GIBSON, DUNN & CRUTCHER LLP

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FINANCIAL MARKETS IN CRISIS: SECTION-BY-SECTION ANALYSIS OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

To Our Clients and Friends:

We are pleased to provide our clients and friends with a section-by-section analysis of the Emergency Economic Stabilization Act of 2008 (hereinafter, the "Act") as passed by the Senate, by a vote of 74-25, on October 2, 2008. The section-by-section analysis includes commentary from experts on Gibson, Dunn & Crutcher LLP's Financial Markets Crisis Group. We hope you find it useful as you work through the challenges and opportunities posed by the market crisis and the government's response.

On a procedural note, the Senate used H.R. 1424, which was a resolution to amend the Employment Retirement Security Act to include mental health parity provisions, as a vehicle to pass the Emergency Economic Stabilization Act. As passed by the Senate, the bill also included energy and tax extender provisions. We have not included those provisions in this analysis.

Division A – Emergency Economic Stabilization

Sec. 1: Short Title and Table of Contents

Summary:

- The short title of the bill will be the "Emergency Economic Stabilization Act of 2008."

Sec. 2: Purposes

Summary:

- The Act's purposes include providing the Secretary of the Treasury (the "Secretary") authority to restore liquidity and stability to the financial system and to ensure that the authority is used in a way to protect home values and savings, promote job growth and homeownership, maximize returns to taxpayers, and provide public accountability for its exercise.

Sec. 3: Definitions

Summary:

The most relevant definitions of which our clients should be aware include:

- "Financial Institution" means any institution including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company which is organized and regulated under United States law or the law of the states or territories, and which has significant operations in the United States. The definition excludes any central bank of, or institution owned by, a foreign government.

- "Fund" means the Troubled Assets Insurance Financing Fund established by Section 102.

- "TARP" refers to the troubled asset relief program established in Section 101.

- "Troubled assets" include:

    - residential or commercial mortgages and other instruments "based on or related to" such mortgages. The instruments must have been originated or issued on or before March 14, 2008, and the Secretary must determine that purchasing them will promote market stability; and

    - any other instrument which the Secretary determines the purchase of is necessary to promote financial market stability, after consulting with the Chairman of the Federal Reserve. The Secretary must transmit this determination in writing to Congress.

Analysis:

The definitions of "financial institution" and "troubled assets" are critical in terms of who and what can participate in the asset purchase program created by the bill. Both definitions have evolved since earlier drafts and, yet, each raises a number of questions.

The definition of "financial institution," for example, employs undefined terms in phrases like "significant operations in the United States" and "owned by a foreign government." It is not clear what "significant operations" means; nor is it clear what constitutes foreign ownership. Also, the Treasury Secretary is not granted authority to expand the scope of eligible "financial institutions" as was the case in earlier drafts. Finally, as worded, there are technically no limits on what constitutes a "financial institution" other than that it has to be an "institution" and cannot be a central bank or an institution owned by a foreign government. The list of institutions is just illustrative.

The definition of "troubled assets" was broadened from earlier versions to include "commercial mortgages." The language gives the Secretary the authority to expand the definition to include assets that if their purchase is necessary to promote "financial market stability." How the Secretary will exercise this authority – and what additional assets or instruments he might include in the definition of "troubled assets," is an important question for financial institutions who would like to participate in the program.

Title I: Troubled Assets Relief Program

Sec. 101: Purchases of Troubled Assets

Summary:

- Authorizes the Secretary to establish TARP to purchase troubled assets from any financial institution, on terms and conditions determined by the Secretary in accordance with the Act.

- Provides that the TARP program's commencement should not be delayed by the establishment of policies, procedures, and other administrative requirements by the Secretary.

- Establishes an Office of Financial Stability within the Office of Domestic Finance of the Department of the Treasury and mandates that the Secretary carry out these programs through that office.

- Requires the Secretary to consult with the Federal Reserve Chairman, the Federal Reserve Bank of New York, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Administration Board, and the Secretary of Housing and Urban Development.

- Allows the Secretary to have direct hiring authority to appoint employees necessary to administer the Act and allows the Secretary to enter into contracts.

- Allows the Secretary to designate private financial institutions as financial agents of the Federal Government.

- Establishes vehicles which are authorized to purchase, hold, and sell troubled assets, providing the Secretary flexibility to manage the troubled assets.

- Requires the Secretary to publish program guidelines before the earlier of 2 business days after first purchasing troubled assets or within 45 days of the Act's enactment. The guidelines will include:

    - mechanisms for identifying, pricing, and purchasing troubled assets; and

    - procedures for selecting asset managers.

- Requires the Secretary to prevent "unjust enrichment" of participating financial institutions.

