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News Bulletin

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Capital Alternatives for Financial Institutions: Treasury's TARP Capital Purchase Program

On October 3rd, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (Act), which authorized the Treasury Secretary (Treasury) to establish the Troubled Assets Relief Program (TARP) to purchase "troubled assets." On October 14th, the TARP Capital Purchase Program (CaPP), through which Treasury makes capital investments in banking institutions, was announced as the first TARP program. Please also see our companion article on the newest Treasury capital program, announced February 25, 2009, the Capital Assistance Program.

Below we discuss the CaPP and the potential impact on capital-raising by financial institutions. For a detailed discussion of the TARP, recent action by the Federal Reserve and the FDIC, impact of the Act and tax impacts and considerations, consult our recent Client Alert "*TARP and the Various Federal Tent Poles: Will it be Enough?*" at http://www.mofo.com/news/updates/files/081015TARP.pdf.

Troubled Assets Relief Program Overview

Generally, under TARP, Treasury will be able to purchase troubled assets from financial institutions. As described below, for the CaPP, Treasury adopted a narrow definition of financial institutions, including only U.S. depository institutions and their U.S. holding companies.

The Act broadly defines troubled assets in two categories. The first category includes residential or commercial mortgages and any securities, obligations or other instruments that are based on, or related to, such mortgages. To qualify, an asset must have been originated or issued on or before March 14, 2008. Additionally, Treasury must make a determination under the program that the acquisition of the asset promotes financial market stability. In the second category, Treasury can include other financial instruments if, after consultation with the Chairman of the Federal Reserve, it makes a written determination that the purchase is necessary to promote financial market stability, and that determination is provided to the appropriate committees of Congress. We would note that there is no approval process, only a requirement that notice be provided to Congress.

Under this second category, Treasury will purchase capital securities of qualifying banking institutions through the Capital Purchase Program.

TARP Capital Purchase Program

The CaPP is the first program announced under the Act to purchase 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, including: Bank of America, The Bank of New York Mellon, Citigroup, Goldman Sachs, J.P.

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Morgan Chase, Merrill Lynch, Morgan Stanley, State Street Corp., and Wells Fargo. The terms of the program are standardized and any publicly-held qualifying financial institution was required to elect to participate by notifying its federal banking agency by November 14, 2008, 5:00 p.m. After receiving notification of election to participate, Treasury consults with the appropriate regulator and determines eligibility and allocations. An institution is not automatically eligible for the CaPP; Treasury and the financial institution's primary federal regulator determine if the institution may participate. Once the institutions are selected, Treasury determines the allocations of capital to each institution and funds the purchase of the preferred stock.[1] As discussed below, privately-held institutions and entities formed as subchapter S organizations have separately created programs with terms that reflect the organizational structure of each.

The principal terms 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 to Treasury senior preferred shares 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; once directors are elected, the right ends 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; Treasury 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; and
    - be funded by Treasury by December 31, 2008.

[1] Funding of all publicly-held investments was initially scheduled to be completed by December 31, 2008.

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- In connection with each investment, Treasury will also receive warrants to purchase common stock with the terms outlined below.
    - 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.

Terms of Treasury's Investment

Executive Compensation. Financial institutions will be subject to the executive compensation requirements for participants in the TARP. Although Treasury published guidelines for executive compensation under the Act, ongoing media reports of year-end bonuses at CaPP participants have resulted in retroactive amendments to the Act's executive compensation provisions through the American Recovery and Reinvestment Act of 2009 (Recovery Act). Treasury has not yet published updated guidelines, but the Securities and Exchange Commission has released guidance that certain provisions requiring a non-binding shareholder vote on executive compensation were effective immediately upon passage of the Recovery Act and apply to the current proxy season. Participants in the CaPP should review carefully and consider taking steps to comply with the executive compensation provisions provided in the Recovery Act.

Eligibility. Eligibility requirements for financial institutions are set forth in the program Term Sheet published by Treasury, and Treasury determines 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 that, in each case, 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 that the institutions' 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 TLGP, as described below.

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Ability to Redeem. Under the CaPP documents, 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. Additionally, as discussed below under "Recent Events," the Recovery Act prohibits Treasury from requiring replacement capital transactions to redeem the CaPP investment. Treasury is required to consult with the relevant banking regulator when evaluating a request for a redemption of the CaPP investment.

