

# Publications

## Client Alert: Financial Crisis Update 5

### Related Services

Corporate and Business  
Organizations

Government Relations

Litigation

Taxation

CLIENT ALERT | 10.21.2008

### Update on TARP Implementation

The department has created seven policy teams to address specific TARP concerns:

1. Mortgage-backed securities purchase program
2. Whole loan purchase program
3. Insurance program
4. Equity purchase program
5. Homeownership preservation
6. Executive compensation
7. Compliance

The Treasury Department has named an interim leader for the Office of Financial Stability, Neel Kashkari, and several team members, as well as a legal adviser, custodian, and investment adviser. Proposals for asset managers remain outstanding but will be filled soon.

### TARP Capital Purchase Program (CPP)

On October 14, 2008, the Treasury announced it was exercising its authority under EESA to expand the definition of troubled assets to include senior preferred shares of a subset of financial institutions. The Treasury will use up to \$250 billion of the amount allocated in EESA to purchase these shares at market price. The details of this program follow.

*Eligibility and Application.* The CPP is available to a subset of financial institutions (a term which, as we explained in previous updates, is broadly defined as *any* entity not owned by a foreign government) consisting of U.S. banks, savings associations, and bank and savings and loan holding companies that engage exclusively in financial activities. To qualify, an interested institution must consult with its primary federal regulator, then submit an application ([available on the Treasury's website](#)) to that regulator no later than **5:00 PM EST on**

**November 14, 2008.** The new Office of Financial Stability will review the application along with the regulator's recommendation (to which the Treasury will give "considerable weight") and decide whether to make the capital purchase. If the institution cannot obtain necessary internal approvals, such as any required shareholder approval to authorize the senior preferred shares, or otherwise make all of the representations and warranties in form agreements the Treasury soon will publish, the institution may still participate if it "robustly" explains any limitations and fulfills all outstanding requirements within 30 days of receiving preliminary approval.

*Confidentiality.* The Treasury will announce all transactions within 48 hours of execution, but will not announce any applications that are withdrawn or denied. Beyond that, an institution that needs information in its application to be kept confidential must separate that information from the public portion of the application, label it confidential, and enclose with its application a written request, demonstrating the harm of public availability. An institution's regulator can pre-advise the institution whether certain information in its application can be kept confidential.

*Size of Purchases.* The Treasury will purchase senior preferred shares worth between 1 and 3% of an institution's risk-weighted assets, with a maximum of \$25 billion per institution. The senior preferred shares will constitute Tier One capital of the institution.

*Dividend rate.* The shares issued to the Treasury must pay dividends of 5% for the first five years, then 9% thereafter. Holding companies and their subsidiaries' dividends are cumulative, meaning that they are not required to be paid annually; banks that are not subsidiaries of holding companies must pay non-cumulative dividends.

*Voting.* The Treasury's shares will be non-voting shares, except for voting on matters that would uniquely affect the shares, such as authorization or any issuance of senior shares, any amendment to rights of the senior preferred shares, or any merger, exchange or similar transaction that would adversely affect the rights of the senior preferred shares.

*Transferability.* The Treasury's shares will be fully transferable at all times.

*Limits on Executive Compensation.* EESA's restrictions on executive compensation, which we have discussed in previous updates, apply to the CPP as well as to the TARP programs originally envisioned by EESA. Therefore, any institution participating in the CPP must maintain "appropriate standards" for executive compensation and corporate governance, including:

- Identifying to the Treasury and eliminating incentive compensation arrangements that encourage senior executives to take unnecessary and excessive risks that threaten the value of the financial institution.
- Providing for recovery of any bonus or incentive paid to senior executives based on materially inaccurate statements of earnings, gains or other criteria.
- Not making golden parachute payments to senior executives during the period in which Treasury holds an equity or debt position acquired under the CPP.

In addition, participating institutions must agree not to take tax deductions for executive compensation exceeding \$500,000, even if the institutions would not be subject to the Tax Code provisions (e.g., Section 162(m)(5)) limiting that deduction absent their participation in the CPP.

These regulations apply to all entities in an institution's "controlled group," not just the participating institution. However, where an institution that has participated in the CPP acquires or is acquired by a non-participating institution, the non-participating institution will not be subject to these restrictions.

*Redemption and Repurchase by Institution.* After three years, participating institutions can "call" the Treasury's shares at their issue price, plus accrued and unpaid dividends. Before three years have passed, institutions can only repurchase the shares using the proceeds of an offering of other shares which yields at least 25% of the preferred shares' issue price.

*Restrictions on Transactions in Other Shares.* Participating institutions can pay dividends on preferred shares that have a seniority equal to that of the Treasury's shares, on a pro rata basis with the Treasury's shares. Otherwise, during the first three years of the Treasury's investment, the Treasury's consent is required for any increase in common dividends per share on or repurchase of non-Treasury shares. In addition, participating institutions cannot declare a dividend on or repurchase or redeem non-Treasury shares unless the institutions have paid all accrued, unpaid dividends (in the case of non-cumulative shares, the full dividend for the latest completed dividend period). However, participating institutions can repurchase junior preferred shares or common shares in connection with a benefit plan in the ordinary course of business and consistent with past practice.

*Warrants.* In addition to preferred shares, the Treasury must also receive warrants to purchase *common* stock, in an amount equal to 15% of the Treasury's investment in senior preferred shares.