Analysis:

The Treasury Department has proposed the hiring of experienced private asset managers to aid the government in valuing securities – as the Fed did when it hired BlackRock to manage Bear Stearns' asset portfolio earlier this year. The rescue bill requires the Secretary to establish procedures for choosing asset managers. The bill grants the Secretary broad authority to solicit proposals, manage potential conflicts of interest, and restrict information sharing by managers contracted to aid the government's asset valuation. Section 107 of the bill further allows the Treasury Department to hire the Federal Deposit Insurance Corporation as an asset management entity, similar to the agency's role in the Savings & Loan bailout. However, Secretary Paulson has publicly supported the retention of private portfolio managers.[1]

Sec. 102: Insurance of Troubled Assets

Summary:

- Requires the Secretary to establish a program to guarantee troubled assets originated or issued prior to March 14, 2008, including mortgage-backed securities, if the Secretary establishes TARP.

- Requires the Secretary to collect premiums for the guarantees from participating financial institutions sufficient to cover anticipated claims, and allows the Secretary to vary the rates based on credit risk.

- Requires the Secretary to report to Congress about the program.

- Establishes a Troubled Assets Insurance Fund, which will consist of the premiums paid by participating institutions, and will be used to fulfill obligations of guarantees provided to financial institutions.

Sec. 103: Considerations

Summary:

- Requires the Secretary to take a number of considerations into account, including protecting taxpayers, providing stability to the market, and preserving home ownership.

- Requires the Secretary to consider the long-term viability of a financial institution before allowing it to participate in the program.

- Requires the Secretary to consider the need to ensure stability for counties and towns, small financial institutions, and financial institutions serving lower income populations.

Sec. 104: Financial Stability Oversight Board

Summary:

- Establishes the Financial Stability Oversight Board to review the exercise of authority under the Act and to make recommendations to the Secretary. The Board will comprise the Federal Reserve Chair, the Treasury Secretary, the Director of the Federal Home Finance Agency, the Securities and Exchange Commission Chair, and the Secretary of Housing and Urban Development.

Analysis:

This is one of four oversight entities created or tapped into by the bill. In addition to the Board, the bill creates a Special Inspector General for the Troubled Asset Relief Program (SIGTARP) (section 121) and a congressional oversight panel (section 125). It also gives the Comptroller General substantial oversight and audit responsibilities and requires it to undertake a study and report on margin authority (sections 116 and 117). This is all on top of congressional oversight and investigatory committees as well as executive branch oversight bodies.

The responsibilities of these oversight entities overlap considerably. That is not surprising given the concerns that have been expressed repeatedly by Members of Congress over the potential cost of this legislation. Presumably, Congress wants to hear from multiple perspectives how the asset purchase program is performing and whether it is meeting its goals. However, the potential for these oversight entities to trip over each other in the course of their work is great.

Sec. 105: Reports

Summary:

- Requires the Secretary to make monthly reports to Congress which will include an overview of the Secretary's actions, the obligation and expenditure of funds provided for administrative expenses during the period, and a detailed financial statement about the Secretary's use of its authority under the Act.

- Requires the Secretary to provide Congress a written tranche report for every $50 billion of assets purchased about all the transactions made during the period, a description of the pricing mechanism for the transactions, and a justification for the price paid for the transaction.

- Requires the Secretary to submit a written Regulatory Modernization Report to Congress no later than April 30, 2009 analyzing the current state of the market, evaluating the effectiveness of the regulatory system, and providing recommendations.

Sec. 106: Rights; Management; Sale of Troubled Assets; Revenues and Sale Proceeds

Summary:

- Allows the Secretary to exercise its authorities under the Act at any time.

- Allows the Secretary to manage troubled assets purchased under the Act, including the ability to determine the terms and conditions associated with the disposition of troubled assets.

- Requires that proceeds from sales be used to reduce the national debt.

Analysis:

House Democrats had proposed committing a portion of profits to fund affordable housing assistance through the Housing Trust Fund and the Capital Magnet Fund. This provision was strongly opposed by Republicans and was dropped during negotiations on the final package.

Sec. 107: Contracting Procedures

Summary:

- Allows the Secretary to waive provisions of the Federal Acquisition Regulation where urgent circumstances make compliance contrary to the public interest. Such waivers must be submitted to Congress within 7 days.

- Requires the Secretary to implement alternative standards to ensure the inclusion of minority- and women- owned businesses if the Secretary waives provisions of the Federal Acquisition Regulation pertaining to minority contracting.

- Requires that the FDIC be considered in the selection of asset managers.

Sec: 108: Conflicts of Interest

Summary:

- Requires the Secretary to issue guidelines to prevent conflicts of interest relating to the execution of the authorities provided under the Act.

Analysis:

This provision is focused on possible conflicts with respect to (1) hiring contractors, including asset managers, (2) purchasing assets, (3) managing assets, and (4) post-employment restrictions. The provision does not prescribe the form or content of the regulations but rather reflects significant congressional concern with conflicts that could arise during the program's implementation.

Sec. 109: Foreclosure Mitigation Efforts

Summary:

- Requires the Secretary to implement a plan to maximize homeowner assistance and to encourage servicers of the underlying mortgages purchased through TARP to take advantage of the HOPE for Homeowners Program.

- Allows the Secretary to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.

- Requires the Secretary to consent to reasonable loan modification requests arising under existing investment contracts.

