Katten
Katten Muchin Rosenman LLP

Client Advisory

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TARP Capital Purchase Program Expanded to Include Mutual Holding Companies

On April 7, the U.S. Treasury Department (UST) published guidelines for insurance companies and other companies that are structured as bank or savings and loan holding companies in mutual organization[1] or their stock holding company subsidiaries to receive TARP funds under the Capital Purchase Program (CPP).[2] Initially, participation in the CPP was available only to publicly traded and privately held financial institutions (including those that were organized as S corporations).

The UST published its guidelines in the form of three separate term sheets that describe how (i) publicly traded subsidiary holding companies may participate in the CPP by issuing preferred stock, (ii) privately held subsidiary holding companies may participate by issuing preferred stock and (iii) top-tier mutual holding companies that do not have subsidiary holding companies may participate by issuing debt. The UST will determine eligibility and allocations for each mutual holding company that constitutes a "Qualifying Financial Institution" (QFI) after consultation with such institution's federal banking regulator. As discussed below, a QFI is defined differently depending upon the form of the mutual holding company. The deadline for mutual holding companies to submit CPP applications is May 7, 2009.

Publicly Traded Subsidiary Holding Companies

With respect to any publicly traded subsidiary holding company of a mutual holding company (Public MHC Subsidiary), the term "QFI" means any bank holding company or savings and loan holding company that:

(i) engages solely or predominantly in activities permissible for financial holding companies under relevant law;

(ii) is publicly traded;[3]

(iii) is directly owned and controlled by a bank holding company or savings and loan holding company that is organized in mutual form; and

(iv) is not controlled by a foreign bank or company.

1 A mutual company is a company whose ownership and profits are distributed among members in proportion to the amount of business that such members do with the company. Many insurance companies are organized in mutual form; other examples of mutual companies include certain state-chartered mutual savings banks and federal savings and loan associations.

2 The guidelines with respect to participation in the CPP are available on the UST's website at http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html.

3 "Publicly traded" means a company (1) whose securities are traded on a national securities exchange and (2) which is required to file periodic reports with the SEC or its primary federal bank regulator.

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Terms of Senior Preferred

Each Public MHC Subsidiary will participate in the CPP by selling senior preferred securities (Senior Preferred) to the UST. The following are the main terms for the Senior Preferred:

- Each Public MHC Subsidiary that is a QFI may issue an amount of Senior Preferred 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 Senior Preferred will pay cumulative dividends at a rate of 5% per annum, which rate will increase to 9% per annum after the fifth anniversary of the date of the investment. Dividends will be payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year.
- The Senior Preferred will be entitled to Tier 1 regulatory capital status and will be senior to common stock and pari passu with existing preferred shares other than those which by their terms rank junior to existing preferred shares.
- The Senior Preferred will be non-voting (except for class voting rights on authorizing or issuing shares ranking senior to the Senior Preferred, amendments to the rights of Senior Preferred, or significant matters such as mergers that would adversely affect the rights of the Senior Preferred). However, if dividends on the Senior Preferred are not paid in full for six quarterly dividend periods, whether or not consecutive, the Senior Preferred will have the right to elect two directors. This right will end when full dividends have been paid for four consecutive dividend periods.
- The Senior Preferred will not be subject to any contractual restrictions on transfer.

Restrictions on Redemptions, Dividends and Repurchases

Redemptions. For Public MHC Subsidiaries that are QFIs, all redemptions of the Senior Preferred will be at 100% of the issue price, plus any accrued and unpaid dividends, and will require the approval of the QFI's primary federal bank regulator. Following the redemption in whole of the Senior Preferred held by the UST, the QFI may repurchase any other equity security of the QFI held by the UST at fair market value.

Dividends on Junior Securities. For as long as any Senior Preferred is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking pari passu with the Senior Preferred,[4] or common shares, nor may the QFI repurchase or redeem any such shares, unless all accrued and unpaid dividends for all past dividend periods on the Senior Preferred are fully paid. Also, for so long as any Senior Preferred or common stock of the QFI issued under the CPP is outstanding and owned by the UST, dividends declared and paid on the common stock may not exceed $0.01 per share per quarter without the UST's consent.

