

October 14, 2008

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TARP LEGISLATION SUMMARY

The Emergency Economic Stabilization Act (the "Act") that was enacted into law on October 3, 2008, establishes a program called the Troubled Assets Relief Program, now generally being referred to as the "TARP." Of the 169 pages to the Act, approximately 36 are devoted to the rescue program. The balance of the provisions are related to legislation related to energy, tax, mental health programs, and a myriad of other matters generally unrelated to solving the financial crisis. The principal features of TARP include: (a) the amount available under the program is limited and becomes available in increments; (b) the Treasury Secretary (the "Secretary") is authorized to purchase residential or commercial mortgages, and securities, obligations or other instruments based on or related to the mortgages, issued as of March 14, 2008, and any other financial instrument, if certain determinations are made; (c) the Secretary is required to use market means including auctions and reverse auctions, where appropriate, and to maximize taxpayer resources and permit the Secretary to purchase troubled assets (as defined in the Act) directly from financial institutions (as defined in the Act) for reasonable prices if market methods are not appropriate; and (d) financial institutions may purchase insurance for troubled assets. Discussed below are these principal features of the Act and TARP and some other provisions enacted as part of the Act relevant to the financial industry.

SIZE OF THE FUND

The Secretary's authority to purchase troubled assets is limited in the following manner: (a) as of the effective date of the Act, the maximum amount outstanding is limited up to \$250 billion; (b) if the President submits a written certification to Congress that the Secretary needs to exercise the authority under the Act, the limit increases a maximum of \$350 billion; and (c) if the President submits a written report to Congress detailing the Secretary's plan under the Act, unless Congress blocks it as prescribed in the Act, the limit increases to \$700 billion. Unless extended pursuant to the Act, the Secretary's authority terminates on December 31, 2009. In addition, the Act contains many provisions dealing with oversight and transparency.

TREASURY'S AUTHORITY TO PURCHASE MORTGAGES AND SECURITIES

Under TARP, the Secretary is authorized to purchase troubled assets. "Troubled assets" are defined as: (a) residential or commercial mortgages, and securities, obligations or other instruments based on or related to the mortgages, issued as of March 14, 2008; and (b) any other financial instrument, if the Secretary determines after consulting with the Chairman of the Board of Governors of the Federal Reserve (the "Federal Reserve") that the purchase will promote financial market stability and delivers to Congress in writing that determination. The Secretary may purchase troubled assets from any "financial institution" defined as 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 . . ." that has "significant operations" in the United States. Foreign central banks and any institution owned by a foreign government are excluded, except that a foreign financial authority or bank that owns troubled assets because it extended credit to a financial institution that failed or defaulted on the credit is eligible to sell troubled assets to the Secretary.

PURCHASES OF TROUBLED ASSETS

TARP requires, provided it is appropriate, the Secretary to maximize the use of taxpayer money through the use of market methods for the purchase of troubled assets. The Act specifically provides that among the market means that the Secretary is authorized to use are auctions and reverse auctions. The Act also provides that the Secretary is required to ". . . make purchases at the lowest price that the Secretary determines to be consistent with the purposes of this Act . . ." The auctions provided for in the Act are not the exclusive market means. The Secretary may use any other market means the Secretary determines as set forth in the guidelines the Secretary is to promulgate. The Secretary is also authorized to make direct

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purchases of troubled assets from an individual financial institution if the Secretary makes certain determinations. To make direct purchases, the Secretary must determine “. . . that use of a market mechanism is not feasible or appropriate, and the purposes of the Act are best met through direct purchases from an individual financial institution . . .” For any direct purchase, the Secretary must also “. . . pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset.”

The Act imposes certain conditions on the Secretary’s purchase of any troubled asset. If the seller is a financial institution whose stock is traded on a national securities exchange, the Secretary must receive a warrant giving the right to the Secretary to receive nonvoting common stock or preferred stock in the seller, or voting stock for which the Secretary will agree not to exercise voting power as the Secretary deems appropriate. If the Seller is a publicly traded company, the warrant must be convertible to a senior debt instrument or contain appropriate protections to ensure the Treasury is appropriately compensated for the value of the warrant, as determined by the Secretary, if the financial institution is no longer listed or traded. If the seller is not a publicly traded financial institution, the Secretary must receive a warrant for common or preferred stock or a senior debt instrument. The warrant from the non-publicly traded financial institution shall contain appropriate protections for the Secretary to ensure that the Treasury is appropriately compensated for the value of the warrant in an amount determined by the Secretary. Any of the warrants or senior debt instruments required to be issued must provide for reasonable participation in equity appreciation or a reasonable interest rate premium, as applicable, and additional protection against losses from the sale of assets by the Secretary under the Act and the administrative expenses of the program. The Secretary is further authorized to sell, exercise, or surrender a warrant or any senior debt instrument received. The Act requires the Secretary to establish *de minimis* exceptions to the requirements of the issuance of warrants and senior debt instruments based on the size of the cumulative transactions of troubled assets purchased from any one financial institution for the duration of the program of not more than \$100 million.