Sec. 110: Assistance to Homeowners

Summary:

- Requires the Federal Government to minimize foreclosures on properties underlying the mortgages and mortgage-backed securities the government purchases.

Sec. 111: Executive Compensation and Corporate Governance

Summary:

- Requires that if the Secretary makes direct purchases of troubled assets from a financial institution and the Secretary receives a meaningful equity or debt position in the institution, the Secretary will set executive compensation and corporate governance standards for the institution. The standards will only apply while the Secretary holds a debt or equity position in the institutions. The standards include:
    - limits on compensation for senior executive officers to prevent unnecessary risk-taking;

- the recovery of any bonus or 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

- a prohibition on golden parachute payments to senior executive officers.

- Defines "senior executive officer" as an individual who is one of the top 5 highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and non-public company counterparts.

- Provides that if the Secretary purchases an institution's troubled assets through an auction and those purchases exceed $300 million (including direct purchases), the Secretary shall prohibit any new employment contract with a senior executive officer that provides a golden parachute in the event of involuntary termination, bankruptcy filing, insolvency, or receivership. These provisions only apply to arrangements entered into while the TARP authorities are in effect.

Analysis:

The legislation does not provide a definition of the terms "employment contract" or "golden parachute;" likely, we will have to wait for Treasury to issue guidance on those terms once legislation is passed. The provision will not apply, however, to existing golden parachute agreements.

Sec. 112: Coordination With Foreign Authorities and Central Banks

Summary:

- Requires the Secretary to coordinate with foreign financial authorities and central banks to establish programs similar to TARP.

- Provides that if foreign financial authorities and central banks hold troubled assets as a result of extending financing to financial institutions that have failed or defaulted on the financing, those troubled assets qualify for purchase under TARP.

Sec. 113: Minimization of Long-Term Costs and Maximization of Benefits for Taxpayers

Summary:

- Requires the Secretary to minimize long-term harm to taxpayers by holding assets to maturity and maximizing return on the assets for taxpayers and the Federal Government.

- Requires the Secretary to encourage the private sector to participate in purchases of troubled assets.

- Requires the Secretary to make purchases "at the lowest price that the Secretary determines to be consistent" with the Act's purposes.

- Requires the Secretary to use market mechanisms, such as auctions or reverse auctions, to maximize efficiency of resources.

- Allows the Secretary to make direct purchases of assets if the Secretary determines that using market mechanisms is not appropriate.
- Requires the Secretary to pursue additional measures to ensure that Treasury pays reasonable prices that reflect the assets' underlying value if Treasury makes direct purchases of assets.
- Requires that the Secretary receive warrants from participating financial institutions giving the Secretary the right to receive non-voting common or preferred stock in the institution. The exercise price for the warrants will be set by the Secretary.
- Requires that any warrant received by the Secretary contain anti-dilution provisions.
- Requires the Secretary to establish an exception and alternative procedures to these requirements for any participating financial institution that is legally prohibited from issuing securities and debt instruments.

Analysis:

Secretary Paulson testified before the House Committee on Financial Services that the Treasury Department would employ market mechanisms to value mortgage securities. Paulson identified key goals of the auctions as "price discovery" and "transparency."[2]

The Secretary mentioned instituting reverse auctions as a means of pinpointing market prices and allowing smaller financial institutions to enter the process. In a reverse auction, the government would accept bids from multiple sellers to offload debt, and the sellers would compete by successively lowering their bids until only one participant remained. The government has past experience in operating reverse auctions for mineral rights, Treasury securities and wireless spectra.

The Treasury Department also may utilize the descending auction model. In a descending auction, the government would start the auction for a particular quantity of security at a relatively high price. The price would then be lowered gradually until supply equals demand – at the price where the aggregate of security holders wish to sell the stated auction quantity. The descending auction would help accomplish Paulson's "price discovery" goal, hopefully leading the secondary market to use newly acquired pricing information and re-liquidate the assets among private investors.[3]

Federal Reserve Chairman Bernanke opined in questioning before the Senate Banking Committee that opening up the auctions to a greater number of institutions would increase competition and allow for market forces to determine prices with greater accuracy. Ideally, these market forces would eventually settle prices well above the "fire-sale" point, but slightly below "hold-to-maturity" book prices.[4]

In order to structure an efficient buyout, the government could set up separate auctions for an announced quantity of different classes of securities. The Treasury may decide to auction the most widely held mortgage-backed securities first in order to create an overall pricing scheme for later, more specialized sales of collateralized-debt obligations. Declining to give details, Secretary Paulson has merely stated that the initial auctions would probably be for "smaller" amounts.[5]

Sec. 114: Market Transparency

Summary:

- Requires the Secretary to make publicly available a description, amount, and pricing of assets acquired under the Act within 2 business days of purchase.

- Requires the Secretary to determine whether the public disclosures required for financial institutions authorized to use the program is adequate to provide the public with enough information about the true financial position of the institutions with regard to off-balance sheet transactions, derivatives instruments, contingent liabilities, and other sources of potential exposure.

