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The Emergency Economic Stabilization Act of 2008

October 3, 2008

Background

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008 (the "EESA" or the "Act") into law. After a failed vote in the US House of Representatives on Monday, the US Senate passed the legislation on Wednesday as amended to increase temporarily deposit insurance coverage and to provide numerous tax benefits. The House then passed the amended legislation today and the Act was sent to President Bush late this afternoon. The Act is summarized below with the exception of the tax provisions.

The Act provides the Secretary of the US Department of the Treasury (the "Treasury") with the authority to establish a troubled asset relief program (TARP) in which it can purchase or insure up to US$700 billion in troubled assets for the purposes of providing stability and preventing disruption in the economy and financial system and protecting taxpayers. This authority terminates December 31, 2009, unless extended by the Treasury.

The Act provides that the US$700 billion will be available in three segments: US$250 billion is available immediately — but additional amounts, while authorized, would have to be specifically requested; an additional US$100 billion will be available upon certification by the President to Congress; and the remaining US$350 billion will be available after the President sends a written report to Congress detailing the Secretary's intended use of the remaining funds. Congress can vote to disapprove this additional amount.

While the Act is lengthy, it lacks significant detail in a number of important areas. As a result, important aspects of legislation, including the specific characteristics of assets that will qualify for purchase, the manner in which the government establishes prices for those assets and the criteria for participation in the program, will have to be defined by rules and guidance to be issued by the Treasury. To the extent that institutions are interested in participating in the program, we recommend that they closely follow the implementation of the Act and participate to the greatest extent possible in any public comment opportunities.

Troubled Asset Relief Program

The Act authorizes the Treasury to create a purchase program and an insurance program. The asset purchase program was

included in the Treasury's original proposal and is the primary focus of this legislation. Nevertheless, the Treasury is obligated to establish the insurance program to accompany the asset purchase program.

As noted, the TARP enables the Treasury to purchase, and to make and fund commitments to purchase, troubled assets from certain financial institutions. These will be made on such terms and conditions as are determined by the Treasury, and in accordance with the policies and procedures developed and published by the Treasury.

The Treasury is required to publish program guidelines for TARP before the earlier of either the second business-day after the date of the first purchase of troubled assets or 45 days after the enactment date. Thus, if the Treasury seeks to immediately utilize the purchasing authority on October 6, program guidelines must be published on October 8. The Act does not specify that the guidelines be subjected to a public notice and comment process prior to implementation, although they could be adopted in interim final form subject to change after public comment. The guidelines must address the following points: (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.

While the actual pricing mechanisms are left to the Treasury's discretion, the Act requires the Treasury to use market mechanisms for purchases whenever possible and to maximize the efficiency of taxpayer resources with auctions and reverse auctions. The program guidelines are expected to provide additional information about pricing, on which the legislation is silent.

The Act's definitions of "financial institution" and "troubled asset" are key to determining the ability of an institution to participate in TARP. As discussed below, these terms are defined broadly and provide the Treasury with significant discretion in determining the institutions and assets covered.

FINANCIAL INSTITUTIONS ELIGIBLE TO PARTICIPATE

Under the Act, "financial institution" means any institution, including but not limited to any bank, savings association, credit union, securities 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, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.

The Act includes institutions "established and regulated" under the laws of the United States or any state. An earlier draft more narrowly defined the term to include institutions "organized and regulated" under the laws of the United States or any state. The final language helped clarify that US branches and agencies of foreign banks are financial institutions under the Act. In addition to the financial institutions specifically cited, the broad definition should also cover bank holding companies and their US subsidiaries that are subject

to regulation and supervision by the Board of Governors of the Federal Reserve System (the "Board") under the Bank Holding Company Act of 1956, as amended. Other aspects of the definition remain unclear and the Treasury will need to address several points, including: (i) what constitutes "significant operations" in the United States; (ii) whether ownership stakes by sovereign wealth funds would constitute government ownership; (iii) the level or nature of foreign ownership that would preclude an institution from participating in TARP; and (iv) the extent to which affiliates of financial institutions are eligible to directly participate in TARP.

