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EMERGENCY ECONOMIC STABILIZATION ACT UPDATE

The Financial Institutions Regulatory Practice Group of Sidley Austin LLP

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Summary of the Emergency Economic Stabilization Act of 2008

On October 3, 2008 the House of Representatives voted to approve the Senate version of the Emergency Economic Stabilization Act of 2008 (the "Act"), a statute designed to create a "troubled asset relief program" ("TARP") administered by the U.S. Department of Treasury in response to the recent financial crisis.[1] The President is expected to sign the Act quickly.

The Act will have far-reaching implications for financial markets and financial institutions in the United States. While many aspects of the TARP remain to be defined through regulation and agency implementation, a number of issues for asset sellers, potential servicers and others are apparent on the face of the statute. Assuming the Act is signed by the President, the following is an attempt to briefly summarize some of the key aspects of the Act that would have the broadest and most direct impact on the financial industry.

I. Covered Assets and Institutions

At its most fundamental level, the Act provides $700 billion to the Secretary of the Treasury (the "Secretary") in order to purchase, and to make and fund commitments to purchase, "troubled assets" from "financial institutions." For this purpose, "financial institutions" eligible to participate in the TARP must be established and regulated under federal or state law (or the law of any territory or possession of the United States) and have significant operations in the United States. "Financial institutions" include, but are not limited to, banks, savings associations, credit unions, broker-dealers, and insurance companies. The language "not limited to" leaves open the possibility that the Secretary could determine that other entities, such as certain hedge funds and securitization vehicles, could qualify to participate in the TARP. Branches and agencies of foreign banks arguably are "established and regulated" under United States law for purposes of this definition. Central banks of, and institutions owned by, a foreign government are not eligible to be financial institutions. However, to the extent such central banks or foreign institutions hold troubled assets as a result of the

1 The Act includes two unrelated tax measures, the Energy Improvement and Extension Act of 2008 and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, that were added by the Senate to make the bill politically palatable. Those items are not discussed here.

default or failure of a financial institution to which such entity extended credit, such assets may be purchased under the TARP.

"Troubled assets" initially include residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, in each case originating on or before March 14, 2008, that the Secretary determines would promote financial market stability if purchased. The term also means any other financial instrument, the purchase of which the Secretary, in consultation with the Chairman of the Board of the Federal Reserve System ("Fed Chairman"), determines is necessary to promote financial market stability, but only after transmittal of such determination to Congress. Thus, while the TARP clearly is targeted at residential and commercial loans and instruments based on such assets, such as mortgage-backed securities, the Secretary has extremely broad authority to expand the scope of the covered asset classes as necessary to promote market stability.

II. Asset Acquisition

As noted above and widely reported, the Act provides $700 billion to the Secretary to stabilize the financial markets by acquiring troubled assets. Contrary to the Secretary's original request, however, the funds will become available in stages, with the first $250 billion available immediately, an additional $100 billion to be released upon the President's notification to Congress of the Secretary's need and the remaining $350 billion to be released following the President's further notice to Congress of the Secretary's need, but subject to a Congressional joint resolution of disapproval that must pass within 15 days of Congress receiving the President's notice. At the end of the 5 year period following the date of enactment of the Act, if there is a shortfall in the net amount within the TARP, the President must submit a proposal to Congress to recoup from the financial industry an amount equal to the shortfall, so that the TARP does not add to the national debt or the deficit.

The Act states that the Secretary can establish programs or vehicles that are authorized to purchase such troubled assets and issue obligations through market mechanisms, including auctions or reverse auctions, where appropriate. The details of such auction or other purchase mechanisms remain controversial because of the problems with pricing illiquid assets and the concomitant risk to the taxpayer of mispricing. Nonetheless, in light of the exigent circumstances, the implementation details remain open to the Secretary's discretion. To promote transparency, however, the Secretary must make available to the public in electronic form the description, amount and pricing of assets it acquires pursuant to the Act within 48 hours of purchase, trade or other disposition. While the Secretary must consider conflicts of interest when engaging in asset purchases, the Secretary also has broad discretion in determining the mechanisms for doing so.

The Secretary also is directed to minimize taxpayer expense by "encourag[ing] the private sector to participate in purchases of troubled assets, and to invest in financial institutions," thereby potentially providing opportunities for private funds looking to leverage the TARP as a partner rather than a competitor. Here too the structures by which the Treasury would propose to take advantage of private sector equity remain to be defined, with the Secretary exercising maximum flexibility to pursue the goals of the Act.

