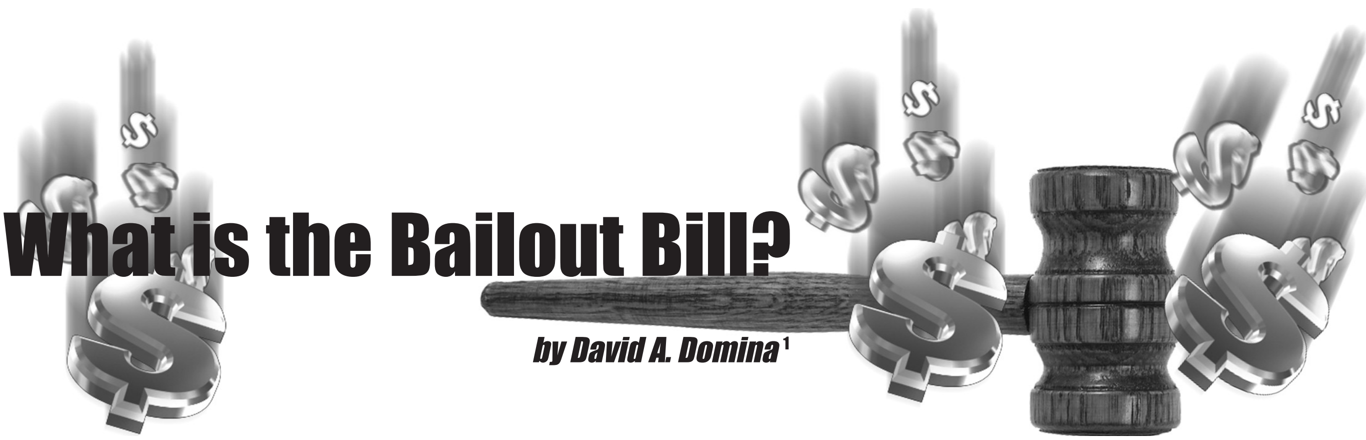

What is the Bailout Bill?

by David A. Domina[1]

The Emergency Economic Stabilization Act of 2008

The United States Senate version of the Emergency Economic Stabilization Act of 2008 ("EESA"), occupies 451 pages. The bill is divided into components:

I. Troubled asset relief program–36 sections.

II. Budget related items–four sections.

III. The tax provisions–three sections.

The Act's purposes have been headline news. Its text says the EESA's purpose is:

> To authorize the Secretary of the Treasury to use authority to restore liquidity and stability to the U.S. financial system, and to ensure that the tools in the statute are used in a manner that 'protects home values, college funds, retirement accounts and life savings, preserves home ownership and promotes jobs and economic growth, and maximizes overall returns to the taxpayers of the United States and provides public accountability for the exercise of the statutory authority by the Secretary of the Treasury.'

These four (4) purposes were identified by democratic Presidential candidate Barack Obama as central to any successful plan. They are expressed as the plan's purposes.

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The statute creates a *Troubled Assets Insurance Financing Fund ("TAIFF")* and a *Troubled Asset Relief Program ("TARP")*. The fund is used to acquire "troubled assets" defined as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary [of the Treasury] determines promotes financial market stability…."

The new law authorizes the Secretary to establish the TARP "to purchase and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary."[2] The Secretary has rulemaking authority to implement the TARP.[3]

The Secretary is directed to implement the program through an "*Office of Financial Stability* established for such purpose within the Office of Domestic Finance of the Department of the Treasury, which office shall be headed by an Assistant Secretary of the Treasury, appointed by the President, by and with the advice and consent of the Senate…."[4] The Secretary is not to act without consultation and is directed to "consult with the [Federal Reserve] Board, the FDIC, the Comptroller of the Currency, and the Director of the Office of Thrift Supervision. The Secretary of HUD is also to be consulted."

