TARP Capital Exit Strategy (CaPP Public Institutions*)

Summary: Exiting the Treasury capital investment under the Capital Purchase Program (does not address Capital Assistance Program)

- Capital Purchase Program participants sold senior preferred stock and issued warrants to Treasury
- Repurchase by issuers of these securities is:
  - governed by contracts with Treasury *and*
  - subject to the Emergency Economic Stabilization Act of 2008 (Stabilization Act) *and*
  - subject to the American Recovery and Reinvestment Act of 2009 (Recovery Act)
- Treasury has published limited information on the procedures for repurchasing/redeeming CaPP securities
- The American Recovery and Reinvestment Act (Recovery Act) amends provisions of the Emergency Economic Stabilization Act (Stabilization Act) applicable to the Capital Purchase Program – but Treasury has provided very limited information on the new law

* NOTE: warrants issued by private institutions were immediately exercised by Treasury

Exiting - Defined

- Preferred stock must be repurchased from Treasury, or Treasury must transfer 100% of the preferred stock *and*
- Repurchase other CaPP securities from Treasury, or Treasury must transfer 100% of the other securities:
  - Warrants must be repurchased (or transferred)
  - If warrants have been exercised, common stock must be repurchased (or transferred)

Impact of Repurchases

- Repurchase of 100% of preferred stock
  - Terminates limits on dividends, repurchases of other securities, Treasury's right to board seats
  - Permits repurchase of warrant (or common stock if Treasury has exercised the warrant)
  - Impact on executive compensation unclear – see below
  - Registration rights for warrants (and underlying common stock) remain
- Repurchase of 100% preferred stock and 100% warrant/common stock terminates all obligations to Treasury under the agreements

Repurchasing Senior Preferred

- **Important Note:** The Recovery Act changed the terms of the CaPP contracts
- **Recovery Act:** Request permission from primary federal banking regulator to repurchase senior preferred securities; regulator will work with Treasury
- **Contract requires:**
  - Within the first 3 years: with consent of primary federal banking regulator issuers may repurchase with proceeds from a "qualified equity offering"
  - qualified equity offering: sale of preferred or common stock qualifying as Tier 1 capital, in cash transaction with non-affiliate; proceeds must be no less than 25% of senior preferred investment amount
- **After 3 years:** May repurchase any amount of senior preferred at any time, with consent of primary federal banking regulator

Repurchasing the Warrant – Contract Terms

- After redeeming all of the senior preferred, issuer can repurchase all or some of the other equity securities (warrants or common stock) at "fair market value"
- NOTE: After senior preferred is repurchased in full, Treasury will seek to "liquidate" its warrant/common stock investment as soon as practicable; anticipated to be sales by Treasury; issuers seeking control over distribution of their securities should plan on repurchasing both preferred stock and warrants/common stock at the same time
- Fair Market Value:
  - Determined in good faith by the issuer's board based on an opinion of an independent investment bank ("independent" should exclude affiliates)
  - If Treasury disagrees with valuation, it may object and parties must meet to agree upon fair market value within 10 days of Treasury receiving board's determination
  - If no agreement, then appraisal procedure is implemented
  - Contracts define "market value" for purposes of certain registration rights – for common stock as its market price and for the warrants as the common stock price less exercise price – this may be helpful in determining fair market value
- Appraisal procedure:
  - Two independent appraisers (one chosen by each party) agree on fair market value
  - If unable to agree in 10 days, a third appraiser is chosen with mutual consent of two original appraisers
  - Average of three will be binding (outlier value, as determined by contract, will be excluded)
  - Issuer pays for appraisers

NOTE: If issuer receives proceeds from qualified equity offering of at least 100% of liquidation preference of preferred stock before 12/31/09, then the number of shares of common stock underlying warrant is automatically reduced by half – thereby reducing the amount needed to be repurchased to exit the program

Considerations

- Consultation with federal banking regulators is required (and recommended) as part of exit strategy
- Consider accounting impacts: SEC and FASB permitted warrants to be recorded as equity
- Regulatory capital / rating agency treatment: Although Treasury preferred stock was accorded Tier 1 treatment, rating agencies gave only partial equity credit; replacement Tier 1 transactions would be regulatory capital neutral but improve rating agency treatment
- Replacement common stock – also would be regulatory capital neutral but improve both rating agency treatment and tangible common equity ratios
- Qualified equity offerings must be either common stock or preferred stock & Tier 1: mandatory convertible debt issued under the FDIC's TLGP would not be eligible

Executive Compensation Requirements

- Existing executive compensation rules were **retroactively** amended by the Recovery Act
- New Recovery Act rules are more extensive **but** include a provision that if Treasury is only holding a warrant, executive comp rules will no longer apply
- Treasury has not issued regulations under Recovery Act or confirmed that the executive compensation rules will no longer apply if only the warrant is outstanding
- **New Rule** (Recovery Act, but no guidelines issued yet): executive comp rules apply while Treasury holds securities of issuer **other than** warrants - upon repurchase of the senior preferred or similar instrument, executive comp limits will end (new Sections 111(a)(5), (b) and (f))
- **Old Rule** (Stabilization Act): The standards required under this subsection shall be effective for the duration of the period that the Secretary holds an equity or debt position in the financial institution. (Section 111(b)(1) – direct purchases, not auctions)

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