Capital Purchase Program – Publicly Traded Financial Institutions

As you are no doubt aware, the United States Treasury has decided to forgo its initial plan to buy troubled assets from financial institutions, and intends instead to use the funds made available under the Troubled Asset Relief Program (**TARP**) to inject capital directly into banks. As of the date of this memorandum, over 80 publicly traded financial institutions[1] have announced their intent to participate in the Treasury's Capital Purchase Program, accounting for almost $250 billion in investments by the Treasury.

A capital infusion from the federal government may help your balance sheet, but are the investment terms worth it? The Capital Purchase Program raises a number of practical considerations for qualifying financial institutions, especially regional and community banks, that might participate. Some of these include:

- Handling a denial or withdrawal of a Capital Purchase Program application;
- Understanding the consequences of issuing preferred stock and/or warrants;
- Analyzing the need for and obtaining all necessary shareholder approvals;
- Conducting an assessment of executive compensation policies for compliance with program guidelines;
- Ensuring that anticipated use of Capital Purchase Program funds complies with all program requirements; and
- Planning for alternative sources of funding and/or developing an exit strategy from the Treasury's investment.

The deadline for publicly traded financial institutions (including those institutions which file reports with the Fed and the OCC) to apply for participation in the Capital Purchase Program was November 14, 2008. Many publicly traded banks that applied for the program are now analyzing the merits of participating in the program and assessing the impact of participation on their institution. We are providing this memorandum to assist these institutions in their analysis by highlighting certain key points of the investment terms and providing commentary on certain key terms.[2]

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[1] Although the term "publicly traded" was not defined in the Emergency Economic Stabilization Act of 2008 or in the Capital Purchase Program materials initially released by the Treasury for publicly traded institutions, the Treasury issued a term sheet on November 17, 2008 for the privately-held financial institutions Capital Purchase Program which defined the term as "a company (1) whose securities are traded on a national securities exchange and (2) required to file, under the federal securities laws, periodic reports such as the annual (Form 10-K) and quarterly (Form 10-Q) reports with either the Securities and Exchange Commission or its primary federal bank regulator. A company may be required to do so by virtue of having securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, which applies to all companies that are traded on an exchange or that have $10 million in assets and 500 shareholders of record or Section 15(d) of the Exchange Act which requires companies that have filed a registration statement under the Securities Act of 1933, as amended, and have 300 or more securityholders of record of the registered class to file reports required under Section 13 of the Exchange Act, e.g., periodic reports."

[2] We will provide a similar memorandum with respect to the Treasury's recently released terms for its proposed investment in privately held financial institutions.

GENERAL INVESTMENT TERMS

Eligible Institutions

Qualifying financial institutions (QFIs) are US bank holding companies, certain US savings and loan holding companies and certain stand-alone US banks and thrifts.

Application Deadline Date

The deadline for publicly-traded financial institutions was 5:00 p.m. (EDT) on Friday, November 14, 2008.

We have been advised informally that because of the lack of a definition of the term "publicly traded" in the initial Capital Purchase Program materials, a financial institution that meets the definition of " publicly traded" released on November 17, 2008 (see footnote 1) and that did not submit an application by the November 14, 2008 deadline may still be able to submit an application for consideration by its banking regulator. We invite any financial institution in this situation to consult with a member of our TARP Team.

Subscription Amount

The amount of preferred stock that Treasury may purchase from any QFI must equal at least one percent of its risk-weighted assets and not more than the lesser of (i) $25 billion and (ii) three percent of its risk-weighted assets.

Healthy Banks

Treasury has stated that it will invest only in "healthy" institutions, and its comments to date make it clear that it expects further bank failures despite the equity injections.

This implies further consolidation among regional banks or deposit purchases by systemically important banks.

PREFERRED STOCK

General Terms

The preferred stock will be perpetual and cumulative, except that it will be noncumulative if issued by a bank that does not have a holding company.

Preferred stock should be accounted for as equity under GAAP and will be treated as Tier 1 capital for regulatory capital purposes.

Ranking

Senior to common stock and pari passu with any other preferred stock, other than junior preferred stock.

Dividends

<u>Rate</u>: Five percent rate that increases to nine percent rate after five years.

This step-up in the dividend rate may incent the issuer to raise equity in the capital markets to redeem the preferred stock. See "—Redemption," below.

<u>Cumulative</u>: Dividends not only accumulate, but unpaid dividends compound at the dividend rate then in effect.

<u>Payment Date</u>: Generally, February 15, May 15, August 15 and November 15, but can be changed with the consent of Treasury.

