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Who Will Bailout the Bailoutters?: An Overview of the Unique Legal Risks Facing Treasury's New Asset Managers and their Subcontractors

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Introduction

On October 3, 2008, Congress passed and President Bush signed into law the Emergency Economic Stabilization Act of 2008 (EESA).[1] Pursuant to the authority granted to it under the EESA, the Department of the Treasury (Treasury) is now in the early stages of implementing the sweeping Troubled Asset Relief Program (TARP).[2] This authority includes the power to enter into agreements with private sector financial institutions to serve as asset managers for the portfolio of troubled assets that Treasury will purchase under the EESA. As firms have begun to jockey in earnest for a piece of the action, whether it be directly from Treasury or through subcontracts or consulting agreements, those private sector institutions must be mindful of the unique, and for the most part uncharted, legal and attendant financial risks that are likely to lay ahead. The potential traps, and there are many, may prove painful for the unwary.

Treasury has two available legal devices for utilizing private-sector firms to implement TARP: (1) financial agent authority; and (2) procurement contracts awarded under the Federal Acquisition Regulation (FAR),[3] the regulatory regime that governs standard federal executive agency contracting. To date, Treasury has used its financial agent authority to retain Bank of New York Mellon to serve as its custodian for the implementation of TARP,[4] while utilizing FAR-based procedures in awarding a contract to EnnisKnupp and Associates to serve as Treasury's investment advisor.[5] Estimates suggest that five to ten firms will ultimately be selected by Treasury to handle the bulk of portfolio management services.[6] While the total number of asset managers in privity with Treasury will likely not exceed 10 firms, there are sure to be a significant number of subcontract agreements between Treasury's agents and contractors and those seeking to provide financial services in support thereof. In addition, Treasury has stated that it intends to issue a solicitation for small and small disadvantaged businesses, but the release date is presently unknown.

Although there are meaningful differences in legal status between financial firms serving as agents of the government and those that merely serve in the more traditional role of government contractor or subcontractor, regardless of the authority employed by Treasury private sector firms doing business for or on behalf of Treasury will face special legal and regulatory requirements. These requirements are different from, and more stringent than, the rules that apply to purely commercial transactions. These unique federal procurement rules and regulations, including rules against improper business gratuities, conflicts of interest, and false claims and statements to the government, present many potential pitfalls, risk of significant penalty, and, in some cases, criminal liability.

Many of the private sector firms that will assist in implementing TARP lack meaningful relevant prior experience doing business with or on behalf of the federal government, including as subcontractors. This lack of familiarity will substantially increase the probability that some of the private firms will face serious sanctions and penalties if they do not exercise reasonable care to learn, understand and comply with the unique requirements of federal contracting. While some of the financial firms may have experience providing services to the Resolution Trust Corporation (RTC), created in response to the Savings & Loan (S&L) crisis of the 1980s, the potential risks that will be encountered in the TARP implementation will be far greater and more complex. In this regard, under the RTC, private sector firms provided assistance with respect to selling the assets of institutions that had already failed. Here, the private sector will be involved in purchasing and managing the assets of organizations that are still operating, albeit often in a financially wounded state. Moreover, the value of many of those assets is uncertain, further increasing risk. Beyond these major distinctions between the RTC and TARP scenarios, the rules have changed in material respects since the S&L bailout. Relying solely on experience with the RTC may therefore by risky business.

Set forth below is a discussion of some of the areas that may present some of the more significant risks to asset managers and their employees and subcontractors, and steps that may help to avoid or at least mitigate any potential exposure.

Rules against Business Courtesies

Picking up the tab for an expensive meal or giving out tickets to a sporting event is arguably part of the fabric of doing business in the commercial world. However, in connection with government contracting, such gifts are off-limits and failure to abide by the applicable gift restrictions may yield stiff consequences. Federal law prohibits providing gratuities to government employees,[7] and includes many traps for the unwary. The rules are anything but intuitive and the distinctions between a legal business courtesy and an illegal gratuity are often subtle. For instance, providing coffee and donuts at a meeting is permissible, but spending more than $20 to pay for a government employee's lunch, even a working lunch, is not.[8]

Another trap for the unwary is the Anti-Kickback Act, which makes it illegal for a vendor or supplier to provide anything of value to a contractor or subcontractor in exchange for or because of favorable treatment.[9] A kickback may be anything from cash or gifts, to entertainment, to work on a home or vacation cabin, to employment of friends or relatives. Thus, it is illegal for firms seeking subcontracts to provide *anything of value* to one of the government's agents, contractors or subcontractors in an attempt to receive favorable treatment. Conversely, it is illegal for asset managers and their subcontractors to solicit or accept anything of value in return for favorable consideration in the award of subcontracts. Also significant, the Anti-Kickback Act imposes an affirmative obligation to report to the government when there are "reasonable grounds" to believe that a violation of the Act has occurred.

