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NEWSLETTER OF THE **BANKING AND SPECIALTY FINANCE** PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

The Implications of the Federal Bailout Legislation

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The legislation continues to be short on details and probably will leave much crucial information to the development of procedures by the Treasury, in consultation with industry experts. Nevertheless, financial institutions and other interested parties should begin to understand this extremely important legislative development. Here are the key questions and observations:

1. What does the legislation seek to accomplish?

In the broadest of terms, it seeks to restore confidence and liquidity to markets that are frozen and unyielding. It targets the broad "real estate" market as a proxy for the credit markets as a whole because it (housing most certainly) is the "root cause" of the problems being confronted. The intention is to encourage private capital to conclude that a floor has been set so private deals should happen.

2. Can any institution participate as a seller in this new program (the "TARP")?

The Treasury and the Fed continually emphasize that any "regulated financial institution" will be able to participate, which includes commercial banks, investment banks, credit unions, savings & loans and industrial loan companies. Presumably, however, it includes only those institutions that are federally regulated in some fashion. This would exclude payday lenders, commercial finance lenders and similar state-licensed-only lenders. Ostensibly, hedge funds and other investment pools that are registered investment companies would be eligible; if privately held or exempt, probably not. Since insurance companies are state regulated they would have to be given special mention in order to be covered.

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3. What assets can an institution sell as part of this program?

Although the final legislation will cover all manner of mortgages, mortgage-related products and mortgage-based securities, all broadly defined, the TARP will focus initially and probably primarily on the MBS market, including CDSs. The Treasury and the Fed have made it very clear in Congressional testimony that they will deal with one asset class at a time, starting with the simplest and most illiquid. Portfolios of real estate assets consisting of mortgages and OREO do not seem to be high on the list so that for regional or community commercial bank clients, the TARP does not at this stage appear to be much help except as it will encourage sellers and buyers closer together on price.

4. How will the sale price be determined?

Both the Treasury and the Fed admitted that they do not yet know how this will work. They expect to solicit immediately the assistance of experts in the private sector. There will be a period of experimentation utilizing, for example, a hold to maturity valuation in conjunction with a reverse auction process. However, nothing is cast in concrete and it is likely that other forms of valuation will be tried.

5. What role will the Treasury play in this effort besides having the authority to spend up to $700 billion?

The Treasury intends to be the purchaser of the troubled assets with an intention to hold and ultimately to sell to third parties once the marketplace is stabilized. It is expected that the Treasury and the Fed will be able to start something in a matter of weeks although it probably will take as long as 90 days to consult and figure out what pricing mechanism works best. It is probable that while the full $700 billion will be authorized, there will be several tranches that will require some type of additional Congressional approval before the Treasury can utilize them.

6. What could the impact of a sale be to the balance sheet of the selling institution?

The Fed consistently argued that it was not their intention to penalize an institution that desires to sell troubled assets but, in reality, it will depend on a number of factors, including how realistic the institution has been in writing down these assets on its own books. It also will be affected by the extent to which the legislation and subsequently adopted rules require that the institution provide some upside opportunity to the

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Treasury in the form of warrants or other incentive payments.

7. Will a selling institution be required to provide additional consideration to the Treasury in connection with a sale?

The Treasury has acceded to Congressional demands that the Treasury be compensated in some fashion for having paid cash for assets that were frozen in an institution's balance sheet. The Democrats regard this concept to be nonnegotiable. Ideally, this would be some type of incentive compensation, such as warrants for stock of a publicly held company, but in privately held situations, perhaps a stipulated cash payment in the future. The Chrysler bailout of 1980 is cited as precedent as is the most recent AIG bailout.

8. Will a selling institution be subject to any further limitations or proscriptions if it participates in the program?

The Treasury initially resisted any type of limitation on executive compensation but has now agreed to limit the amount of money an executive of an institution may take with her/him (the so-called “golden parachute” payment) upon departure from an institution that has sold troubled assets to the Fed in the TARP. This also is presented as a nonnegotiable demand of the Democrats. Rules will have to be adopted and the preemption of previously contractual relationships will have to be tested constitutionally, unless the executives in question agree.

9. Will there be relief to individual homeowners facing foreclosure or already in bankruptcy?

This has been the biggest bone of contention and it is not yet known how it will be resolved. However, this is the third prong of the nonnegotiable points that the Democrats are insisting upon in the negotiations that are ongoing, at least for foreclosure relief or perhaps even cram down procedures.

10. Will this legislation be passed and signed over the next few days?

There seems to be a developing consensus from the White House and theCongressional Democrats that there will be legislation ready for a vote next week even though Presidential politics diverted attention during Thursday’s negotiations.