Analysis:

The provision duplicates SEC authority by providing that the Secretary shall determine whether the public disclosure by firms that sell assets to the Secretary is adequate with respect to items such as off-balance sheet disclosures.

Sec. 115: Graduated Authorization to Purchase

Summary:

- Authorizes the full $700 billion requested by Treasury to be released in tranches.

- Allows the Secretary to immediately use up to $250 billion.

- Allows the Secretary authority to use up to $350 billion if the President submits to Congress a written certification that the Secretary is exercising the authority under the Act.

- Allows the Secretary authority to use up to $700 billion if the President submits a written report detailing the Secretary's plan to exercise the additional authority and Congress does not enact a joint resolution disapproving the plan.

Analysis:

The joint resolution of disapproval must be passed by both chambers within 15 calendar days of the President submitting a report to Congress. That is not a lot of time and, hence, it stands to reason that there would have to be a significant groundswell of opposition to the program for the President's plan to be rejected.

Sec. 116: Oversight and Audits

Summary:

- Requires the Comptroller General to commence ongoing oversight of the activities and performance of TARP, and to report every 60 days to Congress.

- Requires TARP to prepare financial statements in accordance with GAAP, which financial statements will be audited annually by the Comptroller General.

- Requires TARP to establish and maintain a system of internal controls that would provide reasonable assurance of the effectiveness of operations, the reliability of financial statements, and legal compliance.

Sec. 117: Study and Report on Margin Authority

Summary:

- Requires the Comptroller General to conduct a study and report back to Congress by June 1, 2009 about the extent to which leveraging and sudden deleveraging of financial institutions was a factor behind the current financial crisis.

Sec. 118: Funding

Summary:

- Provides for the authorization and appropriation of funds consistent with Section 115 of the Act.

Sec. 119: Judicial Review and Related Matters

Summary:

- Provides standards for judicial review and limitations of injunctive and similar relief.

- Provides that actions of the Secretary will be deemed unlawful if they are arbitrary, capricious, an abuse of discretion or not in accordance with law.

Sec. 120: Termination of Authority

Summary:

- Provides that the authorities to purchase and guarantee assets under the Act terminate on December 31, 2009.

- Provides that the Treasury Secretary may extend the authority of the Act, upon submission of certification to Congress, to expire no later than 2 years after enactment of the Act.

Sec. 121: Special Inspector General for the Troubled Asset Relief Program

Summary:

- Establishes the Office of the Special Inspector General for TARP to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets by the Treasury Secretary under the Act.

- Requires the Special Inspector General to submit a report to Congress summarizing its activities and the activities of the Secretary under the Act within 60 days after confirmation of the Special Inspector General and thereafter, every calendar quarter.

Analysis:

This language is based on the organic statute creating the Special Inspector General for Iraq Reconstruction. With broad authority and a $50 million budget, the SIGTARP could be a robust overseer.

Sec. 122: Increase in Statutory Limit on the Public Debt

Summary:

- Raises the debt ceiling from $10 trillion to $11.315 trillion.

Sec. 123: Credit Reform

Summary:

- Sets forth the treatment of the Act for budgetary purposes under the rules set forth in the Federal Credit Reform Act.

Analysis:

This means that the bill will be scored on a subsidy, as opposed to an outlay basis. In other words, funds will not be scored as they are spent. Rather, the Office of Management and Budget and the Congressional Budget Office will project how much the government will lose, or gain, over time, in buying and selling assets under the bill's authority.

Sec. 124: Hope for Homeowners Amendments

Summary:

- Amends the HOPE for Homeowners program to increase eligibility for distressed borrowers and improves the tools available to prevent foreclosures.

Sec. 125: Congressional Oversight Panel

Summary:

- Establishes a Congressional Oversight Panel to conduct an ongoing review of the state of the financial markets, the regulatory system, and the effectiveness of TARP.

- Requires the Congressional Oversight Panel to report to Congress every 30 days and to submit a special report on regulatory reform no later than January 20, 2009.

- Sets the membership of the Congressional Oversight Panel at 5 members to be appointed by the House and Senate Minority and Majority leadership.

Sec. 126: FDIC Authority

Summary:

- Prohibits the misuse of the FDIC logo, symbols or name to falsely advertise or misrepresent that deposits or shares are insured.

- Provides authority for enforcement by appropriate federal banking agencies.

- Authorizes the FDIC to take enforcement action against any person where the appropriate banking agency has not acted upon the FDIC’s recommendation.

- Protects acquirers of insured banks from being subject to litigation or damages based on standstill, confidentiality, or other agreements that would restrict or prohibit the acquisition of such banks.

Analysis:

Sections 126(a) and (b) of the Act provide the FDIC with broad express authority to stop and penalize any person or entity that misrepresents or implies falsely that any "deposit liability, obligation, certificate, or share" is covered by FDIC insurance. The FDIC currently does not have express statutory authority to address false representations concerning whether such an obligation, investment or instrument issued by an entity other than an insured bank is protected by FDIC insurance.