In making direct purchases[2] from financial institutions, the Secretary will be required to consider the long-term viability of the financial institution in determining whether the purchase represents the most efficient use of funds. Accordingly, institutions that are too weak to save, and that are not otherwise "too big to fail" still may not benefit from the TARP, at least in non-auction situations.

Furthermore, the Secretary is required to take steps to avoid the "unjust enrichment" of financial institutions participating in the TARP, including by preventing the resale of a troubled asset to the Secretary at a higher price than what the seller paid to purchase the asset (unless the assets were acquired in a merger

2 The term "direct purchases" as used in the Act appears to refer to purchases for which pricing was set by direct negotiation with the seller, rather than by market mechanisms such as an auction.

or acquisition, the financial institution is in conservatorship or receivership, or the financial institution has filed for bankruptcy under title 11). In short, Congress has attempted to prevent institutions that have purchased troubled assets in the market from profiting by reselling them to the TARP.

Finally, under the guise of taxpayer protection and reforming Wall Street, the Act includes two further requirements for purchases of troubled assets that will complicate both the calculus of institutions considering participating in the TARP and the practicalities of actually implementing a transaction. As discussed in the next two sections, the Act requires the Secretary to obtain equity participation rights from any financial institution that sells to the TARP and imposes significant restrictions on executive compensation for such institutions.

III. Equity Sharing

The Secretary may not purchase or make a commitment to purchase troubled assets under the Act unless the applicable financial institution provides the Secretary with: (a) a warrant giving the Secretary the right to receive non-voting common stock or preferred stock in the institution as the Secretary determines appropriate; or (b) a senior debt instrument (in the case of a financial institution that is not registered and traded on a national securities exchange or securities association). As with other provisions of the Act, the Secretary is given broad discretion with regard to the size of the equity stake or debt instrument that will be required. The Secretary's demands in this regard will, of course, impact an entity's decision-making regarding whether to participate in the programs established by the Act.

Any such warrant or debt instrument must be subject to conditions that are designed to provide for reasonable participation by the Secretary in equity appreciation in the case of a warrant, or a reasonable interest rate premium, in the case of a debt instrument, for the benefit of taxpayers. They also must cover any potential losses that the Secretary could realize from the sale of the troubled assets purchased from the issuing financial institution. The Secretary is allowed to sell, exercise or surrender such warrants or debt instruments.

Warrants have several additional requirements under the Act. First, the warrant must provide that in the event that the issuing financial institution becomes no longer traded on a national securities exchange or securities association, the warrant will convert to a senior debt instrument in an amount determined by the Secretary. Second, such warrants must contain anti-dilution provisions of the type employed in capital market transactions, as determined by the Secretary, in order to protect the value of the securities from transactions such as stock splits, stock distributions, dividends, mergers, and other forms of reorganization and recapitalization. Third, the exercise price for these warrants will be set by the Secretary. Finally, the financial institution must guarantee to the Secretary that it has enough authorized shares of non-voting stock available to fulfill its warrant obligations. If it does not, the Secretary may accept a contingent senior debt note in anticipation of a shareholder vote for such authorization; such note must be for a limited period of time, with a penalty determined by the Secretary if it expires.

With regard to all of the foregoing equity sharing requirements, the Secretary may establish *de minimis* exceptions based on the cumulative amount of troubled assets purchased from any one financial institution for the duration of the program, at not more than $100 million. The Secretary also must establish an exception to the foregoing requirements for any participating financial institution that is legally prohibited from issuing securities and debt instruments.

IV. Executive Compensation and Corporate Governance

Another fundamental political compromise in the Act is a series of provisions imposing limitations on compensation paid to senior executive officers of financial institutions that participate in the TARP. In those instances in which the Treasury purchases troubled assets from a financial institution where no bidding process or market prices are available, and the Secretary

receives a meaningful equity or debt position in the financial institution as a result, the Act provides that the Secretary "shall require that the financial institution meet appropriate standards for executive compensation and corporate governance." These standards apply as long as the Treasury holds a debt or equity position in the affected financial institution. The Act requires that the standards, which presumably will be adopted and published by the Department of the Treasury, must include the following:

(i) Limits on compensation to exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution;

(ii) A provision for the recovery by the financial institution 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

(iii) A prohibition on the financial institution making any "golden parachute payment to its senior executive officer" during the period that the Secretary holds an equity or debt position in the financial institution.

