U.S. Implements Four Programs under Emergency Economic Stabilization Act to Strengthen Market Stability

October 24, 2008

On October 3, 2008, the Emergency Economic Stabilization Act ("EESA") became law. EESA's first purpose is to provide the Secretary of the Treasury (the "Secretary") with the authority and tools necessary to restore stability to the U.S. financial system. On October 14, 2008, U.S. agencies announced three programs being implemented to strengthen market stability: (1) a Capital Purchase Program (the "CPP") instituted under the Troubled Asset Relief Program authorized by EESA; (2) a program under which the FDIC will guarantee senior debt of financial institutions and (3) the Federal Reserve Board Commercial Paper Funding Facility. In addition, on October 21, 2008, the Federal Reserve Board announced the creation of the Money Market Investor Funding Facility.

Capital Purchase Program

The purpose of the CPP is to assist qualifying financial institutions ("QFIs"), which include U.S. banks, savings associations and other bank and savings and loan holding companies engaged only in permitted financial activities, in raising capital which, in turn, will ease the current credit crunch by increasing the monetary flow through the financial system to businesses and consumers. Under the CPP, the U.S. Department of the Treasury ("Treasury") will purchase up to $250 billion of senior preferred stock ("Senior Preferred") and warrants issued by QFIs that elect to participate on a voluntary basis, under standard terms set forth in a publicly-released term sheet.

While the CPP is open to a broad range of banks, regardless of financial strength, Treasury's focus is to encourage participation by institutions that are most critical to the financial system, including healthy institutions. The influx of CPP funds to healthy institutions is anticipated to increase their willingness to extend credit while at the same time attract private capital. To date, nine large financial institutions have agreed to participate in the program by selling Senior Preferred for an aggregate amount of $125 billion, which represents half of the money currently allocated to the CPP.

Each QFI desiring to participate in the CPP must, after consulting with its federal banking agency ("FBA"), submit an application to the FBA.[1] Treasury will determine eligibility and allocation of CPP funds to a QFI after consultation with the institution's FBA. The deadline for QFIs to apply to participate in the program is 5:00 p.m. (EST) on November 14, 2008.

Terms of Capital Purchase - Senior Preferred Shares

Below is a summary of the key terms regarding Senior Preferred to be issued to Treasury in exchange for CPP funds.

- Each participating QFI (each a "Participant") will receive CPP funds in an amount not less than 1% of its risk-weighted assets and not more than the lesser of $25 billion or 3% of its risk-weighted assets.
- The Senior Preferred will have a liquidation preference of $1,000 per share; however, Treasury may agree to an increased preference amount depending on the Participant's available authorized preferred shares.
- The Senior Preferred will qualify as Tier 1 capital, ranking senior to common stock and ranking equally with the Participant's existing preferred stock (except for any issued preferred stock that is, by its terms, junior to existing preferred stock).
- The Senior Preferred will be non-voting, except with respect to class voting rights on: (1) the authorization or issuance of shares that rank senior to the Senior Preferred; (2) any amendment to the Senior Preferred rights and (3) matters that could adversely affect the rights of the Senior Preferred.
- The Senior Preferred will pay cumulative dividends at an annual rate of 5% for the first five years, and 9% thereafter. Senior Preferred issued by banks that are not subsidiaries of holding companies will pay non-cumulative dividends at the same percentage rates as the cumulative dividends. Dividends will be payable quarterly in arrears on the 15th of every February, May, August and November. The Participant will be prohibited from declaring or paying dividends on junior preferred shares, preferred shares ranking equally with the Senior Preferred, or common shares, unless the Participant maintains its compliance with the required Senior Preferred dividend payments. Although the Senior Preferred is non-voting, it will obtain the right to elect two directors if its dividend payments are not paid in full for six dividend periods, which need not be consecutive. That right will continue until the full dividend payment has been made for four consecutive dividend periods.
- A Participant may not redeem the Senior Preferred for three years, except the Participant may redeem the Senior Preferred with proceeds from a Participant's qualified equity offering of Tier 1 perpetual preferred or common stock in exchange for cash.
- Consent of Treasury is required for a period of three years from the date of investment for any increase in common dividends per share and for any share repurchases (except that of Senior Preferred and of junior preferred shares or common shares in connection with benefit plans) unless the Senior Preferred is redeemed in its entirety or Treasury has transferred all Senior Preferred to third parties.

- The Participant will file a shelf registration statement covering the Senior Preferred, the warrants (discussed below) and the common stock underlying the warrants (collectively, the "Securities") as promptly as possible after the date of investment, and will take all action necessary to facilitate Treasury's transfer of the Securities. The Participant will also grant Treasury piggyback registration rights.
- Each Participant will be required to adopt certain executive compensation and corporate governance standards.

