



Regulated Financial Institutions Alert

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Treasury announces TARP Capital Purchase Program and provides initial additional guidance

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The U.S. Treasury Department announced on Tuesday, October 14, 2008, its voluntary TARP Capital Purchase Program (CPP) and also circulated initial guidance on the CPP. The stated purpose of the CPP is to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers, and support the U.S. economy.

The CPP provides for qualified financial institutions (QFIs) to sell senior preferred stock (Senior Preferred) to Treasury with a liquidation preference of \$1,000 per share. The amount of Senior Preferred a QFI can issue under the CPP would be equal to not less than 1 percent of its risk-weighted assets and not more than the lesser of (i) \$25 billion and (ii) 3 percent of its risk-weighted assets. Senior Preferred, within the above limitations, will qualify as Tier 1 capital, without further limitation. The availability of capital under the CPP will provide many institutions with a more favorable alternative (and, in some cases, the only alternative) to seeking capital through the more usual channels relied upon in the past.

Treasury also will receive 10-year, immediately exercisable warrants for common stock having an aggregate market price equal to 15 percent of the Senior Preferred issuance amount, subject to reduction under certain circumstances. The price for the warrants, and the price for determining the number of shares of common stock subject to the warrants, will be the market price for the common stock on the date of the Senior Preferred investment, calculated on a 20-trading-day trailing average. If the QFI lacks sufficient authorized common shares to reserve for issuance on exercise of the warrants and/or stockholder approval is required for the issuance under applicable stock exchange rules, the QFI will be required to seek stockholder approval as soon as practicable after issuance of the Senior Preferred, to increase the number of authorized shares of common stock and/or comply with the exchange rules. But, if the necessary stockholder approval has not been obtained, the warrant exercise price will be reduced by 15 percent of the original exercise price on each six-month anniversary of the warrant issue date, up to a maximum reduction of 45 percent of the original warrant exercise price.

For five years after issuance, Senior Preferred issued by bank holding companies or their bank subsidiaries will pay 5 percent annual cumulative dividends and, after five years at a rate of 9 percent. Senior Preferred issued by non-bank holding company banks will pay dividends at the same rates, but

on a non-cumulative basis.

While a bank has any Senior Preferred outstanding, it cannot declare or pay any dividends on, purchase, or redeem any junior preferred, preferred ranking equally with the Senior Preferred, or common shares (other than dividends on a pro rata basis with the Senior Preferred on preferred with an equal ranking), unless, (i) in the case of cumulative Senior Preferred, all accrued and unpaid dividends for all past dividend periods on the Senior Preferred are fully paid or (ii) in the case of non-cumulative Senior Preferred, the full dividend for the latest completed dividend period has been declared and paid in full. In addition, Treasury consent will be required for any increase in dividends on common stock for three years after issuance of the Senior Preferred, unless the Senior Preferred has been redeemed in full or transferred by Treasury to a third party.

Similarly, during the first three years after issuance, Treasury's consent will be required for any share repurchases (other than (i) repurchases of the Senior Preferred and (ii) repurchases of junior preferred shares or common shares in connection with any benefit plan in the ordinary course of business consistent with past practice), unless the Senior Preferred has been redeemed in full or transferred by Treasury to a third party. Share repurchases of junior preferred, preferred shares ranking equally with the Senior Preferred, or common shares will be subject to the same limitations on payment of dividends on those classes of stock.

During the first three years after issuance, the Senior Preferred will be redeemable; however, redemption may only be made out of the proceeds from the sale by the QFI for cash of Tier 1 qualifying perpetual preferred stock or common stock (a Qualified Equity Offering) with aggregate gross proceeds of at least 25 percent of the issue price of the Senior Preferred. After the first three years, the Senior Preferred will be redeemable at any time, in whole or in part. All redemptions will be subject to the approval of the QFI's primary federal bank regulator and must be at the full issue price, plus, (i) for cumulative Senior Preferred, any accrued and unpaid dividends and, (ii) for noncumulative Senior Preferred, accrued and unpaid dividends for the then-current dividend period, whether or not declared. After redemption in whole of the Senior Preferred held by Treasury, the QFI will have the right to repurchase, at fair market value, any other equity security of the QFI held by Treasury.

