

News Bulletin

October 21, 2008



Update to Treasury's Capital Purchase Program

On October 20, 2008, the Treasury provided additional details and clarifications on the Capital Purchase Program (CaPP) under the Troubled Assets Relief Program (TARP). We expect further updates prior to the **November 14th** CaPP application deadline. See also our CaPP News Bulletin at <http://www.mofo.com/news/updates/files/o81016NewLiquidity.pdf>.

The TARP was established by Treasury under the authority granted in the Emergency Economic Stabilization Act of 2008 (Act). For a detailed discussion of the TARP, recent action by the Federal Reserve and the FDIC, the Act's impact and its tax implications and considerations, consult our recent News Bulletin "*TARP and the Various Federal Tent Poles: Will it be Enough?*" at <http://www.mofo.com/news/updates/files/o81015TARP.pdf>.

Updated Information on the CaPP

The Federal Reserve, Treasury and FDIC each released statements on October 20th encouraging banking institutions to utilize the tools available to enhance capital positions and increase lending, including the CaPP and the FDIC's Temporary Liquidity Guaranty Program (TLGP).

Treasury also provided the additional information below related to its Capital Purchase Program for financial institutions. To date, the term sheet published last week and the recent updates relate to publicly-held eligible institutions. Treasury continues to work on program modifications for other institutions.

- Applicants should consult with their primary federal banking regulator as they prepare to complete and submit an application to participate in the CaPP. The application information should be based on the most current quarterly supervisory reports, updated to include material changes to the institution's financial condition, pending capital raising and mergers.
- Applications should be submitted to the financial institution's primary federal banking regulator on the new form available on each regulator's web site (see the Application Guidelines available at <http://www.treas.gov/press/releases/reports/applicationguidelines.pdf>.)
- Applicants that have corporate or other limitations on their ability to comply with the terms of the CaPP are asked to provide detailed information about these limitations in their applications.
- The program is not going to be run on a "first come first served" basis, and Treasury has indicated that there has been sufficient capital allocated under the TARP for all qualifying financial institutions to participate. Based on the maximum participation level of 3% of risk-weighted assets, the total commitment of the TARP for all eligible institutions will be \$225 billion.
- Treasury will make the final decision on eligibility and the amount of capital an institution will receive, giving considerable weight to the recommendation of the primary federal banking regulator.

- The applications and process have been designed to be consistent across all federal banking regulators, with a standardized set of forms and a standardized review process, described as streamlined.
- Participants in the program will be announced within 48 hours of executed transaction documents with Treasury. There will be no public disclosure of institutions whose applications were denied or withdrawn. Applicants seeking confidential treatment of portions of their applications are encouraged to follow closely the requirements set forth in the applications.
- If approved for participation in the CaPP, an institution will have 30 days to submit the investment agreements and related transaction documentation. Institutions that are interested in participating but do not have the necessary corporate authority (*e.g.*, inability to issue preferred stock) will have until the end of the 30 days following notice of approval to obtain all required authorizations or otherwise be in a position to make the representations and warranties in the agreements accurate.
- The form of agreement will be posted on the Treasury's website in the coming days; it will contain the representations and warranties that the financial institution will need to make to participate. Forms will be available at <http://www.treas.gov/initiatives/essa/>. The financial institution will need to make statements in its application based on a review of those representations and warranties. An institution that submits an application prior to the availability of the transaction documents will be required to update its application to reflect such a subsequent review.

Questions have arisen on the program, most of which are still being reviewed by Treasury. Some of these matters pending review by Treasury, for which we expect more definitive answers in the coming days and weeks, include:

- What ability will privately owned financial institutions, mutual institutions and banks that have elected S corporation status have to participate? Treasury has indicated informally that it is working on making the program available to all otherwise eligible financial institutions. We expect Treasury is developing alternative terms that will provide an equivalent return for its investment, with comparable structural considerations.
- How will financial institution participants account for the Treasury warrants? Recent accounting guidance (EITF 00-19) would suggest that the warrants would have to be accounted for as bifurcated instruments or as liabilities subject to mark-to-market adjustments. A fluctuation in the market value of the warrant would affect a participant financial institution's income statement. The CaPP was intended to bolster the economic position of financial institution participants, so this would be a counterintuitive result. To address this, it has been reported that the Securities and Exchange Commission and Financial Accounting Standards Board will release guidance that, despite accounting guidance, the warrants in the CaPP may be treated as permanent equity.
- Will there be additional restrictions imposed on participating institutions? In addition to the executive compensation requirements, Treasury has indicated its focus on mortgage mitigation through the TARP. We expect Treasury will encourage participating financial institutions to engage in mortgage mitigation efforts consistent with the public policy objectives of the Act.
- Is participation required for participation in other programs? While the Treasury, FDIC and Federal Reserve have encouraged all eligible banks to participate in the CaPP and the TLGP, institutions will not be barred from future TARP programs if they do not participate in the CaPP. Participation in the CaPP is not required for participation in the TLGP and vice versa.

The TARP Capital Purchase Program

The CaPP is the first program under the Act to announce purchase of specific troubled assets. Treasury has earmarked the first \$250 billion from the Act for the program, and has allocated the first \$125 billion to nine major financial institutions, reported to include: Bank of America, The Bank of New York Mellon, Citigroup, Goldman Sachs, J.P. Morgan Chase, Merrill Lynch, Morgan Stanley, State Street Corp., and Wells Fargo. **The terms of the**

program are standardized and any qualifying financial institution may elect to participate by notifying its federal banking agency by November 14, 2008, 5:00 p.m. After notification of election to participate, Treasury will consult with the appropriate regulator and determine eligibility and allocations. An institution will not be automatically eligible for the CaPP; Treasury and the financial institution's primary federal regulator will determine if the institution may participate. Once the institutions are selected, Treasury will determine the allocations of capital to each institution and will fund the purchase of the preferred stock no later than December 31, 2008.

The principal terms, as set forth in a public term sheet published by Treasury (available at <http://www.treas.gov/press/releases/reports/document5hp1207.pdf>), are summarized below:

- Subscription amounts: minimum available is one percent of risk weighted assets and the maximum amount is the lesser of \$25 billion or three percent of risk-weighted assets
- Each participating financial institution will issue senior preferred shares to Treasury, which will:
 - qualify as Tier 1 capital
 - be senior to common stock
 - be pari passu with existing preferred shares (other than junior preferred shares)
 - be transferable by Treasury
 - pay a dividend of 5% per year for the first five years, and 9% per year thereafter; the dividend will be cumulative unless the financial institution is a bank that is not a subsidiary of a holding company
 - pay dividends quarterly beginning February 15, 2009
 - permit Treasury to elect two directors if dividends are not paid in full for six quarterly periods; but this right will end when full dividends have been paid for four consecutive dividend periods
 - be non-voting other than for market terms for similar securities (class voting rights on matters that could adversely affect the shares)
 - be callable at par after three years (and otherwise redeemable with the proceeds of an offering of replacement equity securities that provide Tier 1 capital)
 - be redeemable (as described above) with the consent of the issuer's primary federal bank regulator
 - restrict the ability of a financial institution to increase common dividends until the third anniversary of the investment (unless Treasury consents or has transferred the investment)
 - have a liquidation preference of \$1,000 per share (Treasury may purchase senior preferred with a higher liquidation preference per share if necessary given the issuer's authorized preferred shares; it may then require a depository to hold the shares and Treasury would hold depository receipts)
 - require Treasury's consent before any share repurchases other than in connection with a benefit plan or in the ordinary course of business consistent with past practice until the third anniversary of the program
 - be covered by a shelf registration statement filed by the financial institution as soon as practicable and be subject to piggyback registration rights
 - be funded by Treasury by December 31, 2008