Different rules apply with respect to financial institutions that sell more than $300 million in troubled assets under the Act through the mechanism of auction purchases. Those entities will be prohibited from entering into any new employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. The Act directs the Secretary to issue guidance to carry out this requirement within two months after the date of enactment of the Act.

For purposes of the foregoing, the term "senior executive officer," means one of the top 5 highly paid executives of a public company, whose compensation is required to be disclosed, in the case of public companies, and in the case of non-public companies, their counterparts. Many of the other key terms, such as "golden parachute payment," are not defined.

Earlier versions of the draft Act had included provisions that would have imposed corporate governance reforms on participating institutions, including those related to "say-on-pay" and "shareholder access" to the management proxy for the purpose of making nominations of director candidates. These provisions are not included in the final version of the Act.

In addition to these substantive compensation and governance provisions, the Act also includes the following changes to the tax treatment of compensation paid by all employers selling assets into the TARP:

Section 162(m) Deduction Limit. Generally, Section 162(m) of the Internal Revenue Code limits to $1 million the amount that public companies can deduct with respect to compensation (other than commissions and "performance-based" compensation meeting certain requirements) paid to their most highly compensated executive officers. As this section is amended by the Act, certain employers from whom troubled assets are acquired pursuant to the Act (and their affiliates) are subject to a lower $500,000 deduction limit on the amount of the deduction they can claim for compensation paid to each of an employer's CEO, CFO, and its three most highly compensated officers other than the CEO and CFO for each year during which the TARP is in effect, including any portion of such compensation which is deferred and otherwise would have been deductible in a subsequent year.

This limit would apply to any employer — whether publicly or privately held — from which troubled assets are acquired if the cumulative amount of acquired assets exceeds $300 million, disregarding acquisitions that are effected entirely through direct purchases from the employer. Unlike the $1 million deduction limit under Section 162(m), there would be no exclusion for commissions or performance-based compensation, and once an executive's compensation becomes subject to the annual limits,

the executive remains subject to such limits for all subsequent years in which the TARP is in effect or in which deferred compensation for applicable years continues to be paid.

Parachute Taxes. Generally, Section 280G of the Internal Revenue Code limits the deduction that a company can take with respect to parachute payments made in connection with a change in control to certain officers, shareholders and highly compensated individuals. Section 4999 of the Internal Revenue Code imposes a 20% excise tax on individuals who receive such non-deductible payments. The Act would amend Section 280G so that for the same employers to which the reduced Section 162(m) limits apply (see description above) the deductibility limits of 280G (and indirectly, the 20% excise tax imposed by Section 4999) would apply to all severance payments, even in the absence of a change in control, that are made to the employer's CEO, CFO and its three most highly paid officers other than the CEO and CFO upon an involuntary termination or in the event of the company's bankruptcy, insolvency or receivership. Unlike the general application of the parachute rules in the change in control context, no exemptions are available under the Act for the payment of reasonable compensation, payments by non-corporate entities or Subchapter S corporations, or payments that are approved by the shareholders of a privately held corporation.

Taken together, these provisions will have profound implications for financial institutions participating in the programs established under the Act. A few initial observations:

(i) The Act contemplates that the Secretary will adopt standards that will apply to the executive compensation paid by financial institutions that participate in the programs established by the Act. Given the broad language that is used in some provisions of the Act, the particular standards adopted by the Secretary will be critical in determining the Act's ultimate impact on compensation practices.

(ii) The compensation-limiting provisions of the Act will create at least the appearance of conflicts-of-interest for the senior executive officers of financial institutions considering whether to participate in the TARP. These conflicts must, of course, be taken into account as Boards of Directors determine whether to participate in such programs. Boards should be certain that they are fully aware of all conflicts that are presented and that conflicted parties (such as "inside" directors) are recused from voting on any related matter. In addition, boards must consider whether they should obtain advice and information from sources (internal or external to the entity) that are not directly conflicted.