Executive Compensation and Corporate Governance

On October 20, 2008, Treasury published an interim final rule describing executive compensation standards applicable to financial institutions that elect to participate in the CPP. The interim final rule is effective immediately.[2]

The interim final rule applies to any Participant as well as to any other entity in the same parent/subsidiary (as opposed to brother/sister) "controlled group" under the Internal Revenue Code of 1986 (the "IRC"). Generally, the rule:

- for senior executive officers ("SEOs"), limits compensation that contains incentives to take unnecessary and excessive risks;
- requires the "clawback" of certain compensation paid to an SEO that was paid based on financial information that is later proven to be materially inaccurate, even if there was no wrongdoing on the part of the SEO;
- prohibits any "golden parachute payment" to any SEO and
- requires the institution to agree to limit claims for federal income tax deductions for certain executive compensation.

For purposes of the rule, an SEO is a "named executive officer" under the SEC's executive compensation regime who is employed by a Participant (or, in the case of a controlled group, the parent entity) in the CPP while Treasury holds an equity or debt position acquired under the CPP. In the case of a public company, an SEO is (a) the principal executive officer ("PEO"), (b) the principal financial officer ("PFO") or (c) one of the three most highly compensated executive officers of such Participant, other than the PEO or PFO, generally determined in accordance with the SEC's executive compensation regime. Additionally, the Participant is required to use its best efforts to identify the three most highly compensated executive officers for the current fiscal year until such time as actual compensation data is available. Analogous executive officers are included in the case of a non-public company.

Unnecessary and Excessive Risk

EESA requires Participants to limit certain types of compensation for SEOs that could incentivize SEOs to take unnecessary and excessive risks that threaten the value of the Participant, and thus the value of Treasury's investment in the Participant, during the period that Treasury holds an equity or debt position in the Participant. The rule requires Participants to follow certain procedures, including a prompt, and in any event within 90 days after the sale of Senior Preferred under the CPP, review by the Participant's compensation committee (or committee acting in a similar capacity) and the Participant's senior risk officers (or other personnel acting in a similar capacity) of the SEO incentive compensation arrangements to ensure that SEOs are not encouraged to take unnecessary and excessive risks that threaten the value of the Participant. Thereafter, the committee is required to meet at least annually with the senior risk officers to review the relationship between the Participant's risk management policies and the SEO incentive compensation arrangements. The committee is required to certify that it has completed the reviews of SEO incentive compensation described above-committees of public companies must certify as such in the Compensation Discussion and Analysis section of their proxy statement (or other applicable SEC filing), while committees of non-public companies must certify as such to their primary regulatory agency.

"Clawback"

EESA requires Participants to be able to recover any bonus or incentive compensation paid to an SEO based on financial statements or other criteria that are later proven to be materially inaccurate. The interim final rule clarifies that a Participant must require that SEO bonus and incentive compensation paid during the period that Treasury holds an equity or debt position acquired under the CPP be subject to "clawback" or other recovery by the Participant if the applicable payment was made based on materially inaccurate performance criteria, whether financial or otherwise. The rule specifically notes that its "clawback" standard is different (and arguably broader) than a similar provision in Section 304 of the Sarbanes-Oxley Act of 2002.

Golden Parachute Payment Prohibition

EESA prohibits Participants from making any "golden parachute payment" to an SEO during the period Treasury holds an equity or debt position acquired under the CPP. As clarified in the rule, a golden parachute payment is defined under Section 280G(e) of the IRC and means any payment in the nature of compensation to (or for the benefit of) an SEO made on account of an "applicable severance from employment," but only to the extent that the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO's "base amount." Base amount is defined in Section 280G(b)(3) of the IRC and generally means the average compensation paid to the SEO during the five years prior to the "applicable severance from employment." "Applicable severance from employment" means any SEO's severance from employment by reason of involuntary termination of employment, including change of control, or in connection with any bankruptcy filing, insolvency or receivership.

Limits on Federal Income Tax Deductions and Successor Provisions

In addition to the requirements above, a Participant must agree to claim no deduction for federal income tax purposes for compensation that would not be deductible if Section 162(m)(5) of the IRC applied to the Participant, regardless of whether Section 162(m)(5) in fact applies. Although several procedural details are provided in the rule, the general effect is that, during the period that Treasury holds an equity or debt position in the Participant acquired under the CPP, a Participant may claim no deduction for remuneration during a taxable year for compensation in excess of $500,000 for an SEO. The rule also provides that a non-related acquirer that acquires a Participant does not become subject to the executive compensation and corporate governance provisions of the rule merely as a result of the acquisition; however, employees of the Participant who were SEOs prior to the acquisition will remain subject to the golden parachute payment prohibition provisions until the first anniversary following the acquisition.

Warrants

Treasury, in connection with its purchase of Senior Preferred, will also receive warrants to purchase common stock of the Participant, having an aggregate market price of 15% of the amount invested in Senior Preferred. A summary of the key terms regarding the warrants to be issued to Treasury is below.

