GALLAGHER, CALLAHAN & GARTRELL

Understanding the TARP Capital Purchase Plan

NH Bankers Association
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I. Emergency Economic Stabilization Act of 2008 – Enacted on October 3, 2008

- Established the Troubled Asset Relief Program ("TARP")
- Several programs are being created under the TARP, including:
  - The TARP Capital Purchase Program ("CPP"), $250 billion allocated;
  - The Troubled Asset Auction Program ("TAAP")

II. The TARP Capital Purchase Program

- Treasury will purchase up to $250 billion of senior preferred shares on standardized terms described in the CPP's term sheet entitled "TARP Capital Purchase Program – Senior Preferred Stock and Warrants" (such shares, the "Senior Preferred Shares" or "SPS").
- CPP offering available to "qualifying financial institutions" ("QFIs"), including US-controlled banks, savings associations and certain bank and savings and loan holding companies.
- Election to participate must be made before close of business on November 14, 2008.
- To date the large mega-banks, several regional banks and recently several smaller banks have announced participation in the CPP.
- Treasury has indicated that troubled institutions, generally institutions with a capital rating of 4 or 5, will not be approved for participation.
- Definitive guidance pending on how CPP will apply in the case of QFIs that are organized as private stock banks, mutuals or S corporations pending. Required "Investment Agreement" not yet publicly available, see below.
- Treasury to fund SPS purchases by year-end 2008

The Application Process

- A single uniform application form is posted on the websites of the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency and the Office of Thrift Supervision

- QFIs to submit application to their primary federal regulator – **early contact and consultation with primary federal regulator strongly encouraged**. Bank Holding Companies ("BHCs") submit to FRB with copy to regulator of primary banking subsidiary. Regulators to use a standardized process to review all applications.
- Application calls for basic information – amount of SPS offered for purchase, number of authorized but unissued shares of common and preferred stock available for purchase.
- Applicant must identify and describe any mergers, acquisitions or capital raising efforts that are pending or under negotiation and expected time frame for same
- CPP Term Sheet is structured for the SEC reporting, public institutions with capital stock registered with the SEC – <u>see</u> list of initial institutions participating in the CPP as of October 29th. Applicants are encouraged to discuss any corporate structure obstacles or other challenges with regulator.
- FDIC instructions provide that state nonmember institutions with non-public structures should submit their CPP application to the FDIC regional office prior to November 14th "and describe any structural condition that may not comply with Treasury's guidelines."
- **Confidentiality** – requests for confidential treatment of specific portions of the application must be submitted in writing with the application – check with regulator re confidential treatment.
- Applicants must also agree to certain terms and conditions, and make certain representations and warranties, set forth in form of "Investment Agreement" to be signed with Treasury at time of investment. In event application is filed <u>prior to availability of Investment Agreement for review,</u> applicant must file an amended application which includes updated responses to any items that required review of such Investment Agreement. In the event the applicant cannot take action to be in compliance with the Investment Agreement prior to November 14, the applicant must provide an explanation of the condition or conditions that cannot be met [for example, shareholder approval of increase in common shares, or to authorize preferred shares] as part of the application. Applicant will have 30 days from date of notification of preliminary approval to submit necessary Investment Agreement.
- After completing the review, the regulator will send the application and its recommendation to Treasury's Office of Financial Stability, which will make the final decision; Treasury "will give considerable weight to their recommendations" (Secretary Paulson)
- All approved CPP transactions will be announced publicly within 48 hours of Treasury <u>making the investment;</u> denied or withdrawn applicants will <u>not</u> be publicly announced.

The Senior Preferred Shares ("SPS")

- Holding Companies to issue cumulative senior perpetual preferred shares; banks to issue non-cumulative senior perpetual preferred shares.

- Generally, liquidation preference of $1,000 per share; Treasury may agree to a higher liquidation preference per share depending on the participating financial institution's available authorized preferred shares
- SPS must be senior in rights to common stock and 'pari passu' [equivalent terms] with existing preferred shares, other than preferred shares which by their terms rank junior to any existing shares.
- The SPS will qualify as Tier 1 capital
- The SPS will have a perpetual life.
- The minimum subscription amount available is 1% of risk weighted assets.
- Maximum subscription amount will be the lesser of $25 billion or 3% of risk weighted assets.
- Bank holding companies will pay <u>cumulative dividends</u> at a rate of 5% a year for the first five years, will reset to a rate of 9% per year after the fifth year. Banks which are not subsidiaries of holding companies will pay <u>non-cumulative dividends</u> at a rate of 5% a year for the first five years and will reset to the 9% rate after the fifth year.
- Dividends are payable quarterly in arrears on February 15, May 15, August 15 and November 15.
- Investment Agreement – participating QFIs required to enter into CPP Investment Agreement with Treasury with applicable terms and conditions, representations, and warranties (see Application Process above).

Redemption

- At the option of the QFI, the SPS may be redeemed at par (100% of issue price) <u>after three years</u>, including (i) any accrued and unpaid dividends for the cumulative SPS, and (ii) any accrued and unpaid dividends for the then current dividend period for the non-cumulative SPS.
- Redemption of SPS will be subject to approval of the primary federal bank regulator.
- Prior to three year period, the SPS may be redeemed with the proceeds from a "Qualifying Equity Offering" of any Tier 1 perpetual preferred or common stock resulting in aggregate gross proceeds of not less than 25% of the issue price of the SPS.

