News Bulletin

October 17, 2008

# New Liquidity and Capital Alternatives for Financial Institutions: Treasury's TARP Capital Purchase Program; FDIC's Temporary Liquidity Guarantee Program

On October 3rd, the President 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 will make capital investments in banking institutions, was announced.

Also on October 14th, the FDIC announced the Temporary Liquidity Guaranty Program (TLGP): a new guarantee program for certain banking institution liabilities. These, together with the expanded Federal Reserve Commercial Paper Funding Facility, were structured to unfreeze inter-bank lending and encourage lending more broadly.

Below we discuss the details currently available on CaPP and the FDIC's TLGP, 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

The Act permits Treasury to establish programs to buy and to insure financial institutions' troubled assets. The outstanding program obligations will be $700 billion, subject to the requirements and limitations set forth in the Act. The purchase program will be conducted using either auctions or direct purchases of troubled assets, with a preference for auctions and other "market mechanisms." Treasury is required to publish program guidelines within two days of the first purchase, or no later than 45 days after the Act's passage. Several announcements from Treasury have already provided details on the development of purchase programs, most recently the terms for the CaPP.

 Attorney Advertisement

Generally, under TARP, Treasury will be able to purchase troubled assets from financial institutions. For the CaPP, Treasury adopted a narrower definition, including only U.S. depository institutions, as described below under "*TARP Capital Purchase Program*."

A *Financial Institution,* as defined under the Act, is any institution established and regulated under U.S. laws and having significant operations in the U.S.

> The definition includes a non-exclusive list of institutions, including: any bank, savings association, credit union, security broker or dealer or insurance company.
>
> It is expected that U.S. branches of foreign financial institutions, if their U.S. operations are significant, will qualify. Institutions owned by a foreign government and foreign central banks are expressly excluded. However, to the extent that a foreign financial authority acquired troubled assets as a result of extending financing to a financial institution that has failed or defaulted on the financing, those assets are eligible for purchase. For example, if a foreign financial institution with a significant U.S. presence, such as a branch, became significantly undercapitalized or failed, its home jurisdiction banking authority would take action. If, as a result of a bailout or other emergency measures, the home country banking authority acquires troubled assets, those troubled assets could be eligible for purchase under the program. The Act also requires that Treasury take into consideration protection of retirement security of Americans, and certain tax-qualified plans are eligible to sell troubled assets.
>
> Treasury must also consider the impact of the current environment on public instrumentalities, including the increased costs and losses faced by counties and cities. It is currently unclear how the TARP will remediate the impact to public instrumentalities, as a municipality would not appear to be a "financial institution." The most straightforward approach may be to conduct auctions to purchase, and rebuild price stability in, securities issued by counties and cities. That in turn raises questions regarding the allocation of funds of the TARP and its goals of reestablishing the broader markets, protecting taxpayer resources and preserving homeownership. We expect that this, as with many other areas, will be addressed in guidance and reports to be released by Treasury in the coming days and weeks.

*Troubled Assets* are broadly defined in two broad 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.

Second, 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 under the Capital Purchase Program.

## TARP Capital Purchase Program

The CaPP is the first program under the Act to announce purchase of 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, reported to include: Bank of America, The Bank of New York Mellon, Citigroup, Goldman Sachs, J.P. Morgan Chase, Merrill Lynch, Morgan Stanley, State Street Corp., and Wells Fargo. **The terms of the program are standardized and any qualifying financial institution may elect to participate by**

**notifying its federal banking agency by November 14, 2008, 5:00 p.m.** After notification of elections to participate, Treasury will consult with the appropriate regulator and determine eligibility and allocations. An institution will not be automatically eligible for CaPP; Treasury and the financial institution's primary federal regulator will determine if the institution may participate. Once the institutions are selected, Treasury will determine the allocations of capital to each institution and will fund the purchase of the preferred stock no later than December 31, 2008.

The principal terms, as set forth in a public term sheet published by Treasury (available at http://www.treas.gov/press/releases/reports/document5hp1207.pdf), 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 senior preferred shares to Treasury, 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
  - permit Treasury to elect two directors if dividends are not paid in full for six quarterly periods; but this right will end when full dividends have been paid for four consecutive dividend periods
  - be non-voting other than 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)
  - 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; it may then require a depository 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
  - be funded by Treasury by December 31, 2008

- In connection with each investment, Treasury will also receive warrants to purchase common stock with the following terms:
  - 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 debt or another instrument.
- Financial institutions will be subject to the executive compensation requirements for participants in the TARP (see our broader Client Alert on the TARP)
- Eligibility requirements for financial institutions are set forth in the program Term Sheet published by Treasury and Treasury will determine eligibility of interested participants. Note that 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, in each case that are U.S. entities not controlled by a foreign bank. U.S. entities are those organized under the laws of the U.S., 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) the Bank Holding Company Act (BHC) or whose 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 TLGF, as described below.