- The initial exercise price will be the market price for the common stock of the Participant on the date of issue and will be subject to anti-dilution adjustments. The initial exercise price, however, will be subject to a 15% reduction on each six-month anniversary after the issue date, with a maximum reduction of 45%, if required consent of the Participant's stockholders for authorization and issuance of the underlying common stock of the warrants has not been obtained by such anniversary dates.
- The warrants received will be immediately exercisable and will continue to be exercisable for 10 years.
- The underlying common stock will be non-voting.
- The warrants will be transferable; however, Treasury may not transfer or exercise more than 50% of the warrants, in the aggregate, prior to the earlier of (a) the date on which the Participant receives at least 100% of the issue price of the Senior Preferred from one or more qualified equity offerings or (b) December 31, 2009.
- If, on or prior to December 31, 2009, the Participant receives aggregate gross proceeds of at least 100% of the issue price of the Senior Preferred from one or more qualified equity offerings, the number of shares of common stock originally underlying the warrants will be reduced by 50%.
- Treasury, at its option, may exchange the warrants for senior term debt or other instruments or securities of the Participant if (1) the Participant ceases to be listed or traded on a national securities exchange or securities association or (2) the required consent of the Participant's stockholders has not been obtained within 18 months after the warrants were issued.

FDIC Guarantee Program

On October 14, 2008, the Secretary signed the systemic risk exception to the FDIC Improvement Act of 1991, temporarily enabling the FDIC to guarantee the senior debt of all FDIC-insured institutions and certain holding companies as well as deposits in non-interest bearing deposit transaction accounts. This program enhances the capacity of institutions to lend to U.S. businesses and consumers by federally backing an important source of bank funding. Entities that elect to issue guaranteed debt under this program may do so until June 30, 2009. Regulators will announce further details regarding the supervisory framework to assure appropriate use of this new guarantee.

Federal Reserve Commercial Paper Funding Facility

On October 7, 2008, the Federal Reserve Board announced the creation of the Commercial Paper Funding Facility ("CPFF") to provide a liquidity backstop to U.S. issuers of commercial paper. The CPFF is designed to improve liquidity in short-term funding markets and thereby broadly increase the availability of credit for businesses and households. Beginning on October 27, 2008, the CPFF will purchase unsecured and asset-backed commercial paper from eligible issuers through its primary dealers. Under the CPFF, the Federal Reserve Bank of New York will finance the purchase of only highly rated, U.S. dollar-denominated, three-month commercial paper. The CPFF's financing of such commercial paper is scheduled to terminate on April 30, 2009, although the program may be extended by the Federal Reserve Board.

Federal Reserve Money Market Investor Funding Facility

On October 21, 2008, the Federal Reserve Board announced the creation of the Money Market Investor Funding Facility ("MMIFF") to provide liquidity to U.S. money market investors. The MMIFF is designed to improve the liquidity position of money market investors by facilitating the sales of money market instruments in the secondary market by funding several special purpose vehicles that will purchase eligible assets from eligible investors. By doing so, the MMIFF should increase the ability of money market investors to meet redemption requests as well as encourage these investors to purchase money market instruments. As a result, the MMIFF will enhance the ability of banks and other financial intermediaries to accommodate the credit needs of businesses and households. Under the MMIFF, the special purpose vehicles will purchase U.S. dollar-denominated certificates of deposit, bank notes and commercial paper with remaining maturities of 90 days or less from 10 highly rated financial institutions as specified in each special purpose vehicle's organizational documents. MMIFF-funded special purpose vehicles will cease purchasing assets on April 30, 2009, although the program may be extended by the Federal Reserve Board. Additional details as to when the MMIFF will begin funding the special purpose vehicles have yet to be announced.

Conclusion

As with EESA itself, the three programs announced on October 14, 2008, and the MMIFF announced on October 21, 2008, are unprecedented. Through these actions, the government has heightened its involvement in the financial markets and has taken bold steps to stabilize the markets by increasing access to financing for businesses and consumers. Under the CPP, the government will become an equity holder of some of the most important banks in our financial system; however, there are incentives for the Participant to replace the government's stake with private equity. For example, the incentives for the Participant to replace the government's investment with private equity include (1) the restrictions on the Participant's executive compensation guidelines; (2) a potential increase in dividend rates to the government and (3) the requirement to obtain government consent for up to three years on certain matters.

Duane Morris will be monitoring and commenting on the regulations, guidance and interpretations of the Emergency Economic Stabilization Act and its implementation as each becomes available.

For Further Information

If you have any questions regarding EESA or any of the programs described in this Alert, including how they may affect your company or its executives, please contact anymember of the Corporate Practice Group, any member of the Business Reorganization and Financial Restructuring Practice Group or the attorney in the firm with whom you are most regularly in contact.

Footnotes

1. Further information regarding the application process is available at each institution's appropriate federal banking agency website. Federal banking agency websites are: www.fdic.gov; www.federalreserve.gov; www.occ.treas.gov andwww.ots.treas.gov.
2. Treasury is accepting comments on the interim final rule, and there may be changes to the rule based upon those comments.