The Federal Reserve passed an interim final rule, effective October 17, 2008, that allows bank holding companies to include in their Tier 1 capital without restriction the senior perpetual preferred stock issued to the Treasury under CaPP.

Application Process

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 additional information related to its CaPP. This information primarily relates to publicly-held eligible institutions; see below for more information on the terms for privately-held and subchapter S organizations.

- Applicants initially consult with their primary federal banking regulator when preparing 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 are submitted to the financial institution's primary federal banking regulator on the 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 run on a "first-come first-served" basis, and Treasury indicated that sufficient capital was 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 makes 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 were 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 are announced within 48 hours of executing transaction documents with Treasury. There is 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.
- When approved for participation in the CaPP, the institution has 30 days to submit the investment agreements and related transaction documentation. Institutions interested in participating but do not have the necessary corporate authority (*e.g.*, inability to issue preferred stock) have until the end of the 30

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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 forms of agreement are available on the Treasury's website and contain the representations and warranties that the financial institution will need to make to participate. See http://www.treas.gov/initiatives/essa/. The financial institution needs to make statements in its application based on a review of those representations and warranties. An institution submitting 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, including:

- How financial institution participants would account for the Treasury warrant. Recent accounting guidance (EITF 00-19) suggests 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, the Securities and Exchange Commission and Financial Accounting Standards Board released guidance that, despite accounting guidance, the warrants in the CaPP may be treated as permanent equity.

Considerations for Participating Financial Institutions

The CaPP's term sheet and form documents provide details and raise 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 securityholders 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 securityholders 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, the announcement of two distinct programs on the same day created some confusion. The CaPP and the TLGP are 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.

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Capital Purchase Program for Private Institutions

On November 17, 2008, Treasury released a standard form term sheet detailing the terms and conditions of the preferred stock and warrant offerings under the CaPP for private institutions. As with the terms for public institutions, the terms of the CaPP for private institutions are standardized. Any privately-held financial institution electing to participate was required to notify its primary federal banking agency by December 8, 2008. After notification of elections to participate, Treasury consults with the appropriate regulator and determines eligibility and allocations.

Eligibility. Qualifying Financial Institutions (QFI) are eligible to participate in the CaPP. A QFI is either a (1) top-tier Bank Holding Company (BHC) or top-tier Savings and Loan Holding Company (SLHC) that engages solely or predominately in activities permissible for financial holding companies under relevant law, that in either case is not publicly-traded, (2) U.S. bank or U.S. savings association organized in stock form that is neither publicly-traded nor controlled by a BHC or SLHC or (3) U.S. bank or U.S. savings association that is not publicly-traded and is controlled by a SLHC that is not publicly-traded and does not engage solely or predominately in activities that are permitted for financial holding companies under relevant law.[2] S corporations, mutual depository institutions and institutions that are controlled by foreign banks or companies are excluded from the CaPP. Treasury makes the final determination of eligibility and allocation for QFIs after consultation with the appropriate Federal banking agency.

Publicly-traded. A QFI is "publicly-traded" if (1) its securities are traded on a national securities exchange and (2) it is required to file, under the federal securities laws, periodic reports with either the Securities and Exchange Commission or its primary federal bank regulator.

The principal terms of the CaPP for private QFIs are, in many respects, consistent with the terms for public QFIs, but with the material differences described below. As with the CaPP for public QFIs, the minimum subscription amount is 1% of risk-weighted assets and the maximum amount is the lesser of $25 billion or 3% of risk-weighted assets. In addition, private QFIs are subject to the executive compensation requirements to which any direct seller of assets under TARP are subject, including the public QFIs. The preferred issued to Treasury (Treasury Preferred) will:

- qualify as Tier 1 capital;
- rank senior to common stock;
- rank *pari passu* with existing preferred shares (other than junior preferred shares);
- 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;
- have a liquidation preference of $1,000 per share or such other amount as may be agreed to based on the available authorized preferred shares of the QFI;
- permit Treasury to elect two directors if dividends are not paid for six dividend periods (subject to the provisions described below);
- be non-voting other than for market terms for similar securities (class voting rights on matters that could adversely affect the shares);

[2] Treasury has clarified in its published Q&A that CaPP structures are under consideration for S corporations and mutual organizations.

