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Treasury Announces Terms of TARP Capital Purchase Program for Non-Public Financial Institutions Other Than S Corporations and Mutual Depository Institutions

On November 17, 2008, the United States Treasury Department (Treasury) announced the general terms by which non-public qualifying financial institutions (non-public QFIs), other than S corporations and mutual depository institutions, may participate in the Capital Purchase Program (CPP). **The application deadline for non-public QFIs is December 8, 2008**. Treasury is still considering the CPP participation terms for S corporations and mutual depository institutions, and they are *not* subject to the December 8, 2008 deadline. The application form and the governing documents for non-public QFIs have not been published by Treasury as of the date of this newsletter.

As with the CPP program for public QFIs, Treasury's investment in non-public QFIs is made through the purchase of preferred stock (Preferred Shares), which will be accompanied by a warrant to purchase additional securities. However, there are several important differences between the two programs. Most noteworthy, rather than a warrant to purchase common shares, a non-public QFI will grant Treasury a warrant to purchase additional preferred shares at an exercise price of $0.01 per share (or such higher par value per share required by charter).

The general terms of the CPP program for non-public QFIs are as follows:

- The Preferred Shares will count as Tier 1 capital and will pay a cumulative dividend of 5% for the first 5 years, and 9% thereafter.
- The minimum Treasury purchase is 1% of risk-weighted assets, and the maximum purchase is 3% of risk-weighted assets or $25 billion, whichever is less.
- Treasury will receive a warrant to purchase preferred stock (Warrant Preferred) in an amount equal to 5% of the Preferred Share investment.
- The warrant is immediately exercisable at $0.01 per share (or such higher par value per share required by the QFI's charter) and Treasury intends to exercise the warrant immediately.
- The Warrant Preferred will pay a cumulative dividend of 9%, and may not be redeemed until all of the Preferred Shares have been redeemed.
- Participating institutions will be subject to restrictions on dividend payments, share repurchases (for 10 years) and executive compensation.

Example. A non-public QFI with $500 million of risk-weighted assets issues $15 million of Preferred Shares (*i.e.*, 3% of risk-weighted assets) to Treasury (15,000 shares with a liquidation preference of $1,000 per share). The non-public QFI is required to grant Treasury a warrant to purchase an additional 750 Warrant Preferred shares, with a liquidation preference of $1,000 per share (a total of $750,000 of Warrant Preferred shares, or 5% of the face value of the Preferred Shares). Treasury intends to immediately exercise the warrant, and would pay, in the aggregate, $7.50 for the Warrant Preferred, which pays a 9% dividend per year.

Eligibility. Eligible institutions include all QFIs, other than S corporations and mutual depository institutions, that are not "publicly traded." A company is publicly traded if its securities are traded on a national securities exchange <u>and</u> it is required to file periodic reports such as the annual (Form 10-K) and quarterly (Form 10-Q) reports with either the Securities and Exchange Commission or its primary federal bank regulator. QFIs with securities listed on the bulletin board or pink sheets <u>are not "publicly traded</u>." The definition of a "mutual depository institution" includes bank holding companies and savings and loan holding companies organized in mutual form. Currently, Treasury considers each mutual holding company, whether publicly traded or private, as a "mutual depository institution."

Any bank or thrift holding company that receives funding under the CPP must maintain its status as a bank or thrift holding company for as long as Treasury holds preferred stock and/or warrants in the company. A bank or thrift holding company seeking to terminate its status as such must fully redeem all preferred stock and warrants held by Treasury prior to terminating its status.

<u>Terms and Conditions of Preferred Shares and Warrant Preferred.</u> The Preferred Shares qualify as Tier 1 capital and will rank senior to common stock and equally with existing preferred shares, other than preferred shares which by their terms rank junior to any other existing preferred shares. The Preferred Shares pay an annual dividend of 5% for the first five years and thereafter a 9% annual dividend. Dividends will be cumulative, except that dividends paid by non-public QFIs that are not subsidiaries of holding companies will be non-cumulative. Dividends are payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year. The Preferred Shares are non-voting, except on matters that could adversely affect the Preferred Shares.

The Preferred Shares are callable at original issue price after three years. Prior to the end of three years, the Preferred Shares may be redeemed only with the proceeds of a qualifying equity offering of Tier 1 perpetual preferred or common stock (excluding any offering pursuant to arrangements entered into, or financing plans publicly announced, before November 17, 2008), which offering results in gross proceeds of not less than 25% of the issue price of the Preferred Shares.

Treasury may transfer the Preferred Shares at any time; *provided however*, Treasury and its transferees shall not effect any transfer of Preferred Shares which would cause the non-public QFI to become subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (Exchange Act).

As part of the purchase of Preferred Shares, Treasury will receive an immediately exercisable warrant to purchase additional shares of preferred stock of the non-public QFI (Warrant Preferred) having a liquidation preference equal to 5% of the purchase price of the Preferred Shares. The initial exercise price will be $0.01 per share, unless the non-public QFI's charter requires a higher par value. Treasury intends to exercise the warrant immediately.

