



BROWN RUDNICK'S STRUCTURED RESOLUTION GROUP

US TREASURY BAIL-OUT ALERT

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Those of us who cannot wait to see the final legislation authorizing and governing the Treasury's \$700 billion bailout of financial institutions will have to be a little patient as Tuesday's developments have put in jeopardy the administration's plan to have the legislative framework developed and approved by the end of this week. It is no surprise that Congress has refused to give fast-track approval to the original proposal by the Treasury: the Democratic leaders have demanded significant changes to the proposal and some Republicans have expressed misgivings at the prospect of spending "a massive amount of taxpayer's money on bad securities" and the government's interference into the capital markets.

Tuesday's developments began with Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke testifying on the proposed bailout legislation before the Senate Banking Committee. Paulson and Bernanke both urged a swift passage of the rescue legislation as the only alternative for addressing the root cause of the crisis, reviving the "frozen credit markets" and preserving the health of the U.S. economy. The testimony was met with much criticism by members of both parties. A similar hearing is taking place today in the House.

While the majority of the legislative leaders expect the bailout plan to be approved in the near future, a number of critical issues remain outstanding. The core of the Democratic objections to the bailout plan was summed up in the counterproposal to the Treasury's draft circulated by Senate Banking Committee Chairman, Christopher Dodd, on Monday. Dodd's proposal would impose restrictions on the Treasury's discretion to run the program and would limit the duration of the bail-out plan. More importantly, the proposal would place certain restrictions on the financial institutions seeking the government's assistance and permit bankruptcy courts to modify residential mortgages.

The following issues are currently being debated by the legislators:

- ***Executive Compensation:*** The Dodd bill requires that all financial institutions seeking to sell assets through the government program must meet "appropriate standards for executive compensation and shareholder disclosure." This would essentially involve limits on executive compensation and claw-back provisions for incentive compensation. The administration's position is that limiting executive compensation would discourage at least some financial institutions from participating in the program and could, therefore, result in the Treasury having fewer choices and purchasing inferior assets from the most troubled institutions. This issue could become the largest stumbling block to negotiating the final proposal.

- **Bankruptcy Law Changes:** Democratic members of the Senate Banking Committee have requested that bankruptcy courts be given the authority to modify a chapter 13 bankruptcy filer's primary residence mortgage (the current law allows modifications only with respect to second home mortgages). The Treasury and the lending industry are strongly opposed to such changes in the bankruptcy law. This would permit, for example, a bankruptcy court to write down the principal amount of such a mortgage to the current fair market value of the home and allow for such reduced amount to be paid on different terms (i.e. term and interest rate) than is provided under the original mortgage.
- **Pricing:** There was relatively little discussion at yesterday's hearing on the specific questions of how the price at which the government would purchase and sell these assets would be set and neither the Treasury's proposal nor Dodd's bill provides much guidance on this issue. Instead, the lawmakers appear to be leaving this puzzle to the Treasury's discretion. Chairman Bernanke stated that the Treasury should buy the troubled assets at "hold-to-maturity" values rather than at deeply discounted "fire-sale" prices. Essentially, Bernanke is proposing that the Treasury use a pricing model that assumes the debt will be paid in full over its period of maturity, as opposed to using the mark-to-market model to price assets on a given day. Bernanke also added that using a reverse auction mechanism would benefit financial institutions and allow them to more accurately value the assets. If the government were to buy these assets based on a price to maturity assumption, it might pay more for them than it could get back in the market when it sold them. This could help re-capitalize the sellers, but would appear to drive up the overall cost of this program.
- **Ownership Shares:** Dodd's bill mandated that the Secretary of the Treasury receive a contingent debt or equity interest in the selling financial institutions which would allow it to recover any shortfall between its purchase and selling price for these assets. It is believed that the Treasury and the Congressional leaders are close to a compromise whereby Treasury would have the option to receive an ownership stake (in the form of warrants to buy stock or a contingent debt interest) from financial institutions seeking to participate in the program.

UNANSWERED QUESTIONS:

Lurking beneath the issues being openly debated in Congress are some difficult questions that must be resolved (explicitly or implicitly) before a final bill emerges. Some of these questions sit close to the nerve endings that are imbedded in the compromises and accommodations central to our capitalist system as it has operated ever since the Great Depression and even before. Among these are:

Government's Stake in Participating Companies:

- If the goal of the bail-out plan is to recapitalize the financial system, is it preferable to do so through direct equity investments by the U.S. Government or by the U.S. Government buying distressed assets at "hold-to-maturity" (i.e., inflated) values?
- If the latter approach is chosen, then should the Government own a stake in the selling institutions equal to the "premium" portion of the purchase price paid for the assets?



- Under either a direct investment or premium purchase approach, how should the Government's stake in the institutions be structured so as to protect the Government's interest while at the same time encouraging private investment in these institutions?
- Should private investment be further encouraged by relaxing Federal Reserve transparency rules imposed on investors with large stakes in banks, and if so, does this run contrary to protecting the taxpayers' stakes in the companies?

Pricing Considerations:

- Even if hold-to-maturity pricing is agreed upon for setting the purchase price of the distressed assets, how will prices be determined, by whom, and with what oversight?
- If a reverse auction process is to be used to price the troubled assets, how should the details work, e.g., should Treasury name the price it is willing to pay and the banks then decide whether to sell, or should the banks name the price at which they are willing to sell and the government decides whether it is willing to buy at that price? Are there other options? Because of the complexity of this issue, how much detail should be contained in the bill?

Homeowners' Protection:

- If homeowner protection should be a component of the program, how can this be achieved, in light of restrictions on loan modifications inside large mortgage-backed securities pools, other than by giving bankruptcy judges the power to modify mortgage terms for primary residences in Chapter 13 proceedings?
- Will giving bankruptcy courts such authority in fact disrupt the housing market by sidelining lenders, and is there evidence of such effect in the second-home mortgage market?
- To assure no adverse effect on the residential lending market, what types of restrictions could be imposed on such powers which would provide relief where needed but maintain stability in the market?
- If the decline in housing prices is at the root of the problem, should the U.S. Treasury focus on propping up the housing market instead of buying distressed mortgage-backed securities?

Executive Compensation:

- If salary and severance caps are placed on firms which participate in the bail-out, how can you make sure that such caps will not run off the qualified executives needed to run these institutions?
- Is a required incentive compensation plan that stretches out the payments for several years a better response, which focuses executives on taking a longer-term view?



- Is there a misalignment between the incentives of executives and traders at financial institutions and the shareholders, and if so, are corporate governance reform measures a better way to correct this misalignment?

Program Oversight:

- If there is going to be oversight from another branch of government, how can it be achieved without it being either a paper tiger, with no authority to overturn Treasury actions, or at the other extreme, a disruptive force?

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