Repurchases. The UST must consent before 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) until the third anniversary of the date of the UST's investment unless, prior to that time, the Senior Preferred is redeemed in whole or the UST has transferred all of the Senior Preferred to third parties. In addition, there shall be no share repurchases if prohibited as described in the preceding paragraph.

Warrant Terms

Each Public MHC Subsidiary that is a QFI will be required to grant to the UST warrants (Warrants) to purchase a number of shares of the QFI's common stock having an aggregate market price equal to 15% of the Senior Preferred amount on the date of investment. However, in the event that the QFI has received aggregate gross proceeds of not less than 100% of the issue price of the Senior Preferred from one or more qualified equity offerings on or prior to December 31, 2009, the number of shares of common stock underlying the Warrants then held by the UST will be reduced by half of the number of shares originally underlying the Warrants (taking into account all adjustments).

The initial exercise price for the Warrants, and the market price for determining the number of shares of common stock subject to the Warrants, will be the market price for the QFI's common stock on the date of the UST's Senior Preferred investment, calculated on a 20-trading day trailing average and subject to customary anti-dilution adjustments, and to three successive penalty reductions, each equal to 15% of the initial exercise price, on the six-, 12- and 18-month anniversaries of the issue date, if any needed stockholder approval to authorize QFI common shares underlying the Senior Preferred or the Warrants (described below) has not been obtained by those anniversaries.

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4 But pari passu preferred shares may receive dividends pro rata with the Senior Preferred.

The Warrants will have a term of 10 years and the UST will not exercise voting power with respect to any shares of common stock of the QFI issued to it upon exercise of the Warrants.

The Warrants will not be subject to any contractual restrictions on transfer, although the UST may only transfer or exercise an aggregate of one-half of the warrants prior to the earlier of (i) the date on which the QFI has received aggregate gross proceeds of not less than 100% of the issue price of the Senior Preferred from one or more qualified equity offerings and (ii) December 31, 2009.

If the QFI's common stock is no longer listed or traded on a national securities exchange, or any required approval of the QFI stockholders has not been received within 18 months after the issuance date of the Warrants, the Warrants will be exchangeable, at the UST's option, for senior term debt or another economic instrument of the QFI.

If the QFI does not have sufficient authorized shares of common stock to reserve for issuance upon exercise of the Warrants and/or stockholder approval is required for such issuance under applicable stock exchange rules, the QFI will call a meeting of its stockholders as soon as practicable after the date of a CPP investment to increase the number of authorized shares of common stock and/or comply with such exchange rules, and to take any other measures deemed necessary by the UST to allow the exercise of the Warrants for common stock.

Privately Held Subsidiary Holding Companies

With respect to any privately held subsidiary holding company of a mutual holding company (Private MHC Subsidiary), the term "QFI" means any bank holding company or savings and loan holding company that:

(i) engages solely or predominantly in activities permissible for financial holding companies under relevant law;

(ii) is not publicly traded;

(iii) is directly owned and controlled by a bank holding company or savings and loan holding company that is organized in mutual form; and

(iv) is not controlled by a foreign bank or company.

Terms of Senior Preferred

Each Private MHC Subsidiary will participate in the CPP by selling to the UST senior preferred securities (Senior Preferred), with terms that are generally similar to those for Public MHC Subsidiaries, with the following exceptions:

- The voting rights are the same, although the right of the holders of the Senior Preferred of Private MHC Subsidiaries to elect directors will end when full dividends have been paid for all prior dividend periods, not when full dividends have been paid for four consecutive dividend periods as described above with respect to the Senior Preferred for Public MHC Subsidiaries.
- Transferability restrictions are different with respect to the Senior Preferred of Private MHC Subsidiaries. Specifically, the Senior Preferred will not be subject to any contractual restrictions on transfer or the restrictions of any stockholders' agreement or similar arrangement, provided that no transfer may be made that would require a Private MHC Subsidiary that is a QFI to become subject to the periodic reporting requirements of Section 13 or Section 15(d) of the Exchange Act.
- With respect to related parties, for as long as the UST holds any debt or equity securities (including the Senior Preferred) of a Private MHC Subsidiary that is a QFI, such QFI and its parents and subsidiaries may not enter into a transaction with related persons (as defined by the Securities and Exchange Commission) unless such transaction (i) is on terms no less favorable to the QFI and its parents and subsidiaries than could be obtained from an unaffiliated third party, and (ii) has been approved by the audit committee or a comparable body of independent directors of the QFI. Where there are no independent directors, the board of directors may so approve, but only if they maintain written documentation supporting their determination that the transaction meets the requirements of clause (i) in this paragraph.