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- be redeemable with the proceeds of an offering of replacement equity securities that provide Tier 1 capital, subject to the approval of the QFI's primary federal bank regulator during the first three years and callable thereafter; and
- require that the QFI facilitate the transfer by Treasury of the Treasury Preferred.

The differences in the public and private CaPPs stem primarily from the fact that in connection with the private CaPP, the securities are private and Treasury may be forced to hold the Treasury Preferred for longer periods of time and will not immediately have a market available for their disposition. However, the logical basis of the differences does not detract from the materiality thereof. The terms, as they vary from the public CaPP are as follows:

- There is no express right for the QFI to repurchase other securities of the QFI held by Treasury at fair market value, upon redemption of the Treasury Preferred, as is the case with securities issued under the CaPP by public QFIs.
- The ability of Treasury to elect two directors will end, for non-cumulative Treasury Preferred, upon the payment in full of dividends for four consecutive periods. However, the term sheet provides that, in the case of cumulative Treasury Preferred, the right will end upon payment of the dividend "for all prior dividend periods." Either the voting right will not end for so long as dividends are payable or Treasury will need to clarify the termination of this right in an update to the Q&A or in the forms of transaction documents.
- Treasury's consent is required before any repurchases of equity securities or trust preferred securities other than in connection with a benefit plan in the ordinary course of business consistent with past practice until the 10th anniversary of the program (instead of the third for the public CaPP) unless, prior to the 10th anniversary date (instead of the third for the public CaPP), all of the Treasury Preferred and Warrant Preferred (as described below) are redeemed or Treasury has transferred all of the Treasury Preferred and Warrant Preferred to third parties.
- Treasury's consent is required for any increase in dividends payable to the holders of common stock until the third anniversary of the date of the investment. After the third anniversary and prior to the 10th anniversary, Treasury's consent shall be required for any increase in aggregate dividends payable to the holders of common stock 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. These restrictions lapse if all of the Treasury Preferred and Warrant Preferred are redeemed or Treasury transfers all of the Treasury Preferred and Warrant Preferred to third parties. With respect to the public CaPP, Treasury's consent is not required to increase dividends payable on the common stock after the third anniversary of the date of investment.
- From and after the 10th anniversary of the investment date, the QFI shall be prohibited from paying common dividends or repurchasing any equity securities or trust preferred securities until all equity securities held by Treasury are redeemed in whole or Treasury has transferred all of such equity securities to third parties. The public CaPP has no similar provision.
- The Treasury Preferred are not subject to any contractual transfer restrictions, but:
  - the term sheet specifies that the Treasury Preferred will not be subject to any pre-existing stockholders' agreements or similar arrangements restricting transfer; and
  - Treasury will agree not to effect any transfer of the Treasury Preferred that would cause the QFI to be required to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (Exchange Act).
- If the QFI otherwise becomes subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, the registration requirements of the public CaPP will be imposed, including that the QFI will file a

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shelf registration statement covering the Treasury Preferred as promptly as practicable and the Treasury Preferred will be subject to piggyback registration rights.

- For as long as Treasury holds any equity securities of the QFI, the QFI and its subsidiaries will not enter into transactions with related persons (within the meaning of Item 404 under Regulation S-K) unless such transactions (1) are on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated third party and (2) have been approved by the audit committee or comparable body of independent directors of the QFI.

Warrant for Preferred Stock. In connection with each investment, the private QFI will issue to Treasury a warrant to purchase, upon net settlement, shares of Treasury Preferred (Warrant Preferred). There is a limited exception to the requirement to issue the warrant outlined in the Treasury's Q&A for certified Community Development Financial Institutions where the Treasury investment is $50 million or less.

Treasury announced that it intends to exercise the warrant immediately upon closing. The Warrant Preferred will be identical to the Treasury Preferred except that the Warrant Preferred will immediately pay dividends at a rate equal to 9% per annum and may not be redeemed until all of the shares of Treasury Preferred have been redeemed. Contrast this with the warrant issuable by public QFIs that is exercisable for common stock and is subject to exercise restrictions. The warrant issuable to Treasury by public QFIs is exercisable immediately according to the terms of the warrant but Treasury agreed to limit the exercise or transfer of the warrant with respect to up to half of the initial underlying shares until the earlier of the date the public QFI has received proceeds from a replacement capital transaction and December 31, 2009. The warrant issuable by private QFIs also has the following terms which differ from the terms of the warrant issuable by public QFIs:

- The warrant will be exercisable for a number of shares of Warrant Preferred with an aggregate liquidation preference equal to 5% of the amount of the Treasury Preferred issued on the date of the investment.
- The exercise price of the warrant will be equal to $0.01 per share or such greater amount as the QFI's charter may require as the par value of such shares.
- Treasury will agree not to transfer the warrant or Warrant Preferred if it would cause the QFI to be required to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Exchange Act.
- If the QFI becomes subject to the requirements of Section 13 or 15(d) of the Exchange Act, the QFI will file a registration statement covering the warrant and the Warrant Preferred as soon as practicable, and the Treasury will become entitled to piggyback registration rights covering the warrant and the Warrant Preferred.

The following provisions, which are applicable to public companies participating in the CaPP, are <u>not</u> applicable to private QFIs:

- Treasury did not agree to withhold voting the Warrant Preferred issued upon exercise of the warrant. Since the Warrant Preferred only confers vote rights in certain circumstances, this difference may prove immaterial and may be included in the transaction documents.
- The amount of Warrant Preferred underlying the warrant is not subject to reduction upon a qualified equity offering of replacement capital.
- There is no provision for automatic reduction of the warrant or requirements for a shareholders meeting to increase the amount of authorized preferred stock if the QFI does not have enough preferred shares available. Since Treasury will likely not close unless enough preferred shares are authorized, these are not material differences.
- There are no anti-dilution adjustments.

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If Treasury exercises the warrant immediately upon the closing, as is its stated intention, these terms have little relevance.

As with the public CaPP program, Treasury is required to publicly release the names of all of the recipients and amounts of all investments.

Capital Purchase Program for Subchapter S-Corporations

On January 14, 2009, Treasury released a standard form term sheet detailing the terms and conditions for its direct investment in banking institutions organized as subchapter S-corporations (S-Corps) pursuant to the CaPP. As with the terms for the other CaPP programs, the terms of the CaPP for S-Corps are standardized. Any qualified financial institution was required to electe to participate in the CaPP by notifying its primary federal banking agency by February 13, 2009. The eligibility criteria for S-Corps are substantially the same as those for the private bank program if the institution in question is a corporation that has made a valid election to be taxed under subchapter S of Chapter 1 of the U.S. Internal Revenue Code.

The principal terms of the CaPP for S-Corps are, in many respects, consistent with the terms for the other programs, especially the program for other private banking institutions. As with the CaPP for nonpublic, or private, banking institutions, the minimum subscription amount is 1% of risk-weighted assets and the maximum amount is the lesser of $25 billion or 3% of risk-weighted assets. In addition, participating S-Corps are subject to the executive compensation requirements to which any direct seller of assets under TARP is subject, including public and private qualified financial institutions. The material differences of the CaPP for S-Corps are based primarily on the statutory structure of S-Corps, not on the nature of the offering. For example, the securities to be offered are subordinated debentures and warrants as opposed to preferred stock and warrants. Under the Internal Revenue Code, S-Corps may issue only one class of stock. In addition, the government is not an eligible stockholder of an S-Corp.[3] If Treasury were to be purchasing preferred stock in this program, the S-Corp would probably lose such tax status.

Other differences exist to make sure that the different structures do not give S-Corps better terms. For example, unless expressly provided otherwise, the subordinated debentures issued by S-Corps are expressly subordinated to claims by depositors and general and secured creditors or to senior indebtedness, depending on the type of S-Corp in question. An entity's depositors and other creditors have superior claims to its assets than do the entity's preferred stockholders. In addition, the interest rates payable by the S-Corps are higher than the dividends payable by other qualified financial institutions in recognition of the fact that interest payments on debt securities are deductible for tax purposes but dividend payments on preferred stock are not.[4]

Certain other noticeable differences between the S-Corp program and the CaPP for other private banking institutions follow.

- The capital status of securities issued by S-Corps that are banks or savings associations qualify as Tier 2. The securities issued by S-Corps that are top-tier bank holding companies or top-tier savings and loan holding companies (Holding Companies) qualify as Tier 1; however, prior to any closing of an offering by an S-Corp, it will be necessary for the appropriate Federal banking agency to issue an interim final rule designating the senior securities issuable by such institutions as Tier 1 capital.
- The senior securities have a 30-year term; the preferred stock is perpetual.

