

Global Financial Restructuring

Client Alert

Global

BAKER & MCKENZIE

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If Enacted, Proposed Emergency Economic Stabilization Act of 2008 Leaves Many Questions Unanswered Regarding Participating Financial Institutions

This client alert focuses on the provisions of the proposed **Emergency Economic Stabilization Act of 2008** (the "Act") of most relevance to financial institutions considering participating in the programs to be established by the Act. Less attention is given to the public law provisions of the Act dealing with executive and legislative oversight of the programs and related budgetary provisions. This client alert is based upon the text of the Act as considered (and rejected) by the House of Representatives on September 29, 2008. Further client alerts on the Act will be provided as the proposed legislation is further amended to gain Congressional approval.

The Act authorizes the Secretary of the Treasury (the "Secretary") to establish a Troubled Asset Relief Program ("TARP") for the purchase of "troubled assets" from "financial institutions," subject to the provisions of the Act. [Section 101] The Act provides that, if the Secretary establishes such an asset purchase program, the Secretary is also required to establish an insurance program to guarantee troubled assets. [Section 102]

Central to the operation of the Act are the definition of a "financial institution" which is eligible to participate in the programs established by the Act and the definition of "troubled assets" which are to be the subject of purchases or guarantees under the Act.

Definition of Financial Institution

For the purposes of the Act, a "financial institution" means "any institution, including but not limited to, 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, 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.”

Financial institutions thus have been broadly defined to include most domestically incorporated financial institutions – commercial banks, savings banks, investment banks, securities firms and insurance companies. Investment companies, private equity funds, hedge funds, pension funds, endowments and foundations – many of which currently hold troubled assets – would not appear to be covered by the definition, except to the extent that the introductory language referring to “any institution, including but not limited to” (emphasis added) the types of institutions enumerated, will be interpreted to permit a more expansive list, even though the Act nowhere expressly grants the authority to the Secretary or anyone else to determine how the definition is to be expanded. Such authority might be read into the mandate requiring the Secretary to publish Program Guidelines for TARP within 45 days of the Act’s enactment or, if earlier, two business days after the first purchase of troubled assets under the Act. [Section 101(d)]

Equally troubling is the limitation in the definition of “financial institution” to institutions “established and regulated under the laws of the United States,” its states and territories. This clearly includes the U.S. incorporated subsidiaries of foreign banks, but may exclude the branches and agencies of foreign banks, which are not separately incorporated within the United States, though such branches and agencies are licensed and regulated on a basis comparable to domestically incorporated banks. Such U.S. branches and agencies of foreign banks are a formidable force within the U.S. banking community – holding nearly 20% of all loan assets in the U.S. banking system. They may be viewed as being “established” in the United States even though they are not incorporated in the United States, and they may be included in the Act’s coverage by the “including but not limited to” language noted above. If not, exclusion of such branches and agencies from the operation of the Act would seem to violate the United States treaty obligations to provide many of such banks “national treatment” comparable to that of domestically owned banks, under the terms of numerous bilateral investment treaties, free trade agreements and treaties of friendship, commerce and navigation to which the United States is a party and by which it is bound. Similarly, the exclusion of commercial and investment banks owned by foreign governments would appear to violate comparable treaty obligations which entitle foreign companies to national treatment irrespective of government ownership.

The Act encourages foreign central banks and financial authorities to establish programs similar to TARP in respect of banks and other institutions within their jurisdiction. Troubled assets held by central banks and financial authorities as a result of their financing of “financial institutions” which have failed or defaulted on such financing are eligible for purchase under TARP; use of the defined term “financial institutions” would seem to limit such coverage to financial institutions in the United States which have received financial assistance, in respect of their overseas operations, from such authorities. [Section 112]

Though all purchases of troubled assets are to be from financial institutions [Section 101(a)(1)], another provision of the Act contemplates the Secretary purchasing troubled assets held by or on behalf of an eligible retirement plan, subject to certain exceptions [Section 103(8)] - suggesting that pension plans might be eligible sellers. What this provision highlights as well is the fact that the legislation talks of purchasing troubled assets from financial institutions but does not explicitly require that such troubled assets are beneficially owned by such institutions. The Act is thus capable of interpretation to allow participating financial institutions to sell troubled assets which they hold for non-financial institution customers (including pension funds) in a fiduciary capacity. Similarly, there does not appear to be a prohibition on financial institutions selling troubled assets acquired by such financial institution after enactment of the legislation, subject to the requirements (discussed below) that the troubled assets were originated on or prior to March 14, 2008 and that any sale of such troubled assets to the Secretary under TARP be at a price lower than the financial institution's acquisition cost.

