

### **The Emergency Economic Stabilization Act of 2008 Impact of the Historic New Law**

The Emergency Economic Stabilization Act of 2008 (the “Act”) was signed into law by President Bush on October 3, 2008. Passage of the Act was the result of intense debate in both the U.S. Senate and the U.S. House of Representatives and among the American people. Debate was to be expected given the magnitude of the requested funds—\$850 billion (including up to \$700 billion for the purchase of troubled assets and up to \$150 billion for the extension or expansion of a variety of tax breaks)—and the importance of the issues the Act addresses to an economy that has been experiencing severe stress from the fallout of the “subprime crisis” which has morphed into a more general credit crisis.

The heart of the Act is based on the concept that if financial institutions could sell their “troubled assets” (including mortgages, mortgage-backed securities and other instruments), retaining assets that are not “troubled” on their balance sheets, those institutions would be perceived as safer transactional counterparties by those with whom they do business. The Act assumes that once worries about the solvency of financial institutions dissipate, credit will again begin to flow.

The Act attempts to address some very difficult questions, including how to determine the prices the U.S. government should pay for “troubled assets,” how much power is vested in the Secretary of the U.S. Department of the Treasury (the “Secretary”) under the Act and the suspension of mark-to-market accounting.

There are, of course, no easy answers to the financial crisis and to the many questions left unanswered in the Act. We hope, however, that this summary and our practice-specific comments are useful resources, and we will continue to update you as events unfold.

#### *Overview*

The Act is designed to provide the Secretary the authority to restore liquidity and stability to the financial system in the United States through the Troubled Assets Relief Program (TARP), which authorizes the Secretary to purchase certain troubled assets from eligible financial institutions in an amount up to \$700 billion. To win the support of members of the U.S. House of Representatives who voted against the bill in its earlier form, new provisions were added to the Act (totaling an estimated \$150 billion), including a temporary increase in the federal deposit insurance limit from \$100,000 to \$250,000 and an extension or expansion of a variety of tax breaks for individuals and businesses.

### ***Troubled Assets Relief Program; Market Mechanisms and Pricing***

Under TARP, the Secretary is authorized to purchase certain “troubled assets” from “financial institutions” in an amount up to \$700 billion through a newly created Office of Financial Stability (the “OFS”). Troubled assets “include residential and commercial mortgages and any securities, obligations or other instruments that are based on or related to such mortgages, originated on or before March 14, 2008,” but “troubled assets” could also include “any other financial instrument.”

The definition of “financial institution” is broad and includes any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company established or regulated under the laws of the United States or any of its territories. Specifically excluded are foreign central banks and institutions owned by foreign governments, although the Secretary appears nevertheless to be permitted to buy assets from them.

The funds will be disbursed over time in tranches. Sums equaling \$250 billion will be available immediately, an additional \$100 billion will be available upon a certification by the President to Congress that these funds are needed, and the remaining \$350 billion may be made available after the President transmits a written report to Congress detailing the Secretary’s plan to exercise the remaining authority, unless Congress votes within 15 days to disapprove the plan.

Under the Act, broad discretion is given to the Secretary to value, price, select and purchase troubled assets. This provision does not directly address the pricing concerns but attempts to require the Secretary to use market mechanisms to the extent possible in determining pricing for troubled assets. It includes some make-whole procedures if these do not work properly, such as imposing higher insurance premiums and equity arrangements.

Generally, in pricing assets to be purchased, the Secretary is required to (i) make such purchases at the lowest price that the Secretary determines to be consistent with the purposes of the Act and (ii) maximize the efficient use of taxpayer resources by using market mechanisms, including auctions or reverse auctions, where appropriate. If the Secretary determines that a market mechanism is not feasible or appropriate, and that the purposes of the Act are best met through direct purchases from an individual financial institution, the Secretary is required to pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset. The Secretary must take necessary measures to prevent unjust enrichment of financial institutions participating in TARP. In addition, the Secretary has broad authority to manage the troubled assets it purchases, including the revenues and portfolio risks of such assets.

Generally, sellers of troubled assets will be required to issue warrants to the Treasury exercisable for nonvoting common or preferred shares, or in some cases voting shares, for which the Secretary will waive voting rights (or, in the case of institutions that are not listed on U.S. exchanges, warrants for common or preferred shares or senior debt instruments). In addition, five years after the date of enactment, the Director of the Office of Management and Budget will report to Congress on TARP’s net gain or loss. If there is a shortfall, the President will be required to submit a legislative proposal that recoups for taxpayers the amount of the shortfall from the financial industry.

The Act also requires the Treasury to establish a federal insurance program to guarantee certain troubled assets in amounts not greater than 100% of the amount of the payment of principal and interest on the troubled assets. Premiums will be paid by any financial institution participating in the program.

