

**PRESIDENT SIGNS “EMERGENCY ECONOMIC STABILIZATION ACT OF 2008” INTO LAW; AUTHORIZES THE TREASURY SECRETARY TO PURCHASE UP TO \$700 BILLION IN TROUBLED ASSETS AND FOR OTHER PURPOSES**

On October 3, 2008, the President signed into law the “Emergency Economic Stabilization Act of 2008” (Pub.L. 110-343), a landmark piece of legislation empowering the Secretary of the Treasury (the “Secretary”) to purchase up to \$700 billion in troubled assets from financial institutions doing business in the United States in an effort to restore liquidity and stability to the financial markets and to minimize foreclosures through a troubled asset relief program (“TARP”). This memorandum provides an executive summary of the legislation and an analysis of key provisions relating to the economic stabilization issues.

**I. Executive Summary**

The landmark bill authorizes the Secretary to purchase up to \$700 billion in troubled assets to provide liquidity to the market and promote financial market stability. The troubled assets included in the program are residential and commercial mortgages, securities, obligations or other instruments related to such mortgages, and any other illiquid financial instruments determined by the Secretary to be necessary, such as car and truck loans.<sup>1</sup> The bill includes a variety of taxpayer protections such as executive compensation limits, measures to prevent unjust enrichment, and a warrant provision for the government to retain an equity stake in financial institutions participating in the program. The bill also includes homeownership preservation provisions such as mortgage modification measures. In addition, the bill includes an insurance program to guarantee troubled assets of financial institutions under the program, using risk-based premiums for such guarantees to cover anticipated claims. The insurance program will be an option for eligible institutions.

The details on how pricing of troubled asset and hiring asset managers will function under the program have yet to be established. The bill requires the Secretary to determine methods for pricing and valuing troubled assets while preventing the resale of a troubled asset to the Secretary at a higher price than what the seller paid to purchase the asset. Further, the bill empowers the Secretary to solicit and award contracts to asset managers, servicers, property managers, and other service providers or expert consultants in a streamlined process to be established by the Secretary.

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<sup>1</sup> The definition of “troubled asset” is worded broadly enough that non-mortgage related troubled assets such as car loans or student loans could be included if the Secretary deems it is necessary for the stability of the financial markets.

Notably, a bankruptcy “cramdown” provision favored by some Democrats is not included. This provision would have permitted bankruptcy court judges to modify the terms of mortgage contracts by reducing the amount of principal.

## **II. Discussion of Key Provisions**

The following discusses key elements of the legislation, including: (1) Treasury’s Authority; (2) Graduated Funding Authority; (3) How the Program Will Work; (4) Asset Managers; (5) Pricing of Assets; (6) Insurance of Troubled Assets; (7) Preventing Unjust Enrichment; (8) Conflict of Interest; (9) Equity-Sharing; (10) Executive Compensation; (11) Homeownership Preservation; (12) Oversight and Accountability; (13) Judicial Review; (14) Increase in Statutory Debt Limit; (15) Congressional Oversight Panel; (16) FDIC Enforcement Enhancement; (17) Tax Provisions; (18) Study of Suspending “Mark-to-Market” Accounting; (19) Study on Margin Authority; (20) Recoupment; and (21) Termination of Program.

**(1) Treasury’s Authority.** Under the program, the Secretary is authorized to establish a program to purchase, manage, and sell troubled assets from any financial institution on terms and conditions to be determined by the Secretary.<sup>2</sup> The Secretary must consider a variety of factors, including the interests of taxpayers, minimizing the impact on national debt, providing stability to financial markets, preserving homeownership, the needs of all financial institutions regardless of size or other characteristics, the needs of local communities, the need to ensure stability for United States public instruments, and protecting the retirement security of Americans. In addition, the Secretary must examine the long-term viability of an institution in determining whether to directly purchase assets under the TARP program. The financial institutions covered by the bill include banks, savings associations, credit unions, securities brokers and dealers, insurance companies, any institution established and regulated under the laws of the United States, and any State, territory, or possession of the United States and having significant operations in the United States, including U.S. branches of foreign-owned banks. The bill, however, excludes any central bank or institution owned by a government. However, to the extent that foreign financial authorities and central banks hold troubled assets as a result of extending financing to financial institutions that have failed or defaulted, such troubled assets will qualify for purchase by the Secretary. The “troubled assets” include residential and commercial mortgages, any securities, obligations or other instruments that are related to such mortgages originated or issued on or before March 14, 2008, and any other financial instrument that the Secretary determines necessary to promote financial market stability.<sup>3</sup>

