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The Emergency Economic Stabilization Act of 2008

Late Sunday afternoon, Congressional leaders circulated the Emergency Economic Stabilization Act of 2008 (the "Stabilization Act"), compromise legislation to enact with substantial modification Treasury Secretary Henry Paulson's original proposal for intervention into the United States financial system.

The Stabilization Act now includes both elements of Senator Christopher Dodd's counterproposal to the Paulson plan (which we addressed in a Client Alert last Tuesday) and additional taxpayer protections that emerged from the House of Representatives over the weekend. The Stabilization Act not only proposes a modified version of Treasury's mortgage-related and other financial asset purchase plan (the "Asset Purchase Program"), but also limits executive compensation, allows for the modification of accounting standards and bank reserve ratios, mandates foreclosure mitigation and provides taxpayers additional relief from tax on cancellation of indebtedness income.

Asset Purchase Program/Insurance Program

The Stabilization Act would authorize the Secretary to borrow and spend up to \$700 billion purchasing, managing, and reselling the mortgage-related and other financial assets described therein ("Troubled Assets"); however, the fundamental structure of the Paulson plan has been altered significantly to provide for Congressional constraint, oversight and protection for the taxpayers' investment. The Stabilization Act would constrain Treasury by granting graduated spending authority: The Secretary would be autho-

riized (i) immediately to purchase \$250 billion of Troubled Assets, (ii) to purchase an additional \$100 billion of Troubled Assets only after Presidential certification of need to Congress and (iii) to purchase up to an additional \$350 billion of Troubled Assets only after receipt by Congress of a report from the President that details the plan to exercise the remaining authority (which final tranche Congress may vote to disapprove). The Asset Purchase Program would be overseen by Congress, the Comptroller General, an oversight board and an independent Inspector General. In order to provide taxpayers with a greater potential recovery of their investment, the Stabilization Act would require Treasury to take an equity or senior debt position in all direct purchase-participating financial institutions.

As an alternative to the Asset Purchase Program, the Stabilization Act also would require the Secretary to establish an opt-in insurance pool (the "Insurance Program") for financial institutions. Under the Insurance Program, a financial institution that chose not to sell any particular Troubled Assets could elect to pay risk-based premiums established by the Secretary in exchange for government guarantees of the timely payment of up to 100% of the principal and interest on the Troubled Assets.

Executive Compensation Restrictions

The Stabilization Act would grant the Secretary substantial authority to alter and amend the future compensation contracts of senior executives of any direct purchase-participating financial institution

in which Treasury held an equity or senior debt position. The Secretary would also have the right to require any such institution—for as long as Treasury holds such equity or debt interest in it—to limit incentives for taking unnecessary and excessive risks. The Secretary could also “claw back” bonuses or incentives paid on the basis of materially inaccurate financial statements, and ban so-called “golden parachute payments.”

Mortgage Modifications and Homeowner Assistance

The Stabilization Act would require the Secretary to exercise all rights in relation to the Troubled Assets acquired under the Asset Purchase Program, to modify mortgages where appropriate with the goal of keeping borrowers in their homes. Nevertheless, the legislation does not adopt the provision of the Dodd proposal which would have allowed bankruptcy judges to modify mortgages in lieu of foreclosure.

Mark-to-Market Accounting

Under the Stabilization Act, the Securities and Exchange Commission, in its discretion, could permit certain financial institutions to opt out of the otherwise applicable “Fair Value” or “Mark-to-Market” accounting regime.

This would be a significant development since over the past two years, compliance with mandatory Mark-to-Market accounting has forced many financial institutions to write down the value of the Troubled Assets on their books in order to bring them in line with prevailing market valuations. Such write-downs have strained the balance sheets of financial institutions, and resulting collateral calls have further impaired their liquidity.

Taxation

The Stabilization Act would effect several changes in the tax code, including a provision to allow certain financial institutions to deduct their losses on investments in Fannie Mae and Freddie Mac against ordinary income and a provision to exclude from taxable income the so called “cancellation of indebtedness income” that a taxpayer receives from debt forgiveness.

Judicial Review

The Secretary’s actions carrying out the Asset Purchase Program would be subject to the traditional standard of review under the Administrative Procedure Act. Courts may overturn any decision found “arbitrary, capricious, or contrary to law.” Notably, the legislation does not adopt the Paulson proposal’s provision

that the authority of the Secretary to carry out the asset purchase program be “committed to agency discretion” and non-reviewable by the courts.

How We Can Help

Hunton & Williams is helping clients today address the challenges presented by the Stabilization Act. We are providing interested clients with regular, exclusive updates on the progress of legislative deliberations and advising on the practical implementation of the Asset Purchase Program and the Insurance Program. For more than 25 years, our Firm has been a market leader on mortgage trading, servicing and securitization matters. Hunton & Williams designed the only REMIC programs backed by the full faith and credit of the United States government (for VA and Ginnie Mae) and represented financial institutions and the Resolution Trust Corporation on various matters during the course of the RTC program. In these historical and challenging times in the capital markets, we stand ready to partner with our clients to address issues and pursue opportunities presented by the Stabilization Act.

If you have any questions relating to the developments in Congress or in the markets today, please contact us.

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