Capital Purchase Program – Non-Public Financial Institutions

The United States Treasury has released a term sheet for the injection of capital into non-public qualifying financial institutions under the Treasury's Capital Purchase Program, implemented as part of the Troubled Asset Relief Program (TARP). The deadline for submitting applications under the Capital Purchase Program for publicly traded financial institutions was November 14, 2008, and as of the date of this memorandum, over 80 publicly traded financial institutions have announced their intent to participate in the Capital Purchase Program, accounting for almost $250 billion in investments by the Treasury. Non-public financial institutions are comprised of approximately 4,300 entities in the United States, far outnumbering the approximately 930 publicly traded financial institutions.

If your institution is eligible to apply as a non-public qualifying financial institution, 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 non-public qualifying financial institutions, especially regional and community banks, that might participate. Some of these include:

- Understanding the consequences of issuing new preferred stock and/or warrants;
- Conducting an assessment of executive compensation policies for compliance with program guidelines;
- Ensuring that anticipated use of Capital Purchase Program funds complies with program requirements; and
- Planning for alternative sources of funding and developing an exit strategy from the Treasury's investment.

The deadline for non-public financial institutions to apply for participation in the Capital Purchase Program is December 8, 2008. Many non-public financial institutions are now in the process of analyzing the merits of participating in the program and assessing the impact of such participation. 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. We issued a similar memorandum for publicly traded financial institutions on November 21, 2008, a copy of which may be accessed here: http://www.financialinstitutionlawblog.com/capital-purchase-program-a-publicly-traded-financial-institutions-capital-purchase-program-publicly-traded-financial-institutions.html

TARP Capital Purchase Program

Non-Public QFIs

General Investment Terms	
Eligible Institutions	Qualifying financial institutions (**QFIs**) are certain US bank holding companies, certain US savings and loan holding companies and certain stand-alone US banks and thrifts[1] which are <u>not</u> publicly traded.[2] Subchapter 'S' corporations and mutual corporations are specifically excluded.
Application Deadline Date	The deadline for non-public financial institutions to apply for the program is 5:00 p.m. (EDT) on Monday, December 8, 2008. Applications will be reviewed by the QFI's applicable Federal regulator in consultation with the Treasury.
Subscription Amount	The amount of preferred stock that the Treasury purchases from any QFI must equal at least one percent of the QFI's risk-weighted assets and not more than the lesser of (i) $25 billion and (ii) three percent of its risk-weighted assets.
Healthy Banks	The Treasury has indicated 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.
	We may therefore expect 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 is not a subsidiary of 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.
	Consent of holders of existing preferred stock may be required in order to issue new pari passu preferred stock.

[1] QFIs are any (i) top-tier Bank Holding Company (BHC), or top-tier Savings and Loan Holding Company (SLHC) which engages solely or predominately in activities permissible for financial holding companies under relevant law, and which is not publicly traded (see footnote 2 below), (ii) U.S. bank or U.S. savings association organized in a stock form which is neither publicly traded nor controlled by a BHC or SLHC, or (iii) U.S. bank or U.S. savings association which is not publicly traded and is controlled by a SLHC which is not publicly traded and does not engage solely or predominately in activities which are permitted for financial holding companies under relevant law.

[2] The term "publicly traded" is defined 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."

Dividends

Rate: 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 to redeem the *preferred stock. See "—Redemption," below.*

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

Payment Dates: Generally, February 15, May 15, August 15 and November 15 of each year. The Treasury has changed these dates for certain publicly traded financial institutions.

Redemption

Before the Third Anniversary. Redeemable at par, plus any accrued but unpaid dividends, 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 in whole or in part at par, plus any accrued and unpaid dividends.

Other Considerations.

- Any redemption requires approval of the QFI's primary federal banking regulator.
- The right to repurchase the stock underlying the warrant is triggered by the redemption of the preferred stock.

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 (cumulative) or four consecutive dividend periods (noncumulative).

The form documents for the publicly traded program state that this 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 elect the two directors).

Because of the lack of publicly available information, it is not clear at this time whether the Treasury's preferred will vote with other preferred for the election of the two directors for non-public QFIs, as is the case for publicly-traded QFIs. Similarly, it is not clear how the Treasury will address existing preferred stock with the right to elect more than two directors.

[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. Issuances made pursuant to financing plans publicly announced, or pursuant to arrangements entered into, on or prior to November 17, 2008, are not qualified equity offerings. Based on the documents for publicly traded financial institutions, the issuer will not be required to use the proceeds of a qualified equity offering to redeem the preferred stock.