[3] Eligible shareholders of S-Corps include individuals, decedents' estates, estates of individuals in bankruptcy, certain trusts and tax-exempt organizations. In general, a government will not qualify as an eligible S-Corp shareholder.
[4] The adjustment assumes a 35% tax rate for the qualified financial institutions.

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- The senior securities will pay interest at a rate of 7.7% per annum until the fifth anniversary of the investment date and thereafter at a rate of 13.8% per annum. The dividend rates for the preferred stock under the other CaPP programs are 5% and 9%, respectively.
- S-Corps that are Holding Companies may defer interest on the senior securities for up to 20 quarters; however, any unpaid interest shall be cumulative and interest will compound at the then-applicable interest rate in effect. For so long as any interest deferral is in effect, an S-Corp may not pay dividends on shares of equity or trust preferred securities.
- Notwithstanding the restrictions relating to increases in dividend amounts by S-Corps participating in the CaPP, Treasury's consent shall not be required for any increase in dividends where such increase is solely proportionate to the increase in taxable income of the S-Corp and such increased dividends are distributed to shareholders of the S-Corp in order to fund their individual tax payments on their allocable shares of the S-Corp's taxable income.
- Principal and accrued interest of the senior securities may only become immediately due and payable (i.e., accelerate) (i) in the case of a Holding Company, upon the bankruptcy or liquidation of the Holding Company, the receivership of a major bank subsidiary of the Holding Company or deferral of interest on the senior securities for more than 20 quarters or (ii) in the case of a bank or savings association, upon the receivership of the bank or savings association.

One interesting difference in the CaPP for S-Corps is notable more for the insight it may offer regarding the future administration by Treasury of the CaPP program than for its effect on the offerings. Under the CaPP program, Treasury's consent right with respect to the increase in dividend rates by a participating qualified financial institution terminates if the securities purchased from the qualified financial institution have been redeemed in whole or if Treasury transfers all of the securities to third parties. The CaPP for S-Corps clarifies that the latter clause refers to a transfer by Treasury to unaffiliated third parties and that the term "unaffiliated third parties" does not include a securitization vehicle or investment pool in which Treasury is an initial sponsor or participant so long as Treasury has an economic interest in such vehicle or pool. Last December, Chairman Cox wrote an editorial stressing the importance of the federal government having an exit strategy with respect to its growing equity stake in qualified financial institutions.[5] We doubt that Treasury has formalized its exit strategy at this time, but any indications regarding the ultimate disposition of the securities acquired in connection with the CaPP will grab the attention of market participants and other practitioners, especially when the term "securitization" is used.

Recent Events

The Recovery Act directs Treasury, upon consultation with the primary banking regulator, to permit redemption of the CaPP investments without regard to the source of funds.[6] On February 26, 2009, Treasury released a FAQ addressing redemption of CaPP investments. Recipients of CaPP funds may apply to their primary regulator, who will consult with Treasury. A minimum of 25% of the CaPP investment must be redeemed. Accrued and unpaid dividends are payable upon redemption. Warrant repurchases are permissible following the guidelines set forth in the original transaction documents.

Additionally, on February 25, 2009, Treasury announced its new capital program, the Capital Assistance Program. Interested CaPP participants can apply to exchange their CaPP securities into Capital Assistance Program securities. Unlike the senior preferred stock issued under CaPP, CAP requires issuance of a mandatory convertible

[5] Christopher Cox, *We Need a Bailout Exit Strategy: Let's Not Forget That Free Markets Made America Strong*, THE WALL STREET JOURNAL, December 11, 2008, available at http://www.sec.gov/news/speech/2008/spch121108cc.htm.
[6] NO IMPEDIMENT TO WITHDRAWAL BY TARP RECIPIENTS.—Subject to consultation with the appropriate Federal banking agency (as that term is defined in section 3 of the Federal Deposit Insurance Act), if any, the Secretary shall permit a TARP recipient to repay any assistance previously provided under the TARP to such financial institution, without regard to whether the financial institution has replaced such funds from any other source or to any waiting period, and when such assistance is repaid, the Secretary shall liquidate warrants associated with such assistance at the current market price.

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preferred. Institutions may prefer having outstanding securities that automatically convert into common stock. Please see our companion article on the Capital Assistance Program.

Contacts

Contact your Morrison & Foerster lawyer with any questions.

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situation.