As is now evident from the most recent developments, the Secretary is initially using TARP not to purchase “bad loans” but rather to purchase equity in banks. As of the morning of October 14, 2008, as reported in the various financial news media, the initial \$250 billion, and, apparently, the additional \$100 billion, will be used to purchase preferred shares. The precise terms of the preferred shares are being negotiated. As reported in the *Wall Street Journal* for October 14, 2008, the Secretary will first invest in nine “top financial institutions” including Bank of America, JP Morgan Chase & Co., and Wells Fargo & Co. After the capital infusions in the first nine financial institutions, the initial indications are that investments will then be made in potentially thousands of banks. As the events of the last week demonstrate, the implementation of the legislation and use of TARP is an exceedingly fluid and fast-moving situation that will undoubtedly have additional twists and turns.

INSURANCE FOR TROUBLED ASSETS

The Act further provides that the Secretary shall establish a program to guarantee troubled assets, including mortgage-backed securities, originated or issued before March 14, 2008. The Secretary may determine guarantees and premiums by categories or classes of troubled assets to be guaranteed and may develop various guarantees of troubled assets and the premiums for the guarantees. If a financial institution requests, the Secretary may guarantee the timely payment of principal and interest on troubled assets up to the full amount of the payments due on terms and conditions established by the Secretary. Financial institutions are not required to participate. Any financial institution that participates in the program shall pay the premiums established by the Secretary. Among other things authorized by the Act, the Secretary may provide for variations in the premium rates according to the credit risk of the troubled assets being guaranteed. The Secretary is required to publish the methodology used to establish the premiums for a class of troubled assets along with an explanation of the type of assets that may participate in the class. The premiums are to be established using an actuarial analysis. The total amount available under the Act to purchase troubled assets is reduced by the amount equal to the difference between the total of the outstanding guaranteed obligations and the balance in the insurance fund.

ADDITIONAL MATERIAL PROVISIONS OF THE ACT

Executive Compensation and Corporate Governance

Any financial institution that sells troubled assets under the program shall be subject to limitations on executive compensation and other requirements of the Act. During the effectiveness of the Secretary’s authority under the Act, if the Secretary makes direct purchases of troubled assets in accordance with the provisions of the Act and receives a “meaningful” equity or debt position in the financial institution because of the transaction, the Secretary shall require the financial institution meet “appropriate” standards for executive compensation and corporate governance including: (a) limits on compensation “. . . that exclude incentives for senior executive officers [as defined in the Act] . . . to take unnecessary and excessive risks that threaten the value of the financial institution . . .”; (b) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to senior executive officers based on statements of earnings,

gains, or other criteria that are later proven to be materially inaccurate; and (c) a prohibition on the financial institution making any golden parachute payment to its senior executive officers. "Senior executive officer," for purposes of the Act, means an individual who is one of the top five (5) highly paid executives of a public company whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and any non-public counterparts. In addition, during the effectiveness of the Secretary's authority pursuant to the Act, if troubled assets purchases are made through auction purchases and exceed in the aggregate per financial institution \$300 million (including direct purchases), the financial institution shall not enter into any new employment contract with a senior executive officer that includes a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership.

Market Transparency

To facilitate market transparency, the Secretary is required to make available to the public, in electronic form, a description, amounts, and pricing of assets acquired under the Act within two (2) business days of the transaction. The Secretary may require additional public disclosures for any financial institution that sells troubled assets under the Act of off-balance sheet transactions, derivative instruments, contingent liabilities, and similar sources of exposure.

Authority to Suspend Mark-to-Market Accounting

The Securities and Exchange Commission is granted the authority to suspend the mark-to-market rules of Financial Accounting Standards Board Statement Number 157 for any issuer as defined in the Securities Exchange Act.

Increase in Deposit Insurance

From October 3, 2008, through December 31, 2009, the FDIC insurance is increased to \$250,000 per account. The temporary increase is not to be taken into account in setting assessments. The guarantee of deposits is another aspect of the various actions being taken by the FDIC and Treasury that is changing rapidly.

Tax Provisions

Gain or loss of an "applicable financial institution" on the sale or exchange of preferred stock in Fannie Mae or Freddie Mac held on September 6, 2008, or sold or exchanged on or after January 1, 2008, and before September 7, 2008, shall be treated as ordinary income or loss. An "applicable financial institution" means generally a bank, savings and loan, and certain other entities.

For financial institutions participating in the TARP program, deductions are disallowed for executive compensation that exceeds \$500,000, or in the case of deferred deduction, executive compensation exceeds \$500,000 reduced by the executive compensation for the tax year plus the portion of deferred deduction executive compensation taken into account in a prior taxable year. This provision only applies if the financial institution sells under the program troubled assets having an aggregate amount exceeding \$300 million. To calculate the aggregate amount of \$300 million per financial institution, direct purchases of troubled assets in one or more transactions are excluded. The executive compensation tax provisions are certainly among the more provocative for financial institutions, and many believe they may create some resistance to participation in TARP.

HRO has a team of experienced lawyers to help you with addressing the opportunities that are presented by the legislation and TARP. If we can be of assistance, please contact any of the attorneys listed on the first page of this alert.

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