Dividend Restrictions

- So long as SPS are outstanding, no dividend may be declared or paid or any junior preferred shares, pari passu preferred shares or common shares (i) unless and until all accrued and unpaid dividends for the cumulative SPS are fully paid, OR (ii) the full dividend for the latest completed dividend period for the non-cumulative SPS has been fully paid.
- Restrictions on repurchase or redemption of junior preferred shares unless all accrued and unpaid dividends have been paid.

- For the first three years that the Treasury owns SPS or warrants, the institution may not increase its dividend payments on common shares without the permission of the Treasury.

Repurchases

- Prior consent of Treasury required for any share repurchases other than repurchases of the SPS (other than repurchases of junior preferred shares or common shares in connection with any benefit plan [i.e., stock option plans where existing shares used to pay stock option exercise price] in the ordinary course of business consistent with past practice) <u>for the first three years</u>, unless (i) the SPS have been redeemed in full, or (ii) the SPS shares have been sold by Treasury to a third party.
- No repurchases, other than SPS, if dividend restrictions apply [failure to pay accrued and unpaid dividends]

Voting Rights

- SPS are non-voting, except for class voting rights on matters adversely affecting the SPS (i.e., such as issuance of senior ranking shares, any amendment to the rights of the SPS, or any merger, exchange or similar transaction that would adversely affect the rights of the SPS).
- If fail to pay dividends for six periods, whether or not consecutive, the SPS shares will have the right to elect two directors.
- Such right to elect directors ends when full dividends have been paid for four consecutive dividend periods.

Transferability

- Treasury may transfer the SPS to a third party at any time. The standard term sheet for a participating QFI requires such issuer to file a "shelf registration statement" covering the SPS and take action to cause such registration to be declared effective as soon as possible – very difficult for non public QFI.
- Also required to grant "piggyback registration rights" for the SPS and take reasonable actions to facilitate the transfer of the SPS, including reasonable efforts to list the shares on the National Security Exchange.

Warrants

- In connection with the purchase of SPS, the Treasury will receive warrants to purchase common stock from the institution.
- Warrants will have an aggregate market price equal to 15% of the SPS investment.
- Exercise price on warrants will be the market price of the common stock at the time of issuance, calculated on a 20 trading day trailing average.
- Term of 10 years, immediately exercisable in whole or in part.

- Freely transferable [see caveat below], however, Treasury may only transfer or exercise an aggregate of one-half of the warrants prior to the earlier of (i) the date on which gross proceeds of 100% of the price of the SPS are received in one or more qualifying equity offerings, or (ii) December 31, 2009.
- REDUCTION – the number of common shares underlying the warrants held by the Treasury will be reduced by one-half (0.5) if the QFI conducts one or more "Qualifying Equity Offerings" prior to December 31, 2009 that result in gross proceeds of not less than 100% of the issue price of the SPS.
- Required to file a "shelf registration statement" covering the warrants and the underlying common stock.
- Also grant piggyback registration rights for the warrants and the underlying common stock.
- Required to list the underlying common stock on a National Securities Exchange as with existing common stock.
- Treasury will not exercise voting rights of any common stock issued to it upon exercise of the warrants [query whether such commitment will bind third party purchasers of common from Treasury].
- RISK to non public QFIs – a company becomes a 'public' company subject to obligation to register common stock with SEC when 500 shareholders of record – no certainty of buyers of common from Treasury upon exercise of warrants.
- QFI granted time post SPS investment to call meeting of shareholders necessary to authorize number of common shares necessary to underlie the warrant, and/or to obtain shareholder approval of transaction if required by applicable stock exchange rules.

III. Executive Compensation and Corporate Governance Restrictions

- Restrictions apply to QFIs senior executives determined as with public companies - encompasses the CEO, CFO, and the next three most highly compensated executive officers ("SEOs").
- Executive compensation and corporate governance rules apply to SEOs during the period for which the Treasury holds equity or debt issued under the CPP. Note the Warrants have initial term of ten years – if warrants exercised and common sold, restrictions end.
- RISK ASSESSMENT/Incentive Compensation – within 90 days of the CPP investment, and annually thereafter, the QFIs 'compensation committee' must review, ensure and certify, that any incentive compensation programs for SEOs do not encourage unnecessary excessive risks that threaten the value of the institution. Intent to move from 'short term' to longer term incentive compensation programs.
- The participating institution must require and have the ability to affect a "clawback" of any bonus or incentive compensation paid to a SEO based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate. Broader scope of clawback than Sarbanes-Oxley Act.

- QFIs are prohibited from making any "golden parachute payment" to a SEO (generally a severance payment greater than 3 times the SEOs prior 5-year average compensation).
- The QFI is also subject to annual limit on its federal tax deduction to $500,000 for each SEO. Unlike the federal tax code section 162(m) limitation, there are no exceptions for performance based compensation such as stock options, and applies to deferred payments.
- As a condition of closing an investment, participating institutions shall modify or terminate all benefit plans, arrangements and agreements to the extent necessary to be in compliance.
- The institution and the SEOs covered by the TARP standards are required to grant the Treasury a waiver releasing the Treasury from any claims that the institution or such officer may otherwise have as a result of the issuance of any regulation which modify the terms of benefit plans, arrangements and agreements to eliminate any provisions that would not be in compliance with the executive compensation and corporate governance standards.

IV. Latest CPP Developments

- Listing of initial CPP participants as of October 29th – all public, SEC reporting companies.
- ABA has submitted letter to Treasury dated October 28th asking for (i) clarification of terms and conditions, and an alternative investment framework, under which "certain non-exchange traded public C Corporations, private companies, Sub-S Corporations, and mutual institutions" {some 6,000 in number} could participate in the CPP, and (ii) an extension of time beyond November 14th for such institutions to file an application for participation.

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