The preferred shares can be redeemed with the proceeds of a qualified equity offering. 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.

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. The rule is effective on an interim basis, and the Federal Reserve is seeking comment on the proposed final rule. Comments are due within 30 days of publication of the interim rule in the Federal Register.

## Considerations for Participating Financial Institutions

CaPP's term sheet provides a number of details, and raises questions for participants to consider. Financial institutions need to review carefully their existing capital structure 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 security holders will be important.

For each of the securities, the financial institution will need to look closely at their 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 the rights of existing security holders 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.

## Purchase Programs: What We Know So Far

Other than the CaPP, detailed program guidelines have not been released for the separate program teams created by Treasury for the TARP, including the previously announced mortgage-backed securities program and the whole loan purchase program. Given the speed with which the Capital Purchase Program was established, we would expect additional details on other troubled assets to come quickly.

The Act provides some guidance on the key components of the TARP and what we should expect from the guidelines. Treasury is directed to use market mechanisms, such as auctions and reverse auctions, wherever possible to achieve the purposes of the Act. Where an auction would not be feasible or appropriate, Treasury may engage in direct purchases. For example, distressed financial institutions are expected to need structured and negotiated direct sales.

The Act directs Treasury to prevent unjust enrichment of the financial institutions selling troubled assets, including by prohibiting sales to Treasury at a higher price than what the seller paid to purchase the asset. However, methods to price and value the troubled assets are yet to be established. There are extensive and detailed reporting obligations and additional information will become available through the initial sales disclosures, release of the program guidelines as well as through periodic reports required under the Act.

On October 14, 2008, Treasury announced that work was ongoing to develop a program to potentially provide assistance to failing institutions. The Program for Systemically Significant Failing Institutions will have terms negotiated on a case-by-case basis.

## Treasury to Acquire Securities from Sellers

Under each of the TARP sub-programs, in connection with every purchase of troubled assets (subject to limited exceptions), Treasury must acquire securities of each financial institution that sells troubled assets. The type of security and structure of the investment depends on whether the financial institution has publicly traded securities. These general rules are as follows:

> *Public Companies*: A financial institution that is traded on a national securities exchange will be required to provide Treasury with equity securities. These can be in the form of warrants for non-voting common stock or preferred stock, or warrants for voting common stock. In the case of voting stock, Treasury will agree not to exercise voting rights, other than class voting rights on matters that could adversely affect the shares. If Treasury later sells the warrant, the voting rights would transfer to the purchaser. The warrant


Attorney Advertisement

of any public company must contain a provision protecting Treasury if the financial institution is no longer publicly traded; either a provision converting it to senior debt, or “appropriate protections” against that risk.

*Non-public Companies*: A financial institution without listed securities may sell Treasury a warrant for common or preferred stock, or senior debt.

Where a holding company has publicly traded common stock, we would expect its troubled assets to be held at a subsidiary in most, if not all, cases. Given the benefit of holding publicly traded securities of the parent institution, we would expect Treasury, looking at the purposes of the Act and its responsibility to protect the taxpayer investment, to establish procedures to accept securities of the parent financial institution.

*Exceptions*. Treasury may establish a de minimis exception to the requirement that the financial institution issue securities. However, the Act requires that Treasury cannot establish a threshold higher than $100 million; any financial institution selling more than $100 million, or such lower amount as Treasury may establish, must issue securities. Additionally, there is an exception for issuers that are legally unable to provide securities to Treasury. Treasury shall arrange an “appropriate alternative requirement” for that seller of troubled assets that does not have the legal authority to issue securities. An example would include a purchase by Treasury of troubled assets from a foreign financial authority or foreign central bank that had acquired those troubled asset from a financial institution it had rescued. Finally, in the event a financial institution does not have a sufficient number of authorized shares to issue warrants, senior debt will be acceptable, if the terms will provide equivalent value. The provisions of the CaPP provide a guide for some of the design features that may be used to work around financial institutions with insufficient authorized shares.