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<sup>2</sup> The bill authorizes the Treasury to establish a program to 1) purchase troubled assets from any financial institution on terms and conditions to be determined by the Secretary; 2) manage troubled assets purchased under the Act; and 3) sell, or enter into securities loans, repurchase transactions, or other financial transactions in regard to, any troubled asset purchased on terms and conditions and at prices determined by the Secretary. In exercising the authorities granted in the Act, the Secretary is required to take certain goals and principles into consideration.

<sup>3</sup> The program is to be implemented through an Office of Financial Stability within the Office of Domestic Finance of the Department of the Treasury. In order to purchase assets under the program, the Secretary must receive contingent shares in the financial institution from which assets are to be purchased equal in value to the purchase price of the assets to be purchased.

(2) **Graduated Funding Authority.** The Secretary's request for \$700 billion is authorized, with a limit of \$250 billion outstanding at any one time. An additional \$100 billion can be released upon the Secretary's certification that funds are needed to bring the total to \$350 billion outstanding at any one time. The final \$350 billion is subject to a Congressional joint resolution of disapproval.

(3) **How Program Will Work.** The bill requires the Treasury Department to structure the purchases and pricing of the assets using market mechanisms to maximize the efficiency of its use of taxpayer resources. Among the market mechanisms the Treasury Department may use are auctions or reverse auctions to set the discount at which the assets would be picked up, with the goal to buy at a discount to face value. Under the program, the Treasury Department would primarily purchase mortgage-backed securities, although other assets debt tied to auto loans, credit cards, student loans, and other non-mortgage related assets may also be included.

1. Definition of "financial institution" not limited to banks, savings associations, credit unions, and the like. Motor vehicle finance companies thus should qualify.

2. Definition of "troubled assets". Not limited like earlier bills to mortgage related assets. Term includes "any other financial instrument that the Secretary . . . determines the purchase of which is necessary to promote financial market stability . . . " Unlike definition of mortgage-related troubled assets, no requirement paper was issued before March 14, 2008. Hence, it should cover our paper on a going-forward basis.

3. Treasury is authorized to "develop guarantees of troubled assets and the associated premiums for such guarantees. Such guarantees and premiums may be determined by category or class of the troubled assets to be guaranteed."

4. Fed Discount Window. Under section 129, the Fed is to provide a report to Congress when it has used authority under 12 USC 343 to use the discount window to make loans. Presumably this is a signal from Congress to use the window, conditioned only on telling Congress when and why the authority has been used.

(4) **Asset Managers.** The bill empowers the Secretary to solicit and award contracts to asset managers, servicers, property managers, and other service providers or expert consultants. The bill allows for a waiver of the usual Federal Acquisition Regulation (FAR) upon a determination of urgent and compelling circumstances that make compliance contrary to the public interest. The bill directs the Secretary to design a streamlined process to solicit proposals from a broad range of qualified vendors interested in performing the work, including minority- and women-owned

businesses, and directs the Secretary to publish program guidelines that specify procedures for selecting asset managers.

(5) **Pricing of Assets.** The bill requires the Secretary to publish program guidelines that will include mechanisms for purchasing troubled assets, methods for pricing and valuing troubled assets, and criteria for identifying troubled assets for purchase.

