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Financial Crisis

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An Overview Of The Emergency Economic Stabilization Act Of 2008

Joshua Robinson

WEIL, GOTSHAL & MANGES LLP

On Friday, October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law by President Bush. The EESA was first proposed by the Treasury Secretary for the purpose of restoring liquidity and stability to U.S. financial markets by authorizing the Treasury Secretary to establish a troubled asset relief program ("TARP") for the purchase by the U.S. government from financial institutions of up to \$700 billion of mortgage-backed and other troubled assets. The EESA was initially rejected by the House of Representatives on Monday, September 29, 2008, leading to the largest single day decline in the Dow Jones Industrial Average in history. The EESA was then amended and approved by the Senate on Wednesday, October 1, 2008, and was ultimately approved by the House of Representatives on Friday, October 3, 2008 and signed into law by President Bush on the same day.

The revised legislation includes an increase in FDIC insurance of deposits from \$100,000 to \$250,000 until the end of 2009 and a host of additional provisions unrelated to TARP that were added to garner more votes in the House of Representatives. These additional provisions include, among other things, extensions of tax incentives for renewable energy, extension of Alternative Minimum Tax relief and a requirement that health insurance cover mental health on par with physical health.

Many provisions of the EESA leave discretion to the Treasury Department in their implementation. Therefore, many interpretive ambiguities and issues remain to be settled in the application of the EESA and the TARP. Some of these should be resolved as regulations and guidelines are promulgated by the Treasury Department under the EESA.

A summary of the EESA's key provisions is provided below.

Troubled Asset Relief Program

Program Overview

The EESA authorizes the Treasury Secretary to purchase troubled assets from financial institutions. The EESA

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Joshua Robinson

defines "troubled assets" very broadly and leaves discretion to the Treasury Department to determine what assets are eligible to be purchased under the TARP. The EESA defines "troubled assets" 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 determines promotes financial market stability;

and

... any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

The EESA defines a "financial institution" as:

any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company,

established and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.

Under the TARP, the Secretary has broad authority to purchase, manage, and otherwise exercise rights relating to troubled assets. In addition, the Secretary has broad authority to hire employees, enter contracts, enlist financial institutions to perform duties under the EESA, and implement other regulations and guidance to carry out the purposes of the EESA. The TARP is to be implemented through a specially established office of the Treasury called the Office of Financial Stability. On October 6, 2008, the Secretary designated Neel Kashkari as Interim Assistant Secretary of the Treasury for Financial Stability who will oversee the TARP.

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The authority of the Treasury Department to purchase troubled assets pursuant to the TARP terminates on December 31, 2009. Such authority may be extended to no later than October 3, 2010, upon written certification by the Secretary to Congress justifying why the extension is necessary to assist American families and stabilize financial markets, and setting forth the expected cost to the taxpayers for such extension.

Publication Of Guidelines

Although the EESA lays out considerations and requirements that the Secretary is required to take into account while conducting the TARP, many of the program's specific details will be promulgated through Treasury regulations and guidelines. The Treasury Department is required to publish program guidelines for the TARP before the earlier of two business days after the date of the first purchase under the TARP or November 17, 2008. Such guidelines are required to include:

- mechanisms for purchasing troubled assets;
- methods for pricing and valuing troubled assets;
- procedures for selecting asset managers; and
- criteria for identifying troubled assets.

On Monday, October 6, 2008, the Treasury Department published an outline of the process of selecting asset managers and a set of interim guidelines for conflicts of interest among contractors performing services in conjunction with the EESA. These are available at www.treasury.gov/press/releases/hp1181.htm and www.treasury.gov/initiatives/eesa/conflict.shtml. On the same day the Treasury Department published three notices seeking responses from financial institutions interested in performing:

- securities asset management services;
- whole loan asset management services; or
- custodian, accounting, auction management and other infrastructure services.

These notices set forth minimum qualifications for providing these services and required responses by 5:00 p.m. on October 8, 2008. The Treasury Department has said that it will at a future date issue a separate notice seeking responses from smaller and minority- and women-owned financial institutions interested in providing securities asset management services as sub-managers or in providing whole loan asset management services as contractors or sub-managers. These future notices would allow financial institutions that do not meet the minimum requirements set forth in the original notices to become asset managers under the TARP. The original notices, which are available at www.treasury.gov/press/releases/hp1185.htm, include a minimum requirement of \$100 billion in dollar-denominated fixed income assets under management for securities asset managers and \$25 billion of mortgage loans under management for whole loan asset

managers or, in the case of whole loan asset managers, clear and credible evidence that they can scale their capacity to manage a portfolio of at least \$25 billion.

