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Update of the Administration's Proposal to Bail Out the Financial Industry

Key provisions of the Administration's plan to address the crisis affecting the capital markets and financial institutions continue to evolve as demonstrated today during the hearing before the Senate Committee on Banking, Housing and Urban Affairs. Although further revisions to the legislation are certain, the bill in its latest form would:

- Expand the assets that Treasury may purchase from "mortgage-related assets" to "troubled assets." Previously, the bill only permitted the U.S. Department of the Treasury ("Treasury") to purchase commercial and residential mortgage-related assets. The current version defines troubled assets to include the previously defined mortgage-related assets and, the much broader, "any other financial instrument" as determined by the Secretary of the Treasury (the "Secretary") in consultation with the Chairman of the Board of Governors of the Federal Reserve as he determines necessary to promote financial market stability.
- Clarify those institutions that may participate in the program as any institution including, but not limited to, banks, thrifts, credit unions, broker-dealers, and insurance companies, having significant operations in the United States; and, upon the Secretary's determination in consultation with the Chairman of the Board of Governors of the Federal Reserve, any other institution he determines necessary to promote financial market stability. This broad authority would permit the Secretary to allow any company holding a "troubled asset" to sell such asset to the Treasury if the Secretary determined it was necessary to promote market stability, although it is contemplated that only "financial" companies would be able to participate. This latest version of the bill also differs from the original in that it permits foreign firms to be participants in the program.

During the hearing before the Senate Banking Committee, a few specifics of the plan were discussed. For instance it was noted that the Treasury would utilize a reverse auction process to buy the troubled assets. That is, firms would bid on the price at which they would sell their assets to the Treasury. This process presents a double-edged sword. If Treasury pays up for assets compared to their current market value, more firms would be encouraged to sell troubled assets which would revive the credit markets. Paying up for assets however, will reduce the potential return to taxpayers. On the contrary, if the Treasury

buys assets at current depressed prices, taxpayers would have greater potential upside, but there will be fewer sellers and those firms holding distressed assets on their balance sheets at values higher than what Treasury is paying may suffer additional mark-to-market write downs. Another aspect of the bill that was discussed included Treasury's stated intent to use contract managers selected by the Treasury to determine when and if to sell the assets purchased through the program. Several questions were raised by Senators as to how the Treasury will select these managers, their compensation and whether any of the firms selling assets to the Treasury would be able to act as a manager. These details are still to be determined.

Testifying at the hearing were the Honorable Henry M. Paulson, Secretary of the Treasury, the Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, the Honorable Christopher Cox, Chairman, Securities and Exchange Commission and the Honorable James B. Lockhart, III, Director, Federal Housing Finance Agency.

Treasury Secretary Paulson stated that the legislation is needed to avoid a continuing series of financial institution failures and frozen credit markets that threaten American families' financial well-being, the viability of businesses both small and large, and the very health of the U.S. economy. He further stated that the ultimate taxpayer protection will come from restoring market stability, which will be provided as the Treasury removes the troubled assets from the financial system. He stated that this bold approach will cost American families far less than the alternative – a continuing series of financial institution failures and frozen credit markets unable to fund everyday needs and economic expansion.

Chairman Bernanke stated that the Federal Reserve believes that, whenever possible, difficulties should be addressed through private-sector arrangements—for example, by raising new equity capital, by negotiations leading to a merger or acquisition, or by an orderly wind-down. He stated that government assistance should be given with the greatest of reluctance and only when the stability of the financial system, and, consequently, the health of the broader economy, is at risk. In the cases of Fannie Mae and Freddie Mac, and AIG, such private market solutions were not possible, resulting in federal intervention. Chairman Bernanke supported the Treasury plan stating that removing troubled assets from institutions' balance sheets will help to restore confidence in our

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financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.

The general theme of the hearing from the Senators was that while the crisis is indeed extraordinary, the legislation must be fully vetted before Congress acts. Some of the more notable comments during the hearing included:

- Senator Michael Enzi (R-WY) stated that some type of punitive measures must be taken against the officers of the firms that caused the crisis. On that same topic, Senator Dodd (D-CT) stated clearly that any bailout will address executive compensation. Indeed the Senate version of the bill requires all firms seeking to sell assets to have limits on compensation for executives taking inappropriate risks, includes a claw back provision for incentive compensation based on earnings that are proven to be inaccurate, and limits severance packages to executives of firms that sell assets to the Treasury.
- Senator Shelby (R-AL) asked whether the \$700 billion plan may fail. Secretary Paulson responded by saying that if the Federal Reserve allowed A.I.G. to fail, the U.S. would be facing a major meltdown. Senator Shelby also asked about the impact to the homeowners that may lose their homes. Secretary Paulson responded that some may lose their home, but that it was critical to get liquidity back in the market place through this program.
- Senator Enzi asked whether the program was meant just for the large institutions while the small community banks and credit unions would be “left holding the bag.” The response was that if the government meant to help only the big banks, then the Treasury would have designed a completely different program.
- Senator Schumer (D-NY) asked whether the government should create an FDIC-like institution to protect all financial institutions, not just banks. He envisioned a corporation that all financial institutions would pay into, similar to FDIC assessments. Both Secretary Paulson and Chairman Bernanke gave luke-warm responses to the suggestion, but stated they were open to discuss the idea. Chairman Bernanke stated that the bigger issue was the “too big to fail” problem.
- Senator Schumer also asked whether the program could start with \$150 billion, instead of \$700 billion, with the idea that Congress can review the progress of the program in January and allocate additional funds at that time. Secretary Paulson was emphatic that the government needed the tools to make this work at this time and felt that

the markets would have a negative reaction to being allocated only a portion of the funds deemed necessary to address the problem.

- One Senator also noted that reform of the financial regulatory scheme was needed and that a federal insurance charter should be created.

While Congress must go through this hearing process, and indeed some members of Congress are questioning whether any action should be taken at all, Secretary Paulson and Chairman Bernanke stressed that action must be taken immediately to prevent imminent financial calamity and restore order to the financial markets.

Following the hearing, Committee Chairman Dodd stated that the Treasury proposal “is not acceptable and that it is not going to work.” He stated that the Administration is going to have to work with Congress and that it will be Congress’ decision as to whether they will send a bill back to the Administration that they can work with. Chairman Dodd is clearly sending a signal that the Congress will not allow the Administration to ram-rod this bill through Congress.

Secretary Paulson and Chairman Bernanke are scheduled to appear before the House Financial Services Committee tomorrow. Legislators are hoping to have a vote on the bill by the end of the week.

ABOUT THE AUTHORS

Douglas P. Faucette is a banking attorney in Locke Lord Bissell & Liddell’s corporate department in Washington, DC. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions. In the past decade, he has been involved in the passage of all major financial institution legislation including FIRREA and FDICIA.

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