*Structuring Warrants*. With respect to the equity underlying warrants, financial institutions may have limitations in their organizational documents authorizing only one class of common stock, rendering them unable to issue non-voting common stock. As a result, we would expect that these financial institutions will prefer a preferred stock structure. All warrants must contain market standard anti-dilution provisions to provide for adjustments in the event of stock splits, stock distributions, dividends and other distributions, mergers and other forms of reorganization or recapitalization. In structuring warrants, the initial financial institutions will need to avoid “death spiral” provisions. Any increase in the number of shares that results from a decline in the trading price of common stock will result in the Treasury, or the third party to whom it subsequently sells the warrants, taking an ownership interest larger than initially planned, with greater dilution for existing holders. We expect the initial warrants issued will be duplicated quickly and a limited number of ‘standard’ forms of Treasury-held warrants will be established.

The terms and conditions of the individual securities granted under this provision will be largely at the discretion of Treasury, and subject to compliance with the purposes of the requirement. Treasury is charged with acquiring assets that protect the taxpayers’ investment through participation in appreciation of equity securities or the return of a reasonable premium. Additionally the investment provides additional economic protection against losses incurred through sales of troubled assets as well as the administrative expense of running TARP. We expect that the other TARP programs will mirror the CaPP, including the requirement for registration statements with respect to the securities received by Treasury. For private companies, the terms will need to provide similar economic benefit to Treasury. Treasury has the authority to sell, exercise or surrender any security received under these provisions, but must protect taxpayers when managing the securities.

## FDIC’s Temporary Liquidity Guaranty Program

On October 14, 2008, the FDIC announced the creation of a new program, the Temporary Liquidity Guarantee Program (TLGP), designed, together with Treasury’s Capital Purchase Program and the Federal Reserve’s enhanced Commercial Paper Funding Facility, to unfreeze credit markets. Through the TLGP, the FDIC will

provide insurance to previously uninsured amounts in non-interest bearing deposit accounts and certain newly-issued senior unsecured debt.

The FDIC has held a series of informational calls and is currently gathering questions from financial institutions and industry participants. The FDIC will be issuing Financial Institution Letters and a policy statement and may issue interim regulations. The FDIC encourages all market participants to check the TLGP's web site regularly for updates (www.fdic.gov\tlgp).

## Eligible Institutions

Institutions able to participate include (1) FDIC insured depository institutions, (2) U.S. bank holding companies, (3) U.S. financial holding companies and (4) U.S. savings and loan holding companies that engage only in activities that are permissible for financial holding companies to conduct under section 4(k) of the BHC. There are few differences between the QFI under CaPP and the eligible institutions under TLGP. For example, Industrial Loan Companies that are FDIC insured would qualify for the FDIC program, but would not be qualifying financial institutions covered by CaPP. The FDIC has indicated that it is are reviewing the ability of a U.S. branch of a foreign bank to qualify for the program, whereas foreign branches are excluded from CaPP. In addition, Treasury will make the final determination of eligibility to qualify for CaPP in consultation with the institution's primary banking regulatory. The FDIC will coordinate with the primary regulator for supervisory purposes, but has not indicated that no special steps need to taken to qualify for the program. Each of the nine financial institutions that agreed to participate in the CaPP also agreed to participate in the TLGP.

All eligible institutions are currently covered by the guarantees described below, and will remain in the TLGP without further action for the 30-day period that began October 14, 2008. See "*Participation and Duration*" below for more information on the automatic inclusion of financial institutions, opt-out requirements and expiration of the program.

## Guarantees

*Senior Debt*. Under TLGP, newly issued senior unsecured debt issued on or before June 30, 2009 will be fully insured in the event the issuing institution subsequently fails, or its holding company files for bankruptcy. The debt included in the program includes all newly issued unsecured senior debt, including: promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt. The aggregate coverage for an institution may not exceed 125% of the debt outstanding on September 30, 2008 that was scheduled to mature before June 30, 2009. The guarantee of any newly issued debt will extend to June 30, 2012, even if the maturity of the debt is after that date. The estimated amount of eligible institution qualifying senior unsecured debt outstanding as of September 30, 2008 is $1.4 trillion.

It may be worth noting that although this has been named a 'guarantee' it operates under the same terms as FDIC insurance. The FDIC is not providing a payment guarantee in the event the issuer of senior unsecured debt fails to make payments of interest or principal. Only in the event of an institution's failure – receivership or bankruptcy – will the FDIC pay the guaranteed debt.

