

Troubled Asset Relief Program – Update (as of February 12, 2009)

As part of their continuing efforts to promote financial stability and restore the health of the economy, the United States Treasury has continued to develop new applications for the funds allocated to the Troubled Asset Relief Program (**TARP**), established in October 2008 by the Emergency Economic Stabilization Act of 2008 (**EESA**). In mid-October 2008, the Treasury announced it would forgo its initial plan to buy troubled assets from financial institutions and would instead use TARP funds to inject capital directly into banks. To date, \$195.3 billion has been invested directly into qualifying financial institutions, both publicly traded and non-public, under the Treasury's Capital Purchase Program (**CPP**). To date, CPP funds have been invested in 359 financial institutions in 45 U.S. states and Puerto Rico.

On February 10, 2009, the Treasury unveiled its new "Financial Stability Plan" for promoting economic recovery. The Financial Stability Plan includes a plan to purchase troubled assets from financial institutions, as originally contemplated by the EESA. The plan also further develops the Term Asset-Backed Securities Loan Facility, which has not yet been implemented.

The new Financial Stability Plan also introduces new programs under TARP. Although the Treasury outlined certain high-level elements of the Financial Stability Plan, many of the details of the programs that will comprise the Financial Stability Plan have yet to be announced.

This memorandum summarizes TARP developments since our prior publications on this topic - our November 21, 2008 memorandum entitled *Capital Purchase Program – Publicly Traded Financial Institutions*,¹ and our December 4, 2008 memorandum entitled *Capital Purchase Program – Non-Public Financial Institutions*.² We suggest you refer to those publications in conjunction with this update.

¹ A copy can be accessed here: <http://www.financialinstitutionlawblog.com/capital-purchase-program-a-publicly-traded-financial-institutions-capital-purchase-program-publicly-traded-financial-institutions.html>.

² A copy can be accessed here: <http://www.financialinstitutionlawblog.com/capital-purchase-program-a-nonpublic-financial-institutions-capital-purchase-program-nonpublic-financial-institutions.html>.

Recent TARP Developments

TARP Expenditures to Date

As of February 6, 2009, the Treasury has spent \$301.1 billion of the \$700 billion allocated to TARP. This includes \$195.3 billion out of \$250 billion allocated to the CPP for capital investments in financial institutions. The total TARP expenditures to date also include the Treasury's separate targeted investments in and loans to AIG Capital for \$40 billion, Citigroup for \$20 billion, the automotive industry for \$20.9 billion and Bank of America for \$20 billion.

On January 15, 2009, Congress cleared the way for release of the second \$350 billion in funds allocable under the EESA. A total of \$398.8 billion in TARP funds remains available to be spent by the Treasury.

Term Asset-Backed Securities Loan Facility

On November 25, 2008, the Treasury unveiled the Term Asset-Backed Securities Loan Facility (**TALF**) program under TARP. TALF was originally intended to be launched in February 2009. To date, the Treasury has not provided an update with respect to the implementation time frame.

Under TALF, the Federal Reserve Bank of New York (**New York Fed**) would lend to investors the funds to purchase eligible asset-backed securities. TALF was designed to finance only certain newly issued, highly rated asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. TARP funds of up to \$20 billion were to be used to purchase subordinated debt in a special purpose entity created by the New York Fed to purchase and manage any assets received by the New York Fed in connection with any TALF loans. The purpose of TALF was to provide incentives for investors to resume purchase of loans on the secondary market so as to free up the flow of credit to consumers.

As part of the Financial Stability Plan announced by Treasury Secretary Geithner on February 10, 2009, TALF has been dramatically expanded to increase the investment by the Treasury and to encompass commercial mortgage-backed securities, as set forth in more detail below under the heading "Financial Stability Plan." For additional detail relating to TALF, please refer to our memorandum entitled "Term Asset-Backed Loan Facility" which will be posted here: <http://www.financialinstitutionlawblog.com>.