Section 126(c) of the Act broadly protects acquirers of FDIC-insured banks, or their assets, in a FDIC supervisory transaction from being subject to litigation or damages based on existing standstill, confidentiality, or other agreements that would restrict or prohibit the acquisition of such bank. This provision would thus relieve a company from the potentially adverse effects of agreements that the target banks had entered into prior to the acquisition. This protection extends both to the acquisitions commenced before enactment of the Act as well as to future acquisitions.

It is our understanding that the FDIC requested that this authority be added to the bill in order to allow for a full range of possible buyers in the case of a bank failure, including banks that may have been involved in merger discussions with another bank before that bank failed.

Sec. 127: Cooperation with the FBI

Summary:

- Requires any federal financial regulatory agency to cooperate with the FBI or other law enforcement agencies investigating fraud, misrepresentation and malfeasance with respect to development, advertising, and sale of financial products.

Sec. 128: Acceleration of Effective Date

Summary:

- Accelerates the effective date of amendments to the Financial Services Regulatory Relief Act, which provides the Federal Reserve with the ability to pay interest on reserves.

Sec. 129: Disclosures on Exercise of Loan Authority

Summary:

- Requires the Federal Reserve to provide a report to Congress within 7 days after the use of its emergency lending authority under Section 13(3) of the Federal Reserve Act.

- Requires the Federal Reserve to provide status reports to Congress every 60 days while an emergency loan is outstanding.

Sec. 130: Technical Corrections

Summary:

- Makes technical amendments to the Truth in Lending Act.

Sec. 131: Exchange Stabilization Fund Reimbursement

Summary:

- Requires the Treasury Secretary to reimburse the Exchange Stabilization Fund for any funds used for the temporary money market mutual fund guaranty program.

- Prohibits any use of the Exchange Stabilization Fund to establish any future money market mutual fund guaranty program.

Sec. 132: Authority to Suspend Mark-to-Market Accounting

Summary:

- Authorizes the SEC to suspend for any issuer or with respect to any class or category of transaction the application of Statement of Financial Accounting Standards No. 157 ("FAS

157"), which defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements, if the SEC determines that the suspension is in the public interest and protects investors.

Analysis:

A number of House members recently signed on to a letter to the SEC asking Chairman Christopher Cox to suspend the mark-to-market accounting rules, which have been a major source of concern throughout the debate on the rescue bill. The new legislation, if passed, would affirm that the SEC does have the authority to suspend those rules. In the meantime, the SEC and the Financial Accounting Standards Board have provided guidance about how mark-to-market accounting should be applied, and now will allow companies to use their own assumptions about the value of illiquid assets in their public accounting in cases where market values do not reflect the actual value of the assets because markets have ceased to function normally. The SEC has, however, thus far elected not to suspend the rules altogether.

Sec. 133: Study on Mark-to-Market Accounting

Summary:

- Requires the SEC, in consultation with the Federal Reserve and the Treasury, to conduct a study on mark-to-market accounting standards as provided in FAS 157 and to report to Congress within 90 days.

- Requires the SEC's study to consider FAS 157's effects on balance sheets of financial institutions, impact on bank failures, impact on the quality of financial information available to investors, and alternative accounting standards.

Sec. 134: Recoupment

Summary:

- Requires the Director of the Office of Management and Budget to submit a report to Congress within 5 years on the net amount within TARP.

- Requires the President to submit to Congress in 5 years a legislative proposal that recoups from the financial industry any projected losses to taxpayers.

Sec. 135: Preservation of Authority

Summary:

- Clarifies that nothing in the Act limits the authority of the Treasury Secretary or the Federal Reserve under any other provision of law.

Sec. 136: Temporary Increase in Deposit and Share Insurance Coverage

Summary:

- Temporarily increases the amount of deposit coverage for banks and share coverage for credit unions from $100,000 to $250,000. The coverage amount reverts back to $100,000 after December 31, 2009.

- Temporarily increases the borrowing limit on what banks and credit unions can borrow from the Treasury to facilitate additional coverage.

- Provides that because these increases are temporary, they will not be factored into either insurance premium charges, share insurance deposit adjustments, or deposit insurance inflation adjustments.

Title II: Budget-Related Provisions

Sec. 201: Information for Congressional Support Agencies

Summary:

- Requires that all information used by the Secretary in connection with activities authorized by the Act be made available to the Congressional Budget Office and Joint Committee on Taxation.

Sec. 202: Reports by the Office of Management and Budget and the Congressional Budget Office

Summary:

- Requires the Office of Management and Budget and the Congressional Budget Office to report to Congress and the President regarding exercises of authority by the Secretary.

- Allows the Director of the CBO to employ personnel and procure the services of experts and consultants with financial expertise.

Sec. 203: Analysis in President's Budget

Summary:

- Requires the President to submit with his budget proposal a separate budgetary analysis of the actions taken under the Act.

Sec. 204: Emergency Treatment

Summary:

- Designates all provisions of the Act as an "emergency requirement," which means they will not be counted for purposes of the fiscal year 2008 budget.