## *Oversight*

Given the wide latitude provided the Secretary in acquiring, managing and disposing of troubled assets, including contracting with third parties for asset management, it is not particularly surprising that the legislation includes significant oversight provisions. The newly established Financial Stability Oversight Board (the “Board”) will review and make recommendations regarding the exercise of authority under the Act. The Board will be comprised of the Chairman of the Board of Governors of the Federal Reserve System, the Secretary, the Director of the Federal Home Finance Agency, the Chairman of the Securities and Exchange Commission (SEC) and the Secretary of the Department of Housing and Urban Development. Oversight will also be provided by a new Office of the Special Inspector General for TARP and a Congressional Oversight Panel, which will be established to review the state of the financial markets, the regulatory system and the use of authority under the Act.

## *Executive Compensation and Corporate Governance*

Any financial institution that wishes to take advantage of the Act and determines to directly sell troubled assets to the Secretary will be subject to certain executive compensation requirements, including: (i) limits on senior executive officer compensation, if it is determined to be based on incentives that encourage unnecessary risk-taking, clawback of bonuses or incentive compensation paid to senior executive officers, based on statements of earnings, gains, or other criteria that prove to be materially inaccurate; and (ii) a prohibition on golden parachutes while Treasury holds an equity or debt position in the financial institution. When troubled assets are purchased from a financial institution through an auction, the institution is prohibited from entering into a new employment contract with a senior executive officer that provides a golden parachute payment in the event of an involuntary termination, bankruptcy filing, insolvency or receivership. This prohibition is only effective if Treasury’s purchases of troubled assets from the institution exceed \$300 million (including direct purchases).

Notably, the standards for clawbacks and golden parachute payments only apply to “senior executive officers.” The law defines a “senior executive officer” as one of the top five executives in a public company whose compensation must be disclosed under the Securities Exchange Act of 1934, as amended, and nonpublic company counterparts.

## *Mark-to-Market Accounting*

The Act reaffirms the authority of the SEC to suspend the application of Statement Number 157 issued by the Financial Accounting Standards Board (FAS 157), the so-called mark-to-market rule, if the SEC determines that it is in the public interest to do so and to protect investors. Furthermore, the Act requires the SEC, in consultation with the Federal Reserve and the Secretary, to conduct a study on the mark-to-market accounting standards as provided in FAS 157, including its effects on balance sheets of financial institutions, their impact on bank failures in 2008, their impact on the quality of financial information available to investors, and other matters, and to report to Congress within 90 days on its findings. The impact of this provision will not be immediate as many financial institutions have relief under regulatory guidance for their difficult-to-value assets already. Nevertheless, the impact on the financial condition of institutions holding such assets in a rapidly declining market where prices are difficult or impossible to find has been thought by many to have added fuel to the declines.

## ***Temporary Increase in Deposit and Insurance Coverage***

Effective on the date of enactment and ending on December 31, 2009, the federal deposit insurance limit will increase from \$100,000 to \$250,000.

Following are discussions of certain issues raised by the Act, and its possible impact on certain industries:

Commercial Real Estate:

[http://www.morganlewis.com/pubs/FinancialCrisisLF\\_CommercialRealEstate\\_05oct08.pdf](http://www.morganlewis.com/pubs/FinancialCrisisLF_CommercialRealEstate_05oct08.pdf)

Derivatives:

[http://www.morganlewis.com/pubs/FinancialCrisisLF\\_Derivatives\\_05oct08.pdf](http://www.morganlewis.com/pubs/FinancialCrisisLF_Derivatives_05oct08.pdf)

Hedge Funds and Private Equity Funds:

[http://www.morganlewis.com/pubs/FinancialCrisisLF\\_HedgeFunds\\_PrivateEquity\\_05oct08.pdf](http://www.morganlewis.com/pubs/FinancialCrisisLF_HedgeFunds_PrivateEquity_05oct08.pdf)

Securities Litigation and Enforcement:

[http://www.morganlewis.com/pubs/FinancialCrisisLF\\_SecuritiesLitigation\\_05oct08.pdf](http://www.morganlewis.com/pubs/FinancialCrisisLF_SecuritiesLitigation_05oct08.pdf)

Morgan Lewis also recently sent its clients an Investment Management FYI, addressing the impact of the Act on investment management firms:

[http://www.morganlewis.com/pubs/IMFYI\\_EESA08ImpactOnInvestmentMgmtFirms\\_4oct08.pdf](http://www.morganlewis.com/pubs/IMFYI_EESA08ImpactOnInvestmentMgmtFirms_4oct08.pdf)

If you have any questions or would like more details concerning any of the points mentioned, in this introduction or in the series of discussion briefings, please contact the Morgan Lewis attorney with whom you normally communicate or any of the Morgan Lewis attorneys in our Financial Crisis Working Group: [http://www.morganlewis.com/pubs/FinancialCrisisWorkingGroup\\_Directory.pdf](http://www.morganlewis.com/pubs/FinancialCrisisWorkingGroup_Directory.pdf).

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