Restrictions on Redemptions, Dividends and Repurchases

Redemptions. For Private MHC Subsidiaries that are QFIs, all redemptions of the Senior Preferred will be at 100% of the issue price, plus any accrued and unpaid dividends and will require the approval of the QFI's primary federal bank regulator.

Dividends. For Private MHC Subsidiaries, in addition to the restrictions on any increase in common dividends before the third anniversary of the date of the UST's investment, during the period between the third anniversary and tenth anniversary, the UST's consent is 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 (although such common dividend restrictions do not apply if all of the Senior Preferred and Warrants (as described below) have been redeemed or transferred by the UST to third parties).

In addition, from and after the tenth anniversary of the date of the investment, any Private MHC Subsidiary that is a QFI will be prohibited from paying common dividends or repurchasing any equity securities or trust preferred securities until all equity securities held by the UST are redeemed in whole or transferred by the UST to third parties.

Repurchases. The UST's consent is required for any repurchases of equity securities or trust preferred securities (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) until the tenth anniversary of the date of this investment unless, prior to such tenth anniversary, the Senior Preferred and the Warrant Preferred (as described below) are redeemed in whole or are transferred by the UST to third parties.

Terms of Warrants and Warrant Preferred

Each Private MHC Subsidiary that is a QFI will be required to grant to the UST warrants (Warrants) to purchase, upon net settlement, a number of net shares of the QFI's preferred stock (Warrant Preferred) having an aggregate liquidation preference equal to 5% of the amount of Senior Preferred on the date of investment. The initial exercise price for the Warrants shall be $0.01 per share or such greater amount as the charter may require as the par value per share of Warrant Preferred. The UST intends to immediately exercise the Warrants.

The Warrant Preferred will have the same rights, preferences, privileges, voting rights and other terms as the Senior Preferred, except that the Warrant Preferred will (i) pay dividends at a rate of 9% per annum, and (ii) may not be redeemed until all the Senior Preferred has been redeemed. The UST may transfer its interest in the Warrant Preferred, provided that no transfer will be made that would require any Private MHC Subsidiary that is a QFI to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Securities Exchange Act.

With respect to the Warrants, in the event the QFI has received aggregate proceeds of not less than 100% of the issue price of the Senior Preferred from one or more qualified equity offerings on or prior to December 31, 2009, the number of shares of preferred stock underlying the Warrants then held by the UST shall be reduced by half of the number of shares originally underlying the Warrants (taking into account all adjustments).

Mutual Holding Companies Without A Subsidiary Holding Company

With respect to any mutual holding company that does not have any subsidiary mutual holding company (Non-Subsidiary MHC), the term "QFI" means any bank holding company or savings and loan holding company that:

(i) is mutual in organization;

(ii) engages solely or predominantly in activities permissible for financial holding companies under relevant law;

(iii) is publicly traded;

(iv) does not directly own or control a bank holding company or savings and loan holding company that is organized in mutual form; and

(v) is not controlled by a foreign bank or company.