- In connection with each investment, Treasury will also receive warrants to purchase common stock with the following terms:
 - an aggregate market price equal to 15% of the senior preferred instrument on the date of the investment
 - the exercise price on the warrants will be the financial institution's 20-day average market price prior to issuance
 - 10 year term
 - immediately exercisable
 - the financial institution will be required to file a registration statement as soon as practicable, grant piggyback registration rights to Treasury, and apply to list the underlying common stock on the relevant exchange
 - non-contractual limitations on Treasury's ability to transfer warrants that are designed to prevent transfer until market stability or individual financial stability has returned; warrants may be transferred on the earlier of the successful completion of an offering of replacement Tier 1 capital or December 31, 2009
 - the number of shares of common stock underlying the warrants is subject to reduction
 - in the event the financial institution does not have a sufficient number of authorized shares of common stock when the investment is made, it is required to take all actions necessary to increase the number of authorized shares. If unsuccessful, the exercise price of the warrants will be reduced every six months until the number of authorized shares is sufficient, or the reduction reaches 45%. In the event the financial institution is unable to obtain approval to increase the number of authorized shares, or its common stock is no longer listed, the warrant will be exercisable for senior term debt or another instrument.
- Financial institutions will be subject to the executive compensation requirements for participants in the TARP (see our News Bulletin "TARP and the Various Federal Tent Poles" discussed above)
- Eligibility requirements for financial institutions are set forth in the program Term Sheet published by Treasury, and Treasury will determine eligibility of interested participants. The definition of a qualified financial institution under the program (QFI) is narrower than the definition of a financial institution under the Act. QFIs include banks, savings associations, bank holding companies and savings and loan holding companies, in each case that are U.S. entities not controlled by a foreign bank. U.S. entities are those organized under the laws of the United States, any state, the District of Columbia or any territory or possession of the U.S. There are also requirements that bank holding companies or savings and loan holding companies only be engaging in permitted activities under Section 4(k) of the Bank Holding Company Act (BHC) or whose depository institution subsidiaries are the subject of an application under Section 4(c)(8) of the BHC. U.S. branches of foreign banks will not be qualifying financial institutions. The QFI definition also differs from the list of eligible institutions that can participate in TLGF, as described below.

The preferred shares can be redeemed with the proceeds of a qualified equity offering. And the number of shares of common stock underlying the warrants will be reduced by half if the financial institution receives, prior to December 31, 2009, proceeds from one or more qualified equity offerings in an amount at least equal to the amount of CaPP capital raised. A "qualified equity offering" is the sale of Tier 1 qualifying perpetual preferred stock or common stock, in either case for cash. After the senior preferred is redeemed in full, the institution will have the right to repurchase any other equity security held by Treasury, at fair value.

Considerations for Participating Financial Institutions

The CaPP's term sheet provides a number of details, and raises questions for participants to consider. Financial institutions need to review carefully their existing capital structures and the terms of outstanding securities. While

Treasury's program makes the preferred securities "senior," the issuance of new senior preferred securities may trigger covenants or other limitations in contractual obligations of the issuer. For example, any prior issuance of preferred securities with anti-dilution protections may need to be addressed. Any outstanding preferred securities, whether senior or subordinate, may have been issued with limitations on future issuance of more senior or pari passu securities. A careful review of the rights of other security holders will be important. As indicated above, Treasury understands that financial institutions may need to take corporate action to authorize or permit the issuance of the securities under the CaPP. Institutions will have 30 days following approval of the program to ensure all corporate action has been taken.

For each of the securities, the financial institution will need to look closely at its authorization to issue additional securities. This includes corporate authority, as well as the requirements of any stock exchange. The issuance of significant equity securities may trigger existing poison pill provisions that would need to be addressed.

The review of the existing capital structure and rights of existing security holders will also be helpful when evaluating the impact of the warrant issuance. The new warrants may trigger adjustments to conversion, timing or other features in outstanding securities with a conversion feature.

The CaPP and the TLGP

While announcing the CaPP and the TLGP programs on the same day was intended to increase confidence and enhance lending capabilities on multiple fronts, it has created some confusion. The CaPP and the TLGP remain separately administered and impose different requirements on their participants. The executive compensation requirements imposed through participation in the CaPP are not applicable to participants in the FDIC's guarantee program. Similarly, there is no capital investment by a federal regulator required of the financial institutions volunteering for the guarantee program. An institution can participate in either, both or neither, depending only on eligibility.

Contacts

Contact your Morrison & Foerster lawyer with any questions.

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