More fundamentally, perhaps, boards considering whether to participate in the TARP must assess whether, given their particular situation, the benefits of participating in the program outweigh its costs, including costs associated with imposing the required limitations on the compensation programs in place for their senior executive officers. These costs could involve, among other things, those costs with respect to retention, incentives and morale of senior executives and deductibility of their compensation by the entity. In many instances, it may be obvious that the benefits of participating in the program will outweigh the costs. As with any other decision of significance, boards should be sure that they are aware of, and understand, all relevant and reasonably available information prior to acting. If appropriate procedures are followed, boards should generally be protected with regard to the "business judgments" that they make in this regard.

(iii) It is not clear from the text of the Act how the prohibition on "golden parachute payments" to senior executive officers will apply. Presumably the Secretary will adopt regulations defining the term. If the term is defined to include payments made pursuant to contracts that were in place on the date of the enactment of the Act, it is uncertain as to whether that prohibition could require a participating

financial institution to not honor a contractual provision that would otherwise require a payment to a departed senior executive officer.

(iv) The Act, by its terms, applies only to companies that elect to participate in the TARP. It remains to be seen, however, whether it will nevertheless have a broader impact on compensation practices at other entities. It is possible that the standards to be developed by the Secretary will ultimately be thought to establish "best practices," and thereby become standards advocated for by shareholder activists, governance advisory firms and others. In addition, financial institutions that do not have an immediate need to participate in the programs established by the Act may nevertheless conclude that it is advisable to structure their compensation arrangements so as to make it possible to participate if the need arises. Separately, it is of course also possible that Congress could ultimately decide that the standards imposed on participating entities should be more broadly applied.

V. Asset Disposition

The Secretary may sell, or enter into securities loans, repurchase transactions or other financial transactions, with regard to any troubled asset it has purchased, at any time and on terms and conditions and at prices set by the Secretary. Unlike with asset purchases, asset sales are not expressly subject to a directive to use market pricing mechanisms, although a failure to do so would create significant political risks. Given the Secretary's broad authority to structure asset dispositions, a wide range of re-packaging mechanisms, including securitization with or without government guarantees, may well be considered in order to help free up markets in these asset classes.

VI. Role of Private Sector Assistance — Opportunities and Pitfalls

The Act gives the Secretary the power to enter into private sector service agreements and to designate financial institutions as financial agents of the federal government. Furthermore, the Act authorizes the Secretary to create a streamlined process for awarding contracts for asset managers, servicers, property managers and other providers by waiving specific provisions of the Federal Acquisition Regulation ("FAR") subject to notice to Congress. However, even if the FAR is waived, the Secretary must still adopt and implement standards and procedures "to ensure, to the maximum extent practicable" the inclusion and utilization of minorities, women and minority and women-owned businesses.

Given the size and scope of the TARP, it is assumed that the Secretary will make substantial use of private industry assistance in connection with the purchase, management, servicing and sale of assets under the TARP. The Secretary is required to "manage" or prohibit potential conflicts of interest that arise from, among other things, the selection and hiring of asset managers and other advisors, but is provided substantial flexibility in doing so. Indeed, the reference to "manage" appears to be a tacit acceptance that the demands of the TARP will require engagement of providers who are otherwise active in the industry.

Additionally, the Act specifically provides that the Federal Deposit Insurance Corporation ("FDIC") is eligible and shall be considered in the selection of asset managers for residential mortgage loans and residential mortgage-backed securities, which will create some interesting competitive considerations if the FDIC determines to bid aggressively for such business.

VII. Insurance of Troubled Assets

In a concession to Republican opponents to the original Treasury plan, the Secretary is required to create a program for the guarantee of troubled assets, including mortgage-backed securities issued prior to March 14, 2008, as an alternative to straight asset purchases. Under such a program, the Secretary, upon request from a financial institution, may guarantee, on terms and conditions set by the Secretary, the timely payment of principal of, and interest on, a troubled asset up to 100% of principal and interest. The program would be funded by premiums assessed to participating institutions at "a level

necessary to create reserves sufficient to meet anticipated claims, based on an actuarial analysis, and to ensure that taxpayers are fully protected." Given this funding requirement, it is uncertain whether the guarantee program will receive significant usage, and questions remain in any event as to what would happen if claims were made in excess of the premiums collected.