Title III: Tax Provisions

Sec. 301: Gain or Loss from Sale or Exchange of Certain Preferred Stock

Summary:

- Changes the tax treatment by financial institutions of gains and losses on the preferred stock of Freddie Mac and Fannie Mae.

- Provides that gains and losses from the sale or exchange of preferred stock in Fannie Mae or Freddie Mac by "applicable financial institutions" will be treated as ordinary gains and losses for federal income tax purposes. "Applicable financial institutions" generally include banks (and bank holding companies), savings and loans (and savings and loan holding companies), SBICs operating under the Small Business Investment Act of 1958 and certain business development corporations (often referred to as "BDCs").

- The new rules apply to stock that was either held on September 6, 2008 or was sold by the applicable financial institution on or after January 1, 2008 and before September 7, 2008. Thus, for instance, stock acquired after September 6 will not qualify for this treatment. Special rules apply to prevent entities from converting to applicable financial institutions in order to take advantage of this provision.

- Grants to Treasury the authority to issue regulations governing situations where the stock was acquired after September 6 in a "transferred basis" transaction. This occurs where the basis in the preferred stock is determined with reference to the basis of the stock in hands of the person who transferred the stock to the applicable financial institution, such as where the stock was transferred to the applicable financial institution as a capital contribution.

- Grants to Treasury the authority to issue regulations where the preferred stock is held by a partnership in which the applicable financial institution is a partner.

Analysis:

Many applicable financial institutions acquired preferred stock of Fannie Mae and Freddie Mac in order to satisfy their regulatory capital requirements. The preferred stock qualified as "Tier 1 capital" for these purposes. Since the stock paid a hefty dividend rate that, unlike interest on debt instruments, allowed its owners to exclude 70 percent of the return from taxable income, it was an attractive investment for financial institutions and their holding companies. When the government placed Freddie Mac and Fannie Mae into receivership in early September 2008, the preferred stock became worthless and resulted in a loss for federal income tax purposes. Since the preferred stock was a "capital asset" for tax purposes, however, its worthlessness in most cases resulted (prior to the Act) in a capital loss.

Under the tax rules, capital losses may be used to offset capital gains (including capital gains realized in prior years), but not ordinary income (such as income from most banking operations). Since applicable financial institutions, especially large banks and savings and loans, generally earn relatively meager capital gains relative to their ordinary income, they would receive little if any tax benefit from the worthlessness of the preferred stock without this change in law. Banks and their lobbying groups, including the American Bankers Association and the Independent Community Bankers of America, cried foul and sought this change of law in order to lessen the impact of the Fannie Mae and Freddie Mac receiverships. In certain cases, the refund generated by tax losses resulting from current economic events may be among the largest assets of applicable financial institutions, because they could reach as much as 35 percent of the income upon which tax was paid during the current year and preceding two years (plus any state benefits). We expect to see significant litigation concerning the rights to these refunds.

As a result of the Act, a loss recognized by an applicable financial institution on the preferred stock will be treated as an ordinary loss. This means that the applicable financial institution can use the loss against its ordinary income for the current tax year, and if the institution has a net operating loss for the current year, the loss could be carried back to the two preceding tax years in order to obtain a refund of taxes paid in those years (subject to certain limitations).

Interestingly, the benefit extends not only to the banks and savings and loans, but to their holding companies as well. Individuals and other entities will not be entitled to this special treatment, and thus their losses on Fannie Mae and Freddie Mac preferred stock generally will be treated as capital losses. Whether individual states will adopt conforming changes to their tax laws in order to permit the same treatment for state income tax purposes remains to be seen, but it is worth noting that certain states do not permit the carryback of net operating losses. We have not seen estimates of the tax cost of this change, but press reports thus far seem to ignore the revised treatment of these losses when referring to the cost of the Act.

Sec. 302: Special Rules For Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program

Summary:

- Amends Section 162(m) of the Internal Revenue Code to limit the annual tax deduction to $500,000 for compensation paid to the CEO, CFO or one of the other three highest compensated officers of employers from whom one or more troubled assets are acquired under the Act if the aggregate amount of such assets exceeds $300 million.

- Amends Section 280G of the Internal Revenue Code with respect to parachute payments paid to executives of firms participating in TARP.

- Authorizes the Treasury Secretary to prescribe further guidance, rules, and regulations to carry out the purposes of the Act.

Analysis:

Section 302 addresses certain tax consequences of compensation paid to senior executives at firms that transact business with the government pursuant to the Act. The provision contains two sets of rules: one designed to limit the deductibility of compensation deemed excessive and the other making the "golden parachute" rules applicable to certain severance benefits of top executives at participating firms.

Deductibility rule, Section 302(a)--as mentioned above in this summary, Section 111 of the Act provides disparate treatment for executive compensation paid by firms selling securities to the government. The same holds true for the tax treatment of executive compensation paid by those firms. For instance, if a firm engages only in direct purchase transactions with the government, the firm is not treated as an "applicable employer" and the new deduction limits will not apply to that firm. The theory here is that firms engaging in direct purchase transactions under Section 111(b) of the Act will be subject to stringent requirements imposed by Treasury relating to limits on compensation, recovery of certain bonuses, and limits on golden parachutes.