CPP Term Sheet for Subchapter 'S' Corporations

On January 14, 2009, the Treasury unveiled terms for participation in the CPP by Subchapter 'S' corporations, which corporations had previously been excluded from the CPP due to tax regulations which make them unable to issue preferred equity securities. Subchapter 'S' corporations will issue notes to the Treasury on terms comparable with the preferred securities issued by publicly traded and non-public qualified financial institutions under the CPP. **The deadline for 'S' Corporations to apply for CPP funds is February 13, 2009.**

Executive Compensation Requirements

Financial institutions receiving TARP funds are required to modify existing executive compensation arrangements to comply with the mandated restrictions imposed by Section 111(b) of the EESA, including agreements to:

- ensure that compensation does not encourage excessive risk taking;
- impose a clawback on compensation paid based on financial results or performance metrics later proved to be materially inaccurate;

- limit severance benefits to not more than three times the executive's average taxable compensation for the prior five years; and
- not deduct annual compensation to any senior executive in excess of \$500,000.

On February 4, 2009, the Treasury adopted further executive compensation restrictions for institutions receiving TARP funds under future programs. The additional restrictions will not apply retroactively to institutions that have already received TARP funds or that will receive TARP funds under programs that existed prior to February 4, 2009.

The Treasury guidelines on executive pay distinguish between financial institutions participating in generally available capital access programs (e.g., CPP and Capital Assistance Program) and financial institutions needing more assistance than is allowed under a generally available capital access program (i.e., "exceptional assistance"). Banks falling under the "exceptional assistance" standard have bank-specific negotiated agreements with Treasury (e.g., AIG, Bank of America and Citi).

Compliance and Certification

General Chief executive officers of financial institutions that receive government assistance must annually certify that their companies have strictly complied with statutory, Treasury, and contractual executive compensation restrictions.

In addition, the compensation committees of such companies must explain how their senior executive compensation arrangements do not encourage excessive and unnecessary risk-taking.

Financial Institutions Receiving Exceptional Assistance

\$500,000 Cap Senior executives may not receive total compensation in excess of \$500,000, except for restricted stock awards, discussed below.

Restricted Stock Any pay to a senior executive over \$500,000 must be made in restricted stock (or other similar long-term incentive arrangement), which generally may vest only after the government has been repaid (including the contractual dividend payments).

"Say on Pay" Shareholder Resolution A financial institution's executive compensation structure and the rationale for how compensation is tied to sound risk management must be submitted to a non-binding shareholder resolution.

Clawback Bonuses Under existing programs, only the bonuses and incentive compensation awarded to the top five senior executives were subject to a clawback. Under the new guidelines, a financial institution must have in place mechanisms to claw back bonuses and incentive compensation from any of the next 20 senior executives

if they are "found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay."

Ban on Golden Parachutes The existing programs prohibited the top five senior executives from receiving any golden parachute payment. Under the new guidelines, the ban will be expanded to include the top 10 senior executives. In addition, and at a minimum, the next 25 executives will be prohibited from receiving any golden parachute payment greater than one year's compensation.

Luxury Expenditures The boards of directors must adopt a company-wide policy on any expenditures related to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events. In addition, any expenditures that could be viewed as excessive or luxury items will require certification from the chief executive officer. It is not yet clear what the content of the certification will be.

Financial institutions are also to post the text of the expenditures policy on their web sites.

Financial Institutions Participating in Generally Available Capital Access Programs

General These new guidelines will be subject to public comment. The guidelines discussed above for financial institutions receiving "exceptional assistance" are not expected to be subject to public comment.

\$500,000 Cap & Restricted Stock Limits The \$500,000 cap on executive compensation and the restricted stock limitations discussed above may be waived for financial institutions receiving "exceptional assistance" only by "disclosure of their compensation and, if requested, a non-binding "say on pay" shareholder resolution."

All financial institutions must review and disclose the reasons that compensation arrangements of both the senior executives and other employees do not encourage excessive and unnecessary risk taking. Under CAP, this requirement only applied to the top five executives' compensation arrangements.

Clawback Bonuses The same clawback provisions that apply to financial institutions receiving "exceptional assistance" will apply to financial institutions participating in generally

available capital access programs.

Ban on Golden Parachutes The top five senior executives will not be allowed a golden parachute payment greater than one year's compensation. Under CAP, the limit was three years' compensation.