Definition of Troubled Assets

"Troubled assets" are defined as:

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 Secretary determines promotes financial market stability; and

any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

Thus the "troubled assets" held by financial institutions which can be the subject of purchases by the Secretary are residential and commercial mortgages and securities and other financial instruments based upon or related to such mortgages. Purchases can also be made of other financial instruments, not limited to mortgages or mortgaged-related securities, subject to a determination by the Secretary after consultation with the Chairman of the Fed. As will be seen, the Act establishes further standards for consideration by the Secretary in making determinations about the purchase of troubled assets.

In the provisions of the Act laying out the considerations which the Secretary is to take into account in exercising authority under the Act, it is stated that the Secretary shall also consider "the utility of purchasing other real estate owned and instruments backed by mortgages on multifamily properties" - suggesting that the Secretary can, in appropriate circumstances, buy the underlying real estate rather than only mortgages, mortgage-related financial instruments and other financial instruments [Section 103(9)]. We note that no other provision of the Act appears to contemplate the purchase of underlying real estate.

Procedures for Troubled Asset Purchases

Office of Financial Stability. The Act directs the Secretary to implement TARP through a new Office of Financial Stability within the Treasury Department's Office of Domestic Finance, which Office is to be headed by an Assistant Secretary of the Treasury appointed by the President with the advice and consent of the Senate. [Section 101(a)(3)] The Secretary is authorized to hire employees, to contract for services, to designate financial institutions as agents of the Federal Government in the Treasury's implementation of the Act, to establish vehicles to purchase troubled assets and "issue obligations," and to issue regulations and guidelines. [Section 101(c)]

Program Guidelines. The Program Guidelines which are to be issued are to address, among other things, (i) the mechanisms for purchasing troubled assets, (ii) methods for pricing and valuing troubled assets, (iii) procedures for selecting asset managers, and (iv) the criteria for identifying troubled assets for purchase. [Section 101(d)]

Direct Purchases and Auctions; Prevention of Unjust Enrichment and Conflicts of Interest. As a practical matter, the procedures to be used will not be known until the Program Guidelines are issued, and the first purchase of troubled assets can and may take place before the Program Guidelines are issued. Purchases of troubled assets through auction procedures and by direct purchases are contemplated. [Sections 111(a) and (b), 113(b) and (c)] The Secretary is to make purchases at the lowest price the Secretary determines to be consistent with the Act and to maximize the efficient use of taxpayer resources by using market mechanisms such as auctions and reverse auctions. [Section 113(b)] Where the Secretary engages in direct purchases, the Secretary is to pursue additional measures to ensure that the prices paid are reasonable and reflect the underlying value of the asset. [Section 113(c)]

The Act also provides that the Secretary shall take steps to prevent the unjust enrichment of participating financial institutions, including preventing the resale of a troubled asset by a financial institution at a price higher than the price paid for its purchase (except where the troubled assets have been acquired in a merger or acquisition or from a financial institution in conservatorship, receivership or bankruptcy). [Section 101(e)] The Secretary is also to issue regulations or guidelines to manage or prohibit conflicts of interest, not just in respect of the purchase of troubled assets, but also in the hiring of contractors or advisors, including asset managers, in the management of troubled assets held by Treasury, and in respect of post-employment restrictions on employees. [Section 108]

Legislative Considerations; Viability of Financial Institutions. In exercising the Secretary's authority under the Act (including with respect to purchases of troubled assets), the Secretary is to take into consideration a number of factors. These include (i) maximizing overall returns and minimizing the impact on the national debt, (ii) providing stability to the financial markets, (iii) the need to help families to keep their homes and to stabilize communities, (iv) assistance to smaller institutions (with assets of less than \$1 billion) the capital adequacy of which has been adversely affected

by their holding of preferred stock of Fannie Mae and Freddie Mac, and (v) the needs of counties and cities adversely affected by the financial crisis. In addition, in respect of direct purchases of troubled assets from a financial institution, the Secretary is to consider the long-term viability of that financial institution. [Section 103] While the financial viability of the seller is identified as a relevant consideration in direct purchases, there is nothing in the Act which suggests that the financial viability of a selling financial institution is a relevant (or limiting) consideration in auction purchases of troubled assets by Treasury.