The statute empowers the Secretary to "take such actions as the Secretary deems necessary to carry out the authorities in the Act." This authorization is expansive and includes:

> Direct hiring authority to employ personnel to administer the program.
>
> Execution of contracts for services.
>
> Designation of financial institutions as financial agents of the federal government to perform reasonable duties related to the Act.[5]

The Secretary is empowered "to purchase, hold and sell troubled assets and issue obligations." The phrase "issue obligations" empowers the Secretary to sell U.S. Treasury bonds to fund the EESA's programs.

The statute provides guidelines[6] including a program the Secretary is to promulgate providing mechanisms to purchase and price troubled assets, select asset managers, and establish criteria to identify troubled assets for purchase.

The Secretary is directed to prevent unjust enrichment from the program's operations by taking "such steps as may be necessary to prevent unjust enrichment of financial institutions participating in a program established under" the EESA. The statute provides the Secretary with no guidance for how to do so.

Section 102 of the statute permits the Secretary to "establish a program to guarantee troubled assets," i.e., to essentially function as an FDIC for corporations. The program protects against losses on both mortgages and mortgage-backed securities. The amount of the guarantee is "not to exceed 100 percent of timely payments of principal and interest on a particular mortgage or mortgage-backed security."

The Secretary is to report to Congress concerning progress, collect premiums from financial institutions that participate to fund the insurance program, and rank risks so that premiums can be coordinated to the risk undertaken by a federal investment in a particular kind of security.

The EESA provides for a limit on the authority to acquire assets. Purchased authority cannot exceed the difference between "the total of the outstanding guaranteed obligation and the balance of the TAIFF." Fees collected are to be placed in the TAIFF, which the Secretary is to keep segregated from the general treasury of the United States.[7]

The Secretary's decision making about rules, purchases, and purchase guidelines is to protect taxpayers, provide stability and prevent disruption of financial markets, help families keep their homes in stabilized communities, and consider the long-term viability of any financial institution that the Secretary considers assisting.[8] This provision of the Act will essentially permit the Secretary to save a troubled bank, even if it is a small one, if the Secretary chooses to do so. It is likely this will occur only where mortgages, or retirement security of investors, are materially threatened.

The EESA's § 104 creates the Financial Stability Oversight Board ("FSOB"). The FSOB is responsible to review the exercise of authority under the Act, including policies implemented by the Secretary of the Treasury and the Office of Financial Stability. The FSOB is also charged with evaluating the effective efforts to assist Americans to preserve their homes, and to stabilize financial markets and protect taxpayers. Its responsibilities also include reporting of suspected fraud to the Special Inspector General for the Troubled Asset Relief Program or the Attorney General.[9]

FSOB membership is statutory. Members are (a) Chairman of the Board of Governors of the Federal Reserve, (b) Secretary of Treasury, (c) Director of Federal Housing Finance Agency, (d) Chairman of Securities Exchange Commission and (e) Secretary of Housing and Urban Development. The FSOB is to elect its own chairman. The Treasury Secretary is not automatically designated to serve in that capacity.

The FSOB may, but is not mandated to, appoint a credit review committee to evaluate exercise of the purchase authority provided under the Act. The FSOB's activities are to be reported to a Congressional Oversight Panel established by Congress.

The statute provides that funds from the Treasury will be available in $50 billion increments, and advanced within seven days after the date "on which commitments to purchase troubled assets" first reach the aggregate level of $50 billion.[10] The Secretary has broad power to invest in eligible mortgages and mortgage-backed securities, and to do so on an emergency basis.[11] Essentially, the Secretary can waive all financing criteria, bypass the FSOB, and make the investment directly where the Secretary believes it is necessary to do so. Where possible the Secretary is to "develop and implement standards and procedures to ensure that to the maximum extent practicable, minorities[12] and women and minority-owned and women-owned businesses[13] are included in the Secretary's assisting

The Secretary is empowered by § 107(c) to consider the FDIC an entity that is eligible to participate in "the selection of asset managers for residential mortgage loans and residential mortgage-backed securities."[14] If the Secretary uses the FDIC for this purpose, it is to be reimbursed by the Treasury for its service.