Terms of Senior Securities

Each Non-Subsidiary MHC will participate in the CPP by selling subordinated debentures[5] (Senior Securities) to the UST. The following are the main terms for those Senior Securities:

- Each Non-Subsidiary MHC that is a QFI may issue Senior Securities (that will not constitute a class of stock) with an aggregate principal 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 Senior Securities will be entitled to Tier 1 regulatory capital status (although it is anticipated that, prior to the UST investment, the federal banking agencies will issue an interim rule permitting inclusion of the Senior Securities in Tier 1 capital, to the extent necessary).
- The Senior Securities will pay interest at a rate of 7.7% per annum, which rate will increase to 13.8% per annum after the fifth anniversary of the date of the investment.[6] Interest will be payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year. Interest may be deferred on the Senior Securities for up to 20 quarters, although any unpaid interest will accumulate and compound at the then-applicable interest rate in effect. During any interest deferral, no dividends may be paid on shares of equity, mutual capital certificates, other capital instruments authorized under state law, or trust preferred securities of the QFI.
- The Senior Securities will be non-voting (except for class voting rights on authorizing or issuing equity securities that purport to be senior to the Senior Securities, amendments to the rights of the Senior Securities, or significant matters such as mergers that would adversely affect the rights of the Senior Securities). If interest on the Senior Securities is not paid in full for six quarterly interest periods, whether or not consecutive, the Senior Securities holders will have the right to elect two directors to the QFI. The right to elect directors to the QFI will end when full interest has been paid for all prior interest periods.
- Principal and accrued interest may only be accelerated upon the bankruptcy or liquidation of the QFI, the receivership of a major bank subsidiary of the QFI, or deferral of interest on the Senior Securities for more than 20 quarters.
- The Senior Securities will not be subject to any contractual restrictions on transfer or the restrictions of any stockholders' agreement or similar arrangement that may be in effect among the QFI and its equity holders at the time of the Senior Security investment or thereafter, provided that the UST will use commercially reasonable efforts to not effect a transfer that would require the QFI to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act.
- For as long as the UST holds any debt or equity securities (including the Senior Securities) of the QFI, the QFI and its subsidiaries will not enter into a transaction with related persons (as defined by the Securities and Exchange Commission) unless such transaction (i) is on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated third party, and (ii) has been approved by the audit committee or a comparable body of independent directors of the QFI. (Where there are no independent directors, the board of directors may so approve, but only if they maintain written documentation supporting their determination that the transaction meets the requirements of (i) in this paragraph.)

Restrictions on Redemptions, Dividends and Repurchases

Redemptions. For Non-Subsidiary MHCs that are QFIs, all redemptions of the Senior Securities will be at 100% of the issue price, plus any accrued and unpaid interest and will require the approval of the QFI's primary federal banking agency.

Dividends. Generally, for as long as any Senior Securities are outstanding, no dividends may be declared or paid on any shares of equity, mutual capital certificates, other capital instruments authorized under state law or trust preferred securities, nor may a Non-Subsidiary MHC that is a QFI repurchase or redeem any shares of equity, mutual capital certificates, other capital instruments authorized under state law or trust preferred securities, unless all accrued and unpaid interest for all past interest periods on the Senior Securities is fully paid.

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5 The subordinated debentures are referred to as "Senior Securities" because they must be senior to mutual capital certificates and other capital instruments of the Non-Subsidiary MHC under state law, although they will be subordinated to senior indebtedness of the Non-Subsidiary MHC, in accordance with applicable federal and state law, unless such debt obligations are explicitly made pari passu or subordinated to the Senior Securities.

6 The interest rates payable on the Senior Securities by QFIs that are Non-Subsidiary MHCs are equal to after-tax effective rates (assuming a 35% tax rate) of 5% per annum and 9% per annum, which are the same as the dividend rates payable on the Senior Preferred issued by QFIs that are Public MHC Subsidiaries or Private MHC Subsidiaries.

In addition, the UST's consent is required for any increase in regularly paid dividends per share, capital certificate or other capital instruments authorized under state law until the third anniversary of the date of the investment. After the third anniversary and prior to the tenth anniversary, the UST's consent is required for any extraordinary dividends on deposit accounts (dividends that are in excess of the stated rate or of the amount resulting from the stated method of calculating the rate on such an account), or to increase aggregate dividends per share or certificate where the resulting aggregate dividend per share, capital certificate or other capital instruments authorized under state law is greater than 103% of the prior year's dividend rate per annum, provided that no increase in dividends may be made as a result of any dividend paid in common shares, capital certificates or other capital instruments authorized under state law, any stock split or similar transaction.[7]

Repurchases. From and after the tenth anniversary of the date of this investment, the QFI shall be prohibited from paying dividends or repurchasing any equity securities, capital certificates, other capital instruments authorized under state law or trust preferred securities until all the Senior Securities and Warrant Securities (as defined below) are redeemed or repurchased in whole.