(6) **Insurance of Troubled Assets.** The bill requires the Secretary to establish a Troubled Assets Insurance Financing Fund to guarantee troubled assets of financial institutions under the program. The Secretary will collect premiums from any financial institution that chooses to participate in the program in an amount that the Secretary deems necessary to provide sufficient reserves to protect taxpayers. The bill authorizes the Secretary to base premiums on the credit risk associated with the particular troubled asset that is being guaranteed. The Secretary will publish the methodology for setting the premium for a class of troubled assets. Profits from the sale of troubled assets are to be used to pay down the national debt. The bill further requires the Secretary to establish risk-based premiums for such guarantees sufficient to cover anticipated claims and requires the Secretary to report to Congress on the establishment of the guarantee programs.

(7) **Preventing Unjust Enrichment.** In making purchases of assets under the program, the bill requires the Secretary to take such steps as may be necessary to prevent unjust enrichment of financial institutions participating in the program. The bill specifically indicates that the Secretary should not purchase a troubled asset at a higher price than what the seller paid to purchase the asset, but does not include any other specific steps to avoid unjust enrichment.

(8) **Conflict of Interest.** The bill requires the Secretary to issue regulations or guidelines to address and manage conflicts of interest that may arise in connection with the administration of the program. The conflicts include, but are not limited to hiring contractors or advisors, management of assets, purchasing of troubled assets, management of troubled assets, post-employment restrictions on employees, and any other potential conflict of interest the Secretary deems necessary or appropriate in the public interest.

(9) **Equity-Sharing/Warrants.** The bill requires that any transaction under the program include equity sharing to minimize any potential long-term negative impact to the taxpayer. In purchasing troubled assets under the program, the Secretary must receive from the financial institution from which assets are to be purchased either (1) a warrant granting the Secretary the right to receive non-voting common stock or preferred stock in such financial institution as the Secretary deems appropriate in the case of a financial institution that is registered and traded on a national exchange; or (2) a senior debt instrument from such financial institution. The bill includes a conversion provision that after the warrant is received by the Secretary, and the financial institution is no longer listed or traded on a national exchange, then the warrant shall convert to senior debt.

**(10) Executive Compensation.** The bill requires any financial institution that sells troubled assets to the Secretary to be subject to certain executive compensation requirements, depending on whether the sale is through a direct purchase or auction. Where the Treasury Department purchases assets directly without a bidding process or available market price and receives a meaningful equity or debt position in the financial institution as a result of the transaction, the institution must observe appropriate standards for executive compensation and corporate governance including: (1) limits on compensation to eliminate incentives that encourage executive officers to take unnecessary and excessive risks that threaten the value of the financial institution during the period the Secretary holds an equity or debt position in the financial institution; (2) a claw-back provision that allows recovery by the financial institution of any bonus or other incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and (3) a prohibition on the financial institution making any golden parachute payment to its senior executive officers during the period that the Secretary holds debt or equity in the financial institution. The bill defines “senior executive officers” as an individual who is one of the top five executives of a public company subject to the disclosure requirements of the Securities Exchange Act of 1934, and their counterparts in a non-public company. When the Treasury Department buys an asset at auction, an institution that has sold more than \$300 million in assets, the Secretary shall 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.

**(11) Homeownership Preservation.** The bill maximizes and coordinates efforts to modify mortgages for homeowners at risk of foreclosure and requires loan modifications for mortgages owned or controlled by the Federal Government. The bill requires the Secretary to take a systemic approach to maximize assistance for homeowners and encourage servicers of the underlying mortgages to take advantage of the Hope for Homeowners Program or other available programs to minimize foreclosures. The bill strengthens the Hope for Homeowners Program by increasing the number of eligible homeowners and improving tools to prevent foreclosures. In addition, the Secretary may use loan guarantees and credit enhancement to facilitate loan modifications to prevent avoidable foreclosures. Further, the bill requires the Secretary to request loan servicers servicing residential mortgage loans to avoid preventable foreclosures to the greatest extent possible and that the Secretary, as an investor, has discretion to do so under existing investment contracts. The bill directs the Secretary to consent, where appropriate, to reasonable requests for implementation of loss mitigation measures, including term extension, 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 limitations and modifications.