Ethical practices in government, as well as in the financial industry, are considered by the EESA. It includes a conflict of interest standard.[15] The Secretary's regulations are to prohibit conflicts that arise "in the selection or hiring of contractors or advisors, including asset managers" and in the purchase or management of troubled assets.

Since assistance of homeowners to retain their homes is a major objective of the Bill, the National Housing Act's §257 is referred to, and the Secretary is empowered to "implement a plan that seeks to maximize assistance for homeowners."[16] The procedure for doing so is vague.

Executive compensation limitations are imposed. These are intended to prevent a few officials at institutions receiving federal funds to be limited.[17]

The executive compensation requirements provided by Section 111(d) and (c) of the Act are as follows:

> (a) Where the Secretary determines that the [Act's purpose is] best met through direct purchases of 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 of the transaction, the Secretary shall require the financial institution to meet appropriate standards for executive and corporate compensation. The standards required … shall be effective for the duration of the period that the Secretary holds inequity or debt position in the financial institution.[18] While much publicized, this executive compensation limits financial incentives that encourage the officer "to take unnecessary and excessive risks that threaten the value of the financial institution" and it prohibits "golden parachute payments" for the period of time during which the Secretary holds the security purchased under the EESA.

But, only the "top five highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934" are included in this constraint. This limitation, alone, is significant. Avoiding the Act through a series of transactions, using relatively simple corporate structural changes could move the actual pay for the executive, and his or her technical reporting and employment level, from a publicly traded company to a privately held, wholly-owned subsidiary, or even a sibling organization. The EESA modestly attempts to plug this hole by mentioning, but not explaining, "non-public company counterparts" to public companies.

The Secretary can require that troubled assets be sold at auction if the amount held by any particular institution exceeds $300 million. Where this level of troubled investment is present, the Secretary is empowered to "prohibit … any new employment contract with a senior executive officer that provides a golden parachute…." This provision of the Act sunsets, however, shortly and it applies "only to arrangements entered into during the period the authorities under Section 101(a) are in effect, as determined under Section 120.[19]

Where a purchase is made, the Secretary is entitled to a warrant or senior debt instrument issued by the financial institution assisted. This warrant is not to be traded on an exchange and "shall convert to senior debt, or contain appropriate protection for the Secretary to ensure that the treasury is appropriately compensated for the value of the warrant, in an amount to be determined by the Secretary."[20]

Congress retained authority to prevent the Secretary from purchasing mortgage or mortgage-backed securities from a particular institution, or in a particular setting disapproved by Congress.[21] Section 117 specifically authorizes Congress to "enact into law a joint resolution disapproving the plan of the Secretary" to invest more than $350 billion. In other words, Congress authorized the first $350 billion to be spent. It authorized the second $350 billion too, but retained the right to change its mind by joint resolution of both houses.[22]

Oversight and Audits

The Comptroller General of the United States is required to establish the Troubled Asset Relief Program ("TARP"). TARP is the oversight agency for the $700 billion bailout. TARP is entitled to use tools involving foreclosure mitigation, cost reduction, and to evaluate effectiveness to bring stability to the markets.

Section 117(2) says the Comptroller General is to be provided space within the Department of the Treasury to set up an oversight office. The Comptroller General is to have access to all of Treasury's books and records concerning the program. The GAO is to be reimbursed by the Treasury for "the full cost of any such oversight activities."[23]

TARP is to audit the financial statement of the program, and report it to Congress, annually.

TARP may direct that corrective actions be taken, and compel compliance with the law.

Funding. The Secretary of the Treasury is empowered to use "the proceeds of the sale of any securities issued under Chapter 31 of Title 31, United States Code." These bond issuing provisions of law "are extended to include actions authorized by [EESA], including the payment of administrative expenses."[24] Treasury bills have not sold as robustly as in the past. A large portion of federal debt is held by foreign countries. No provisions in the EESA protect against further foreign investment in the U.S. Central Treasury through this program.