VIII. Other Authority

Notwithstanding concerns regarding the virtually unbridled authority sought by the Secretary, the scale of the crisis facing the nation led Congress to grant authority to the Secretary that is extraordinary in its breadth, permitting him "to take such actions as the Secretary deems necessary to carry out the authorities in this Act," and to "[i]ssu[e] such regulations and other guidance as may be necessary or appropriate to define terms or carry out the authorities or purposes of this Act." Importantly, the Act also has a savings clause that will mitigate the immediate burden of the myriad of policies, procedures, guidelines and regulations that the Secretary will be required to implement under the Act: "Establishment of the policies and procedures and other similar administrative requirements imposed on the Secretary by this Act *are not intended to delay the commencement of the TARP*." Thus while the Secretary is directed to publish program guidelines within the earlier of 2 business days from the first asset purchase under the TARP or 45 days from enactment of the Act, including regarding asset purchase and valuation mechanisms, procedures for selecting asset managers and criteria for identifying troubled assets, the Secretary likely will rely heavily on this authority in the early days of the TARP in order to be able to take decisive action on a less bureaucratic basis.

Among his other powers, the Secretary may "at any time" exercise rights received in connection with troubled assets purchased under the TARP. In light of issues that have been raised about the processes by which some securities were originated, packaged and sold, this may raise the question as to whether the TARP will become a vehicle for pursuit of legal remedies under the guise of "maximizing taxpayer protection," particularly because the Secretary has a mandate to use its powers to minimize long-term negative impact on taxpayers and maximize the efficiency of its use of taxpayer resources. In this regard, it also is important to note that the Act provides a plethora of goals that the Secretary must consider when exercising its authority under the Act, and such goals may be competing and inconsistent. For example, the goal of providing stability to the banking system through the purchase of troubled assets under the TARP may often be fundamentally at odds with the goal of protecting the interests of taxpayers.

IX. Mortgage Assistance

The Act does not contain amendments to the Bankruptcy Code that would permit "cram downs" on mortgage loans or provide bankruptcy judges with authority to modify terms of mortgage loans, which were broadly opposed by the mortgage industry. However, the Act contains provisions designed to ensure that the government use its power as the owner of mortgages and mortgage-backed securities to facilitate loan modifications (such as, reduced principal or interest rate, lengthened time to pay back the mortgage) and prevent avoidable foreclosures.

In particular, to the extent that the Secretary acquires mortgages, mortgage-backed securities and other assets securitized by residential real estate (including multi-family housing), the Act requires the Secretary to implement a plan that seeks to maximize assistance to homeowners and to encourage servicers of underlying mortgages to take advantage of programs to minimize foreclosures, including the HOPE for Homeowners Program under Section 257 of the National Housing Act. In addition, upon request under existing investment contracts, the Secretary must consent to reasonable loss mitigation measures (including term extensions, rate reductions, and principal write downs) where appropriate and considering net present value to taxpayers. Finally, the Secretary is authorized to use loan guarantees and credit

enhancements to facilitate loan modifications to prevent avoidable foreclosures.

In addition to the obligations imposed on the Secretary to seek these measures, the Act imposes similar obligations on "Federal property managers," meaning the Federal Housing Finance Agency in its capacity as conservator of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, the FDIC with respect to bridge banks, or the Board of Governors of the Federal Reserve with respect to any mortgage or mortgage-backed securities or pool of securities held, owned, or controlled by or on behalf of a Federal Reserve bank. Federal property managers that hold an interest in mortgages, mortgage-backed securities, or obligations secured by residential real estate must implement a plan that seeks to maximize assistance for homeowners and use their authority to encourage loan servicers to take advantage of available programs to minimize foreclosures. Where a Federal property manager is not the owner of a mortgage loan, but holds an interest in obligations secured by mortgage loans, the property manager must encourage loan servicers to implement loan modifications developed by the managers and assist in facilitating such modifications to the extent possible.

The Act contains the following language regarding duties of mortgage servicers: "Except as established in any contract, a servicer of pooled residential mortgages owes any duty to determine whether the net present value of the payments on the loan, as modified, is likely to be greater than the anticipated net recovery that would result from foreclosure to all investors and holders of beneficial interests in such investment, but not to any individual or groups of investors or beneficial interest holders, and shall be deemed to act in the best interests of all such investors or holders of beneficial interests if the servicer agrees to or implements a modification or workout plan when the servicer takes reasonable loss mitigation actions, including partial payments." While this provision may be intended to protect mortgage servicers from potential claims that following mortgage assistance efforts breaches duties of the servicer to investors, problems in the drafting make it unclear whether this provision actually creates a new duty under federal law for mortgage servicers.

