

Highlights of the Emergency Economic Stabilization Act

October 6, 2008

The Emergency Economic Stabilization Act is an unprecedented piece of legislation. It raises many questions that must be answered in order to successfully implement its provisions. The Act creates potential opportunities for sellers and buyers of assets, servicers of mortgages and other market participants. However, it also creates potential challenges.

Discussed below are its highlights:

Purposes of the Act

The immediate purpose of the Act is to provide the Secretary of the Treasury (the "Secretary") with the authority and tools necessary to restore stability to the U.S. financial system. However, by mandating coordination with foreign financial institutions, Congress also appears to have worldwide economic stabilization in mind.

The Secretary is directed to provide liquidity and stability to the financial system; to promote jobs and economic growth; to preserve home values, homeownership and all manner of personal savings; and to maximize overall returns to the taxpayers of the United States.

Extraordinary Power Given to the Secretary of the Treasury

The Act authorizes the Secretary to take all necessary actions to stabilize financial markets while minimizing taxpayer loss. In short, most of the Secretary's discretion is to be guided to restore liquidity and stability to the U.S. financial system and to protect the interest of taxpayers. To serve these interests, the Secretary has the authority and responsibility to determine:

- Criteria for identifying the troubled assets to be purchased;
- Mechanisms for purchasing troubled assets;
- Methods for pricing and valuing troubled assets;
- Procedures for selecting asset managers; and
- The equity interest in the financial institutions represented by the warrants and the price the Secretary will pay for the warrants.

Troubled Asset Relief Program

The Sales Program

The cornerstone of the Act is the Troubled Asset Relief Program (the "TARP"). Under the TARP, the Secretary is authorized to purchase, or to make and fund commitments to purchase, "troubled assets" from any "financial institution."

The Secretary has broad discretion to manage, invest, sell, lend or otherwise transfer any troubled asset purchased under the TARP. To that end, the Act authorizes the Secretary to hire employees and to contract with third parties. This will include the hiring of asset management firms to help manage the growing pool of Treasury assets.

The Insurance Program

Rather than purchase troubled assets, the Secretary may choose simply to guarantee troubled assets. In so doing, the Secretary is authorized to determine the risk inherent in each troubled asset, or portfolio of assets, and to collect a premium from each participating financial institution based on that assessment. The Act instructs the Secretary to deposit all such premiums into a fund which may be invested in U.S. Treasury securities and from which claims may be paid.

Troubled Assets and Financial Institutions

The troubled assets to be purchased or guaranteed by the Secretary include residential and commercial mortgages and any securities, obligations or other instruments based on such mortgages. Additionally, the Secretary and the Federal Reserve may include other instruments if the purchase of those instruments is necessary for the stability of the financial system. To participate in the TARP, a financial institution must be established and regulated under U.S. federal or state law and may be any bank, savings association, credit union, security broker or dealer, or insurance company, excepting any central bank of a foreign government.

Equity Participation and Taxpayer Protections

As a condition to the purchase of any troubled asset, the Secretary must receive from the selling financial institution a warrant to receive either common or preferred stock or a senior debt instrument. The warrant must provide for the Secretary's reasonable participation in equity appreciation or a reasonable interest rate premium. The Secretary will set the interest rate of the debt and exercise price of the warrants. The warrants, in turn, must be protected by anti-dilution provisions and must convert to senior debt if a financial institution should de-list its securities. The Secretary possesses broad discretion to determine the percentage of equity in the issuer that would be represented by the warrants to be issued to the Secretary. The Act does not delineate what percentage of equity the warrants will provide to the Secretary or what price the Secretary will determine to pay for the warrants. Furthermore, the Secretary may freely sell, exercise or surrender warrants, whenever doing so would be in the interest of taxpayers.

Although the Secretary is given broad discretion to execute the TARP, the Secretary must take all steps necessary to avoid unjust enrichment of financial institutions participating in the program. These steps include preventing purchases of troubled assets at prices higher than what the financial institutions paid to acquire the assets. They also include limiting executive compensation as discussed below.

Apart from legal actions asserting that the Secretary's conduct has been arbitrary, capricious, an abuse of discretion or not in accordance with the law, no action or claim may be brought against the Secretary by any person or financial institution participating in the TARP.

If in five years the sales of TARP assets and investment of the insurance fund have left the TARP with a shortfall, the President must submit a legislative proposal that recoups the shortfall from the financial industry. The Act gives no guidance on how any such shortfall might be meted out across the industry.