Generally, the UST's consent is required for any repurchases of equity securities, mutual capital certificates, other capital instruments authorized under state law or trust preferred securities until the tenth anniversary of the date of the Senior Security investment unless, prior to that time, the Senior Securities and Warrant Securities are redeemed in whole or have been transferred by the UST to third parties.

Terms of Warrants and Warrant Securities

Each Non-Subsidiary MHC that is a QFI will be required to grant to the UST warrants (Warrants) to purchase, upon net settlement, a number of additional Senior Securities (Warrant Securities) in an amount equal to 5% of the amount of Senior Securities purchased on the date of investment. The exercise price for the Warrants shall be $0.01 per note representing a Warrant Security and the UST intends to immediately exercise the Warrants. Such Warrants will have a 10-year term with an understanding that the Warrant Securities themselves will have a maturity of 30 years.

The Warrant Securities will have the same rights, preferences, privileges, voting rights and other terms as the Senior Securities except that (i) the Warrant Securities will pay interest at a rate of 13.8% per annum and (ii) the Warrant Securities may not be redeemed until all the Senior Securities have been redeemed.

The UST may transfer its interest in the Warrant Securities provided that no transfer may be made that would require a Non-Subsidiary MHC that is a QFI to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act.

In the event that the QFI has received aggregate gross proceeds of not less than 100% of the issue price of the Senior Securities from one or more qualified equity offerings on or prior to December 31, 2009, the number of Senior Securities underlying the Warrants then held by the UST shall be reduced by half of the number of Senior Securities originally underlying the Warrants (taking into account all adjustments).

Executive Compensation

The executive compensation provisions under the CPP for mutual holding companies are identical to those under the CPP for other institutions. For the period during which the UST holds any equity or debt securities of a QFI, each QFI and its covered officers and employees will be subject to the rules, regulations and guidance of the UST with respect to executive compensation, transparency, accountability and monitoring, as published and in effect at the time of the investment closing. These rules include the executive compensation restrictions imposed by the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA). These rules are broad and comprehensive and include (i) restrictions on bonuses and incentive compensation, (ii) prohibitions on certain severance payments, (iii) recoupment of certain bonus and incentive compensation, (iv) limits on incentives for excessive risk taking, (v) limits to deductions for compensation, (vi) requirements regarding luxury expenditures, (vii) provisions regarding

7 This restriction on dividend increases no longer applies if the Senior Securities and Warrant Securities have been redeemed in whole or transferred by the UST to unaffiliated third parties, which for this purpose does not include a securitization vehicle or investment pool in which the UST is an initial sponsor or participant so long as the UST has an economic interest in such vehicle or pool.

stockholder "Say-on-Pay," and (viii) requirements to provide compliance certifications regarding all of the foregoing items.[8] These rules may require modification or waivers of existing contracts and severance arrangements, and are subject to further change by the UST. Specific rules implementing the recent amendments by the ARRA to EESA, which would be applicable to the CPP for mutual holding companies, are expected to be published by the UST soon.

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 and related government programs. Katten's TARP Task Force advises clients on (i) participating in the TARP Capital Purchase Program, issuing the necessary securities and warrants, determining how the executive compensation rules apply to them, and structuring their compensation arrangements appropriately, (ii) selling or purchasing legacy loans and securities through the Public-Private Investment Program, and (iii) obtaining loans under the Term-Asset Backed Securities Loan Facility (TALF) or issuing and underwriting TALF-eligible asset-backed securities.

8 For detailed information regarding these executive compensation requirements, please see Katten's client advisory on the topic, available at http://www.kattenlaw.com/stimulus-act-expands-executive-compensation-restrictions-for-tarp-recipients-02-26-2009/.

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