ASPATORE SPECIAL REPORT

Understanding the Government Bailout Plan

An Immediate Look at the Legal, Governmental, and Economic Ramifications of the Emergency Economic Stabilization Act of 2008

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Legislative Solutions for the Financial Crisis

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The Act

The overarching aim of the recent bailout bill, named the "Emergency Economic Stabilization Act of 2008" Pub. L. No. 110-343, 122 Stat. 3765 (2008) (the Act), is to create stability in the financial markets and improve the financial condition of large financial institutions, particularly the money center banks. The Act gives broad powers to the Secretary of the Treasury to fashion appropriate policies and procedures to remedy the current crisis. It establishes the Troubled Asset Relief Program (TARP) to purchase troubled assets from financial institutions. The plan attempts to strengthen the balance sheets of the institutions by creating or reviving a market for mortgage-related securities, with the hope that this artificial market will stimulate an active, normal market for these securities.

The theory of the Act is that the market will be stimulated by the government's purchase of mortgage-related securities at a price above the current "fire-sale" price. The artificial market will allow financial institutions to sell these securities and obtain cash for their balance sheets at a price substantially higher than would otherwise be available currently. The Act will also allow the financial institutions to mark the securities that they continue to hold to the new artificial level under FAS 157 (Mark to Market). This adjustment should increase the strength of the balance sheets of the banks. The Mark to Market rule (FAS 157) was adopted by the Financial Account Standard Board (FASB) and made effective for fiscal years ending after November 15, 2007. Some critics have blamed this accounting rule for contributing to the current financial crisis. The basic requirement of the Mark to Market rule is that a company must adjust the value of the assets carried on its balance sheet to reflect the actual current market value of the asset, if such values exist. In the simple case of a share of publicly traded stock, the rule requires the company to state the value that the share would bring in the open market. The more difficult issue arises in the context of assets that are not as liquid. For example, assets such as mortgage-backed securities have been trading at what some consider fire sale prices. Companies holding these assets may believe that in the long run these assets will have a much higher value, but under the Mark to Market rule, the company would be required to carry the asset on its balance sheet at the fire sale price. Critics argue that the rule may cause a gross understating of the asset's actual long term value. Supporters of the rule argue that it creates the most accurate current value of companies and their assets, and thus provides greater transparency in the markets.

Perhaps recognizing the controversy that surrounds Mark to Market, the Act specifically directs the SEC to conduct a study on the effects of FAS 157 and if necessary, suspend the use of FAS 157 until the long-term ramifications are better understood. This study could lead to an attempt to override the authority of the FASB and change the accounting rules for reporting asset values for financial reporting purposes. The actual outcome of the SEC study and the likelihood of any change to the Mark to Market rule are impossible to predict at this time.

The Act is truly historic. The magnitude of the funds involved (almost three quarters of a trillion dollars) is unprecedented. However, it is the intervention of the U.S. government into private capital markets as a lender of last resort that is truly unprecedented. Now the U.S. government will be able to participate in the financial markets as a shareholder of all of the largest private financial institutions in the country. For the first time in U.S. history, the federal government will be an active participant, sharing in the gains and losses of their investments with private financial institutions. It is also significant that the U.S. government will finance this capital by borrowing money (through the issuance of bonds) to acquire the funds to make the purchases of the troubled assets.

This Act cannot be viewed as a stand-alone piece of legislation. It must be viewed as a key part of an overall scheme to reform and further regulate the financial markets. For example, the takeover of Fannie Mae and Freddie Mac is intertwined with the goals of the Act. While these reforms should be effective in the long term, they will not avoid or eliminate significant economic pain for many people in the short term. As discussed in detail below, the Act provides little in the way of assistance to those individuals who have been hardest hit by the financial crisis. People who have already had their homes foreclosed, as well as those who are currently in foreclosure, will receive no help from the Act. The U.S. government will become the owner of these mortgage-related troubled assets and will undoubtedly foreclose the mortgages on many people. The Act could be expensive for the U.S. government if the mortgage-related assets do not receive something near their full value as the mortgage and home equity loan delinquencies continue to rise and we enter a fairly deep recession.

On the other hand, the Secretary of the Treasury has publicly stated his belief that the Act will likely cost the taxpayer nothing, because he is confident that the government's investments will produce profits. In time, as supply and demand in the housing market and mortgage industry find equilibrium, these industries will rebound to more normal conditions. If that happens, the Act will have provided a solution to the current crisis. If the housing market and the mortgage industry do not rebound as predicted by Secretary of the Treasury, the rescue attempt embodied in the Act will have failed and even more radical measures will be required.

Assuming this solution works, it will take an extended time for the full benefits to work through our economic system. There may be some short-term initial benefits, but given the recessionary factors that the U.S. economy currently faces, it may take many years before our economic system fully recovers. If no additional legislation and/or regulations are put in place, then the abuses that originally led to the enactment of this Act could occur again.