Funding and Duration

Although the Secretary ultimately may have access to \$700 billion in purchasing power under the TARP, the funds will be released in stages. Initially, the Secretary may purchase up to \$250 billion in troubled assets, with another \$100 billion available upon a

written certification by the President to Congress that the funds are necessary. The remaining \$350 billion will be available upon the submission to Congress by the President of a report detailing further need, subject to a joint resolution of Congressional disapproval. The Secretary's authority under the Act to purchase and guarantee troubled assets terminates on December 31, 2009; however, Congress may extend that authority to last until October 3, 2010.

Executive Compensation and Corporate Governance

Any financial institution that sells troubled assets under the TARP is subject to requirements regarding executive compensation. There are slightly different requirements depending on whether the troubled assets are purchased directly from an institution or at auction, but in either case the Secretary may delineate standards for executive compensation and corporate governance. These standards may limit incentives that encourage "excessive" risk-taking, provide for recovery of incentives paid on the basis of materially inaccurate criteria (clawbacks), and prohibit golden parachute payments.

An institution selling more than \$300 million in troubled assets to the Secretary also is subject to an amended Section 162 of the Internal Revenue Code, which, with enactment of the Act, now denies such an institution a deduction for any remuneration paid to a covered executive that exceeds \$500,000 per year. Covered executives include the CEO, CFO and, in addition, the three highest-compensated officers of the institution (other than the CEO and the CFO).

Homeowner Assistance and Protection

The Act also provides for more direct homeowner assistance. The Act requires both the Secretary and any federal property manager who controls mortgages or related securities to encourage the servicers of those mortgages to take advantage of the HOPE for Homeowners Program under the National Housing Act. Through the use of loan guarantees and credit enhancements, the Secretary would encourage the servicers to consider reductions in interest rates or principal, or other modifications that will minimize foreclosures while maximizing assistance to homeowners.

The Act provides additional assistance to homeowners in the form of tax relief. The exclusion of income from the discharge of qualified principal residence indebtedness was set to expire on January 1, 2010, but the Act extends the exclusion to January 1, 2013 for discharges occurring on or after January 1, 2010.

Increase in Federal Deposit Insurance Corporation Coverage

The Act temporarily increases the amount of FDIC coverage from \$100,000 to \$250,000 through December 31, 2009.

Suspension of Mark-to-Market Accounting

The Act authorizes the Securities and Exchange Commission to suspend the requirement of mark-to-market accounting (FASB No. 157) either for any individual issuer or for an entire class or category of transactions if the SEC determines that suspension is necessary or appropriate in the public interest and is consistent with the protection of investors.

Treatment of Fannie Mae and Freddie Mac Stock Losses as Ordinary Losses

Certain financial institutions, such as banks, small business investment companies, business development corporations and depository institution holding companies, can treat gains or losses on preferred stock in Fannie Mae and Freddie Mac as ordinary

income or loss. The stock must have been either held on September 6, 2008 or sold sometime between January 1, 2008 and September 7, 2008.

Oversight and Reporting

The Act contains provisions for oversight and reporting that are layered and vast. The oversight includes the creation of the Financial Stability Oversight Board, the Office of the Special Inspector General for the Troubled Asset Relief Program and a Congressional Oversight Panel. The reporting subjects range from periodic audits to extended analysis on leverage and other possible causes of current financial instability.

The Secretary must review the current state of the financial markets and regulatory system, submit a report to Congress and recommend whether any currently unregulated market participants, such as hedge funds, should become subject to the regulatory system. This oversight and reporting may influence future regulations issued by the Secretary and future legislation enacted by Congress.

Regulations

As part of the broad discretion given to the Secretary, the Act also directs the Secretary to issue any regulations and guidance necessary to define terms or carry out the Act's purposes. This guidance may cover a wide range of topics, from the mechanics of the reverse-auction Treasury purchases to the sale of assets back to the private sector, and from the specifics of which issuers may abandon mark-to-market accounting to the potential conflicts of interest in hiring asset managers to manage the new Treasury assets. The regulations may also provide guidance on how purchasers can bid on the assets and what disclosures the government will make to those potential purchasers.

Going Forward and Further Information

While the Act is an unprecedented piece of legislation, it raises many questions that must be answered in order to implement its provisions successfully. Duane Morris will be monitoring and commenting on the regulations, guidance and interpretations of the Act as each becomes available. The Act creates potential opportunities for sellers and buyers of assets, servicers of mortgages and other market participants. However, the Act also creates potential challenges, and further careful consideration should be given by those contemplating participation in the TARP.

If you have any questions regarding the Emergency Economic Stabilization Act, including how it may affect your company or its executives, please contact any [member](#) of the [Corporate Practice Group](#), any [member](#) of the [Business Reorganization and Financial Restructuring Practice Group](#), or the attorney in the firm with whom you are regularly in contact.