- The exercise price of the warrants will be the market price of the common stock at the time the preferred shares were issued, calculated according to a 20-day trailing average.
- As an incentive to participating institutions to raise private capital, the number of shares the Treasury can buy using warrants will be reduced by half if the institution receives the full purchase price of the preferred shares from an offering of other shares by December 31, 2009.
- The warrants will be immediately exercisable and have a 10-year term.
- They will be fully transferable, except that the Treasury may transfer no more than half of its warrants pertaining to a particular institution before December 31, 2009, or earlier if the institution has received the full purchase price of the preferred shares from an offering of other stock.
- The warrants must prohibit the Treasury from voting.
- The CPP's terms include remedies for the Treasury if the warrants cannot be filled when exercised.

## Request for Public Comment on Guaranty Program for Troubled Assets

As we explained in our prior update, one of the programs that EESA required the Treasury to implement was guaranty insurance for troubled assets. The Treasury has since released a request for public comment on a variety of topics, including:

- Whether the program should offer insurance for individual whole loans and individual mortgage backed securities
- The appropriate structure for the program
- Whether the program should offer guarantees of less than 100% of original principal and interest
- Legal, accounting and regulatory issues of the guarantee program
- Eligibility provisions of financial institutions

The comment period ends on **October 28, 2008**. The entire text of the Federal Register Notice can be found [online](#), and public comments may be submitted at the [Regulations portal](#).

## Executive Compensation Regulations

Since our last update, the Treasury has issued regulations and notices concerning definitions of key terms in EESA. For purposes of applying section 111(c) of EESA, including the determination of whether the aggregate amount of the assets acquired from a financial institution exceeds \$300 million, two or more financial institutions that are treated as a single employer under sections 414(b) and 414(c) of the Internal Revenue Code are treated as a single financial institution. However, for purposes of applying the aggregation rules to determine whether section 111(c) of EESA applies, the rules for brother-sister controlled groups and combined groups are disregarded. The senior executive officers to which EESA applies include any "named executive officer" who: (1) is employed by a financial institution to which section 111 of EESA applies; and (2)(i) is the principal executive officer of such financial institution or of the parent entity; (ii) the principal financial officer; or (iii) one of the three most highly compensated executive officers of such financial institution other than the PEO or the PFO. A "new employment contract" for purposes of EESA's executive compensation limits means any material compensatory contract entered into on or after the date when section 111(c) of EESA applies to the financial institution. For this purpose, a contract that is renewed is treated as entered into on the date of the renewal and if a contract is materially modified, it is treated as a new contract entered into as of the date of the material modification.

The Treasury requests comments on the auction purchase related provisions of the executive compensation rules, which can be submitted at [executivecompensationcomments@do.treas.gov](mailto:executivecompensationcomments@do.treas.gov) or at [www.regulations.gov](http://www.regulations.gov).

More information about the Executive Compensation limits, including detailed "Question-Answer" explanations, can be found at [Treasury Notice 2008-TAAP](#), which addresses acquisition of troubled assets through the auction process, or [Treasury Notice 2008-PSSFI](#), which addresses acquisition of troubled

assets through programs for systemically significant failing institutions.

## Changes to the Internal Revenue Code

Sections 162(m)(5) and 280G(e) of the Internal Revenue Code, added by the bailout legislation, limit the deductibility of compensation paid to certain corporate executives and provide that a corporate executive's excess parachute payments are not deductible and are subject to an excise tax. These rules apply to employers who sell troubled assets. Notice 2008-94 contains a Q&A dealing with Sections 162(m)(5) and 280G(e).

- *Section 162(m)(5)*: Clarification regarding applicable employers, applicable tax years, covered executives, application to acquisitions, deferred deduction executive remuneration, etc.
- *Section 280G(e)*: Clarification regarding applicable severance from employment, parachute payments, consequences of such payments, etc.

## Tax Ramifications

Section 382 provides that the taxable income of a loss corporation for a year following an ownership change that may be offset by pre-change losses cannot exceed certain limitations for such year.

- The acquisition of shares of stock of a loss corporation acquired by Treasury pursuant to the CPP shall not be considered to have caused Treasury's ownership in the loss corporation to have increased over its lowest percentage owned on any earlier date (pursuant to Section 382).
- Generally, such shares are considered outstanding for purposes of determining the percentage of loss corporation stock owned by other 5% shareholders.
- When measuring shifts in ownership by any 5% shareholder occurring on or after the date on which the loss corporation redeems shares held by Treasury that were acquired pursuant to the CPP, the shares so redeemed shall be treated as if they had never been outstanding.

Section 597 generally provides that assistance payments made to troubled financial institutions constitute taxable income to the institution.

- However, no amount furnished by Treasury to a financial institution pursuant to TARP will be treated as the provision of federal financial assistance within the meaning of Section 597.

Revenue Procedure 2008-65 sets forth a procedure for taxpayer election not to claim 50% bonus depreciation and instead increase business credit limitation under Section 38(c) or AMT credit limitation under Section 53(c).

## Procurement Authorities and Procedures

The Treasury is currently engaged in selecting Financial Agents and Procurement Contracts under the Federal Acquisition Regulation. Due to the paramount need for expeditious implementation of the Secretary's authorities, certain contracts will be awarded under FAR provisions applicable under conditions of unusual and compelling agency. More information about both can be found at [www.treasury.gov/](http://www.treasury.gov/).

## Immediate Updates

Treasury Department updates can also be found on the [ESSA website](#), which also offers a subscription service that sends email updates with the latest news about the ESSA.

This communication is for general information purposes only and does not constitute a full legal analysis of the subject matter discussed herein. The information in this email should not be relied upon as specific legal advice.