The biggest winners will be the large banks that survived this period of financial stress and lack of liquidity. These large banks will now be able to buy smaller banks at bargain prices, while at the same time selling their troubled assets to the U.S. government (and hopefully on the open market), thereby strengthening their balance sheets and allowing for further expansion in the financial markets.

Another big winner will be distressed debt funds (hedge funds and private equity funds primarily). These funds acquired a number of mortgage-related securities at "fire sale" prices and will now be able to sell at much higher prices if the government is able to stimulate the market for the sale of these products. The Act, however, does contain some provisions such that these debt funds will not be able to sell to the government for a profit, but will have to wait for the development of the active, more normal market for these securities.

Homeowners who are "underwater" on their mortgages and home equity loans will not receive any immediate benefit. No general forgiveness is provided in the Act, nor does it provide any special mechanisms to deal with issues such as adjusting rates, balloon payments, or other esoteric mortgage terms. People "underwater" will be limited as to their options except to continue paying on the mortgages. The other homeowners—both existing and near future home purchasers—may not benefit much either. New home buyers will be faced with an increasingly difficult market to obtain a mortgage, except people with the top credit scores. Existing homeowners may face a difficult market, with tight credit limiting the number of buyers, which tends to exert downward pressure on home prices.

An unexpected big winner under the Act is the alternative energy industry. The extension of numerous tax credits and other tax incentives will generate substantial continuing investment and jobs in the alternative energy industry. For example, solar energy credits have been extended through 2016 (Sec. 103); a new tax credit of 30 percent was enacted for wind turbines (Sec. 104) and; a new tax credit was created for investment in new clean renewable energy bonds (Sec.107). These and other benefits were added to the Act to ensure that it has sufficient votes to pass both houses of Congress.

Effects

The Act raises several interesting legal issues:

1. Constitutional challenges to the Act. Certain groups may, for political reasons, raise constitutional challenges to the Act. Such litigation would seek to undermine the foundation of the Act or merely attack discrete sections.

2. The Act gives the SEC the ability to suspend FAS 157 (Mark to Market) if it deems that too troublesome to apply. This provision raises the issue of whether the government (through the SEC) has the legal authority to suspend accounting rules promulgated by FASB. If so, numerous industries or groups could start lobbying the SEC to change accounting rules that may be particularly troublesome for them.

3. Who has standing to challenge the actions of the Secretary? For the core functions of the bailout, the answer under Section 119 is "no one." The initial proposal for this legislation from the Bush Administration called for absolute immunity for the Secretary of the Treasury. That provision was eliminated in the first version of the legislation that failed to pass the House of Representatives. Section 119 of the Act was a compromise that allows limited judicial review of the actions of the Secretary of the Treasury and restricts equitable relief except in certain circumstances. It also specifically prohibits companies that participate in the program from suing the Secretary except in limited circumstances. The intent of Section 119 was to curtail litigation such as class action lawsuits against the federal government by shareholders of financial companies that were affected by the government's actions. The issue of standing and the limitations of Section 119 will be raised as the first line of defenses by the government in any litigation that is filed. It will be interesting to see how these issue plays out in court

4. Private contract rights of third parties. The Act contains some mandatory functions, such as the limitations on executive compensation. This prohibits the financial institution from paying former employees large severance packages. There is no prohibition, however, against the judicial enforcement of such a contract based on a private right of action. Will the U.S. government be liable for the dollar value of these payments as "taking" is a question that will have to be resolved.

5. There are some "shalls" and "may nots" in the Act directed to the actions of the Secretary of the Treasury (See Sections 113, 114, and 115). These mandates and prohibitions relate to ensuring that the Act does not 1) cost the U.S. taxpayer any more than necessary; 2) promotes transparency and; 3) allow the Secretary to expend more than $250 billion at any one time. These sections of the Act are not within the injunctive relief prohibitions set forth in Section 119, so theoretically a lawsuit can be filed which alleges that the Secretary has done or failed to do something required of him by these Sections of the Act should someone be motivated to incur the expense of bringing suit to challenge these provisions of the Act.

Along with the legal implications, the single most significant economic implication of the Act is that the purchase of troubled assets by the U.S.

government should create liquidity in the credit markets. Such liquidity is intended to induce banks to start loaning money again. As of now, banks still are not lending money, although the recent drop in the London Inter-Bank Offered Rate (LIBOR), which is the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market, suggest that banks are at least starting to lend money to each other, if not their customers. It may take some time and jawboning by the federal government before banks are willing to lend to their customers again.