Luxury Expenditures The same luxury expenditure provisions that apply to financial institutions receiving "exceptional assistance" will apply to financial institutions participating in generally available capital access programs.

Financial Stability Plan

On February 10, 2009, Treasury Secretary Geithner announced a re-framing of TARP, called the "Financial Stability Plan." The Financial Stability Plan, which is expected to be revealed in greater detail over the next two weeks, will promote economic stability through expansion of TARP into several new and developing programs.

The anticipated expenditures under the Financial Stability Plan show a marked increase from prior Treasury initiatives, and are expected to far exceed the remaining \$398.8 billion of TARP funds. Full implementation of the Financial Stability Plan could require up to \$1.5 trillion or more.

The Financial Stability Trust

General The Treasury established a new, separate entity to manage the government's investments under the Capital Assistance Program (**CAP**) in US financial institutions.

Capital Assistance Program

General Investments under the CAP are intended to provide a "capital buffer" to help financial institutions absorb losses and serve as a bridge to private capital. Investments are also intended to ensure that the financial institution has the capital necessary to continue lending and absorb the potential losses resulting from further economic decline.

Eligible Institutions An institution with consolidated assets in excess of \$100 billion must undergo a forward looking "stress test" and a supervisory review process to assess whether it has the capital necessary to continue lending and absorb the potential losses resulting from further economic decline.

Institutions with consolidated assets below \$100 billion will also be eligible after a supervisory review.

Type of Investment The Treasury will purchase preferred securities of a financial institution that the financial institution can convert into common equity if needed to preserve lending capabilities in a "worse-than-expected economic environment." The preferred securities will carry a dividend to be specified later and the conversion price is expected to be a "modest" discount from the financial institution's stock price as of February 9, 2009.

Public-Private Investment Fund

General Working with the FDIC and the Federal Reserve, the Treasury will initiate a Public-Private Investment Fund to facilitate sale of troubled assets by financial institutions. The fund is intended to minimize public capital and maximize private capital.

Attraction of Private Investment The Public-Private Investment Fund is expected to attract private equity contributions for large-scale asset purchases. The program could include putting public or private capital side-by-side and using public financing to leverage private capital on an initial scale of up to \$500 billion, with the potential to expand to \$1 trillion.

Private sector buyers will determine the price of current troubled and previously illiquid assets.

TALF Expansion Up to \$1 Trillion

General The funds earmarked for this program are intended to provide private investors with financing to purchase small business, commercial real estate and auto loans on the secondary market. In turn, the private investor money that banks receive for these bundled loans is expected to allow the banks to make more of these types of loans at lower interest rates.

Changes Previously, the Treasury was supposed to use \$20 billion to leverage \$200 billion of lending from the Federal Reserve. Under the Financial Stability Plan, the Treasury will use \$100 billion to leverage up to \$1 trillion of lending from the Federal Reserve.

The type of assets that may be purchased with TALF funds was expanded to include commercial mortgage-backed securities (**CMBS**), and may be further expanded to include other asset classes, such as non-Agency residential mortgage backed securities (**RMBS**).

The TALF loans may be used to purchase only asset-

backed securities that have been issued since January 1, 2009 and that carry a AAA or equivalent rating.

Increase in Transparency and Accountability

General The Financial Stability Plan calls for an increase in transparency and monitoring on a going forward basis, with even tougher standards for firms receiving "exceptional assistance." These changes are not retroactive.

Changes Monitoring. A recipient of "exceptional assistance" or of CAP funds is required to show how "every dollar of capital" received enabled it to preserve or generate new lending compared to what would have been possible without the government's assistance.

Planned Use. All recipients must submit a plan during the application process of how they intend to use the capital to "preserve and strengthen their lending capacity." Such plans will be publicly available upon completion of the government's investment.

Monthly Reports. Recipients must provide the Treasury with monthly lending reports. Among other things, the reports must show how many new loans the recipient made to businesses and consumers and how many asset-backed and mortgage-backed securities the recipient purchased, and the reports must include a comparison to the recipient's "most rigorous estimate" of what its lending would have been without the government's investment. Public companies will file similar reports on a Form 8-K simultaneous with their quarterly and annual reports.

Transparency. All information disclosed or reported to the Treasury by recipients will be posted on www.financialstability.gov.