Market Mechanisms And Return On Investment

In carrying out the programs under the EESA, the Secretary is required to maximize the return on investment and economic benefits of the program by encouraging private sector participation and taking advantage of optimal market conditions and mechanisms. The Secretary has the authority to make direct purchases of troubled assets or to employ other market mechanisms such as auctions and reverse auctions. When the Secretary makes a purchase of troubled assets from a publicly traded financial institution, the government is required to receive warrants exercisable for non-voting common or preferred stock of such financial institution. For non-public financial institutions, the government is to receive warrants for common or preferred stock or senior debt securities. The Secretary is required to establish de minimis exceptions to the requirement to receive warrants or senior debt securities based on the size of the cumulative transactions of troubled assets purchased from any one financial institution for the duration of the program, not to exceed \$100 million.

The Secretary is also prohibited from purchasing assets at a greater price than was paid by the participating financial institution, subject to certain exceptions for assets received in connection with a merger or in a bankruptcy.

Graduated Authorization To Purchase

The EESA gives the Secretary a graduated authorization to use the full \$700 billion originally requested by the Secretary. Under the EESA, immediate authority is granted for the Secretary to use up to \$250 billion to purchase troubled assets. Upon submission to Congress by the President of a certification of need, the authority to purchase shall be increased to \$350 billion. The remaining \$350 billion would be available if the President transmits a written report to Congress detailing the plan of the Secretary to exercise authority for the remaining \$350 billion and within 15 days Congress does not enact a joint resolution of disapproval.

TARP Capital Purchase Program

On October 14, 2008, the Treasury Department announced a capital purchase program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Under the program, Treasury will purchase up to \$250 billion of senior preferred shares pursuant to the TARP authority. The program will be available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities that elect to participate before 5:00 pm (EDT) on November 14, 2008. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency.

The minimum subscription amount available to a participating institution is one percent of risk-weighted assets. The maximum subscription amount is the lesser of \$25 billion or three percent of risk-weighted assets. Treasury will fund the senior preferred shares purchased under the program by year-end 2008.

The senior preferred shares will qualify as Tier 1 capital and will rank senior to common stock and pari passu with existing preferred shares, other than preferred shares which by their terms rank junior to any other existing preferred shares. The senior preferred shares will pay a cumulative dividend rate of five percent per annum for the first five years and will reset to a rate of nine percent per annum after year five. The senior preferred shares will be non-voting, other than having class voting rights on matters that could adversely affect the shares. The senior preferred shares will be callable at par after three years. Prior to the end of three years, the senior preferred may be redeemed with the proceeds from a qualifying equity offering of any Tier 1 perpetual preferred or common stock. Treasury may also transfer the senior preferred shares to a third party at any time. In conjunction with the purchase of senior preferred shares, Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15 percent of the senior preferred investment. The exercise price on the warrants will be the market price of the participating institution's common stock at the time of issuance, calculated on a 20-trading day trailing average.

Companies participating in the program must adopt the Treasury Department's standards for executive compensation and corporate governance, for the period during which Treasury holds equity issued under this program.

On October 20, 2008, the Treasury Department released guidance on how to apply for capital under the program. This guidance is available at <http://www.treasury.gov/press/releases/hp1222.htm>.

Insurance Of Troubled Assets

Upon establishing the TARP, the Secretary is also required to establish an insurance program to guarantee troubled assets of financial institutions. Upon request of a financial institution the Secretary may guarantee the timely payment of principal of, and interest on, troubled assets in amounts not to exceed 100 percent of such payments. The Secretary is to collect premiums from participating financial institutions that may depend on the risk profile of the guaranteed troubled asset.

The Secretary is required to publish guidelines on the methods used to set premiums as well as an explanation of the types of assets that may be guaranteed under the program. The total amount available for purchase under the TARP program will be reduced by an amount equal to the difference of the outstanding guaranteed obligations and the balance of premiums collected under the insurance program.

Executive Compensation And Corporate Governance Provisions

If the Secretary buys troubled assets directly 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, the Secretary is to require the financial institution to meet appropriate standards for executive compensation and corporate governance, including:

- limits on compensation that exclude incentives for senior executive officers (the top five highest paid executives) of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the government holds an equity or debt position in the financial institution;
- a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; and
- a prohibition on the financial institution making any golden parachute payment to its senior executive officer during the period that the government holds an equity or debt position in the financial institution.

In addition, if the Secretary buys troubled assets from a financial institution in an auction and the aggregate purchases by the Secretary from such institution exceeds \$300 million (including direct purchases), the Secretary is required to prohibit the institution from entering into any golden parachute severance agreements until the authority of the Treasury Department to purchase troubled assets pursuant to the TARP terminates.