TROUBLED ASSETS ELIGIBLE FOR PURCHASE

Under the Act, "troubled assets" means—(i) 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 Treasury determines promotes financial market stability; and (ii) any other financial instrument that the Treasury, after consultation with the Chairman of the 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 Congressional committees.

This definition is very broad, and the first subsection appears to include any security or derivative that is linked to an underlying residential or commercial mortgage loan. The definition does not expressly require that the troubled assets be located in the United States to qualify for sale to TARP. Thus, depending upon guidance to be issued by the Treasury, troubled assets booked in the non-US branch of a US bank should be eligible. Moreover, the Act does not expressly require that the mortgage loans or securities have a nexus to US real estate. However, it would appear that eligibility for troubled assets based on non-US mortgage loans or instruments would be inconsistent with the intent of TARP. The second subsection of the definition grants the Treasury broad authority to purchase any financial instrument that promotes financial market stability. Thus, subject to consultation with the Board and notice to Congress, Treasury can authorize financial institutions to sell non-mortgage assets (such as auto loans and student loans and instruments linked to those underlying loans) under TARP.

The Act does not require that a financial institution own a troubled asset as of particular date in order for it to be eligible for sale under TARP. Assuming that a troubled asset was originated or issued before the March 14, 2008, deadline, the Act therefore permits a financial institution to acquire it from third parties and affiliates and sell it under TARP. However, the Treasury is required to prevent "unjust enrichment" by financial institutions participating in TARP, and the Act expressly prohibits the sale of a troubled asset to the Treasury at a higher price than what the seller paid to purchase the asset. Thus, financial institutions may not purchase assets from third parties or their affiliates with the expectation that they can sell them at a higher price to the Treasury.

This unjust enrichment prohibition does not apply to troubled assets acquired in a

merger or acquisition or in a purchase of assets from a financial institution that is in conservatorship or receivership, or that has initiated bankruptcy proceedings under the Bankruptcy Code. As a result, acquired assets from certain failing institutions could be sold to Treasury at a higher price.

WARRANTS AND DEBT INSTRUMENT ISSUED TO THE TREASURY

The Act imposes significant conditions on financial institutions for participating in TARP. The Treasury is not permitted to purchase, or commit to purchase, any troubled asset under TARP unless the Treasury receives an economic stake in the financial institution. For publicly traded entities, the Treasury must receive a warrant for the right to receive non-voting common or preferred securities or voting stock with respect to which the Treasury agrees not to exercise voting power. All other institutions must provide a warrant for non-voting common or preferred stock or voting stock, with respect to which the Treasury agrees not to exercise voting power, or a senior debt instrument providing for a reasonable interest rate premium.

The terms and conditions of the required warrant or senior debt instrument must, at a minimum, be designed to provide (i) for reasonable participation by the Treasury, for the benefit of taxpayers, in equity appreciation in the case of a warrant, or a reasonable interest rate premium, in the case of a debt instrument; and (ii) additional protection for the taxpayer against losses from sale of assets by the Treasury and the administrative expenses of TARP. The warrants must contain anti-dilution provisions typically employed in capital market transactions.

The Treasury will need to clarify various aspects of this provision. For example, the Treasury may need to address whether a financial institution that itself is not publicly traded but is a subsidiary of a public company should be eligible for the senior note option… In addition, the Treasury will be presented with the question of what kind of interest to take in a US branch or agency of a foreign bank.

The Treasury may establish a *de minimis* exception to this requirement based on the cumulative amount of troubled assets purchased from any one financial institution for the duration of TARP. This exception may not be used by financial institutions that sell more than US$100 million of troubled assets under TARP.

EXECUTIVE COMPENSATION RESTRICTIONS IMPOSED ON FINANCIAL INSTITUTIONS

Prior to selling troubled assets under TARP, the financial institution must agree to certain restrictions on executive compensation. The Act provides some basic principles on the types of restrictions, and the Treasury is required to implement the requirement through the issuance of rules or other guidance. The guidance is required no later than two months after the date of enactment, which suggests that it is possible that early participants in TARP may not, at the time of their transaction, have the benefit of all the details of the limitations that will apply to executive compensation.

