

Torlys on Corporate and Capital Markets

C&CM 2008-26
October 8, 2008

U.S. Financial Rescue Plan

By [William Gray](#), [Alison Bauer](#) and [Emilie Walgenbach](#)

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008, the much-publicized “bailout” or “rescue” law. The Act allows the Secretary of the Treasury (Secretary) to establish certain mechanisms to restore liquidity and stability to the U.S. financial system. The Act permits the Treasury department to establish and implement programs to buy “troubled assets” from, and offer insurance to, “financial institutions” with these troubled assets. The Act also extends certain tax credits to various business sectors.

Purchase of Troubled Assets

The keystone of the Act is the Troubled Asset Relief Program (TARP), which allows the Secretary to purchase from “financial institutions”¹ certain troubled assets such as residential and commercial mortgages and financial products related to these mortgages that were issued or originated on or before March 14, 2008. Other financial instruments may, on further determination and notice to Congress, be purchased if necessary to promote financial market stability.

The Secretary is authorized to spend up to \$700 billion to purchase and guarantee troubled assets, \$250 billion of which is immediately available, increasing up to \$350 billion upon a presidential certificate; the final \$350 billion would be available on the President’s written request to Congress, subject to a 15-day veto by Congress.

Within 2 days of first purchasing a troubled asset or within 45 days of the passage of the Act, whichever is earlier, the Secretary must publish the mechanism for purchasing troubled assets, the methods for valuation and pricing, procedures for selecting private asset managers and criteria for identifying troubled assets. The purchase authority granted under the Act expires on December 31, 2009, but the authority to manage and sell any of the troubled assets continues.

The Secretary is required to receive warrants or debt instruments (depending on the type of financial institution) from financial institutions that sold assets to the government; the type and quantity of warrants depending on whether the institution sold directly or indirectly to the government. Financial institutions from which the Treasury directly purchased assets would be required to implement executive compensation limitations, including limits on “golden parachutes.” The Secretary can determine the market mechanism that will maximize taxpayer returns, including

To discuss these issues, please contact the authors.

For media calls, please contact [Stuart Wood](#), Director, Marketing & Business Development, 416.865.8205.

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¹ Defined to include 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 ..., and having significant operations in the United States but excluding any central bank of, or institutions owned by, a foreign government.”

auctions and reverse auctions (at the latter type of auction, the Treasury purchases a fixed dollar amount of assets at the lowest available price among several bidders).

Insurance Program

The Act includes a provision for the Secretary to guarantee the payment of principal and interest on troubled assets instead of buying them outright. The Secretary may establish premiums based on risk for different classes of assets. These premiums would be paid into a fund by the financial institutions that opt to be covered by the guarantee program. The purchase authority under the TARP will be limited proportionately to the outstanding obligations guaranteed by the insurance fund.

Oversight Established

The Act establishes several oversight functions. First, it requires the Comptroller General of the United States to oversee the activities and performance of the TARP and its agents and representatives. In particular, the Comptroller General shall consider, among other things, (i) whether the TARP has met the purposes of the Act involving mitigating foreclosure, reducing costs, stabilizing the financial markets and protecting taxpayers; (ii) the financial condition and internal controls of the TARP; and (iii) the characteristics of transactions entered into and disposition of assets. The Comptroller General will submit reports to appropriate committees of Congress and the Special Inspector General for the TARP established under the Act.

The Act also establishes a Congressional Oversight Panel to “review the current state of the financial markets and the regulatory system” and submit reports to Congress. These reports must detail, among other things, the Secretary’s use of authority granted by the Act, the impact of the purchases on financial markets, any increased market transparency as a result of information from the transactions and the effectiveness of efforts to mitigate foreclosure. The panel will comprise five members, with one member appointed by each of the majority and minority leaders of both houses of Congress and the final member appointed jointly by the Senate majority leader and the Speaker of the House, after consulting with both minority leaders. In addition, the panel is charged with analyzing the overall regulatory system and making recommendations for improving regulations.

The Office of Management and Budget is required to report to the President and Congress by December 31, 2008 and semi-annually thereafter, on the estimated cost and value of the troubled assets and the information used to derive this information.

Executive Compensation Limits

Any financial institution that sells assets under the Act is subject to executive compensation limits. So long as the Secretary holds a “meaningful” equity or debt position in a financial institution, the institution must limit compensation that has incentives for senior executive officers to take unnecessary and excessive risks; must provide for the recovery of any bonus or incentive compensation paid to executives on the basis of earnings or gains that are later proven to be “materially inaccurate”; and not make golden parachute payments. If the Secretary purchases assets at auction from any financial institution that sold the Secretary more than an aggregate of \$300 million, the financial institution will be prohibited from making any new employment contracts with senior executives that include a golden parachute and is not allowed to take a tax deduction of compensation greater than \$500,000 per executive (reduced from the \$1 million deduction under current law) to the CEO, CFO or three highest-compensated officers.

FDIC Coverage Increased

The Act authorizes the Federal Deposit Insurance Company (FDIC) to borrow unlimited funds from the Treasury, through the end of 2009, in an effort to ensure that the FDIC has sufficient funds available to reimburse customers of the failed banks. Furthermore, the Act temporarily increases the FDIC insurance cap to \$250,000, from \$100,000, per insured customer account per institution. This increase is set to expire on December 31, 2009, and will not be used by the FDIC board of directors to set assessments or premium charges.

Mark-to-Market Accounting

The SEC is authorized to suspend mark-to-market accounting for any issuer it deems appropriate. In addition, the Act instructs the SEC to conduct a study of mark-to-market accounting standards and the effect of this accounting on the balance sheets of financial institutions, on bank failures and on financial information available to investors, among other things.

Tax Implications

The Act contains numerous tax provisions that were added in an effort to get the bill passed by the House. One key tax change for businesses is to allow sales (presumably at a loss) to be counted against ordinary income, and not solely against capital gains in the following situations: a gain or loss from a sale of preferred stock in either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation, if it was held on or before September 6, 2008, or was sold or exchanged by the financial institution after January 1, 2008 and sold before September 7, 2008.

Additional tax breaks in the Act include an extension of the business tax credit for research and development, incentives for wind and refined coal facilities, disaster victim tax relief and a “patch” to the alternative-minimum-tax relief afforded to middle class Americans who would otherwise be subject to the disproportionately burdensome tax. The tax breaks will cost approximately \$80 billion. The Act also includes a requirement that insurers offering mental health coverage do so on par with medical and surgical coverage.

Homeowner Protections

The Act did not modify the Bankruptcy Code to permit bankruptcy judges to modify the terms of mortgages on primary residences. If the TARP acquires mortgages and mortgage-backed securities, it is required to mitigate foreclosures and to “encourage” servicers of mortgages to modify the terms of the underlying mortgages. **1**