

**SUMMARY, STATUS AND ISSUES SURROUNDING THE
PROPOSED \$700 BILLION GOVERNMENT BAILOUT**

In just the past week, the market saw the bankruptcy filing of Lehman Brothers Holding Inc., the opportunistic sale of Merrill Lynch to Bank of America, and the \$85 billion emergency loan to American International Group by the Federal Reserve. In an effort to stem the continued fallout from the subprime mortgage crisis, the Bush Administration has delivered a proposed \$700 billion bailout plan to Congress. As presently crafted, the legislative proposal is breathtaking in the authority and discretion it provides to the Secretary of the Treasury (the “Secretary”). Indeed, the proposed legislation (the “Act”) provides that decisions by the Secretary pursuant to authority of the Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency.

A. Summary of the Proposed Act

The Act provides that the Secretary is authorized to purchase, and to make and fund commitments to purchase, on such terms and conditions as determined by the Secretary, up to \$700 billion of “mortgage-related assets” from any financial institution having its headquarters in the United States. The term “mortgage-related assets” is defined to mean residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case were originated or issued on or before September 17, 2008. The Secretary’s authority to purchase mortgage-related assets under the Act is limited to \$700 billion “outstanding at any one time.” Bloomberg reports that the Treasury has further clarified that the proposed authority also includes “other assets, as deemed necessary to effectively stabilize financial markets.”

To implement this broad grant of authority, the Act raises the statutory limit on the national debt from \$10.6 trillion to \$11.3 trillion and authorizes the Secretary to take such actions as the Secretary deems necessary to carry out the foregoing, including, without limitation:

- (1) appointing such employees as may be required to carry out the authorities in the Act and defining their duties;
- (2) entering into contracts, including contracts for services of experts and consultants, without regard to any other provision of law regarding public contracts;
- (3) designating financial institutions as financial agents of the Government to perform all such reasonable duties related to the Act as financial agents of the Government as may be required of them;
- (4) establishing vehicles that are authorized, subject to supervision by the Secretary, to purchase mortgage-related assets and issue obligations; and
- (5) issuing such regulations and other guidance as may be necessary or appropriate to define terms or carry out the authorities under the Act.

In exercising the expansive authorities contained in the Act, the Secretary is to take into consideration means for providing stability or preventing disruption to the financial markets or banking system, and protecting the taxpayer. The Act further provides that the Secretary shall have the authority to manage mortgage-related assets purchased under the Act, including revenues and portfolio risks therefrom, and may, at any time, upon terms and conditions and at prices determined by the Secretary, sell, or enter into securities loans, repurchase transactions or other financial transactions in regard to, any mortgage-related asset purchased under the Act.

The Secretary must report to Congress (the Committees on the Budget, Financial Services, and Ways and Means of the House of Representatives and the Committees on the Budget, Finance, and Banking, Housing, and Urban Affairs of the Senate) within three months of the Secretary's first exercise of authority under the Act, and every six months thereafter, with respect to the authorities the Secretary has exercised and considerations required by the Act (providing stability or preventing disruption to the financial markets or the banking system and protecting the taxpayer).

The authorities under the Act (other than the Secretary's authority to issue regulations and other guidance as necessary to carry out the Act, to sell or dispose of mortgage-related assets purchased under the Act, and to use proceeds from the sale of securities issued under Chapter 31 of title 31 of the United States Code), terminate two years from the enactment of the Act.

B. Congressional Consideration of the Proposed Act

Staff members from the Treasury Department and Congress immediately began meeting on the proposal over the weekend, and it appears virtually certain that there will be changes to the proposed terms of the Act set forth above as Congressional committee staffs seek to craft a bipartisan bill. Nevertheless, given the market situation and the political pressure on the Administration and Congress to act immediately, it is also clear that the final legislation will grant the Secretary sweeping and unprecedented powers. From a historic perspective, this situation and approach may more closely parallel that of the Great Depression, when President Roosevelt established a vehicle to save financial institutions and provide relief to millions of homeowners through the Home Owner's Loan Corporation, than the Resolution Trust Corporation of the 1980s. The Resolution Trust Corporation acquired the assets of failed savings and loan institutions in liquidation situations, while under the Act, the Secretary will be acquiring assets from entities that in many, if not most, cases will not be insolvent. However, in the case of commercial loans acquired by the Government, one can expect their prompt resale to buyers who are better equipped to restructure and foreclose on those loans in a process that should be more like the Resolution Trust Company disposition process.

It is important to emphasize that, at this point, Congress does not appear to be simply accepting the far-reaching authority sought by the Secretary without attaching a significant number of "strings" that will affect a variety of interests. We understand that the target is to finish drafting the legislation by Tuesday and have the House Financial Services and Senate Banking Committees vote on Tuesday afternoon or Wednesday, so that the bill can be ready for full House and Senate consideration by Thursday or Friday of this week.