**(12) Oversight and Accountability.** Measures include:

(1) Oversight Board. The bill establishes the Financial Stability Oversight Board to review all exercises of authority by the Secretary and Office of Financial Stability, including policies

implemented by the Secretary, appointment of financial agents, designation of asset clauses, plans for the structure of vehicles used to purchase troubled assets, and the effect of actions on assisting American families in preserving homeownership, stabilizing financial markets, and protecting taxpayers; make recommendations to the Secretary regarding the use of the authority; and report any fraud, misrepresentations, or malfeasance.

(2) Reporting Requirements. The Secretary must prepare written monthly reports to Congress regarding an overview of actions taken, the actual obligation and expenditures of the funds provided for administrative expenses; and a detailed financial statement with respect to the exercise of authority, including all agreements made or renewed, all transactions during the month, nature of assets purchased, projected costs and liabilities, operating expenses, valuation method used for each transaction, and a description of the vehicles established to exercise such authority. The bill also requires weekly reports regarding the total amount of assets purchased and sold during the preceding week. Before April 30, 2009, the Secretary is required to submit a report to Congress on the current state of the financial markets, the effectiveness of the financial regulatory system, and provide recommendations.

(3) Transparency Provisions. The bill requires transparency and public accountability through regular, detailed reports to Congress disclosing exercise of the Secretary's authority. The reports must be prepared in accordance with generally accepted accounting principles and a yearly audit by the Government Accountability Office (GAO) to ensure proper use of funds, appropriate internal financial controls, and to prevent waste, fraud and abuse.

(4) Special Inspector General and Reporting Requirements. The bill establishes an independent and objective entity to supervise audits and investigations relating to the program. This new entity, the Office of the Special Inspector General for the Troubled Asset Relief Program, is responsible for conducting, supervising, and coordinating audits and investigations of the purchase, management, and sale of assets by the Secretary under the program. The Inspector General must also submit written reports to Congress every quarter that include a detailed statement of all purchases, obligations, expenditures, and revenues associated with any program established by the Secretary of Treasury.

(5) Tranch Reports to Congress. After each commitment to purchase an aggregate of \$50 million in troubled assets, the Secretary must also provide certain Congressional committees a written report of all transactions, the pricing mechanism for the transactions, a justification of the price paid and other financial terms, a description of the exercise of such authority on the financial system, a description of the challenges that remain in the financial system, and an estimate of additional action that may be necessary. Finally, no later than April 30, 2009, the Secretary shall provide a review of the then current state of the financial systems.

(13) Judicial Review. The bill provides for judicial review of the Secretary's actions and will be set aside if found to be arbitrary, capricious, or otherwise inconsistent with the law or an

abuse of discretion. The bill limits equitable relief, such that no injunction or other form of equitable relief shall be issued against the Secretary for actions under the program except under extraordinary circumstances involving clearly irreparable harm or injury, or in cases involving constitutional claims. The bill also limits actions or claims brought by any person that divests its assets with respect to participation in the program.

**(14) Increase in Statutory Debt Limit.** The bill increases the statutory limit on the public debt to \$11,315,000,000,000.00 from \$10,000,000,000,000.00.

**(15) Congressional Oversight Panel.** The bill creates a Congressional Oversight Panel comprised of a seven members to review the current state of the financial markets and the regulatory system and to submit reports to Congress.<sup>4</sup> The Oversight Panel is empowered to conduct hearings, take testimony, receive evidence, and administer oaths or affirmations to witnesses appearing before it.

