

Client Advisory

Privately Held Financial Institutions Offered TARP Capital Purchase Program Funds

On November 17, the U.S. Treasury Department (UST) published guidelines for privately held financial institutions to receive TARP funds under the Capital Purchase Program (CPP), previously only available to publicly traded financial institutions.¹ The program does not yet cover privately held S corporations or mutual organizations because they are, by definition, not privately held. Both types of organizations may be included in the program in the future, according to the UST. Applications under the expanded CPP program must be filed by December 8, 2008, by any Qualifying Financial Institution (QFI), which is defined to mean any:

- (i) top-tier Bank Holding Company (BHC) or top-tier Savings and Loan Holding Company (SLHC) that engages solely or predominately in activities permissible for financial holding companies under relevant law, that in either case is not publicly traded;²
- (ii) U.S. bank or U.S. savings association organized in a stock form that is neither publicly traded nor controlled by a BHC or an SLHC; or
- (iii) U.S. bank or U.S. savings association that is not publicly traded and is controlled by a SLHC that is not publicly traded and does not engage solely or predominately in activities that are permitted for financial holding companies under relevant law.³

It should be noted that in order to qualify, an applicant company that does not yet own a bank or savings association must acquire an institution that was in existence on or prior to December 8, 2008, and final approval of the acquisition must be received by January 15, 2009.

Program Terms

Many of the terms of the CPP for privately held financial institutions (Private CPP) are very similar, if not identical, to those for the CPP for publicly traded financial institutions (Public CPP). For example, under both programs:

- Each QFI may issue and sell to the UST preferred shares (Preferred) in an amount equal to not less than 1% of its risk-weighted assets and not more than the lesser of (i) \$25 billion and (ii) 3% of its risk-weighted assets.
- The Preferred will have a cumulative dividend rate of 5% for five years, and a rate of 9% thereafter. Dividends on Preferred issued by banks which are not subsidiaries of holding companies will be payable at the same rates but will be non-cumulative. Dividends will be payable quarterly in arrears on February 15, May 15, August 15 and December 15 of each year.

¹ The guidelines, available on the UST's website at <http://www.treasury.gov/press/releases/hp1277.htm>, include a term sheet and answers to a set of frequently asked questions.

² "Publicly traded" means a company (i) whose securities are traded on a national securities exchange and (ii) that is required to file, under the federal securities laws, 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.

³ Since (by definition) only BHCs may control a bank, there appears to be some confusion as to the UST's intent regarding this particular sub-section; we have made inquiry of the UST in this regard.

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- The Preferred will have a perpetual life, will be entitled to Tier 1 regulatory capital status, and will rank senior to common stock and *pari passu* with existing preferred shares, other than preferred shares which by their terms rank junior to existing preferred shares.
- The Preferred will be non-voting (except for extraordinary matters such as mergers) and are callable after three years.
- If dividends are not paid on the Preferred in full for six dividend periods, whether or not consecutive, the Preferred will have the right to elect two directors; this right will end when full dividends have been paid for (i) all prior dividends in the case of the cumulative Preferred or (ii) four consecutive dividend periods for non-cumulative Preferred.
- The Preferred are generally not redeemable for three years. Issuing QFIs, however, may redeem the shares prior to the end of three years with the proceeds from an offering of any Tier 1 perpetual preferred or common stock for cash which results in aggregate gross proceeds to the institution of not less than 25% of the issue price of the Preferred (however, such an offering must not have been entered into or announced prior to November 17, 2008).