Firms that sell assets in the auction process and sell more than $300 million of securities to the government overall (including in direct purchase transactions) are the firms targeted by the deductibility limits. While these firms are prohibited by the Act from entering into new employment contracts providing for golden parachutes, they are not prohibited from fulfilling the terms of existing agreements and are not prohibited from entering into new employment agreements providing for compensation in excess of $500,000 per year.

One must parse through several defined terms in order to fully understand the deduction limits. Below is a list of relevant terms with a summary of the definition of each:

- "Applicable employer": Firms that engage in the auction process and sell more than $300 million of securities to the government. If a firm only sells in direct purchase transactions, the firm is not an applicable employer. However, once a firm sells assets other than through direct purchase transactions, all sales (including direct purchase sales) are counted in applying the $300 million threshold. Entities that are treated as a single employer under the benefit plan aggregation rules (with a couple of modifications) are treated as a single employer.

- "Applicable taxable year": Any taxable year that includes any portion of the period during which Treasury has authority under Section 101(a) of the Act and in which the cumulative assets acquired by the government from the applicable employer pursuant to the Act exceed $300 million. If the employer only made sales in direct purchase transactions, however, those sales are not counted toward the $300 million threshold.

- "Covered executive": An employee who, while Treasury's authority under Section 101(a) of the Act remains in effect, is the CEO or CFO of the applicable employer or who is one of the other three "highest compensated officers" for the applicable taxable year, other than the CEO and CFO. Whether someone is a "highest compensated officer" is determined under the SEC compensation disclosure rules (even if those rules do not apply to the employer), and the determination excludes employees who were not employed while the Treasury had authority under Section 101(a) of the Act. Once an employee is a covered executive for an applicable employer, that person remains a covered executive of that employer for all relevant taxable years. Thus, unlike the existing $1 million limit, which ceases to apply when the executive is no longer in the "top five," this $500,000 limit will continue to apply to deductions that arise after the executive is no longer in the top five.

- "Deferred deduction executive remuneration": Remuneration that would be "executive remuneration" for services performed in an "applicable taxable year" but for the fact that the deduction is allowable (without regard to these rules) in a later tax year.

- "Executive remuneration": Amounts that otherwise constitute deductions for compensation of the covered executive. Certain exclusions under the existing $1 million deduction limit apply, but most notably the exclusions for commissions or other performance-based compensation (including performance bonuses and option gains) do not apply, and therefore deductions for such amounts are subject to the limits. Executive remuneration excludes "deferred deduction executive remuneration" with respect to services performed in a prior "applicable taxable year." Thus, for instance, if a deduction for executive remuneration for services performed in Year 1 is deferred until Year 2, that deduction is treated as deferred deduction executive remuneration in Years 1 and 2, and not as executive remuneration in Years 1 or 2.

The deduction rules as set forth in the Act are as follows:

1. No deduction is allowed to an applicable employer for executive remuneration for any applicable taxable year attributable to services performed by a covered executive during that applicable taxable year, to the extent the amount of remuneration exceeds $500,000; and

2. In the case of deferred deduction executive remuneration for any taxable year for services performed during any applicable taxable year by a covered executive, no deduction will be allowed to the extent that remuneration exceeds $500,000 reduced by (a) executive remuneration for such applicable taxable year, and (b) the portion of deferred deduction executive remuneration for such services taken into account under this rule in a preceding taxable year.

The deduction rules also coordinate with the golden parachute provisions and the rules for stock compensation of employees of expatriated corporations. These rules apply to all tax years ending on or after the date of enactment of the Act.

Golden parachute excise tax rules, Section 302(b)--the second set of compensation-related tax rules apply the existing golden parachute provisions to payments made to executives of participating firms whose employment is terminated.

By way of background, the golden parachute tax rules deny deductions to corporations for certain payments and other benefits, and impose a 20 percent nondeductible excise tax on the recipient of those payments or other benefits, if (a) the recipient is a "disqualified individual," (b) the payments and other benefits are deemed contingent on a change of control of the corporation, and (c) the payments and other benefits exceed three times the individual’s average compensation for the five-year period preceding the change of control. Once the payments and other benefits exceed this three-times threshold, all payments in excess of the five-year average are subject to the deduction disallowance and the excise tax.

Under the Act, a "covered executive" (described above) is automatically treated as a disqualified individual. In addition, the rules now treat the "applicable severance from employment" of a covered executive as a change of control for purposes of applying the golden parachute rules, and treat payments that are "on account of" the "applicable severance" as payments contingent on a change of control.

"Applicable severance from employment" means any severance from employment resulting from involuntary termination or in connection with the bankruptcy, liquidation, or receivership of the employer. The rules also substitute the term "applicable employer" for "corporation" as that term is used in Section 280G, meaning that they apply to all payments by entities subject to the deduction disallowance rules described above, and to "covered executives" with respect to such applicable employers.