The type of executive compensation restrictions vary depending upon whether the troubled assets are purchased directly or through an auction process. For direct

purchases where the Treasury receives a "meaningful" equity or debt position, the financial institution must have implemented: (i) limits on compensation that exclude incentives for executive officers to take unnecessary and excessive risks; (ii) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a "senior executive officer" (generally the top five executives) based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and (iii) a prohibition on the financial institution making any golden parachute payments to senior executive officers.

For auction purchases, the financial institution may not enter into 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. When the Treasury purchases troubled assets at auction from a financial institution, there are limits on the ability of the institution to deduct as a business expense any compensation to certain executives over US$500,000. These auction-related restrictions only apply where the financial institution sells troubled assets under TARP in an aggregate amount exceeding US$300 million.

The Treasury will need to issue guidance to implement these requirements. This includes defining a "meaningful" equity or debt position and clarifying the extent to which these restrictions might apply to the ultimate parent of a financial institution.

GUARANTEE PROGRAM FOR TROUBLED ASSETS

In addition to TARP, and at the request of Republicans in the House of Representatives, the Act provides the Treasury with the authority to establish a program to guarantee timely payment of principal and interest on troubled assets. Under the program, the Treasury may charge the holder of the troubled asset a premium for the guarantee. The guarantees and premiums may be determined by category or class of the troubled assets to be guaranteed. The Treasury has the authority to determine the terms and conditions of the guarantee consistent with the purposes of the Act. It is unclear whether the guarantees provided under this program would continue after the expiration date of the program. Possible uses of this program could include serving as an alternative for insuring assets covered by a guarantee from one of the monoline insurance companies, or as short-term protection for risky assets held by financial institutions.

ADDITIONAL CONSIDERATIONS FOR THE TREASURY

In exercising the authorities granted by the Act, the Treasury is required to consider several factors including: (i) protecting the interests of taxpayers; (ii) providing stability and preventing disruption to financial markets in order to limit the impact on the economy and protect American jobs, savings, and retirement security; (iii) the need to help families keep their homes and to stabilize communities; (iv) the long-term viability of the financial institution; (v) ensuring that all financial institutions are eligible to participate in the program; (vi) providing assistance to financial institutions with assets under US$1 billion that suffered as a result of devaluation of the preferred government-sponsored enterprises stock (i.e., stock in Fannie Mae and Freddie Mac); (vii) the need to ensure stability for

United States public instrumentalities; (viii) protecting the retirement security of Americans by purchasing troubled assets held by or on behalf of an eligible retirement plan; and (ix) the utility of purchasing real estate owned (REO) and instruments backed by mortgages on multifamily properties.

While these factors do not require the Treasury to take any specific action, they appear to favor an expansive use of the statutory authority. These factors could encourage broader interpretations of key definitions by the Treasury.

MANAGEMENT AND SALE OF TROUBLED ASSETS BY THE TREASURY

The Treasury has broad authority to exercise any rights received in connection with the purchase of troubled assets and to manage troubled assets purchased under TARP, including revenues and portfolio risks. The authority would likely allow the Treasury to use special purpose entities and other structured finance vehicles to purchase and hold troubled assets. The Treasury is expressly permitted to sell assets and enter into securities loans, repurchase transactions, and other financial transactions with respect to these troubled assets.

RECOUPMENT OF TARP COSTS FROM THE FINANCIAL INDUSTRY

Five years after the date of enactment, the Director of the Office of Management and Budget, in consultation with the Director of the Congressional Budget Office, is required to submit a report to Congress on the value of the assets within the Program. If there is a shortfall between the amount spent by the Treasury and the value of the assets received by TARP, the President is required to submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall. This recoupment is intended to ensure that TARP does not add to the national debt.