The sanctions associated with providing illegal gratuities or for violating the Anti-Kickback Act are severe, and include monetary penalties, criminal prosecution and debarment from federal government contracting. Thus, what is normally a routine part of doing business in the commercial world has the potential to land unwitting asset managers and their employees and subcontractors in serious legal or financial jeopardy.

Liability for False Claims and Statements to the Government

The Civil False Claims Act presents another serious risk area for the government's EESA agents and contractors, as well as their subcontractors. Asset managers will be expected to adopt adequate controls to ensure the accuracy of all invoices submitted to the government. This includes ensuring the accuracy of charges from any subcontractor that will be passed through to the government. In this regard, the False Claims Act establishes liability for, among other things, knowingly presenting or causing to be presented to the government a false claim for payment and making or using a false record or statement to get a false claim paid.[10]

There will be no shortage of opportunities for potential False Claims Act litigation. For instance, compensation under the contracts between asset managers and the government will, in most instances, be tied to labor hours. However, the concept of charging based on labor hours is generally foreign to the financial industry. Instead, asset managers and their subcontractors typically receive a flat fee in return for their services. Charging by the hour is generally outside of their comfort zone. Nonetheless, asset managers will be required to ensure that all employees accurately and appropriately record their time. Also, to avoid passing false claims through to the government, asset managers will be responsible for ensuring that the invoices of their subcontractors are accurate. Accurate recording of labor hours is an area that has plagued even the most experienced government contractors, and will no doubt trouble some of Treasury's asset managers as well.

Although the False Claims Act applies to those who directly present false invoices to the government, EESA subcontractors are by no means in the clear. For instance, take the scenario where a subcontractor presents an invoice with inflated labor hour charges to an EESA contractor, and the contractor in turn passes those charges through to the government. The government's (and whistleblowers') only recourse under the False Claims Act would be against Treasury's contractor. If found liable, however, that contractor would certainly sue the subcontractor for indemnification. Moreover, where the asset manager is acting as an agent of the government (as opposed to a traditional FAR-based contractor), a false claim submitted by a subcontractor to that agent could trigger direct liability for the subcontractor under the False Claims Act, because the subcontractor, through its agency relationship with the asset manager, has arguably submitted the claim directly to the United States. Thus, like Treasury's agents and contractors, EESA subcontractors must be diligent in ensuring the accuracy of their invoices.

Unfortunately for the asset managers and their subcontractors, a false claim may be based not only on actual knowledge, but also on deliberate indifference or reckless disregard.[11] The government need not prove any intent to defraud in order to collect under the False Claims Act, and must prove its case by only a preponderance of the evidence. Moreover, bounty provisions in the Act, referred to in legal parlance as qui tam provisions, provide strong financial incentives for whistleblowers. So, the asset managers and their subcontractors will in some sense be at the mercy of the government's cadre of "private attorneys general" who may seek to profit under the False Claims Act.

Beyond the submission of false claims, there are also likely to be opportunities for prosecution of asset managers, their employees and subcontractors for making false statements to the government.[12] These opportunities emerge out of the range of requirements for certifications, valuations and proposals that the asset managers will be required to submit to the government. For instance, the asset managers will be required to prepare and submit to the government reports on, among other things, loan and portfolio holdings, valuations, and characteristics, as well as loan and portfolio performance against the Treasury's benchmarks. False statements in those reports can result in severe sanctions.

Thus, the very need to communicate with the government, whether it is via the submission of an invoice, a report or a proposal statement regarding employee qualifications, can trigger exposure. However, asset managers and their subcontractors with limited experience doing work for the government are not likely to have in place the proper controls to ensure the accuracy of all invoices submitted and statements made to the government. The consequences of failing to do so could be dramatic.

Identifying and Disclosing Conflicts of Interest

Federal law places restrictions on the authority of federal government agencies to enter into contractual relationships with contractors possessing actual or potential conflicts of interest (COIs). There is a substantial risk that many of the financial institutions selected as asset managers, as well as their employees, subcontractors and consultants, may be plagued by actual or potential COIs. The presence of a COI could lead to the loss of work from Treasury, and even worse if the asset managers or their subcontractors fail to exercise due care in identifying potential COIs or altogether neglect to disclose a COI of which they knew or should have been known.

In fact, Treasury issued interim guidance expressly recognizing the risk of COIs among contractors performing services in conjunction with EESA.[13] Those COI concerns are multifold.

There is a risk that asset managers, including their employees and subcontractors, could have "impaired objectivity" COIs.[14] As stated by Treasury, "[u]nder such COIs, the contractor's judgment or objectivity may be impaired due to the fact that the substance of the contractor's performance has the potential to affect other interests of the contractor."[15] For instance, asset managers and their subcontractors will be conducting pre-transaction diligence and valuing loans and portfolios in which the institutions or their employees and relatives could have a financial stake. This could also give rise to actual or potential personal COIs involving individual employees of the asset managers and their subcontractors. Treasury also notes the potential for COI's that may arise if the asset managers and their subcontractors and consultants "obtain access to sensitive, non-public information (belonging to Treasury or to third parties) while performing the contract."[16]

There is no shortage of potential and actual COIs that will arise as Treasury goes forward implementing TARP. While Treasury bears the ultimate responsibility for avoiding COIs or, at a minimum and where possible, taking steps to mitigate or neutralize the COIs, it has placed the burden on asset managers to identify and disclose any actual or potential COIs. This applies to COIs of subcontractors, consultants and affiliates.