Exceptions under the golden parachute rules for payments that are deemed "reasonable compensation" and for payments by private (*i.e.*, non-publicly traded) companies or corporations that could qualify as S corporations do not apply. Thus, private corporations and corporations that could qualify as S corporations also are subject to the golden parachute rules in the Act.

The actual language implementing this particular provision is not clear. The main area of uncertainty stems from language stating that "this section" (meaning Section 280G of the Internal Revenue Code) applies to severance payments to a covered executive. Section 280G, however, applies only to "excess parachute payments," and we would have expected the language to say something to the effect that the applicable severance payments are to be treated as "parachute payments" under these rules instead of providing that the entire section applies to the severance payments. Nevertheless, our sense is the rules are intended to treat payments to a covered executive on account of applicable severance from employment as parachute payments for purposes of the golden parachute rules. If this is the case and if those severance payments exceed three times the executive’s five-year average compensation, the employer is denied a deduction and the employee incurs a nondeductible 20 percent excise tax to the extent of severance payments in excess of that five-year average.

The Act also contains a few coordinating provisions, including a rule making the excise tax provision inapplicable to any payment that would be treated as a parachute payment without regard to the new rules, and a grant of regulatory authority to Treasury in order to (a) carry out the purposes of the provision and the Act in the case of any acquisition, merger or reorganization of an applicable employer, (b) apply the deduction disallowance and the excise tax rules where payments are treated as parachute payments under the new rules and other payments are treated as parachute payments under the old rules, and (c) prevent avoidance of the rules by mischaracterizing a severance from employment as something other than "applicable severance."

These rules apply to all payments with respect to severances occurring while Treasury’s authorities under Section 101(a) of the Act are in effect.

Much like the existing rules imposing limits on the deduction of compensation in excess of $1 million and limiting the deduction and imposing an excise tax on golden parachute payments, in many cases these rules will require significant clarification before they can be implemented with any degree of certainty. While the intent to limit what is perceived as excessive compensation to senior executives of institutions that participate in asset sales under the Act is clear, the implementing rules are far from clear. Terms like "involuntary termination," "in connection with a bankruptcy, liquidation, or receivership," and "on account of such applicable severance" will require more elaboration.

Moreover, it is questionable whether it makes much sense from a policy standpoint to place these limits on the compensation of persons who fall within the definition of "covered executive" while placing no such limits on employees who fall outside that fairly narrow definition.

Historically, in our experience, many employers have considered the limits on deductibility in setting their compensation structures, but ultimately decide what they will pay their executives based on factors independent of tax deductions. One would think this will be even more likely for firms selling assets under the Act, as presumably these firms are not overly concerned with income taxes given the magnitude of their tax losses resulting from the recent economic downturn.

In addition, many executive employment agreements require the employer to pay the 20 percent nondeductible excise tax incurred by the executive as a result of the receipt of golden parachute payments, as well as the additional income and excise taxes incurred by the executive resulting from those payments (since those payments by the employer are treated as additional compensation), ultimately costing the employers significantly more than they would have spent without these rules. While Treasury has authority under the Act to limit payments to executives where it engages in direct purchase transactions, it has no such authority where it is participating in auctions (other than the limited right to prohibit golden parachutes in new employment agreements). Therefore, the excise tax rules could result in substantially higher costs to the entities, and ultimately the shareholders or other stakeholders of those entities, that suffered huge losses leading up to the Act.

Sec. 303: Extension of Exclusion of Income From Discharge of Qualified Principal Residence Indebtedness.

Summary:

- Extends current tax law relating to the cancellation of mortgage debt for qualified principal residences until January 1, 2013.

Analysis:

Section 303 of the Act simply extends the expiration date of the current provision addressing income from the cancellation of "qualified principal residence indebtedness." Under this rule, borrowers who negotiate a reduction in indebtedness incurred to acquire their principal residence will not be required to pay tax on the reduction, provided certain conditions are met. Without this special rule, assuming the borrower was not in bankruptcy or insolvent, the borrower would be deemed to have ordinary income equal to the amount of the reduction in his or her indebtedness. The Act extends this rule to reductions in debt that occur prior to January 1, 2013. Prior to the Act, this rule would apply only to cancellations that occur prior to January 1, 2010.

Interestingly, this provision does not shelter gain on sale, including gain on sale that would result from a foreclosure on a home that secures nonrecourse debt in excess of the homeowner’s tax basis in the home (*e.g.*, where the homeowner refinanced and borrowed more than the original cost of the home plus capitalized improvements and the debt is nonrecourse). Other Internal Revenue Code provisions may apply to shelter that gain, however.

The Financial Markets Crisis Group will continue to keep our clients updated on the latest events in Washington. Additional updates relating to the financial markets crisis are available on Gibson Dunn's website.

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[5] Rebecca Christie and Jody Chenn, *Paulson, Bernanke Put Bank Ahead of Best Deal*, Bloomberg, Sept. 24, 2008.

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