The EESA also includes a provision limiting the deductibility of remuneration paid to the chief executive officer and chief financial officer of any participating financial institutions to \$500,000 if:

- the financial institution sells more than \$300 million in troubled assets to the government under TARP (both direct and auction sales, but not counting direct sales if the institution only makes direct sales); and
- the applicable executive is one of the three highest paid executives of such financial institution.

The limitation on deductibility applies in the first taxable year which includes any portion of the period during which TARP is in effect and in which the government acquires from the applicable financial institution such amount of troubled assets that, when added to all purchases in prior taxable years, exceeds the \$300 million threshold discussed above. The limitation then continues to apply to any subsequent taxable year which includes any portion of the period during which TARP is in effect.

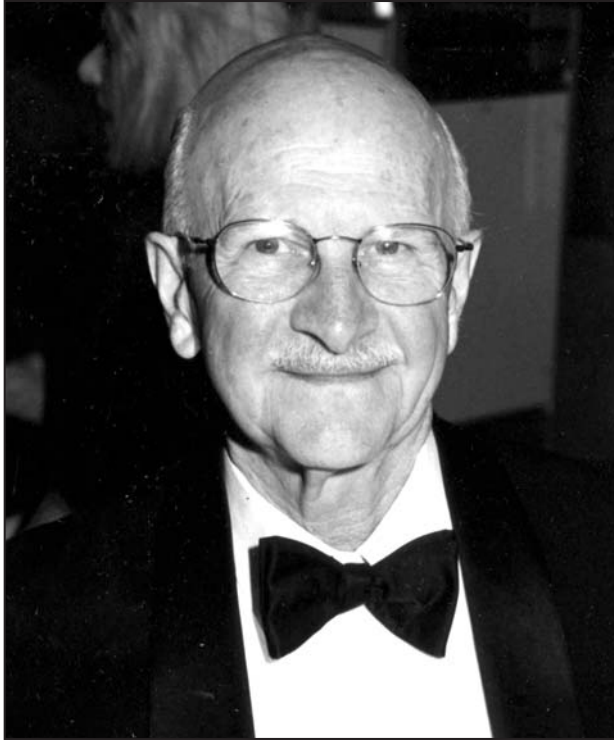
Special Provisions Relating To Home Ownership

The EESA requires the Treasury Department and other government agencies that hold mortgages and mortgage-backed securities to facilitate loan modification and prevent foreclosures by homeowners whose homes secure mortgages held by the government or whose mortgages back mortgage-backed secu-

Please email the author at joshua.robinson@weil.com with questions about this article.

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In Memoriam



R. Glenn Bauer: "Arbitrator Über Alles" (1925-2008)

In saying "farewell" to our dear friend R. Glenn Bauer, Holland & Knight partner, I was prompted to review some articles written by Glenn for *The Metropolitan Corporate Counsel*. Back in August 1995, Glenn wrote an article entitled "The Sky Reefer Case: Arbitration *Über Alles*" describing arbitration regarding a bill of lading in an emerging nation's capital city, "or worse, litigation in an ancient and primitive court system" which may be in your future! How prescient these words were in foretelling the plight of shippers as well as commercial purveyors of goods when faced with arbitration in a strange land absent a reliable judicial system for enforcement.

Our friend, Glenn was a man for all seasons – not only did he have countless articles to his credit on the carriage of goods by sea, charter parties, maritime arbitration and other maritime subjects, he stood as a symbol of good counsel and sound scholarship. He published many law review articles in U.S. and foreign law journals including: *Upsetting a Charter Party Arbitration Award: Are the Courts Lowering the Bar on Judicial Review?*, 25 Tul.Mar.L.J. 419,431 (2001); *Conflicting Liability Regimes; Hague-Visby v.Hamburg Rules – A Case By Case Analysis*, 24 J. Mar.L.&Com. 53 (1993); *The Measure of Liability for Cargo Damage Under Charter Parties: A Second Look*, 21 L.J.Mar.L. & Com.397 (1990); *Effects of War on Charter Parties* 13 Tul.Mar.L.J.13, 17-24 (1988); *Manifest Disregard of the Law* (1979) LMCLQ 142. He co-authored the fourth edition of *The Law of Demurrage* and was the author of *A Short History of Maritime Fraud*, 12 Tul. Mar.L.J.(Fall 1987) in which he took great glee in highlighting certain fraudsters he had encountered in his practice.

He was a teacher during the 1990s, serving as Special Professor of Law at Hofstra University Law School and was an adjunct professor of maritime law at Cardozo University Law School. He was a favorite lecturer at law schools and international conferences, contributing regularly to the International Congress of Maritime Arbitrators' annual meetings.

As a partner in the firm of Haight Gardner Poor & Havens (now Holland & Knight), one of the world's leading admiralty law firms, Glenn handled a broad range of cases relating to the maritime industry, appearing at the U.S. Supreme Court and in other federal courts. He was also a well-known arbitrator.