These directives will pose challenges to existing servicers when the TARP or the Federal property managers acquire assets under existing servicing relationships. Private parties looking to contract with the Treasury Department for loan servicing will need to take account of the expense of pursuing such modifications in pricing their services.

X. Accounting Issues

The Act provides the SEC the authority to suspend the application of Statement Number 157 of the Financial Accounting Standards Board (*i.e.* suspend mark-to-market accounting) for any issuer (as that term is defined in section 3(a)(8) of the Securities Exchange Act of 1934) or with respect to any class or category of transaction if the SEC determines that it is necessary or appropriate.

By contrast, another section of the Act provides the Secretary the authority to recommend to the other regulators of financial institutions participating in the TARP that such institutions be required to publicly disclose additional information regarding off-balance sheet transactions, derivatives instruments, contingent liabilities, and similar sources of exposure if the Secretary determines that current public disclosures do not sufficiently describe the true financial position of such institutions.

XI. Termination of Money Market Fund Program

The Act requires the Secretary to reimburse the Exchange Stabilization Fund from the TARP funds for the emergency expenditures made by the Secretary to guarantee the assets of money market mutual funds. This leaves open the question whether the TARP will then be used going forward to replicate the guarantee previously implemented through the Exchange Stabilization Fund, but presumably the Secretary will use his authority under the Act to do so.

XII. Legal Review

The Secretary's actions under this Act are subject to review under the Administrative Procedures Act and may be held unlawful and set aside if a court finds them to be arbitrary, capricious, an abuse of discretion or otherwise inconsistent with the law. Any financial institution that divests its troubled assets through a program under the Act may not bring any action or claim against the Secretary, except for the foregoing reasons, unless expressly provided otherwise in a contract with the Secretary. Except in cases involving constitutional claims, no injunctive or other form of equitable relief may be exercised against the Secretary for actions pursuant to its authority to purchase troubled assets, insure troubled assets, manage or sell troubled assets, or to mitigate foreclosures. Any injunctive relief issued against the Secretary for actions pursuant to such authorities will be automatically stayed for 3 calendar days in order to allow the Secretary the opportunity to seek a stay from a higher court.

Courts hearing requests for temporary restraining orders against the Secretary pursuant to this Act must consider and grant or deny the request within 3 days of the request, and courts hearing requests for preliminary or permanent injunction against the Secretary must consider and grant or deny such requests on an expedited basis.

The terms of any residential mortgage loan that is part of a purchase by the Secretary pursuant to the Act will remain subject to all claims and defenses that would otherwise apply.

XIII. Oversight

There are a variety of detailed oversight provisions built into the Act. Among other things, the Act provides for the Secretary's frequent reporting to Congress, a requirement to consult with the heads of the bank regulatory agencies, the creation of an independent Special Inspector General to monitor the Secretary's implementation of his authority, and provisions for GAO audits. Importantly, the Act creates the Financial Stability Oversight Board ("FSOB"), composed of the Fed Chairman, the Secretary, the chairman of the Securities and Exchange Commission, the Director of the Federal Home Finance Agency, and the Secretary of Housing and Urban Development. The FSOB has the authority to review the Secretary's actions under the Act, to advise the Secretary, and to report suspected fraud, misrepresentation or malfeasance to the special Inspector General for the TARP or to the Attorney General.

XIV. Temporary Increase of Deposit Insurance Limit

The Act raises the cap on deposit insurance for depository institutions insured under the Federal Deposit Insurance Act ("FDIA") and for credit unions insured under the Federal Credit Union Act ("FCUA") from $100,000 to $250,000 for the period starting on the date of enactment of the Act and ending on December 31, 2009. This increase, however, may not be taken into account by the Board of Directors of the FDIC ("FDIC Board") when setting assessments for insured depository institutions insured under the FDIA, nor may it be taken into account by the National Credit Union Administration Board ("NCUA Board") for purposes of setting insurance premium charges under the FCUA. Likewise, this temporary increase in the deposit insurance limit may not be used to make any inflation adjustment under either the FDIA or the FCUA.

The FDIC Board and the NCUA Board are empowered under the Act to borrow money from the Secretary in any amount necessary to provide for the increased insurance limits. It does not appear that such borrowed amounts will count against the $700 billion limit provided by the Act, since the Act discusses the $700 billion limit in terms of the Secretary's authority to purchase troubled assets.

