

Client Advisory

Analysis of Congressional Response to Treasury's Troubled Asset Relief Program (TARP)

In response to the Treasury Department's proposal to purchase up to \$700 billion of distressed assets, Congressional Democrats have drafted alternate versions of the proposed legislation. The draft proposals authored by Senate Banking Committee Chairman Chris Dodd (the "Dodd Bill") and House Financial Services Committee Chairman Barney Frank (the "Frank Bill") each seek additional concessions, and differ materially from Treasury's initial proposal (as revised by its subsequently issued Fact Sheet). Members of Katten's Troubled Asset Relief Program (TARP) Task Force have outlined the material differences below.

Scope and Authority

The Dodd Bill applies to "troubled assets," which, similar to the Treasury's proposal, may include non-mortgage-related assets, upon a determination of the Secretary of the Treasury (the "Secretary") and the Chairman of the Board of Governors of the Federal Reserve System (the "Fed Chairman") that the purchase of such assets is necessary to "promote financial market stability." However, in the absence of such a determination, only residential and commercial mortgage-related assets can be purchased. The Dodd Bill also limits any purchase to assets that were originated on or before March 14, 2008, rather than September 17, 2008.

The Frank Bill requires the Secretary to consult with the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation ("FDIC") and the Secretary of Housing and Urban Development ("HUD"). In consultation with these entities, upon a determination that certain goals of the program would be met (which includes a requirement that the Secretary consider the strength of the applicable financial institution in terms of the most efficient use of the program funds), the Secretary has the authority to purchase "troubled assets" from any financial institution. The definition of troubled assets is similar to that in the Dodd Bill, except the Frank Bill maintains the September 17, 2008 date originally set forth by Treasury with respect to the origination date of the asset.

The Frank Bill specifically applies to purchases of assets from financial institutions organized and regulated under the laws of the United States, or any state, territory or possession of the United States, and having "significant operations" in the United States, and specifically excludes any "central bank of, or institution owned by, a foreign government." Significantly, it is unclear whether the latter provision would only exclude institutions that are majority owned or controlled by foreign governments, since the literal text could also exclude institutions that are owned to any extent by foreign governments.

Also, the Frank Bill requires the Secretary to coordinate, as appropriate, with foreign financial authorities and central banks to establish similar programs, and specifies that to the extent such authorities or banks hold troubled assets as a result of extending financing to financial institutions (as defined in the proposal) that have failed or have defaulted on such financing, those troubled assets qualify for purchase under the program.

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Oversight, Transparency and Review

A main emphasis in both the Dodd and Frank Bills is to create oversight of the Secretary's actions under the program and to provide for transparency to the public. The Dodd Bill creates the Office of Financial Stability, headed by an Assistant Treasury Secretary, to implement the program. It also calls for the creation of the Emergency Oversight Board, consisting of the Fed Chairman, Chair of the FDIC, the SEC Chair, and two non-government employees with appropriate financial expertise in both the public and private sectors appointed by the majority and minority leadership of the Senate and House. The Emergency Oversight Board may appoint a Credit Review Committee to provide oversight.

The Dodd Bill provides for monthly reports to Congress, instead of semi-annual reports; additionally, the Dodd Bill would require weekly public reports of total value of assets held, and assets purchased and sold that week. Instead of a provision stating that there will be no review in courts of law or administrative agencies, the Dodd Bill provides that the Secretary's determinations with respect to troubled assets may be set aside if they are arbitrary, capricious, amount to an abuse of discretion or are "not in accordance with the law." Therefore, it would appear to provide for both legal and administrative review, provided that any residential mortgage loan (which must be secured by principal residence) remains subject to all claims and defenses.

On this point, the Frank Bill specifically provides that no injunctions or other forms of equitable relief may be issued by any court of law or administrative agency, in a review of actions taken under the proposed legislation. However, the Frank Bill also requires that the Secretary's actions cannot alter any rights of a homeowner whose residence (which is not specifically restricted to primary residences) is secured by a troubled asset.

The Dodd Bill also establishes procedures for annual audits of financial statements of the Office of Financial Stability by the Comptroller General. Finally, Dodd would require the appointment of a special inspector general for the troubled asset program, who would be appointed by the President, and conduct, supervise and coordinate audits and investigations of the purchase, management and sale of assets.

The Frank Bill requires an initial report to Congress within 60 days of the Secretary's first purchase of troubled assets. The Secretary would be required to report to Congress every 90 days thereafter. The Frank Bill also requires the Secretary to make publicly available, in electronic form, a "description, amounts and pricing of assets acquired" under the proposal within 48 hours of purchase, trade or other disposition.