Redemption

Before the Third Anniversary. Redeemable with the proceeds of one or more qualified equity offerings[3] equal to at least 25% of the issue price of the preferred stock.

After the Third Anniversary. Redeemable at par, plus any accrued and unpaid dividends.

Other Considerations.

- Any redemption requires approval of primary federal banking regulator.
- The right to purchase the warrant or the common stock underlying the warrant is triggered by (i) the redemption of the preferred stock, and (ii) Treasury's transfer of all of the preferred stock to third parties.

Voting Rights

Nonvoting except for customary consents and the right to elect two directors if the dividend is not paid for six quarters, whether or not consecutive.

The right to elect directors ends when all dividends have been paid for all past dividend periods.

Right to elect directors is not in addition to any director election rights of other preferred stockholders with like voting rights (i.e., Treasury will be required to vote with the holders of other voting parity preferred stock to appoint two directors).

Negative Covenants

Dividend Restrictions: Generally, dividends on common stock and *pari passu* preferred stock are not permitted unless dividends are paid on the preferred stock purchased by Treasury.

Dividend and Repurchase Restrictions: Subject to a few exceptions noted below, the QFI may not increase its common stock dividends or buy back its common stock for a three-year period. The exceptions include purchases related to:

- employee benefit plans consistent with past practice;
- market making and related activities;
- stockholders rights plans;
- acquisitions for the beneficial ownership of another person (e.g., acting as a trustee or custodian); and
- certain exchanges or conversion of junior stock for other junior stock or preferred stock ranking in parity with the preferred stock sold to Treasury into other parity preferred stock or junior stock.

WARRANTS

Coverage

Treasury will receive warrants to purchase a number of shares having an aggregate market price[4] equal to 15% of the amount of the preferred stock purchased.

Exercise Price

Equal to the 20-trading day trailing average closing price ending on the trading day immediately before the date Treasury accepts the QFI's application to participate in the Capital Purchase Program.

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[3] A qualified equity offering is defined as a sale for cash of common stock or perpetual preferred stock that qualifies as Tier 1 capital. The following issuances do not count: (i) issuance of trust preferred securities or other Tier 1 qualifying instruments; (ii) issuances made pursuant to financing plans publicly announced, or pursuant to arrangements entered into, on or prior to October 13, 2008. The issuer is not required to use the proceeds of a qualified equity offering to redeem the Preferred Stock.

[4] Market price is based on the 20-trading day trailing average price at the time of issuance.

Because of the manner in which the exercise price is calculated, the QFI is exposed to some market risk between the date it submits its application and the date that Treasury approves it.

Exercisability

The warrant is immediately exercisable in full. However, if the QFI raises 100% of the issue price of the preferred stock in qualified equity offerings before December 31, 2009, the number of shares underlying the warrant is reduced by half. As a result, Treasury can only exercise or transfer the warrant with respect to up to half of the shares underlying the warrant before December 31, 2009.

Settlement of Exercise

Unless otherwise agreed, payment of the exercise price will be made by net exercise. The number of shares to be withheld will be based on the closing price of the common stock on the date of exercise.

No Adjustments

Unlike many convertible securities sold in typical financings, the conversion ratio does not increase if the QFI undergoes a cash merger or certain changes of control.

Substitution

The warrant must be substituted for another economic interest if the common stock is no longer listed on a national securities exchange or any necessary stockholder approval is not obtained within 18 months of the issue date of the warrant.

The new security will be an economic interest that is classified as permanent equity under US GAAP (with a value equal to the fair market value of the warrant as determined by Treasury). This avoids any US GAAP requirement to treat the warrant as a liability due to the potential substitution of the warrant for a debt security. The SEC and the FASB have confirmed that they will not object to treating the warrant as permanent equity.

Appraisal Procedures

For the purpose of determining the applicability of an anti-dilution adjustment, Treasury can invoke third-party appraisal procedures to determine the fair market value of any non-cash distributions on the common stock.

Voting the Underlying Common Stock

Treasury will not vote any common stock it receives on exercise of the warrants.

This may raise issues when it comes to obtaining a quorum. Some had asked that Treasury agree to vote its shares of common stock in proportion to other stockholders so that its shares could be counted for quorum purposes.

Registration Rights

Treasury will be granted registration rights so that it may sell the common stock via a resale shelf registration statement

Exchange Considerations

Under certain exchange rules, without shareholder approval, the number of shares issuable upon exercise of warrants cannot exceed 19.99% of the outstanding common stock at the time the warrants are issued.

This may be an issue for some regional and community banks that have a lower number of shares outstanding.