The Role of the Courts

The courts have limited power to review the Secretary. The authority currently in the law[25] is extended by the EESA to the Secretary, and the organizations or entities created by the EESA. Actions of the Secretary are to be adjudged lawful by the courts unless they are found "to be arbitrary, capricious, an abuse of discretion, or not in accordance with law."[26]

Injunctive relief, including temporary restraining orders against the Secretary are permitted.[27]

The EESA prohibits the commencement of any claim "against the Secretary by any person that divests its assets with respect to its participation in a program under the [EESA.]."[28] This limitation essentially means that any financial institution selling its securities to the government must waive any claims against the government associated with the securities.

Sunset Provision

The EESA says that the authorities it provides "shall terminate on December 31, 2009."[29] However, the Secretary "upon submission of a written certification to Congress, may extend the authority provided under [the EESA] to expire not later than two years from the date of enactment…"

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Special Inspector General Created

The EESA[30] creates an "*Office Inspector General*", and provides for the Presidential appointment of a person to head the OSIG for the TARP. The appointment is to "be made on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations."[31]

The Special Inspector General is given broad powers, the authority to engage personnel, and authority to make investigations deemed appropriate.

The amount of money expected to be raised, through issuing new federal securities to fund the program, is accommodated by EESA Section 122. The dollar limitation on the amount of authorized public debt is increased to "**$11,315,000,000,000**".[32]

A *Congressional Oversight Panel* also has a role in compliance, supervision and implementation of the EESA.[33] The Oversight Panel is to consist of five members of Congress. Interestingly, "each member of the Oversight Panel shall each be paid at a rate equal to the daily equivalent of the annual rate of basic pay for Level I of the Executive Schedule for each day (including travel time) during which such member is engaged in the actual performance of duties vested in the commission." Apparently this means members of Congress appointed to the Oversight Panel are to be paid extra, and not to undertake the responsibility as a part of their Congressional work.

Budget Related Provisions

The EESA contains provisions concerning whether the amounts incurred as debt to fund the bailout are to be included in accounting for the budget. EESA Section 204 provides:

> All provisions of this Act are designated as an emergency requirement and necessary to meet emergency needs pursuant to Section 204(a) of S CLN RES 21 (110th Congress), the concurrent resolution on the budget for fiscal year 2008 and rescissions of any amounts provided in this Act shall not be counted for purposes of budget enforcement."

While America's budget is taking an enormous hit to fund this program, Congress has said the amount is not so great as to "be accounted" for in the report of the Treasury Department to the citizens of the United States.

Tax Provisions

The Act's third Segment concerns taxation. A set of special rules are provided to deal with circumstances where a particular sale transaction requires a unique view. The Secretary has authorized to delegate authority through rules and regulations, and adopt necessary rules and regulations as well.

The Act provides certain aggregation rules. These are apparently designed to help assure a fair, responsible approach to qualification for funding, and advancement of funds.[34] The same provision prohibits a deduction for any executive compensation in excess of $500,000 "or in the case of deferred deduction executive remuneration for any taxable year of service performed during any applicable taxable year by a covered executive, to the extent that the amount of such remuneration exceeds $500,000 reduced by" a ratio provided by law.[35]

Tax provisions of the Bill are extensive. Rulemaking authority is broad. Apparently Congress perceived the broad authorization it was granting and the comprehensive tax provisions in the Bill would help eliminate the incentive to pay executive compensation and deduct it, and, otherwise allow tax planning and tax profiteering at the expense of the government upon its rendition of assistance and services to accompany a need.

Incentives Required for the Votes

The Act's substantive provisions consume approximately 112 pages of text. Part of the remaining 451 pages of the Act include special situation and narrow tax provisions. These are not summarized here; they are more appropriate for a separate writing.

Much talk about "pork" in the bill has circulated. A number of things are tucked into the Bill after page 115, and occupy the final 335 pages of this complex statute. These are apparently designed to facilitate and accommodate persons voting for the Bill. Included are tax advantages associated with energy production incentives and renewal energy incentives, and clean coal, modification of rules for hydro power, and a number of other things someone in the government apparently believes will be expanding. An energy credit is included, and a number of other provisions in this comprehensive tax segment of the Bill appear generally to be designed to prevent the government from over-funding a risk, or otherwise under-funding or over-incentifying an alternative energy source that might lend itself to much more tangible and credible thinking.