Government Contracts

The Dodd Bill deletes the provision that would allow contracts to be entered into without regard to normal government contracting rules. Dodd calls for the Secretary to promulgate regulations to manage or prohibit conflicts of interest with respect to selecting contractors, advisors, asset managers, purchasing and managing troubled assets, and "post-employment restrictions on employees." Finally, under the Dodd Bill, entities that would act as "financial agents" of government would not be limited to "financial institutions," but merely need to be "appropriate entities."

The Frank Bill specifically mandates certain contracting procedures for asset managers, requires the Secretary to take affirmative steps to manage conflicts of interest, and requires vendors to acknowledge a fiduciary duty to the United States.

Equity Share

The Dodd Bill calls for the Secretary to receive "contingent shares" from financial institutions in return for purchased assets equal in value to the purchase price of purchased assets. If Treasury disposes of purchased assets at a price less than the purchase price, the contingent shares would vest in an amount equal to (A) 125% of the difference in purchase price divided by (B) the average share price of the financial institution from which the assets were purchased during the 14 business days prior to the purchase.

Executive Compensation

The Dodd Bill puts strict limits on executive compensation. All entities selling assets must meet "appropriate standards for executive compensation and shareholder disclosure" including (a) limits on compensation to exclude incentives for executives to take inappropriate or excessive risks, (b) claw-backs for incentive compensation to senior executives based on earnings, gains or other criteria later proven to be inaccurate, and (c) limits on severance to senior executives as appropriate in light of assistance being given to the entity.

The Frank Bill contains similar provisions concerning executive compensation and adds a requirement that such standards be followed for a period of two years following a financial institution's participation in the program. The Frank Bill also mandates that financial institutions directly selling assets allow certain minority shareholder actions regarding executive compensation and other matters.

Bankruptcy Reform, Homeowner Assistance and Foreclosure Mitigation

Both the Dodd Bill and the Frank Bill add a provision that would allow bankruptcy courts to modify residential mortgages. The Dodd bill also provides Treasury with authority to manage troubled assets, except for residential loans and residential mortgage-backed securities (“RMBS”), which would be managed by the FDIC. The Dodd Bill calls for the FDIC to use a systematic approach to prevent foreclosures through loan modifications and use of the HOPE for Homeowners refinance program established under the recently enacted Housing and Economic Recovery Act of 2008 (“Housing Act”). The FDIC must report monthly on the number of loan modifications completed and the number of pending foreclosures. Under Dodd’s proposal, the Secretary must, to the extent practicable, acquire sufficient control of securitized pools of residential loans, or whole residential loans, in order to have and use authority to modify the loans.

Under the Dodd Bill, at least 20% of profits on the sale of troubled assets must be deposited in the housing funds created by the Housing Act—65% into the Housing Trust Fund and 35% into the Capital Magnet Fund—and the remainder is to be deposited in the Treasury to pay down the debt. The Dodd Bill also provides for assistance to homeowners and localities—“federal property managers” (which is the FHFA as conservator for Freddie and Fannie; the FDIC, the FDIC as conservator or receiver of insured depository institution; or Federal Reserve, with respect to mortgages or RMBS controlled by the Federal Reserve) must develop a program with a systematic approach to prevent foreclosure through loan modifications and use of HOPE for Homeowners, and report regularly on the results.

Additionally, Dodd’s proposal would require federal property managers to make properties available at a discount for purchase to any state or local government receiving emergency assistance under Section 2301 of the Foreclosure Prevention Act of 2008, in order to sell properties and stabilize neighborhoods.

The Frank Bill also contains provisions aimed at allowing “bona fide tenants who are current on their rent” to remain in their homes under the terms of their lease, through loan modification and refinance procedures. The Frank Bill would require the Secretary to maximize assistance to borrowers by encouraging servicers of the purchased mortgages to take advantage of the HOPE for Homeowners Program or other modification programs, based on an analysis of net present value. Frank calls for the Secretary to use its authority under any applicable investor contract to limit the servicers’ actions with respect to preventable foreclosure and to instead focus on loss mitigation measures in order to keep homeowners in their homes.

Program Length

Under Dodd’s proposal, the program would terminate on December 31, 2009, instead of the two years proposed by Treasury. However, the Bill also provides that the program can be extended to two years if Treasury certifies such an extension is necessary, and provides an estimate of expected costs.

The Frank Bill is in line with Treasury’s proposal in that the program would sunset two years from the date of enactment, but that such termination would not include certain rights the Secretary has with respect to the management and sale of troubled assets.

Status of Proposals

Secretary Paulson and Fed Chairman Ben Bernanke appeared before the Senate Banking panel today to defend the rescue plan. The two are also scheduled to appear before the House Committee on Financial Services on Wednesday.

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