We consider our lives considerably enriched as a result of our long-time friendship with Glenn and his charming wife, Rosemary. He brought to the profession a high degree of integrity, sound scholarship and deep understanding of one's commitment to a life work. As one of his colleague's wrote: "Our fondest thoughts and vivid memories of this kind and gentle man will remain with those of us who knew him for decades to come. May he rest in peace."

We salute the life of a dear friend who was "arbitrator über alles."

Martha Driver

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rities held by the government. In addition, if any such homeowner requests reasonable modification of his or her loan, the Secretary is required to consent, where appropriate, to term extensions, rate reductions, principal write downs, increases in the proportion of loans within a trust or other structure allowed to be modified, or removal of other limitations on modification.

Oversight

The EESA includes several layers of protection and oversight, including:

- the establishment of the Financial Stability Oversight Board (composed of the Chairman of the Board of Governors of the Federal Reserve System, the Treasury Secretary, the Director of the Federal Housing Finance Agency, the Chairman of the Securities and Exchange Commission and the Secretary of Housing and Urban Development) to review and make recommendations regarding the exercise of authority under the EESA;

- the Comptroller General of the United States is required to oversee the activities and performance of the TARP;

- the President is required to appoint the Special Inspector General of the Troubled Assets Relief Program who will be responsible for conducting, supervising, and coordinating audits and investigations of the purchase, management, and sale of assets under the TARP; and

- the creation under the EESA of the Congressional Oversight Panel to review the current state of the financial markets and the regulatory system and the effect of the exercise of authority under the EESA on the financial markets.

Reporting Requirements

The reporting requirements under the EESA include:

- the Financial Stability Oversight Board must report quarterly to Congress and the Congressional Oversight Panel;

- within 60 days of the exercise of authority granted in the EESA, and every 30 day period thereafter, the Secretary of the Treasury must report to Congress the acts taken under the TARP;

- within seven days of the purchase of \$50 billion of troubled assets, and for every \$50 billion purchase thereafter, the Secretary must report to Congress regarding the use of funds and the effect on the financial markets;

- no later than April 30, 2009, the Secretary of the Treasury is required to provide a written report to Congress reviewing the state of the financial markets and the regulatory system and to provide any recommendations;

- the Comptroller General of the United States must report to Congress every 60 days and conduct an annual audit of the TARP;

- the Special Inspector General must report to Congress quarterly on its activities and the activities of the Secretary of the Treasury under the TARP; and

- the Congressional Oversight Panel must report to Congress every 30 days and no later than January 20, 2009 the Oversight Panel must submit a special report on regulatory reform analyzing

the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers, and providing recommendations for improvement.

Temporary Increase in Deposit Insurance

The EESA increases the limit on insurance coverage provided by the Federal Deposit Insurance Corporation and the Federal Credit Union Act from \$100,000 to \$250,000 until December 31, 2009. The EESA authorizes the FDIC to fund this increase with borrowings from the Treasury and prohibits the FDIC from taking into account the increased limit for purposes of setting assessments for participating banks.

Mark-to-Market Accounting

The EESA gives the Securities and Exchange Commission the authority to suspend, by rule, regulation, or order, the application of mark-to-market accounting for any issuer or with respect to any class or category of transaction if the Commission determines that it is necessary or appropriate in the public interest and is consistent with the protection of investors. The Commission, in consultation with the Board of Governors of the Federal Reserve and the Secretary of the Treasury, is required to conduct a study on mark-to-market accounting, as applied to financial institutions.

Recoupment

Five years after the enactment of this legislation the President is required to submit a legislative proposal if there is a shortfall in the TARP funds in order to recoup such shortfall from the financial industry.

Tax Provisions

The EESA includes provisions pursuant to which financial institutions referred to in Section 582(c)(2) of the Internal Revenue Code of 1986 and depository institution holding companies as defined in Section 3(w)(1) of the Federal Deposit Insurance Act will recognize ordinary gain or loss, instead of capital gain or loss, when they sell preferred stock of Fannie Mae or Freddie Mac. Since most institutions will recognize losses, these losses will be able to offset ordinary business income. The EESA also extends the exclusion from cancellation of indebtedness income on qualified principal residences for an additional three years through to January 1, 2013.

Additional Provisions

After the initial EESA legislation was voted down in the House on Monday, September 29, 2008, the Senate included various additional provisions unrelated to the TARP to appeal to members of the House. These provisions include, among other things:

- extensions of tax incentives for renewable energy;

- extension of Alternative Minimum Tax relief;

- tax relief to victims of recent natural disasters;

- a provision that requires the current inclusion in a taxpayer's income of deferred compensation payable by offshore entities under certain circumstances; and

- a requirement that health insurance cover mental health on par with physical health.