The key reports that the bill charges the Oversight Panel to produce are:

(1) Monthly Reports. The bill requires the Oversight Panel to submit Regular Reports every 30 days that include the Secretary's use of contracting authority, administration of the program, impact of purchases made on the financial markets and financial institutions, and impact of the program on market transparency;

(2) Special Report on Regulatory Reform. The bill directs the Oversight Panel to submit by January 20, 2009 a special report on regulatory reform that analyzes the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system, protecting consumers, and that provides recommendations for improvement of the program including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system and the rationale underlying such recommendation and whether there are any gaps in existing consumer protections.

Notably, the bill terminates the Oversight panel after the last monthly Regular Report is filed subsequent to the sale or transfer out of Federal Government control of the last troubled asset purchased by the Secretary under the program.

**(16) FDIC Enforcement Enhancement.** The bill provides for enhanced Federal Deposit Insurance Corporation (FDIC) enforcement authority against false advertising, misuse of FDIC names, and misrepresentation to indicate FDIC insured status. Appropriate Federal banking agencies have enforcement authority over violations. The bill empowers the FDIC to recommend

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<sup>4</sup> The seven member oversight panel is comprised of three members appointed by the Speaker of the House, two recommended by the majority and one by the minority, and three members appointed by the president pro tempore of the Senate, three recommended by the majority and one by the minority, with a seventh members appointed by the members to serve as the Chairperson of the panel. The pay for the Oversight Panel is at a rate equal to the daily equivalent of the annual rate of basic pay for level I of the Executive schedule.

to the appropriate Federal banking agency that it take any enforcement action for violations. If the Federal banking agency does not take the enforcement action within 30 days of the FDIC's recommendation, the bill authorizes the FDIC to conduct investigations and take enforcement actions in connection with its own including investigations, issuing a temporary order and civil money penalties. Further, the bill gives the FDIC jurisdiction over any person other than a person for which the agency is the appropriate Federal banking agency or any institution-affiliated party thereof and any person that aids or abets a violation.

**(17) Tax Provisions.** The bill includes three tax provisions, including: (1) Tax Benefit for Writing-Down Value of Owning Fannie Mae and Freddie Mac Preferred Stock: The bill includes a measure stating that gain or loss from sale or exchange of certain preferred stock of Fannie or Freddie shall be treated as ordinary income for financial institutions; (2) Tax Penalty for Executive Compensation: The bill includes special rules for tax treatment of executive compensation over \$500,000 and golden parachutes of employers participating in the program; and (3) Exclusion of Income Provision: The bill extends current tax law forgiveness on the cancellation of mortgage debt for qualified principal residences until January 1, 2013.

**(18) SEC Authority to Suspend “Mark-to-Market” Accounting and Joint Agency Study on Mark to Market Accounting.** The bill restates the Securities and Exchange Commission’s (SEC) authority to suspend the application of Statement Number 157 of the Financial Accounting Standards Board if the SEC determines that it is in the public and interest and protects investors. The bill further requires the SEC, in consultation with the Federal Reserve and the Treasury Department, to conduct a study of mark-to-market accounting standards as provided in FAS 157. This study must include its effects on balance sheets, impact on the quality of financial information, and other matters. The SEC must report to Congress within 90 days on its findings.

**(19) Study on Margin Authority.** The Controller General must conduct a study and report back to Congress by June 1, 2009 on the role in which leverage and sudden deleveraging of financial institutions was a factor in the current financial crisis. The report must include the authority and ability of the SEC, Treasury Department, the Board, and other agencies to monitor, regulate, or curtail the use of leverage by financial institutions, including the ability to set margin requirements.

**(20) Recoupment.** The bill seeks to protect the taxpayer from bearing any loss after the full implementation of this program. In the event there is a shortfall arising from the program, the bill requires the President to present a proposal after five years that recoups from the “financial industry” any projected losses to the taxpayer. This is intended to ensure that the TARP does not add to the deficit or national debt.

**(21) Termination of Program.** The authorities provided under the Act terminate on December 31, 2009. The Secretary may extend the authority provided under the act not later than two years from the date of enactment with a written certification to Congress.

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