XV. Abrogation of Standstill and Confidentiality Agreements

In a somewhat broadly worded amendment of the FDIA, the Act prohibits the enforcement of many contracts that might have the effect of limiting the ability of a bidder who has performed due diligence on an insured institution to later bid in the same

institution's receivership. For example, an institution that has acquired confidential information in connection with a potential unassisted transaction with a target bank would be able to use that same information in later bidding on the receivership assets of the same institution, notwithstanding any confidentiality agreement to the contrary.

XVI. FDIC Enforcement

Under the Act no entity may represent or imply that any deposit liability, obligation, certificate or share is insured or guaranteed by the FDIC if such instrument is in fact not so insured or guaranteed, nor may such entities knowingly misrepresent the extent to which such instruments are insured. Each entity's appropriate federal banking regulatory authority is responsible for enforcing these new requirements. However, if the FDIC determines that such authority is not enforcing these requirements properly, the FDIC has the authority to enforce them directly. Penalties include cease and desist orders designed to prohibit and prevent such conduct in the future and civil money penalties. The new enforcement authority may complicate the risk assessment of institutions offering products where deposit insurance coverage is unclear, such as stored value or prepaid cards.

XVII. Interest on Reserves

The date on which the Federal Reserve banks will begin paying interest on reserves will be accelerated to October 1, 2008.

XVIII. Other Tax Matters

As noted at the outset, the final bill contained two new divisions with tax relief provisions unrelated to the core of the Act, but that were politically necessary to enable enactment. Those provisions are beyond the scope of this memorandum. However, there are two additional tax provisions that were included in the body of the Act.

Gain or Loss From Sale or Exchange of Fannie Mae or Freddie Mac Preferred Stock. In order to help offset recent losses experienced by financial institutions due to the collapse of Fannie Mae and Freddie Mac, the Act provides that gain or loss from the sale or exchange of any "applicable preferred stock" by an "applicable financial institution" will be taxed as ordinary income or loss, rather than capital gain or loss, which in the case of losses is beneficial since capital losses may generally only be used to offset capital gains.

An "applicable financial institution" is a financial institution referred to in Section 582(c)(2) of the Internal Revenue Code (which includes, generally, certain banks, building and loan associations, savings and loan associations, small business investment companies, and business development corporations)[3] or a "depository institution holding company" (as defined in Section 3(w)(1) of the Federal Deposit Insurance Act).[4] "Applicable preferred stock" is any preferred stock in Fannie Mae or Freddie Mac either (i) held on September 6, 2008 by a holder that at all times since that date has been an applicable financial institution or (ii) sold or exchanged on or after January 1, 2008 and before September 7, 2008 by a holder that on the date of sale was an applicable financial institution.

The Act also provides the Secretary with the regulatory authority to extend the foregoing treatment to sales or

3 More specifically, the financial institutions referred to in Section 582(c)(2) include (i) any bank (including certain foreign corporations that would be treated as banks if they were not foreign corporations), (ii) any financial institutions referred to in Section 591 of the Internal Revenue Code (*i.e.*, mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under federal or state law, (iii) any small business investment company operating under the Small Business Investment Act of 1958 and (iv) any "business development corporation" within the meaning of Section 582(c)(2)(B) of the Internal Revenue Code (*i.e.*, a corporation created pursuant to an act of a state legislature, and operated primarily to promote, maintain, and assist the economy and industry within such state on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or state in the ordinary course of their business (except on the basis of a partial participation) and operated primarily for such purposes).

4 A "depository institution holding company" is defined as a bank holding company or a savings and loan holding company.

exchanges of certain applicable preferred stock acquired by an applicable financial institution in a carryover basis transaction from one who held the stock or held by a partnership in which an applicable financial institution is a partner.

Extension of Exclusion of Income From Discharge of Qualified Principal Residence Indebtedness. As a further element of relief to homeowners in foreclosure, the Act extends through December 31, 2012 the rule in Section 108 of the Internal Revenue Code (presently effective only through December 31, 2009) under which gross income does not include income from the discharge of "qualified principal residence indebtedness" (*i.e.*, indebtedness not in excess of $2 million incurred in connection with, and secured by, a taxpayer's principal residence).

XIX. Expiration

The authority granted to the Secretary under the Act to purchase and insure troubled assets will expire on December 31, 2009. However, the Secretary, upon written justification to Congress, may extend its authority under the Act for up to 2 years after the enactment date of the Act.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.