The FDIC has not determined whether participants will be able to elect which of their new senior debt instruments they would like to have guaranteed, for example, on a program by program basis. Recent statements have indicated that new guaranteed debt cannot be used to redeem or replace outstanding debt prior to the maturity of the outstanding debt according to its terms. However, many questions remain unanswered and subject to further discussion and determination. For example, numerous questions have arisen with respect to the coverage for non plain-vanilla debt instruments. Also unclear is the risk weighting that will be assigned to the guaranteed debt. The FDIC is compiling a list of market participant questions and has indicated that it would respond quickly.



Attorney Advertisement

Within the next few days, a mailbox will be established through the link provided above, and financial institutions are strongly encouraged to submit questions directly to the FDIC.

*Deposit Insurance*. A participating eligible institution's non-interest bearing deposit transaction accounts, regardless of dollar amount, will be fully insured by the FDIC. These are primarily payment-process accounts, such as payroll accounts used by businesses. Sweep accounts are expected to be handled the same way they would be in a bank failure. The FDIC will determine where the money is at the close of the business day. If cash in a non-interest bearing deposit account is swept into an interest bearing account during the day (before the close of business), the funds in the interest bearing account will not be insured. The estimated amount of uninsured non-interest bearing transaction account deposits, prior to the TLGP, is between $400 and $500 billion.

## Participation and Duration

All eligible institutions are automatically covered by the TLGP for the first 30 calendar days, which commenced on October 14, 2008. For example, any newly issued senior unsecured debt of an eligible institution, for an amount that is under the issuance cap, is guaranteed automatically and without further action by the institution. This includes all inter-bank debt. Industry participants have raised numerous questions regarding how to determine if their counterparty's debt is covered. The FDIC has indicated that it will publish guidelines as quickly as possible, that financial institutions should determine their outstanding eligible debt as of September 30, 2008 to calculate their issuance limit, and that prior to final guidance counterparties should be making reasonable inquiries of each other when purchasing senior unsecured debt.

If an institution is not interested in participating after the first 30 days it must ***affirmatively opt-out*** of the program. Failure to opt-out of the program will automatically enroll the eligible participant and fees will be assessed by the FDIC. Institutions can opt out of ***either or both*** of the programs. The opt-out is a ***one-time*** event and is a permanent decision for the duration of the program; an institution's status after the 30th day will be its status throughout the program.

*TLGP and CaPP – Important Differences*

Although both programs were announced the same day, the CaPP and the TLGP remain 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 none, depending only on eligibility.

## Fees and Supervision

For the first 30 days, when all eligible institutions are automatically covered by the TLGP, there will be no assessments or fees. Thereafter, special fees will be used to fund the program; it will not rely on taxpayer funding. All fees and assessments will be held in a separate account and not included in the Deposit Insurance Fund. If, at the termination of the program, there is a shortfall, it will be recouped through a special assessment on the industry. Any special assessment will be based on liabilities (rather than deposits), resulting in a greater burden on the largest institutions. If, at the termination of the program, there are excess funds remaining, they are expected to be deposited in the Deposit Insurance Fund.

Newly issued debt guaranteed by the program will require participants pay a fee of 75-basis points per annum. Institutions whose non-interest bearing transaction accounts are fully insured will be assessed a 10-basis point surcharge on the deposit amount in excess of the pre-TLGP insurance limit.



Attorney Advertisement

As a result of the TLGP, banking regulators will be implementing an enhanced supervisory framework to assure appropriate use of the new guarantee and prevent rapid growth or excessive risk-taking. The FDIC will maintain control over eligibility for the program, in consultation with each institution's primary federal regulator.

## Authorization and Duration

The TLGP was established under the FDIC's authority to prevent a "systemic risk." The FDIC Improvement Act of 1991 authorizes the FDIC to take action when Treasury, upon a recommendation of the boards of the Federal Reserve and the FDIC and in consultation with the President, makes a determination of comparable systemic risk.

The guarantees on non-interest bearing deposit accounts will expire on December 31, 2009. The guarantees on senior unsecured debt instruments will attach to instruments issued through June 30, 2009, and all outstanding senior unsecured debt guarantees will expire on June 30, 2012, irrespective of the maturity date of the debt.

### 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.

© 2008 Morrison & Foerster LLP. All rights reserved.

*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.*