The Warrant Preferred will have the same rights, preferences, privileges, voting rights, transfer rights and other terms as the Preferred Shares, except that the Warrant Preferred will pay dividends at a rate of 9% per annum, and the Warrant Preferred may not be redeemed until all the Preferred Shares have been redeemed.

Although Treasury has stated that it intends to exercise the warrant immediately, Treasury may transfer the warrant at any time. However, Treasury may not effect any transfer of the warrant or the underlying Warrant Preferred that would cause the non-public QFI to become subject to the periodic reporting requirements of the Exchange Act.

If the non-public QFI becomes subject to the reporting requirements of the Exchange Act, it must file a shelf registration statement covering the warrant and the Preferred Shares underlying the warrant.

<u>Restrictions on Executive Compensation.</u> As a condition to Treasury's investment in Preferred Shares and for as long as any equity securities are held by Treasury, a non-public QFI *must modify or terminate all benefit plans, arrangements and agreements to ensure compliance* with the executive compensation and corporate governance standards of Section 111 of EESA. These standards will apply to senior executive officers (SEOs) (defined to include the chief executive officer, chief financial officer and the other three highly compensated executive officers) and will:

- require limits ensuring that incentive compensation for SEOs does not encourage unnecessary and excessive risks that threaten the value of the financial institution. The non-public QFI's compensation committee will be required to review such arrangements and certify that this standard has been met;
- require recovery or "claw back" of any bonus or incentive compensation paid to an SEO based on financial statements or measures that are materially inaccurate;

- prohibit "golden parachute" payments to SEOs (which are benefits related to a severance from employment by reason of an involuntary termination of employment, whether or not involving a change in control, or due to a bankruptcy, insolvency or receivership, the present value of which equals or exceed 3x the 280G "base amount"); and
- limit the tax deductibility of compensation to any SEO in excess of $500,000.

As a further condition to closing an investment in Preferred Shares, SEOs must grant Treasury a waiver releasing it from any claim relating to compensation that may be affected by regulations adopted by the Treasury from time to time. Treasury has issued interim final rules for these executive compensation restrictions.

Restrictions on Related Party Transactions. For as long as Treasury holds any equity securities of the non-public QFI, the QFI and its subsidiaries may not enter into transactions with related persons (within the meaning of Section 404 of SEC Regulation S-K) unless (i) the transaction is on terms no less favorable to the QFI than could be obtained from an unaffiliated third party, and (ii) has been approved by the audit committee or comparable body of independent directors. A transaction with a related party under SEC Regulation 404 is any transaction in which the QFI is a participant and the amount involved exceeds $120,000, and in which a director, executive officer, greater than 5% shareholder or their immediate family members have a direct or indirect material interest.

Dividend and Share Repurchase Restrictions. Treasury's consent is required for any increase in common stock dividends until the third anniversary of the investment, unless all Preferred Shares and Warrant Preferred have been redeemed or transferred to a third party. After the third anniversary and prior to the tenth anniversary, Treasury's consent will be required for any increase in aggregate common dividends per share greater than 3% per annum; provided that no increase in common dividends may be made as a result of any dividend paid in common shares, any stock split or similar transaction. These restrictions will not apply if all of the equity securities held by Treasury have been redeemed or transferred to third parties.

Treasury's consent also will be required for any repurchases of equity securities or trust preferred securities (other than repurchases of the Preferred Shares and repurchases of junior preferred shares or common shares in connection with benefit plans) until the tenth anniversary of the investment, unless all of the equity securities held by Treasury have been redeemed or transferred to third parties.

From and after the tenth anniversary of the investment, the non-public QFI will be prohibited from paying common dividends or repurchasing any equity securities or trust preferred securities until all equity securities held by Treasury have been redeemed or transferred to third parties.

Application Process. Applicants should complete the application and follow the procedures that are available on the applicable federal banking agency website or on the following Treasury website at http://www.treasury.gov/initiatives/eesa/application-documents.shtml. Applicants that wish to receive confidential treatment of their application must follow the procedures provided by Treasury in the application guidelines. If you have any questions with applications, please contact any of the persons listed at the end of this newsletter.

Special Rules for Participation by Community Development Financial Institutions. Treasury may, in its discretion, purchase up to $50 million in Preferred Shares from non-public QFIs that are Community Development Financial Institutions (CDFI) without requiring that such non-public QFIs issue Warrant Preferred shares. CDFIs are specialized financial institutions that work in market niches that are underserved by traditional financial institutions. Non-public QFIs wishing to participate in the CPP as a CDFI must file an application for certification as a CDFI by December 8, 2008. Additional information about becoming a CDFI also can be found at http://www.cdfifund.gov/.

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For further details regarding the above-described programs, please contact any of the persons listed below.

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