



CaPP: Private Bank Program

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 Troubled Assets Relief Program (TARP) Capital Purchase Program (CaPP) for private institutions. The Emergency Economic Stabilization Act of 2008 (Act), enacted on October 3, 2008, authorized the Secretary of the Treasury (Treasury) to establish the TARP. On October 14, 2008, Treasury announced CaPP through which Treasury intends to make capital investments in private and public banking institutions. Treasury also announced agreements with 30 financial institutions to purchase almost \$160 billion of preferred stock of institutions under the CaPP. The investments by Treasury in public institutions have been designed as a purchase of preferred stock and warrants to purchase common stock.

Below we discuss the details currently available on the new term sheet released by Treasury regarding participation in the CaPP by private 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?”](#). Additional details regarding currently available information on CaPP are available in our recent Client Alert [“New Liquidity and Capital Alternatives for Financial Institutions: Treasury’s TARP Capital Purchase Program; FDIC’s Temporary Liquidity Guarantee Program”](#).

Capital Purchase Program 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 may elect to participate by notifying its primary federal banking agency by December 8, 2008. After notification of elections to participate, Treasury will consult with the appropriate regulator and determine eligibility and allocations. As of this time, Treasury has not announced the final funding date.

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.¹ S corporations, mutual depository institutions and institutions that are controlled by foreign banks or companies are excluded from the

¹ Treasury has clarified in its published Q&A that CaPP structures are under consideration for S corporations and mutual organizations.

CaPP. Treasury will make 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 will be 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;
- 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);
- 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 retract 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.
 - 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 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 (1) such transactions 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.

Warrants for Preferred Stock. In connection with each investment, the private QFI will issue to Treasury warrants 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 warrants 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 warrants issuable to public QFIs that are exercisable for common stock and are subject to exercise restrictions. The warrants issuable to Treasury by public QFIs are exercisable immediately according to the terms of the warrants but Treasury agreed to limit the exercise or transfer of the warrants 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 warrants issuable by private QFIs also have the following terms which differ from the terms of the warrants issuable by public QFIs:

- The warrants 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 warrants 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 warrants 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 warrants and the Warrant Preferred as soon as practicable, and the Treasury will become entitled to piggyback registration rights covering the warrants and the Warrant Preferred.

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

- Treasury did not agree to withhold voting the Warrant Preferred issued upon exercise of the warrants. Since the Warrant Preferred only vote in certain circumstances, this difference may prove immaterial and may be included in the transaction documents.
- The amount of Warrant Preferred underlying the warrants 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.

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

We expect that additional details will be forthcoming, including updates to the published Q&A, forms of transaction documents and potentially, announcement of the final date by which the investments will be made. As with the public CaPP program, Treasury is required to publicly release the names of all of the recipients and amounts of all investments.

The Treasury materials are available at: <http://www.ustreas.gov/initiatives/eesa/docs/Term%20Sheet%20-%20Private%20C%20Corporations.pdf> and <http://www.ustreas.gov/initiatives/eesa/docs/FAQ%2011-17-08%20-%20Private.pdf>. A link to the materials will be available on the Morrison & Foerster LLP Financial Crisis web site.

Contacts

Amy Moorhus Baumgardner
(202) 887-1532
abaumgardner@mofocom

Joseph R. Magnas
(212) 336-4170
jmagnas@mofocom

Anna T. Pinedo
(212) 468-8179
apinedo@mofocom

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.mofocom.

© 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 situations.