A second significant economic implication is that the U.S. government's deficit will be tremendously increased. The increased deficit will put greater constraints on the U.S. taxation policies and limit what the next administration can do economically. The magnitude of the recession and the resulting loss of revenue to the government further restrict the next president's policy options and will certainly limit large new initiatives. Finally, the new U.S. government bonds issued to pay for the Act's rescue plan will flood the market and create competition for the very mortgage-related securities that the government intends to purchase. That competition will affect the rates of interest offered and ultimately the value of the mortgage-backed securities.

The Future

The call for increased federal regulation, especially for the derivative markets, will likely be heard. Derivatives such as credit default swap transactions (CDS) should become more transparent and be given a uniform accounting treatment. Alan Greenspan, the former chief of the Federal Reserve Bank, recently admitted in his congressional testimony that he had been wrong about CDSs and that the markets had failed to regulate themselves as he believed that they would. Many critics of the existing regulatory scheme are now calling for the complete overhaul of the financial system. These experts want a less fragmented regulatory authority and a greater sharing of information among the regulators. The reformers urge a consolidation of power to prevent the reoccurrence of another financial meltdown. These reforms, if enacted, should boost investor confidence that they know the true financial condition of the parties with whom they are dealing.

Financial litigation will increase dramatically, in response to this Act. There are already numerous class actions filed, and undoubtedly more are on the way. These suits will focus on the viable deep pockets left standing. Officers and directors of failed firms and the insurance policies that protect them will be targets. The accountants and the lawyers for these firms will also be targets. Underwriters of recent preferred stock and bond offerings for these failed firms will find themselves as defendants in lawsuits brought by disappointed investors. Class action lawsuits have already been filed against the underwriters that sponsored the Fannie Mae and Freddie Mac preferred stock offerings that were made in December 2007. In another class action suit filed to block Wells Fargo from buying Wachovia Bank, the plaintiffs claim that due to the Act the price agreed between the parties before the Act is now too low.

Beyond the usual securities litigation that one would normally expect, there could be direct legal challenges to the Act itself on constitutional grounds. The way the government chooses to implement the Act and the regulations that are promulgated will all likely be subject to legal action.

In light of this Act and the activity that will result as it is implemented, lawyers need to understand the business needs of their clients. Lawyers must be able to explain the Act and how it might affect the client's business. For example, the Act will present mid-sized banks the opportunity to participate in the Treasury Secretary's program. Lawyers for these banks need to understand not only the Act but also how the pluses and minuses of participating in the Secretary's program will play out in their client's business. Every crisis creates at least one opportunity. Looking for opportunities for their clients is what lawyers need to do. Opportunities for the lawyers will follow.

This is the first of many future reforms in both the mortgage market and the pooling of mortgages into securities. The Act, coupled with the U.S. government placing Fannie Mae and Freddie Mac into conservatorship, will put the U.S. government in place to control the mortgage market. This control will allow the U.S. government to overhaul and reform the mortgage industry. Stricter underwriting standards will be enforced and mortgage loans will be harder to obtain. The Act will also create a climate in which meaningful reform of the derivative markets can be enacted by Congress.

Financial institutions need to understand not only how the Act could affect their business, but must also be aware of how they can use the Act to their benefit. This Act sends a message to Wall Street that the U.S. government will be the financier of last resort to keep a market active. This fundamental reversal in American political and economic philosophy is a radical departure from the past. The U.S. government's ownership in private financial institutions has never occurred before. The fact that this new scheme has been implemented by a conservative Republican administration only underscores the tremendous sea change that has occurred. In the future, Wall Street will find it hard to resist additional regulation on philosophical grounds. With the precedent just set, it would not be surprising to see a number of other industries start to ask for similar assistance. In deed, last week the automobile industry received a $25 billion loan program from the federal government and it was reported that General Motors is seeking an additional $10 billion from the government to back its bid for a merger with Chrysler LLC. From now on, Wall Street and our financial system will be forever changed. All free markets will now be open to being more highly regulated.

Comprehensive policies, regulations, and procedures for acquiring the troubled assets must be adopted. This policy framework must be established prior to starting the acquisition of the troubled assets. Because the magnitude of troubled assets is so large, the problem cannot be fixed by a rapid-fire acquisition approach. Such an approach could prove very counter-productive. The policy considerations must take into account whom the current owners of the troubled assets are, how they became the owners of the troubled assets, and where the greatest benefit will be created for the dollars spent.

The upcoming election is another key factor in how this Act will be administered. In January, the U.S. government will have a new administration, including a new Secretary of the Treasury. The transition from the current administration to the new administration may very well change how the goals of the Act are implemented. This fact in turn may produce a lack of continuity as the acquisition program continues. It will be imperative that the incoming administration be a central figure in developing the policy as soon after the election as is practicable. Delaying some of the acquisitions may be of benefit to deal with this period of transition.

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