

## Financial and Economic Crisis – Law Firms

# TARP Enforcement: Latest Developments And Insights

James C. Dugan  
and Scott S. Rose

WILLKIE FARR & GALLAGHER LLP

In response to the economic crisis, the federal government has made as much as \$3 trillion available through the Troubled Asset Relief Program ("TARP"). Recognizing that such a large pool of funds is subject to potential misuse, abuse, and fraud, Congress established the Office of the Special Inspector General for TARP ("SIGTARP") as the chief enforcement body overseeing TARP. As part of its mission to improve oversight with respect to TARP funds, SIGTARP has made several recommendations to the Department of the Treasury. Treasury has accepted some of SIGTARP's recommendations, has declined to implement others and, recently, has asserted that it has authority over SIGTARP's audit and enforcement program – a claim with serious implications for SIGTARP's independence. In response, SIGTARP has strongly asserted its independence from Treasury. The issue is now before the Department of Justice's Office of Legal Counsel.

### The Special Inspector General For TARP

The Emergency Economic Stabilization Act of 2008 ("EESA") established TARP and with it SIGTARP. Neil M. Barofsky, a former federal prosecutor, was sworn in as Special Inspector General on December 15, 2008.

SIGTARP's duties include conducting, supervising, and coordinating audits and investigations of the purchase, management, and sale of assets under TARP. SIGTARP's mission is to advance economic stability "through transparency, through coordinated oversight, and through robust enforcement against those, whether inside or outside of government, who waste, steal or abuse TARP funds."<sup>1</sup>

SIGTARP's \$50 million budget was recently increased to \$65 million. Specifically, the Helping Families Save Their Homes Act of 2009, adopted in May, allocates \$15 million to SIGTARP to perform audits and investigations of recipients of nonrecourse federal loans funded by TARP. The audits will focus on conflicts of interest involving TARP fund recipients.

SIGTARP has broad investigative authority and subpoena power. However, because it does not have the power to commence civil or criminal proceedings, it must partner with other enforcement agencies to do so. To that end, SIGTARP has partnered with the Federal Bureau of Investigation, the Securities and Exchange Commission, and the New York State Attorney General's Office, among others.

SIGTARP is required to issue quarterly reports to Congress. Its February 6, 2009 and April 21, 2009 reports described its priorities, enforcement activities, and recommendations to Treasury.

### SIGTARP's Recommendations And Treasury's Response

In an effort to promote oversight and compliance with respect to TARP funds, SIGTARP has made a number of recommen-

*James C. Dugan and Scott S. Rose are Partners in the Litigation Department of Willkie Farr & Gallagher LLP. The authors would like to thank Rachel A. Owens, an Associate with the firm, for her assistance with this article.*



James C. Dugan



Scott S. Rose

dations to Treasury. Many of these recommendations are directed at enhancing transparency concerning such funds. Other recommendations address program-specific issues. And others focus on executive compensation.

### SIGTARP's Recommendations To Enhance Transparency

Many of SIGTARP's recommendations are directed at increasing transparency around the use of TARP funds. SIGTARP's stated goal is to ensure that taxpayers are aware of who is receiving TARP funds and how those funds are being used. SIGTARP is essentially seeking to create a roadmap detailing how recipients are using TARP funds – which will undoubtedly assist SIGTARP's audit and enforcement efforts.

For example, SIGTARP recommended that Treasury post agreements with TARP recipients on Treasury's website, and Treasury has agreed to do so. SIGTARP also prompted Treasury to include oversight and compliance language in all TARP agreements, including language that explicitly acknowledges the jurisdiction and authority of SIGTARP to monitor compliance with the agreements' conditions. Treasury has stated that it will include some of SIGTARP's recommended oversight language in new agreements with AIG and in agreements that are part of the Capital Assistance Program.<sup>2</sup> Moreover, at SIGTARP's urging, agreements with auto industry TARP recipients and others acknowledge SIGTARP's oversight authority and call for internal controls to ensure compliance.

SIGTARP has also recommended that Treasury require all TARP recipients to account for their use of those funds, establish internal controls, and periodically certify the results to Treasury. Treasury has generally refused to adopt this recommendation. As a result, SIGTARP launched its own survey of TARP recipients in an effort to understand how they use TARP funds.

### SIGTARP's Program-Specific Recommendations

#### The Term Asset-Backed Securities Loan Facility

One of the government's bailout programs – the Term Asset-Backed Securities Loan Facility ("TALF") – has been of particular concern to SIGTARP. Under TALF, the Federal Reserve Bank of New York makes nonrecourse loans that are fully secured by collateral. SIGTARP is concerned that, without aggressive oversight and controls, TALF is vulnerable to fraud. SIGTARP has recommended that Treasury require minimum underwriting standards and internal controls for TALF. SIGTARP also has advocated that TALF beneficiaries be made to agree to compliance protocols. Finally, SIGTARP has opposed including "legacy mortgage-backed securities," or troubled mortgage-backed securities, as acceptable TALF collateral. SIGTARP is concerned that credit ratings, which are utilized under TALF for valuing mortgage-backed securities, are unreliable, and that the

underwriting standards for these securities are too lax.