The Senior Preferred generally will be non-voting, but will have class voting rights on (i) any authorization or issuance of shares ranking senior to the Senior Preferred; (ii) any amendment to the rights of Senior Preferred; or (iii) any merger, exchange, or similar transaction that would adversely affect the rights of the Senior Preferred. However, if dividends on the Senior Preferred are not paid in full for six dividend periods, whether or not consecutive, the Senior Preferred will have the right to elect two directors. The director election right will sunset when full dividends have been paid for four consecutive dividend periods.

The Senior Preferred will not be subject to any contractual restrictions on transfer and an issuing QFI will be required to file a shelf registration statement covering the Senior Preferred as promptly as practicable after the issuance. The QFI will also grant piggyback registration rights to Treasury for the Senior Preferred. Similarly, the related warrants will not be subject to any contractual restrictions on transfer. However, Treasury may only transfer or exercise an aggregate of one-half of the warrants before the earlier of (i) December 31, 2009; and (ii) the date on which the QFI has received proceeds of at least 100 percent of the issue price of the Senior Preferred from one or more Qualified Equity Offerings. The QFI also be required to file a shelf registration statement covering the warrants and the common stock underlying the warrants as promptly as practicable after issuance of the related

Senior Preferred, and will be required to grant piggyback registration rights to Treasury for the warrants and the common stock underlying the warrants.

Participation in the CPP will carry with it significant limitations on executive compensation. A QFI that sells Senior Preferred must:

- Certify that the incentive compensation and employment contracts of its top five senior executives do not encourage or reward unnecessary and excessive risk-taking that threatens the value of the financial institution;
- Recover or clawback any bonus or incentive compensation paid to its top five senior executives based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate;
- Not make any golden parachute payments to its top five senior executives; and
- Agree not to deduct, for tax purposes, executive compensation in excess of \$500,000 for each of its top five senior executives.

These restrictions parallel the restrictions applicable to financial institutions from which Treasury acquires troubled assets through the TARP auction purchase process. For a more detailed discussion of those restrictions, please see our [Benefits Alert](#). Note, however, that the executive compensation restrictions are applicable to banks participating in the CPP at any level, without any minimum threshold.

Other corporate governance requirements may be imposed on institutions choosing to participate in the CPP; however, to date, none have been publicly announced.

Who is qualified to participate in the CPP? The universe of institutions in which Treasury *may* invest is very large. Generally speaking, the program is available to (a) any U.S. bank or savings association and (b) any U.S. bank holding company or savings and loan holding company that is engaged only in activities that are financial in nature.

Treasury will decide in which banks it *will* invest after consulting the appropriate federal banking agency for a given bank, savings association, or holding company. Thus, the fact that an institution is in the pool of eligible institutions does not guarantee that Treasury will invest in that institution.

The deadline for deciding whether to participate in the CPP is 5:00 p.m. on November 14, 2008.

Any institution that wants to participate in the CPP should immediately notify its primary federal regulator, which then will consult with Treasury on whether Treasury believes the institution is a good candidate for an injection of capital. Treasury will fund the purchases by the end of this calendar year. We have been advised informally that applications for participation in the CPP will be posted on the websites of each federal bank regulatory agency within the next several days.

Mutual institutions that operate under a mutual holding company structure are eligible to participate in the program; however, at this point, mutual institutions that have not converted to a mutual holding company structure are not eligible. Until the Treasury program is modified to include other solutions for mutual institutions, they will have the option to issue senior unsecured debt, which will

have a 100-percent guarantee from the FDIC. As a complementary program to the TARP Capital Purchase Program, the FDIC has established the Temporary Liquidity Guarantee Program, under which a guarantee is provided at a cost of 75 basis points annually.

Less clear is the eligibility of S Corporation banks that would like to participate. Although Treasury has informally advised that S Corporations will be eligible, under current law, an S Corporation is allowed to issue only one class of stock, which would appear to preclude the issuance of TARP Senior Preferred. Until Treasury clarifies whether the TARP Senior Preferred would constitute a different class of stock from common stock, this issue will remain unresolved. We are continuing to monitor this issue closely.

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