Negative Covenants

Dividend and Repurchase Restrictions: In general, unless dividends are paid current on the preferred stock purchased by the Treasury: (a) dividends on common stock, junior preferred or *pari passu* preferred stock are not permitted (except dividends paid on *pari passu* preferred shares that are paid pro rata with the preferred shares purchased by the Treasury); and (b) repurchases of common stock, junior preferred or *pari passu* preferred stock are not permitted.

Common Dividends: So long as the Treasury holds an equity stake in the QFI, consent of the Treasury will be required for any increase in common dividends that occurs until year 3 of the Treasury's investment, or for any increase in common dividends by more than 3% that occurs between years 3 and 10.

Additional Repurchase Restrictions*:* Subject to an exception for purchases related to employee benefit plans that are consistent with past practice and performed in the ordinary course of business, the QFI may not buy back its securities for a ten-year period. The publicly traded Capital Purchase Program documents contain exceptions for purchases related to:

- employee benefit plans consistent with past practice;
- 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.

The Treasury has not yet publicly announced what exemptions, if any, will be established for non-public QFIs participating in the Capital Purchase Program.

Prohibition: After the 10th anniversary of the Treasury's investment, so long as the Treasury continues to hold an equity stake, the QFI will be prohibited from paying dividends on common stock or repurchasing any securities.

Related Party Transactions: The QFI must not enter into any related-party transactions while the Treasury owns equity in the QFI unless such transactions (i) are on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated third party, and (ii) have been approved by the audit committee or comparable body of independent directors of the QFI.

Transferability: Both the preferred shares purchased by the Treasury and the warrants issued to the Treasury will be free of transfer restrictions.

Warrants	
Coverage	The Treasury will receive warrants to purchase a number of shares of preferred stock having an aggregate liquidation preference equal to 5% of the amount of the preferred stock purchased. QFIs that participate in the program for $50 million or less and which submit an application for Community Development Financial Institution (CDFI) status by December 8, 2008 and become certified as CDFIs will not be required to issue warrants in connection with the Treasury's investment. In general, a CDFI is a specialized financial institution that serves underserved markets, including the low-income and not-for-profit financing markets.
Exercise Price	Equal to $0.01 per share, or any greater amount required as the par value per share by the QFI's charter documents.
Exercisability	The warrant is immediately exercisable in full, and the term sheet states that the Treasury intends to immediately exercise the warrants.
Settlement of Exercise	Unless otherwise agreed, payment of the exercise price will be made by net exercise.
Underlying Preferred Stock	The preferred stock issued upon exercise of the warrant will have the same attributes as the preferred stock purchased directly by the Treasury under the securities purchase agreement, with two exceptions: • the preferred stock issuable upon exercise of the warrant will have a dividend rate of 9%; and • the preferred stock that was purchased directly under the securities purchase agreement must all be redeemed before the preferred stock issued upon exercise of the warrant can be redeemed.
Registration Rights	If the QFI becomes a public reporting company, it must file a shelf registration statement registering the resale of the warrants and the preferred stock underlying the warrants.

Tax Considerations	
Two Notices Clarify Certain Tax Treatment Issues	The IRS recently published two notices clarifying the tax treatment of the investment: • The Treasury's purchases will not be treated as "Federal financial assistance" under Section 597 of the IRC. In other words, the price paid by the Treasury will not be treated as taxable income to the QFI. • The preferred stock, warrants and stock issued to the Treasury upon exercise of warrants will not count towards an "ownership change" under Section 382 of the IRC.[4] 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 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.

[4] 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."

General Thoughts on Other Investment Terms

Note	*The standard form of securities purchase agreement for non-public financial institutions has not yet been released by the Treasury. The following observations are based upon the form of agreement for publicly traded financial institutions, which may or may not apply to non-public financial institutions.*
Information Rights	The Treasury may have the right to examine the QFI's books and records. *This could lead to unplanned disclosures of sensitive information through FOIA requests, which the Treasury has stated (for publicly traded banks) it cannot guarantee will not occur.*
Additional Rights	The following provisions are applicable to publicly traded QFIs and it is not yet clear whether similar provisions will be applicable to non-public QFIs: • the preferred stock is not subject to any existing stockholders' agreements and both the preferred stock and the warrant are freely transferable by the Treasury; • the QFI must use its reasonable best efforts to amend agreements that are inconsistent with certain rights of the Treasury under the securities purchase agreement; and • registration rights continue even after the securities may be sold under Rule 144.
Restrictions on Trust Preferred Securities	Subject to certain exceptions, the QFI may be restricted from redeeming or repurchasing not only 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 including the preferred shares underlying 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.

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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