



BROWN RUDNICK'S STRUCTURED RESOLUTION GROUP

US TREASURY BAIL-OUT ALERT

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Was the Emergency Economic Stabilization Act of 2008 a fundamentally flawed approach to the credit market crisis or is the lack of implementation mechanics responsible for the bail-out legislation's failure to impress the markets? Only time will tell. For now, however, ten days following the enactment of the Treasury's \$700 billion rescue plan, the downward spiral of the financial markets has continued, although an uptick is predicted for today.

Last week the Treasury announced the appointment of Neel Kashkari, the 35-year old former Goldman Sachs executive and current Assistant Secretary of the Treasury for International Economics and Development, as the Interim Assistant Secretary of the Treasury for Financial Stability responsible for overseeing the bail-out program. The Treasury also published its initial program guidelines entitled "Process for Selecting Asset Managers Pursuant to the Emergency Economic Stabilization Act of 2008." The published selection procedures include the following provisions:

- **Securities v. Whole Loans and Status of Managers:** The Treasury will hire two separate groups of asset managers, one to manage securities and another one to manage whole loans. Securities asset managers will handle all types of residential and commercial mortgage-backed securities and the whole loan asset managers will handle a broad range of residential first- and second-lien mortgage loans and home equity loans as well as commercial mortgage loans. As provided in the rescue bill, asset managers will serve as financial agents of the government and not as independent contractors.
- **Eligibility Requirements:** The list of financial institutions eligible to be designated as financial agents of the United States under the program include banks, savings associations, credit unions, security brokers and dealers, insurance companies and other institutions established and regulated under the U.S. state, federal or territorial laws, and having significant operations in the United States. Prospective participants will be solicited through the issuance of public notices posted on the Treasury's website.
- **Stages for Evaluations and Decisions.** The government's review of applications will involve several phases. During the first phase, the Treasury will evaluate the initial responses from qualified financial institutions and will invite certain candidates to participate in the second phase of the selection process. In the second phase (which may be conducted under confidentiality agreements to facilitate information exchange and may include telephone interviews), the prospective candidates will provide additional information as to their management expertise and strategies. In the third and final phase,

the Treasury will evaluate prior responses, conduct face-to-face discussions and make final selections of the asset managers.

- **Multiple Managers:** The Treasury expects to designate multiple asset managers and sub-managers for the program. The appointments are likely to be made in sequence to match the Treasury's asset acquisition schedule. Separate notices will be issued to small and minority- and women-owned businesses that do not meet the minimum management qualifications but could be hired as sub-managers within the portfolio.

Large U.S. asset managers, such as Pacific Investment Management Co (PIMCO), BlackRock Inc. and Trust Company of the West are rumored to be the frontrunners to manage and oversee the Treasury's bail-out program.

Notwithstanding these guidelines, the market participants are still unclear and troubled by the bail-out legislation's failure to provide details on the methods of pricing and mechanisms for valuing and purchasing the troubled assets, as well as to answer the question of whether non-mortgage related assets will be purchased by the Treasury. These, however, are all micro-issues. The real elephant in the room is the question of whether the major component of the bail-out program (i.e., purchasing of mortgage-related securities from financial institutions) is the right remedy and will be sufficient to stabilize the markets.

In an effort to reign in the panic reverberating from Wall Street to Main Street, the Treasury is now considering several alternatives to the purchase of troubled assets. One proposal gaining a lot of momentum is direct equity investments by the Treasury in the troubled financial institutions, emulating the move made by the British government last Wednesday, so that the financial institutions can resume their lending activities. This idea was originally considered but scrapped by the Treasury when initially drafting the bail-out plan, and as recently as September 23, Treasury secretary Paulson rejected this idea outright as something only to be considered in a failure scenario.

The authority on which the Treasury would be relying to accomplish this is actually rooted in the bail-out legislation's definition of the "troubled assets" that the Treasury can purchase, which includes "any financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines ... is necessary to promote financial market stability." Among the various structures that the Treasury is considering to achieve this capital injection is the direct acquisition of equity stakes in financial institutions through the purchase of preferred stock. Another structuring option would permit the government to realize a profit if the bank ends up paying the government back within a certain period and would give the government the option to convert to common stock if the bank misses the deadline. Other possible structures would impose certain conditions on participating banks, including full disclosure about their investment activities and valuations, as well as write-offs of assets to the value that a willing buyer in the market would pay or limit participation to banks that raise some private capital on their own. The Treasury has indicated that any such program would more than likely be voluntary and target healthy financial institutions, as well as include incentives for firms to participate, such as the payment of prices favorable to the banks.



Other suggested steps include additional guarantees of bank debt for billions of dollars and temporary insurance of all U.S. deposits. The pressures to come up with substantive and effective measures to curb this financial crisis are mounting and many had expressed the view that it was imperative for the Group of Seven finance chiefs to come up with a coordinated mix of remedies during the G-7 and International Monetary Fund/World Bank meetings held in Washington over the weekend. However, all that emerged from such meetings was a general statement of principles, rather than specific measures.

In the meantime, the number of unanswered questions grows:

- Assuming that the Treasury opts for direct investments, how will it decide which institutions to invest in?
- With the variety of financial institutions in dire need of help, can the Treasury devise objective determination criteria for who gets the capital infusion and will the smaller institutions get their fair share of assistance?
- How will the Treasury determine the value of a financial institution in question and, therefore, what share of equity the Treasury should be entitled to?
- With the Treasury presumably acquiring a preferred equity position in such institution, will this deter private capital from investing? (Mitsubishi UFJ Financial Group needed assurance from Treasury that its investment in Morgan Stanley would not be adversely affected by a Treasury equity infusion before it was willing to close its \$9 billion investment in the firm.)
- Should the federal capital infusion be made only on a match-funding basis with private capital?
- Will Treasury attach conditions to funding, such as limitations on executive compensation and golden parachutes, and requirements of new inter-bank and customer loans?

And finally, the biggest question of all: Will these tools be enough to unfreeze the credit markets and restore investor confidence? Future editions of the Bail-Out Alert will pursue answers to these questions.

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