Comments beyond this introductory note are excluded as extraneous to an understanding of the basic bailout bill.

The EESA's Impact on the FDIC

Press reports after the House of Representatives initially defeated the EESA powered a change in the Bill providing for an increase in FDIC deposit insurance. The Bill increased coverage amounts from $100,000 to $250,000 per depositor, not per account, through December 31, 2009. The same day, the FDIC issued a "financial institution letter, *FIL102-2008*, authorizing member banks to post, or affix a sticker, with a specific statement next to the official FDIC sign available for display at bank teller stations, alerting customers to this change in the law."

Not everyone understands the increase in coverage. Even banks are perceived as requiring instructions. The FDIC announced it would conduct "a telephone seminar for bankers on the deposit insurance coverage rules on October 10, 14, 22 and 28 and November 4."

Guidelines, Regulations

On October 6, the Treasury Department issued "guidelines", not regulations, to govern conflicts of interests issues related to the EESA's implementation. The Guidelines are[36]:

> Treasury issued the following interim guidelines for potential conflicts of interest related to the authorities granted under the Emergency Economic Stabilization Act of 2008:
>
> These procedures outline the process for reviewing and addressing actual or potential conflicts of interest (COIs) among contractors performing services in conjunction with the Emergency Economic Stabilization Act of 2008 (EESA). Section 108 of the EESA requires Treasury to develop guidelines for addressing COIs as soon as practicable after enactment of the law. These procedures should be considered interim guidelines and will remain in effect until final guidelines are developed.
>
> EESA contracts raise potential for "impaired objectivity" COIs. Under such COIs, the contractor's judgment or objectivity may be impaired due to the fact that the substance of the contractor's performance has the potential to affect other interests of the contractor. EESA contractors may also face potential COIs if they obtain access to sensitive, non-public information (belonging to Treasury or to third parties) while performing the contract. To address this latter type of COI, it may be necessary to restrict the disclosure of such information or to include restrictions on the dissemination of information within the contractor's organization. Lastly, contractor employees are not always subject to the same ethical restrictions that are imposed by law on Federal Government employees. Therefore, EESA contracts may create a potential for personal COIs involving individual employees of a contractor.
>
> Treasury officials should adhere to the following guidelines for addressing COIs arising with EESA contractors:
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> • Where appropriate, Treasury may obtain non-disclosure agreements and COI agreements in advance of supplying an offeror a solicitation.
>
> • The solicitation should instruct prospective offerors that they must disclose any actual or potential COIs (including those associated with an affiliate, consultant, or subcontractor) which could arise from performance of the contract. The solicitation will indicate that, if actual or potential COIs are identified, the prospective offeror must submit a mitigation plan as part of its initial proposal. In some situations, Treasury may also desire to include provisions requiring that the prospective offeror identify personal COIs among employees who would be performing the work, and include measures in its mitigation plan for addressing such personal COIs.
>
> • The solicitation should include an evaluation factor or criteria whereby Treasury will assess the likely effectiveness of the proposed COI mitigation plan.
>
> • The solicitation will identify any minimum requirements or standards for the COI mitigation plan. For example, if Treasury requires that the mitigation plan will address certain specific issues, offerors should be so advised in the solicitation.
>
> • If the contractor will owe a fiduciary duty to Treasury in performing the contract, the solicitation should include a statement to that effect. This provision will become part of the resulting contract.
>
> • The solicitation should include non-disclosure provisions which, at a minimum, apply to the prime contractor. In some situations, Treasury may also desire to include provisions requiring that the prime contractor obtain comparable non-disclosure and/or COI agreements from subcontractors or individual employees.
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> • The solicitation should state that Treasury will oversee and enforce the proposed mitigation plan as part of the contract.
>
> • The Treasury Senior Procurement Executive will review and approve all provisions related to COIs prior to issuance of the solicitation.
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> • The solicitation should require that mitigation plans be submitted with offerors' initial proposals. Treasury's evaluators, source selection personnel, and legal counsel will examine the proposed mitigation plans to determine the extent to which those plans provide sufficient protection against actual or potential COIs.
>
> • The severity of a COI is necessarily dependent upon the circumstances of the case and the nature of the contractual action. Treasury personnel should not assume that a mitigation plan which is acceptable under one situation would also be acceptable under different circumstances.
>
> • The contracting officer may negotiate the mitigation plan with the offeror, taking into account the type of procurement being conducted.
>
> • Notwithstanding the submission of a mitigation plan, it is possible that contractor COIs may exist which cannot be effectively neutralized or mitigated. An offeror with an unacceptable mitigation plan will not be eligible for award unless conflicts are waived by the agency head or designee.
>
> • It is possible that a COI may be waived by the agency head or a designee. Any request for such a waiver should first be coordinated with the