At this point, the projected timetable is for Congressional action this week, but given the multiple demands of many influential members of Congress and the unspoken but obvious desire of the Democratic leadership to make it clear that they are equal players in the process, there could be delays. Since next Tuesday and Wednesday are Rosh Hashanah, there is a distinct possibility that it may be necessary for Congress to work through next weekend to complete the package for President Bush's signature by Monday or Tuesday afternoon.

Although it is expected that the drafting process will proceed without interruption, the Senate Banking Committee will hold a hearing on Tuesday and the House Financial Services Committee will hold a hearing on Wednesday. Paulson and Bernanke will be the primary, and perhaps the only, witnesses on both days.

C. Issues Being and To Be Considered

As currently proposed, the Act leaves open an array of issues material to those holding or wanting to purchase mortgage-related assets, including:

- What will be the size and nature of the cap? Will the cap remain at \$700 billion as proposed, will it be “revolving,” and will it be structured so as to require that the Secretary must come back to Congress for approval as the cap ratchets up beyond specified levels?
- Who will manage the bailout? The Act provides that the Secretary will run the operation and authorizes the Secretary to hire asset managers to service the assets. However, the Act does not give any guidance as to their mandate, standards to operate or compensation arrangements. Congress may seek more oversight over the process and could require that there be an explicit role for the Federal Reserve, or specify that the Secretary must hire a director. Requiring a director involves questions about how he or she should be selected and whether the Senate should “advise and consent” (thus taking up additional supposedly precious time and therefore unlikely).
- How will the Government purchase the mortgage-related assets? The Act authorizes the Secretary to set up acquisition vehicles to acquire mortgage-related assets, but does not give any guidance as to their mandate or operating standards.
- How will appropriate purchase and resale prices be determined? The Act does not establish a process for determining purchase prices, but reports state that the Secretary may use “reverse auctions” to establish asset prices. If private market participants participate in the auction process, would the Government allow private investors to purchase the mortgage-related assets? If no arm's-length price is established for the mortgage-related assets and they are sold to the Government at a price above a market clearing price, does such purchase amount to a capital investment by the Government in the selling financial institution without a commensurate sharing in the future gains by that financial institution?

What will be the “pound (or pounds) of flesh” that the Government will extract from the sellers as “protection for taxpayers”? Will the Government take some form of equity (stock, preferred stock, warrants, etc.) or some other form of upside? Will this be in addition to compensation restrictions and possible but so far unspecified shareholder limitations (such as dividend prohibitions)?

- How will the Government issue obligations to finance the mortgage-related assets? The Act authorizes the Secretary to issue obligations to finance the purchase of mortgage-related assets, but does not indicate whether such obligations will be recourse to the purchased assets, be backed by the “full faith and credit” of the United States, or some combination of the two.
- Which U.S. financial institutions will be eligible to sell mortgage-related assets to the Government? It is unclear whether the proposal is open to all U.S. financial institutions or only those in distress. Reports state that the Secretary would also have authority, after consultation with the Federal Reserve, to expand the program to non-U.S. financial institutions, but given the explicit prohibition in the Treasury draft Act, and Secretary Paulson’s efforts to convince foreign governments to take similar actions, this seems unlikely.
- Will the Government have authority to modify mortgage loan terms? The vast majority of residential mortgage loans in the United States have been securitized (*i.e.*, sold into trusts that have issued securities that are serviced by private companies pursuant to contractual arrangements). The purchase of some of the securities of a given securitization will not give the Government the authority to modify the terms of the underlying loans without breaching the terms of the securities held by other investors in the same securitization or the terms of the servicing arrangement, which raises constitutional issues. For those whole loans (*i.e.*, non-securitized loans) purchased by the Government, the proposal does not indicate how the Government will decide which mortgage loans to modify (*e.g.*, only delinquent loans, loans located in specific communities, *etc.*) and how such loans would be modified (*e.g.*, change rates, forgive principal, extend terms, *etc.*)
- How will the Act affect pending workouts? It is not clear how the Act will affect pending workouts. For example, will lenders now want to accelerate obligations, and terminate forbearances or restructurings, to achieve a higher purchase price or book a lower loss (or gain if sale price exceeds written down carrying value) on sales to the Government? Also, will there be a change in bankruptcy laws, allowing judges to reduce the principal of the mortgage to a home's current market value?

Obviously, the situation is very fluid and a host of new or related issues likely will be raised in connection with changes to the provisions of the Act as currently proposed.

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This memorandum was prepared by various members of the Firm (Paul Shalhoub, Thomas French, Marc Abrams, William Hiller, Eugene Pinover and Russell Smith), including members of the Government Rescue and Credit Crisis Task Force. The Task Force (which includes UK insolvency professionals from our strategic ally, Dickson Minto W.S., and attorneys from our European offices) was formed to respond to client questions and provide targeted advice in connection with the proposed Government bailout and the credit crisis (including the Lehman Brothers Holdings Inc. bankruptcy). If you have any questions about this memorandum, please contact any of the members of the WF&G Government Rescue and Credit Crisis Task Force listed below or the attorney with whom you regularly work.

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