COORDINATION BY THE TREASURY WITH FOREIGN AUTHORITIES AND CENTRAL BANKS

The Treasury is required to coordinate with foreign financial authorities and central banks to work toward the establishment of similar programs by such authorities and central banks. The Act also provides an opportunity for foreign financial authorities and central banks to participate in TARP. To the extent that foreign financial authorities or central banks hold troubled assets as a result of extending credit to financial institutions that have failed or defaulted on such financing, these troubled assets would qualify for purchase under TARP.

CONTRACTING PROCEDURES FOR PROVIDING SERVICES TO TARP

The Treasury is required to follow normal government contracting rules in contracting for services in support of TARP. The Act authorizes the Treasury to waive specific provisions of the Federal Acquisition Regulations, but after making such a determination, a justification must be communicated to certain House and Senate committees within seven days. Additionally, if any provision of the Federal Acquisition Regulations is waived, the Treasury must develop and implement standards and procedures to ensure that minority-owned businesses are included in the contracting process. The Act further provides that

the FDIC should be considered in the selection of asset managers for residential mortgage loans and residential mortgage-backed securities.

CONFLICTS OF INTEREST

It has been contemplated from the outset that private sector participants will have various roles in TARP. However, both the Treasury and Congress were concerned about potential conflicts of interest. To address these concerns, the Act directs the Treasury to issue regulations or guidelines to address conflicts of interest that may arise in connection with the administration and execution of the Act, including the following: (i) conflicts arising in the selection or hiring of contractors or advisors, including asset managers; (ii) the purchase of troubled assets; (iii) the management of the troubled assets held; (iv) post-employment restrictions on employees; and (v) any other potential conflict of interest. The Treasury is required to issue these regulations or guidelines as soon as practicable.

JUDICIAL REVIEW OF THE TREASURY'S ACTIONS

Actions by the Treasury under the Act may only be set aside if they are found to be arbitrary, capricious, an abuse of discretion, or not in accordance with applicable law. Injunctive and other similar types of equitable review are severely limited. No action or claims may be brought against the Treasury by any person participating in TARP, other than as expressly provided in a written contract with the Treasury.

Regulatory Changes

TEMPORARY INCREASE IN DEPOSIT INSURANCE COVERAGE

After the initial defeat of the legislation in the House of Representatives, a provision increasing the deposit insurance coverage was added to the Act. This provision temporarily raises the FDIC and the National Credit Union Share Insurance Fund deposit insurance limits from US$100,000 per account to US$250,000 until December 31, 2009. The premiums paid by financial institutions will not increase as a result of this change.

ADVERTISING ABOUT FDIC INSURED STATUS

The Act amends the Federal Deposit Insurance Act to prohibit persons from falsely representing or implying that any deposit liability is insured by the FDIC or with respect to the scope of such coverage. The FDIC is also provided broad authority to enforce this provision against any depository institution or institution affiliated party to the extent that the appropriate federal banking agency does not respond to the FDIC's written recommendations regarding an institution's practices.

INTEREST ON DEPOSITORY INSTITUTION RESERVES

The Act authorizes the Board to immediately begin paying interest on required reserves maintained by depository institutions with the Federal Reserve Banks. Depository institutions are required to maintain reserves for the purpose of facilitating

monetary policy by the Board. The Financial Services Regulatory Relief Act of 2006 authorized the Board to pay interest on such reserves but delayed the effective date until October 1, 2011.

EXERCISE OF BOARD'S LENDING AUTHORITY

Section 13(3) of the Federal Reserve Act permits the Board to authorize lending to corporations in unusual and exigent circumstances. The Board relies upon this authority in extending credit to AIG and primary dealers. The Act provides that within seven days of exercising this authority, the Board shall provide to the House and Senate a report which includes: (i) the justification for exercising the authority; and (ii) the specific terms of the actions of the Board, including the size and duration of the lending, the available information concerning the value of any collateral held with respect to such a loan, the recipient of warrants or any other potential equity in exchange for the loan, and any expected cost to the taxpayers for such exercise.

FORECLOSURE MITIGATION EFFORTS

In connection with the acquisition of residential mortgage loans or securities representing an interest in residential real estate, the Treasury must implement a plan that seeks to maximize assistance for homeowners and to encourage the servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program or other available programs to minimize foreclosures. In addition, the Treasury may use loan guarantees and credit enhancements to facilitate loan modifications to prevent foreclosures.