Certain of the terms of the Private CPP differ from those of the Public CPP. For example:

- Under both programs, the UST may transfer its interest in the Preferred; provided that for the Private CPP, the UST may not effect a transfer that would require the QFI to become subject to the periodic reporting requirements of Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the Exchange Act).
- Under the Private CPP only, for so long as the UST holds any equity securities of the QFI, neither the QFI nor any of its subsidiaries may enter into transactions with related persons (within the meaning of Item 404 of Regulation S-K) unless such transactions (i) are on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated party, and (ii) have been approved by the audit committee or comparable body of independent directors of the QFI.
- Under both programs, the UST's consent is required for any increase in common dividends per share until the third anniversary of the date of the investment; however, under the Private CPP, (i) after the third anniversary and before the tenth anniversary, the UST's consent also is required for any increase in aggregate common dividends per share greater than 3% per annum, and (ii) no increase in common dividends may be made as a result of any dividend paid in common shares, any stock split or similar transaction.
- Under the Public CPP, the UST's consent generally is needed for any share repurchases until the third anniversary of the date of investment. Under the Private CPP, however, the UST's consent generally is required for any repurchases of equity securities or trust preferred securities until the tenth anniversary of the date of investment.
- Under the Private CPP only, from and after the tenth anniversary of the date of investment, the QFI may not pay common dividends or repurchase any equity securities or trust preferred securities until all equity securities held by the UST are redeemed in whole or the UST has transferred all of such equity securities to third parties.

Different Warrant Terms for Private CPP Versus Public CPP

Under the Public CPP, the UST is entitled to receive warrants to purchase common stock of the QFI that have an aggregate market price equal to 15% of the Preferred amount on the date of investment, subject to reductions in certain cases. For the Private CPP, however, the UST is entitled to purchase, upon net settlement, a number of net shares of preferred stock of the QFI (Warrant Preferred), having an aggregate liquidation preference equal to 5% of the Preferred amount on the date of investment. The initial exercise price for the Warrant Preferred will be \$0.01 per share or such greater amount as the charter of the QFI may require as the par value per share of the Warrant Preferred. Also, the UST intends to immediately exercise the Warrant Preferred.

The Warrant Preferred, like the warrants on the common stock for the Public CPP, will have a term of 10 years. However, for the Private CPP, the Warrant Preferred will have the same rights, preferences, privileges, voting rights and other terms as the Preferred, except that the Warrant Preferred (i) will pay dividends at a rate of 9% per annum and (ii) may not be redeemed until all the Preferred has been redeemed. Like the warrants for the common stock under the Public CPP, the UST may transfer its interest in the Warrant Preferred, provided that no transfer may be made that would require the QFI to become subject to the periodic reporting requirements of Section 13 or Section 15(d) of the Exchange Act.

It should also be noted that the UST will not require Warrant Preferred to be issued if the size of the investment is \$50 million or less and the QFI is, or has filed an application to become, a Community Development Financial Institution, by December 8, 2008.

Executive Compensation

The executive compensation provisions for the CPP for privately held financial institutions are identical to those for the CPP for publicly traded financial institutions. For the period during which the UST holds equity issued under both programs, QFIs must adopt the standards for executive compensation and corporate governance that were set forth in the Emergency Economic Stabilization Act of 2008 (EESA). In addition, the UST is expected to issue guidance on those standards and has the authority to require additional executive compensation and corporate governance standards to be implemented by QFIs.

The standards specified under EESA apply to the QFI's "senior executive officers" (i.e., the chief executive officer, chief financial officer and the next three most highly compensated executive officers) and generally include: (i) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (ii) requiring repayment or "clawback" provisions for any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (iii) prohibiting the QFI from making any "golden parachute" payment to a senior executive officer; and (iv) disallowing tax deductions for compensation paid to each senior executive officer in excess of \$500,000 per year. These requirements may require modification or waivers of existing contracts and severance arrangements.

Katten's TARP Task Force

Katten Muchin Rosenman LLP's multidisciplinary TARP Task Force advises clients on the UST's Troubled Asset Relief Program created under the Emergency Economic Stabilization Act of 2008. Katten's TARP Task Force can advise clients on participating in the TARP Capital Purchase Program, issuing the necessary Preferred Shares and Warrants, determining how the executive compensation rules apply to them, and structuring their compensation arrangements appropriately.

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