Equity and Senior Debt Participations. In respect of all purchases of troubled assets from a financial institution (other than aggregate purchases from a financial institution below a threshold to be established by the Secretary, but not more than \$100 million of troubled assets), the Secretary is to receive, in respect of U.S. listed financial institutions, a warrant to receive non-voting common stock or preferred stock of the financial institution “as the Secretary determines appropriate”. [Section 113(d)(1)(A) and (d)(3)(A)] In respect of non-listed financial institutions, the Secretary is to receive a senior debt instrument of such financial institution. [Section 113(d)(1)(B)] Such warrants or senior debt instruments are to provide “reasonable participation ... in equity appreciation” in the case of a warrant or “a reasonable interest rate premium” in the case of a debt instrument. The exercise price of any such warrants is to be set by the Secretary. Warrants are to contain anti-dilution provisions; if the financial institution is no longer listed, warrants are to be converted into a senior debt instrument. Warrants or senior debt instruments so held by the Secretary may be exercised, surrendered or sold. The financial institution is to assure the Secretary that it has sufficient non-voting shares authorized for issuance on exercise of any warrants granted to the Secretary or, if it does not have such shares authorized, preferred shares “that may carry dividend rights equal to a multiple number of common shares.” If the institution has no such shares authorized, the Secretary may accept a senior debt note, if shareholder approval for the share authorization cannot be obtained. [Section 113(d)(2)] The Secretary is granted the authority to excuse from these requirements any financial institution which is legally prohibited from issuing securities and debt instruments as contemplated by the Act. [Section 113(d)(3)]

Executive Compensation Conditions. The Act sets out various executive compensation and corporate governance requirements in respect of purchases of troubled assets under TARP. When the Secretary makes direct purchases of troubled assets “where no bidding process or market prices are available” and the Secretary receives “a meaningful equity position” in the financial institution as a result of the transaction, the Secretary is to require that the financial institution meet “appropriate standards for executive compensation and corporate governance.” These standards include a (generally stated) limit on compensation for executive officers to “exclude incentives ... to take unnecessary and excessive risks that threaten the value of the financial institution,” provision for recovery of any bonus or incentive compensation paid to a “senior executive officer” (any of the institution’s top five executives) based on financial results that later prove to be materially inaccurate, and a prohibition on making “golden parachute” payments to a senior executive

officer. [Section 111(a) and (b)] In respect of auction purchases from a financial institution aggregating more than \$300 million (including direct purchases from such institution), the Secretary is to prohibit such institution from providing a “golden parachute” under a new employment contract with a senior executive officer in the event of such officer’s involuntary termination or the institution’s bankruptcy, insolvency or receivership. Greater detail about the operation of such “golden parachute” prohibitions is to be provided in “guidance” to be issued by the Secretary within two months of the Act’s enactment. [Section 111(c)] More generally, for financial institutions participating in auctions under TARP and selling in the aggregate in excess of \$300 million in troubled assets (other than through direct purchases), they may only deduct for tax purposes executive remuneration of each of the chief executive officer, chief financial officer and any other of the three most highly compensated officers up to \$500,000 in any tax year (with further rules applicable to deferred deduction executive compensation). [Section 302]

Insurance Program

In addition to the purchase of troubled assets from financial institutions under TARP, the Secretary is to establish an insurance program to guarantee troubled assets, including mortgage-backed securities issued prior to March 14, 2008. The guarantee is to be issued by the Secretary and may extend to the timely payment of 100% of principal of and interest on troubled assets. [Section 102(a)] The Secretary is to establish a Troubled Assets Insurance Fund and to set premiums for guarantees (insurance) at “a level necessary to create reserves sufficient to meet anticipated claims, based on an actuarial analysis” to ensure taxpayers are fully protected. [Section 102(c) and (d)] Payments to fulfill obligations under the program are to be made from the Troubled Assets Insurance Fund [Section 102(d)(3)], suggesting that the guarantees are limited to the assets of the Fund rather than full faith and credit obligations of the United States government.

It would appear that the insurance program, like TARP, is available only to financial institutions (subject to the same definitions as for TARP). The distinguishing feature of the insurance program, however, is that the provisions of the Act applicable to purchases under TARP, which require equity or senior debt positions in participating financial institutions and limitations on participating financial institutions’ executive compensation and corporate governance practices, are not applicable to financial institutions participating in the insurance program.

