring process and to provide certain protections to bona fide tenants of residential rental properties.
- The Act contains provisions similar to those described above applicable to certain other federal agencies that hold, own or control mortgage-backed securities and other assets secured by residential real estate.

### Tax Provisions

The Act makes the following TARP-related tax law changes:

- **Character of Gain or Loss on Sale of Fannie Mae or Freddie Mac Preferred Shares by Financial Institutions.** Banks and certain other financial institutions that held Fannie Mae or Freddie Mac preferred stock on September 6, 2008 and later sell such shares, or that sold such stock in 2008 on or before that date, will recognize ordinary income or loss for U.S. federal income tax purposes rather than capital gain or loss.
- **Tax Deduction Limited for Compensation Paid to Top Executives of Financial Institutions Participating in the TARP.**
  - The tax deduction for compensation paid by companies participating in the TARP will be limited to \$500,000 for each of the company's "top 5" executives (the CEO, the CFO and the three other highest compensated officers).

- The limitation applies to companies that sell more than \$300 million worth of troubled assets under the TARP unless the company's only sales of troubled assets are direct sales to the Treasury Secretary.
- Once applicable to an executive, the deduction limitation will continue to apply to that executive as long as the TARP is in effect, and even after that date for deferred compensation attributable to that period.
- The \$500,000 deduction limitation does not include the performance-based compensation exception generally applicable to the existing law's \$1 million compensation deduction limitation.
- ***Golden Parachute Rules (Tax Deduction Disallowance and Excise Tax) Apply to Severance Payments.***
  - Severance paid to the "top 5" executives (the CEO, the CFO and the three other highest compensated officers) of companies subject to the \$500,000 compensation deduction limitation described above will be treated as golden parachutes if the executive is terminated involuntarily or in connection with any bankruptcy, liquidation or receivership of the company.
  - Under the golden parachute rules, a large portion of the severance payments to an executive generally will be nondeductible to the company and will be subject to a 20% nondeductible excise tax payable by the executive if the amount of the severance payments to that executive equals or exceeds three times a base amount (generally

the executive's average compensation over the last five years). If the severance equals or exceeds three times the base amount, the deduction disallowance and excise tax apply to any severance amount that exceeds one times the base amount.

- ***Relief on Cancellation of Mortgage Debt Extended.*** The Internal Revenue Code is also being amended to extend through 2012 the exclusion from income of discharge of qualified principal residence indebtedness.

### Oversight and Reporting

The Act contains numerous provisions for oversight of actions taken under the Act and for reporting on the status of those actions and on the financial markets generally.

- ***Oversight Bodies and Positions.*** The Act provides for the establishment of several bodies and positions that will be charged with implementing and overseeing the programs established under the Act. These bodies and positions include:
  - ***Financial Stability Oversight Board.*** The Financial Stability Oversight Board will be comprised of the Treasury Secretary, the Chairman of the Board of Governors of the Federal Reserve System, the Director of the Federal Housing Finance Agency, the Chairman of the SEC and the Secretary of Housing and Urban Development, and will oversee implementation of programs under the Act.
  - ***Office of Financial Stability.*** The Office of Financial Stability, which will be headed by a new Assistant Secretary of the Treasury appointed by the President (with the consent of the Senate), will be

established within the Treasury Department to implement the TARP.

- ***Special Inspector General for the TARP.*** The Special Inspector General, who will be appointed by the President (with the consent of the Senate), will be responsible for conducting audits and investigations of the purchase, management and sale of assets under the TARP and the management of the insurance program under the Act.
- ***Congressional Oversight Panel.*** The Congressional Oversight Panel will be comprised of five members appointed by Congressional leaders and will review the current state of the financial markets and the regulatory system and the effectiveness of programs under the Act.
- ***Additional Oversight and Reporting.*** In addition to the establishment of these bodies and positions, the Act provides for oversight and reporting by the U.S. Comptroller General, the Office of Management and Budget, the Congressional Budget Office and the Board of Governors of the Federal Reserve System.

### Studies and Analytical Reports

The Act provides for the preparation of several studies and analytical reports, including:

- ***Mark-to-Market Accounting.*** The SEC, in consultation with the Board of Governors of the Federal Reserve System and the Treasury Secretary, must submit a report to Congress by January 1, 2009 analyzing the mark-to-market accounting standards provided in FASB Statement 157, as applicable to financial institutions.
- ***Regulatory Reform.*** The Congressional Oversight Panel must submit a report to Congress by January 20, 2009 analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement.
- ***Regulatory Modernization.*** The Treasury Secretary must submit a report to the appropriate committees of Congress by April 30, 2009 analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial markets, and providing recommendations for improvement.
- ***Margin Authority.*** The Comptroller General must submit a report to specified committees of Congress by June 1, 2009 analyzing the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis.

### Other Provisions of the Act

The Act contains a number of other provisions relating to the programs under the Act or addressing certain aspects of the recent turmoil in the financial markets.

- ***Temporary Increase in FDIC Insurance Coverage.*** The standard maximum deposit amount to be insured by the FDIC and the National Credit Union Share Insurance Fund will be temporarily increased from \$100,000 to \$250,000 beginning October 3, 2008 and ending on December 31, 2009.
- ***Judicial Review.*** Actions taken by the Treasury Secretary under the Act will be subject to judicial review and will be set aside only if found to be arbitrary,

capricious, an abuse of discretion or not in accordance with law. The Act also places limitations on the ability to obtain injunctive or other equitable relief against the Treasury Secretary. Requests for temporary restraining orders, preliminary injunctions and permanent injunctions will be considered by the courts on an expedited basis.

- ***Non-Enforceability of Standstill and Confidentiality Provisions.*** Provisions contained in existing or future standstill, confidentiality or other agreements that affect or limit the ability of any person to acquire (or prohibit any person from using any previously disclosed information in connection with any acquisition of) all or part of any insured depository institution (including any liabilities, assets or interest therein) in connection with any transaction in which the FDIC exercises certain of its powers will not be enforceable against that person.
- ***Cooperation with the FBI and Other Agencies.*** The Act requires that all federal financial regulatory agencies cooperate with the FBI and other law enforcement agencies investigating fraud, misrepresentation and malfeasance with respect to the development, advertising or sale of financial products.
- ***Mark-to-Market Accounting.*** To address the problem of mark-to-market accounting when there is no longer a market for a held asset, the Act allows the SEC to suspend the application of FASB Statement No. 157 (prescribing mark-to-market accounting in

determining the fair value of certain assets).

- Note that on September 30, 2008, the SEC and the FASB issued a press release providing clarifications intended to help companies, auditors and investors address some of the more urgent fair value measurement questions that have been raised and indicated that the FASB is preparing to provide additional interpretative guidance.

### **Additional Sweetener Provisions Adopted by Congress**

As part of the effort to secure approval of the Act, Congress included several tax breaks and other sweeteners that expanded upon the scope of the originally proposed legislation. These additional sweeteners include:

- extension of renewable energy tax credits;
- alternative minimum tax relief aimed at more middle-income households;
- tax relief to victims of 2008 natural disasters;
- requiring group health plans that provide coverage for mental health conditions to provide mental health coverage on par with other provided medical coverage; and
- securing funding for rural schools and special projects on federal land.

The cost of these sweeteners would be partially offset by provisions aimed at deferred compensation paid by certain partnerships and foreign corporations.

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