Treasury Senior Procurement Executive.

• Upon award of the contract, the successful offeror's mitigation plan will be formally incorporated into the contract, making the mitigation plan a contractually binding obligation.

Conclusion

Events transpiring since the EESA's adoption indicate continuing significant instability in markets, tight credit, and difficulties ahead. It seems likely more problems lie ahead. Regulations authorized by the statute will be forthcoming. Some Midwest lenders—even small ones—can be considered in appropriate circumstances. The lack of government preparedness to undertake this task is readily apparent from a review of the U.S. Treasury Department's website, www.ustreas.gov, as even after two (2) weeks since adoption of the statute, procedures are not in place, and information about how to qualify for funds is not available.

Endnotes

1 Mr. Domina is a lawyer in private practice in Omaha. During financial distress in the 1980s and 1990s, he served as Special Acting Nebraska Attorney General in bank failure matters. He also represented bank officers and directors from many failed or troubled institutions. This summary is Mr. Domina's work intended for reader interest. It does not provide legal advice upon which reliance can be placed for decision-making purposes but is intended for general reader awareness.

2 EESA § 101.

3 *Id.*

4 EESA § 101(a)(3)(A).

5 This authority, much like the Social Security Administration's authority to contract with companies for Medicare services, will create significant fee income for institutions authorized by the Secretary to act as financial agents.

6 EESA § 101(d).

7 EESA § 102(d).

8 EESA § 103. The statute is specific that large and small banks and institutions are able to apply for help as the Secretary is permitted to ensure "that all financial institutions are eligible to participate in the program without discrimination based on size, geography, form of organization, or the size, type and the number of assets eligible…." *Id.*

9 This reporting authority is an expansion of an existing federal statute, 28 U.S.C. Section 535(b), providing for the recording of fraud through suspicious activity reports, ("SAR"), by financial institutions across the country.

10 EESA § 103.

11 EESA § 107.

12 As defined by 12 U.S.C. Section 1811.

13 As defined by 12 U.S.C. Section 1441a(r)(4) of the Federal Home Loan Bank Act.

14 *Id.*

15 EESA § 108.

16 EESA § 109.

17 EESA § 111.

18 EESA § 111(b).

19 The executive compensation regulation sunset provision in Section 111 appears to make the restriction largely theoretical, only.

20 EESA § 113.

21 EESA § 117.

22 Id.

23 EESA § 117(c).

24 EESA § 118.

25 7 U.S.C. Title 5.

26 EESA § 119(a).

27 Id.

28 Id. at Section (b)(3).

29 EESA § 120(a).

30 EESA § 121(a).

31 EESA § 121(b)(2).

32 This new limitation is inserted in the statute limiting the amount of federal debt, 31 U.S.C. Section 3101.

33 EESA § 125 creates the Congressional Oversight Panel.

34 EESA § 302.

35 EESA § 302(a).

36 http://www.ustreas.gov/initiatives/eesa/conflict.shtml