Management of Purchased Troubled Assets

The Act grants broad authority to the Secretary, in consultation with the Federal Deposit Insurance Corporation (FDIC), to manage troubled assets purchased under TARP, including the right, at prices determined by the Secretary, to sell or enter into securities loans, repurchase transactions or other financial transactions in regard to troubled assets purchased under the Act. [Section 106] It is expected that the Secretary will make extensive use of outside asset managers in dealing with the troubled asset portfolios purchased under TARP, though the Act also makes clear that the FDIC is

eligible to serve as an asset manager with respect to residential mortgages and residential mortgage-backed securities. [Section 107(c)] The Act directs the Secretary, in managing acquired assets, to maximize assistance to homeowners and to use the authority of the Secretary to encourage servicers to take advantage of the HOPE for Homeowners Program enacted during the summer and to consent to reasonable loan modification requests. [The extensive homeowner assistance provisions of the Act are set out in Sections 109 and 110.]

Reports; Judicial Review

All purchases of troubled assets under TARP and all insurance contracts issued are subject to monthly reports to various Committees of Congress, on a transaction-by-transaction basis, setting out information as to the types of participating financial institutions (whether through direct purchases, auctions or insurance) and “the valuation or pricing method used for each transaction.” [Section 105] The Secretary is also to make available to the public in electronic form a description, the amounts and pricing of troubled assets purchased, within two business days of each purchase, sale or other disposition; no mention is made, however, of disclosing the counterparty financial institutions to such transactions. [Section 114(a)]. The Secretary is, however, to review generally the public disclosure standards of financial institutions applicable to off-balance sheet transactions, derivatives, contingent liabilities and other “potential exposure” and make recommendations, as necessary, for additional disclosure requirements. [Section 114(b)]

Actions of the Secretary under the Act are subject to judicial review and may be held unlawful and set aside if found to be “arbitrary, capricious, an abuse of discretion or not in accordance with law.” Injunctions are not available against the Secretary for actions under TARP, the insurance program or in respect of the Secretary’s management of purchased assets and, otherwise, applications for temporary restraining orders, preliminary injunctions and permanent injunctions, or other equitable relief, are to be considered by the courts on an expedited basis. [Section 119(a)] A “participating company” which sells assets pursuant to the Act may not bring an action against the Secretary, except pursuant to the “arbitrary, capricious, abuse of discretion, not in accordance with law” standard or except as otherwise provided in any contract between the Secretary and such participating company. [Section 119(a)(3)]

Special Studies; Mark-to-Market

The Act contemplates (a) a Regulatory Modernization Report from the Secretary to Congress by April 30, 2009, (ii) the review of certain financial institution public disclosures, as noted above, (iii) a study by the Securities and Exchange Commission (“SEC”), in consultation with the Secretary and the Fed, on mark-to-market accounting standards under FASB 157, within 90 days of the Act’s enactment, and (iv) a study by the Comptroller General and related recommendations as to the role of leverage and sudden deleveraging of financial institutions as a factor in the current financial crisis, including an analysis of margin lending. Significantly, the Act also authorizes the SEC to suspend the application of FASB 157 for any issuer or any class

or category of transaction “if the Commission determines that [such action] is necessary or appropriate in the public interest and is consistent with the protection of investors.” [Section 132]

Other Provisions

The Act increases the national debt limit to \$11.315 trillion and authorizes up to \$700,000,000 to implement the Act. Upon enactment, the Secretary is authorized to purchase up to \$250 billion of troubled assets outstanding at any time; that limit is increased to \$350 billion on submission by the President to Congress of a certification, and such limit is further increased to \$700 billion upon a report by the President to Congress on the Secretary’s plan to utilize such authority unless Congress by a joint resolution disapproves the plan within 15 days. These limits also include, in addition to purchases under TARP, contracts issued under the Act’s insurance program.

After five years, the Office of Management and Budget is to submit to Congress a report on the “net amount within” TARP. If there is a shortfall (that is, any net taxpayer cost) the President is to submit to Congress a legislative proposal “that recoups from the financial industry” an amount equal to the shortfall.

The Act is a large and complex piece of legislation, still in the process of enactment. Baker & McKenzie will provide ongoing client alerts as the legislation progresses to enactment and as Program Guidelines are issued.