Another potential hurdle with certain exchange rules is the provision that if shareholder approval is required, and such approval is not obtained, the exercise price is reduced by 15% every six months, up to a decrease of 45%.

Antidilution

The warrants include customary antidilution adjustments. However, unlike many convertible securities sold in typical financings, the warrants also include the following adjustment provisions:

- Below Market Issuances. Subject to limited exceptions, the number of shares issuable upon exercise of the warrant and the exercise price adjust in favor of the holder if the QFI issues common stock or securities convertible into common stock for consideration per share (or having a conversion price per share) that is less than 90% of the then current market value of the common stock. This adjustment is effective through the third anniversary of the issue date or until Treasury no longer holds any portion of the warrant, whichever is earlier. This provision may be an issue where the QFI seeks financing in transactions involving a discount to the then current market value of the common stock of more than 10%.

- Catch-All Adjustment. Until such time as Treasury no longer holds any portion of the warrant, the QFI's board of directors must make adjustments (that are not provided for by the terms of the warrant) as are reasonably necessary, in the good faith opinion of the board of directors, to protect the purchase rights of the warrant holder.

TAX CONSIDERATIONS

Two Notices Clarify Certain Tax Treatment Issues

The IRS recently published two notices clarifying the tax treatment of the investment:

- Treasury's purchases will not be treated as "Federal financial assistance" under Section 597 of the IRC. In other words, the price paid by Treasury will not be treated as taxable income to the QFI.

- The preferred stock, warrants and common stock issued to Treasury upon exercise of warrants will not count towards an "ownership change" under Section 382 of the IRC.[5]

The guidance in these notices is subject to change, but any change will not apply on a retroactive basis.

EXECUTIVE COMPENSATION REQUIREMENTS

General

At or before signing the securities purchase agreement, a participating QFI must modify existing executive compensation arrangements to comply with the mandated restrictions imposed by Section 111(b) of the Emergency Economic Stabilization Act of 2008, summarized below.

The participating QFI's senior executive officers will be required to release Treasury and the QFI from any claims related to these changes to their compensation arrangements.

Compensation Restrictions

Participating QFIs must:

- ensure that compensation does not encourage excessive risk taking;
- impose a clawback on compensation paid based on financial results or performance metrics later proved to be materially inaccurate;
- limit severance benefits to not more than three times the executive's average taxable compensation for

[5] An "ownership change" generally results in limitations on the use of net operating loss carryforwards and certain other tax attributes, including "built-in" losses that are realized after an "ownership change."

the prior five years; and agree not to deduct annual compensation to any senior executive in excess of $500,000.

Who's Covered

The limitations apply to the CEO, CFO and the next three most highly compensated executive officers.

GENERAL THOUGHTS ON THE SECURITIES PURCHASE AGREEMENT

Representations and Warranties

The reps and warranties are qualified by the QFI's SEC filings.

Because of this the QFI should confirm its filings are current before signing.

Information Rights

The Treasury will have the right to examine the QFI's books and records.

This could lead to unplanned disclosures of sensitive information through FOIA requests, which Treasury has stated it cannot guarantee will not occur.

Additional Rights

The following provisions merit attention:

- director and officer lock-ups;
- a clear market provision (10 days before and up to 90 days after an underwritten offering on behalf of Treasury or other holders);
- the QFI must use its reasonable best efforts to amend agreements that are inconsistent with certain rights of Treasury under the securities purchase agreement; and
- registration rights that continue even after the securities may be sold under Rule 144.

Restrictions on Trust Preferred Securities

Subject to certain exceptions, the QFI is restricted from not only redeeming or repurchasing outstanding capital stock, but also trust preferred securities.

GENERAL CORPORATE CONSIDERATIONS

Corporate Issues

The QFI should check and confirm whether:

- it is authorized to issue a new series of preferred stock;
- it has a sufficient number of authorized and unissued shares of preferred stock;
- it has a sufficient number of authorized and unissued shares of common stock for issuance upon exercise of the warrant; and
- it must obtain the consent of third parties to issue the preferred stock and warrant, or if any third party rights will be triggered by such issuance.

SEC Filings

A participating QFI will need to file a Form 8-K disclosing the investment, if material, or the filing of a certificate of designations with the secretary of state, if applicable.

Our TARP Team is composed of experts in a variety of our practice groups, including attorneys in our financial institutions, corporate/securities, real estate, executive compensation and litigation practice groups. Should you have any questions about the Capital Purchase Program or any other aspect of the Troubled Asset Relief Program, please contact any member of our TARP Team listed below or your regular Sheppard Mullin attorney:

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