EXCHANGE STABILIZATION FUND REIMBURSEMENT

On September 19, 2008, the Treasury announced a plan to guarantee customer balances in certain money market mutual funds. This guarantee was intended to restore consumer confidence and to stem significant outflows of customer money after the earlier closure of a large money market mutual fund. The US$50 billion allocated by the Treasury to support this guarantee was borrowed from the Exchange Stabilization Fund. The Act requires the Treasury to reimburse the Exchange Stabilization Fund for any funds used for the temporary guaranty program. The Act also prohibits the Treasury from using the Exchange Stabilization Fund for any future guaranty programs for the money market mutual fund industry.

MARK-TO-MARKET ACCOUNTING ISSUES

The Act reaffirms the SEC's authority under the federal securities laws to suspend the application of the fair-value measurement standard set forth in Statement 157 of the Financial Accounting Standards Board for any issuer or with respect to any class or category of transaction if the SEC determines that is necessary or appropriate in the public interest and is consistent with the protection of investors.

The SEC, in consultation with the Board and the Treasury, is also required to conduct a study on mark-to-market accounting standards as such standards are applicable to financial institutions, including depository institutions. The SEC is required to submit a report to Congress within 90 days of the enactment of the Act.

Oversight, Reports and Studies

FINANCIAL STABILITY OVERSIGHT BOARD

To ensure proper oversight, the Act creates the Financial Stability Oversight Board (FSOB) to review the exercise of authority under TARP and to make recommendations to the Treasury regarding use of the authority under the Act. The FSOB will comprise the following individuals: the Chairman of the Board; the Secretary of the Treasury; the Director of the Federal Home Finance Agency; the Chairman of the Securities and Exchange Commission; and the Secretary of Housing and Urban Development. The FSOB is required to meet within two weeks after the first purchase by the Treasury under TARP, and monthly thereafter. The FSOB is authorized to appoint a credit review committee for the purpose of evaluating the exercise of the purchase authority and the assets acquired through the exercise of such authority.

REPORT ON CURRENT REGULATORY SYSTEM

The Treasury is required to review the current state of the financial markets and the regulatory system and submit a written report to the appropriate committees of Congress no later than April 30, 2009, analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial markets, including the over the-counter swaps market and government-sponsored enterprises. The report is also supposed to provide recommendations, and may serve as a starting point for regulatory reform in the financial services industry during the next Presidential administration.

MARKET TRANSPARENCY

The Treasury is required to publish information concerning purchases of troubled assets by TARP. This information must be available within two days of the sale and include a description of the assets, amounts acquired and the price.

OVERSIGHT OF TARP

The Government Accountability Office's Comptroller General (the "Comptroller General") is responsible for oversight of the programs authorized by the Act. In addition, the Comptroller General must conduct an annual audit of TARP.

The Act also creates a Special Inspector General for TARP. The Special Inspector General is required to conduct, supervise and coordinate audits and examinations of the purchase, management and sale of assets under TARP.

OVERSIGHT PANEL

The Act creates an Oversight Panel to review the current state of the financial markets and the regulatory system and submit reports to Congress. These reports are expected to cover the following: (i) the use by the Treasury of authority under this Act, including with respect to the use of contracting authority and administration of the program; (ii) the impact of purchases made under the Act on the financial markets and financial institutions; (iii) the extent to which the information made available on transactions under the program has contributed to market transparency; and (iv) the effectiveness of foreclosure mitigation efforts.

REPORT ON MARGIN AUTHORITY

The Comptroller General is required to undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis. This study is required to include an analysis of the roles and responsibilities of the Board, the SEC, the Treasury, and the other Federal banking agencies with respect to monitoring leverage and acting to curtail excessive leveraging. The Comptroller General is required to complete and submit a report to the House and Senate no later than June 1, 2009.

If you have questions regarding this Act, please contact the Mayer Brown attorney with whom you normally communicate or any of the attorneys below.

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