In response, the Federal Reserve Bank of New York and Treasury have instituted fraud prevention and credit loss protection measures, including requiring a certification from the issuer of an asset-backed security that it is TALF-eligible. The adoption of more stringent criteria for legacy mortgage-backed securities to be used as collateral for TALF loans is also planned.

#### The Public-Private Investment Program

SIGTARP also has focused on the Public-Private Investment Program ("PPIP"), under which TARP funds will be invested along with money from private investors to purchase assets, including mortgage-backed securities, from participating banks. SIGTARP has expressed concern that this program is potentially subject to collusion, conflicts of interest, and money laundering. To address those concerns, SIGTARP has recommended that Treasury require strict conflict-of-interest rules on public-private investment fund managers and transparency regarding participation in and management of public-private investment funds.

SIGTARP's powers over PPIP were expanded in May by the Helping Families Save Their Homes Act of 2009. The act requires that any federal program established to create a public-private investment fund must consult with SIGTARP to impose strict conflict-of-interest rules on the manager of the fund. This requirement is intended to ensure that securities are purchased in arm's-length transactions, that fiduciary duties to investors are not violated, and that there is full disclosure concerning relevant facts about, and financial interests of, fund participants.

The act also gives SIGTARP access to all books and records of public-private investment funds, including all records of financial transactions. Each manager is required to retain all books and records relating to its respective fund, including emails.

#### Executive Compensation Requirements

SIGTARP has also recommended that Treasury eliminate the uncertainty surrounding executive compensation requirements for TARP recipients by immediately issuing regulations. Specifically, SIGTARP has urged Treasury to issue regulations to implement amendments to TARP's executive compensation restrictions enacted in February 2009.

Treasury unveiled interim final rules governing executive compensation for TARP recipients on June 15, 2009. Under the regulations, among other things, TARP recipients are prohibited from accruing or paying any bonuses, retention awards, or incentive compensation to certain "senior executive officers" (as defined by the regulations) and certain other highly compensated employees, with some exceptions. "Golden parachute" payments are also prohibited. The regulations include oversight and compliance obligations, such as the establishment of a company-wide policy on luxury expenditures and the formation of a compensation committee that must meet semi-annually to review the company's compensation policies for risk. Moreover, Treasury has created the position of "Special Master for TARP Executive Compensation." The Special Master is directed to conduct reviews of compensation paid before February 17, 2009 to employees of TARP recipients and negotiate for reimbursements to the federal government where appropriate. The Special Master must also approve the compensation structures for certain employees of

TARP recipients receiving exceptional assistance.<sup>3</sup>

### Treasury Asserts Authority Over SIGTARP's Audit And Enforcement Agenda

Treasury recently has asserted that, under SIGTARP's governing statutory authority, SIGTARP is subject to Treasury's oversight and control. This claim seems contrary to Congress's intent to charge SIGTARP with responsibility for aggressively guarding the TARP program from fraud and abuse. In particular, a lack of independence from Treasury could tarnish the perception that SIGTARP has the ability to do its job effectively. This issue has recently come to light in connection with SIGTARP's audit of bonus payments made by AIG. Treasury initially denied SIGTARP's request for documents on attorney-client privilege grounds but later provided the documents. However, Treasury has requested that the Department of Justice's Office of Legal Counsel consider whether SIGTARP is subject to Treasury's direct supervision. SIGTARP contends that Congress's intent, as reflected in EESA, is clearly that SIGTARP be completely independent of Treasury.

In response to this dispute, Senator Charles Grassley sent a letter to Treasury questioning Treasury's actions and asserting that SIGTARP was "created by Congress as a means to combat waste, fraud, and abuse and to be independent watchdogs ensuring that federal agencies are held accountable for their actions." The matter is now pending before the Office of Legal Counsel. In the meantime, SIGTARP has asserted that "should Treasury take actions that would impede our ability to independently conduct audits and investigations, we would report such interference to Congress without delay."

\*\*\*

It can be expected that SIGTARP will continue to make recommendations to Treasury regarding TARP programs and to audit and investigate the use of TARP funds as appropriate. Nevertheless, it is unclear what degree of control, if any, Treasury holds over SIGTARP. Treasury has sent conflicting messages about SIGTARP's role by choosing not to adopt SIGTARP's recommendation that TARP recipients be required to account for their use of TARP funds and by questioning the independence of SIGTARP. At the same time, TARP recipients are subject to compliance and oversight procedures advocated by SIGTARP and face investigation by SIGTARP if those procedures are not followed.

This state of affairs creates uncertainty for TARP recipients. The issue of SIGTARP's independence may be addressed by the Office of Legal Counsel in the near future. In the meantime, this issue bears close monitoring by TARP recipients and others thinking of accessing funds under TARP programs.

<sup>1</sup> See <http://www.sig tarp.gov/about.shtml>.

<sup>2</sup> The Capital Assistance Program involves the infusion of additional capital into financial institutions and the conversion of preferred shares obtained by Treasury under other TARP programs into convertible preferred shares, which provide the institution with the option of converting those shares into common stock.

<sup>3</sup> Notably, Treasury appointed Kenneth Feinberg to serve as Special Master for TARP Executive Compensation. The Special Master has responsibility for interpreting the application of the executive compensation restrictions under TARP and has direct oversight of those TARP recipients receiving "exceptional financial assistance" under certain TARP programs.