Foreclosure Mitigation. All recipients will be required to commit to participate in industry standard best practices for foreclosure mitigation programs.

Dividend Restrictions. Recipients that receive "exceptional assistance" may not pay quarterly dividends in excess of \$0.01 until the government is repaid. All other recipients will be subject to the same restriction unless the Treasury and that recipient's primary regulator approve otherwise.

Share Repurchase Restrictions. CAP fund recipients may not repurchase any privately-held shares until the government is repaid.

Cash Acquisition Restrictions. Recipients may not pursue cash acquisitions of healthy firms until the government is repaid.

Executive Comp Limits. Recipients will be required to comply with the new executive compensation limits, including a \$500,000 cap on compensation to senior executives, "say on pay" shareholder votes and new disclosure and accountability requirements on "luxury" purchases. See discussion under "Executive Compensation Requirements," above.

Foreclosure Prevention

General The Treasury has said it will soon be announcing a comprehensive plan that will:

- reduce mortgage rates through continuation of purchasing as much as \$600 billion of government sponsored enterprise (GSE) mortgage-backed securities and GSE debt;
- commit \$50 billion to prevent avoidable foreclosures of owner-occupied "middle class" homes by helping to reduce monthly payments;
- establish loan modification guidelines;
- require all Financial Stability Plan recipients to participate in foreclosure mitigation programs; and
- build flexibility into Hope for Homeowners and the FHA.

Our TARP Team is composed of experts in a variety of our practice groups, including attorneys in our financial institutions, corporate/securities, real estate, executive compensation and litigation practice groups. Should you have any questions about the Capital Purchase Program or any other aspect of the Troubled Asset Relief Program, please contact any member of our TARP Team listed below or your regular Sheppard Mullin attorney:

Name	E-mail Address	Phone Number
Edwin Astudillo	eastudillo@sheppardmullin.com	(619) 338-6559
Robert Beall	rbeall@sheppardmullin.com	(714) 424-2844
Richard Brunette	rbrunette@sheppardmullin.com	(213) 617-4174
Steve Cardoza	scardoza@sheppardmullin.com	(714) 424-.8234
David D'Amour	ddAmour@sheppardmullin.com	(212) 332-3526
Dean Demetre	ddemetre@sheppardmullin.com	(714) 424-8238
Domenic Drago	ddrago@sheppardmullin.com	(858) 720-8989
Julie Ebert	jebert@sheppardmullin.com	(415) 774-3202
Brent Liljestrom	bliljestrom@sheppardmullin.com	(714) 424-8236
Margaret Mann	mmann@sheppardmullin.com	(619) 338-6613
Alan Martin	amartin@sheppardmullin.com	(714) 424-2831
David McCarty	dmcCarty@sheppardmullin.com	(213) 617-4171
Pamela Naughton	pnaughton@sheppardmullin.com	(858) 720-8984
Christopher Noon	cnoon@sheppardmullin.com	(858) 720-7467
Bill Opdyke	bopdyke@sheppardmullin.com	(213) 617-4158
Lori Peters	lpeters@sheppardmullin.com	(858) 720-7432
Russell Reid	rreid@sheppardmullin.com	(212) 332-3613
Sherwin Root	sroot@sheppardmullin.com	(213) 617-5465
Susan Rosenthal	srosenthal@sheppardmullin.com	(212) 332-3818
David Sands	dsands@sheppardmullin.com	(213) 617-5536
Gregory Schick	gschick@sheppardmullin.com	(415) 774-2988
Carren Shulman	cshulman@sheppardmullin.com	(212) 332-3611
Darryl Snider	dsnider@sheppardmullin.com	(213) 617-4133
Robert Stumpf	rstumpf@sheppardmullin.com	(415) 774-3288
Ed Tillinghast	etillinghast@sheppardmullin.com	(212) 332-3529
John D. Tishler	jtishler@sheppardmullin.com	(858) 720-8943
Ed Vogel	evogel@sheppardmullin.com	(619) 338-6529
Bob Williams	bwilliams@sheppardmullin.com	(213) 617-4169
John Yacovelle	jyacovelle@sheppardmullin.com	(858) 720-8934