This disclosure obligation raises the stakes. The failure to exercise reasonable care to identify potential or actual COIs, or, even worse, the failure to disclose a known actual or potential COI, could result in liabilities for the asset manager and its employees and subcontractors. These liabilities could include loss of the government contract or subcontract, fraud liability or prosecution under the False Statements Act. Compounding the risk, COI identification will be muddied by the complexity and unknown content of the debt and securities packaging. It may, in many situations, be extremely difficult for the asset managers and their subcontractors to identify actual or potential COIs until the problem is upon them.

Asset Managers and Subcontractors Can Avoid or at Least Minimize Exposure

Of course, it is virtually impossible for any institution to ensure that all of its employees and the employees of its subcontractors and consultants comply with the letter and spirit of the law. There will always be people who run afoul of the rules regardless of the preventative measures a company undertakes. And ultimately, the financial institution will be liable for the acts of its employees and subcontractor employees. Nonetheless, asset managers and their subcontractors can significantly mitigate the risk of exposure by promptly adopting an adequate compliance program. The federal government will expect no less.

Although many of the entities seeking to get a piece of work under TARP will have certain existing internal controls, it will be necessary for those institutions to adopt policies, procedures and internal controls that address the unique rules that apply in the context of federal government procurements. For example, while an entity may have an existing policy regarding gift giving, it must tailor that policy to the specific rules applicable to gratuities to government officials and government contractors and subcontractors. Moreover, although many of the institutions may have financial controls in place, they likely do not have adequate controls to ensure that they accurately record and charge labor hours.

There are substantial potential benefits to focusing on implementing a government contracts-type compliance program. For instance, the presence or absence of a compliance program is one element that the Department of Justice considers under its criminal prosecution guidelines.[17] An institution that has a meaningful compliance program can sometimes avoid prosecution, or, at a minimum, reduce the amount of fines imposed. Similarly, the existence of a compliance program has been a factor the government has cited in declining to intervene in False Claims Act cases brought by whistleblowers.[18]

So what exactly does the government expect to see in a compliance program of its contractors and subcontractors? At a minimum, the government expects an institution to have (1) responsible high-level personnel overseeing the compliance program; (2) written policies, including a code of conduct specific to the unique federal procurement rules and restrictions; (3) a reporting mechanism such as a hotline; and (4) periodic and effective employee training. The asset managers must not only establish their own compliance programs, but they must also ensure that their subcontractors and consultants have done the same. Only then can the institutions truly mitigate their exposure.

Conclusion

TARP presents unique opportunities for the private financial sector to provide services to, for, or on behalf of the U.S. government. However, those business opportunities also carry the potential for significant legal and financial exposure given the private financial sector's general inexperience with the unique rules governing contracting with the government. Given the risks, implementation of an adequate compliance program can be relatively painless, while the consequences of not doing so can be anything but.

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[1] Emergency Economic Stabilization Act, Pub. L. No. 110-343 (2008).
[2] Department of the Treasury Press Release No. HP-1199 (Oct. 13, 2008).
[3] U.S. Department of the Treasury, Emergency Economic Stabilization Act, http://www.treas.gov/initiatives/eesa/authorities.shtml (last visited Oct. 18, 2008).
[4] Department of the Treasury Press Release No. HP-1211 (Oct. 14, 2008).
[5] Department of the Treasury Press Release No. HP-1201 (Oct. 13, 2008).
[6] Mark Lander & Edmund L. Andrews, *For Treasury Dept., Now Comes Hard Part of Bailout*, N.Y. TIMES, Oct. 3, 2008, at A1.
[7] *See* 18 U.S.C. § 201; 48 C.F.R. §§ 3.101-2, 52.203-3.
[8] 41 U.S.C. § 51 *et seq*.
[9] *Id*.
[10] 31 U.S.C. §§ 3729-3733.
[11] *Id*.
[12] 18 U.S.C. § 1001.
[13] U.S. Department of the Treasury, Interim Guidelines for Conflicts of Interest, http://www.treas.gov/initiatives/eesa/conflict.shtml (last visited Oct. 18, 2008).
[14] *Id*.
[15] *Id*.
[16] *Id*.
[17] *See Principles of Federal Prosecution of Business Organizations,* U.S. Department of Justice, Executive Office for U.S. Attorneys' Manual, Title 9, Chapter 28 (Aug. 28, 2008).
[18] 31 U.S.C. § 3730(c)(3).