Hunton & Williams
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A Look At TARP — What To Do Now

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It is tempting to look at Treasury's Troubled Assets Relief Program ("TARP") only as a positive event. Obviously, 5% is cheap capital compared to current market alternatives. There are certain pre-conditions of TARP, however, that are worth considering.

Background

Treasury announced on October 13, 2008, that it would place up to $250 billion into U.S. financial institutions and their holding companies. Each investment would be no less than 1% nor more than 3% of risk-weighted assets subject to a cap of $25 billion. The investment would be in the form of preferred stock ("Senior Preferred"). The Senior Preferred will be deemed to count as Tier I capital.

Terms of the Preferred Stock

The Senior Preferred will have a priority greater than common stock and equal to or greater than any other preferred stock other than preferred stock that by its terms currently are junior to existing preferred stock.

The Senior Preferred would pay cumulative dividends of 5% per year until the fifth year, at which point the dividend rate would increase to 9%. For financial institutions without holding companies, the dividends would be noncumulative.

The preferred stock may not be redeemed for three years absent a "Qualified Equity Offering" (an issuance of noncumulative perpetual preferred stock or common stock). There are other qualifications on the redemption.

Dividends on securities junior to the Senior Preferred can be paid only if the company is current on dividends to Treasury. In addition, stock repurchases cannot be made without Treasury's consent during the first three years after issuance (other than programs to reserve shares for stock option and other benefit plans). An issuer cannot issue securities senior to the Senior Preferred.

The Senior Preferred is nonvoting unless dividends have not been paid for a year and a half. Notwithstanding the fact that the Senior Preferred will be nonvoting in most situations, the Senior Preferred will have the right to vote on matters that generally would have given a holder of preferred stock such rights.

If the issuer is public, it must file a shelf registration (presumably an S-3 if it is S-3 eligible and an S-1 registration if it is not) to register the Senior Preferred. The issuer must also grant the Treasury piggyback rights in conjunction with future public offerings. We can expect that the Treasury will have a form of Certificate of Designation for the Senior Preferred.

Warrants

An issuer must grant Treasury warrants with a 10-year term. The warrants provide for the purchase of a number of shares of common stock having an aggregate market price equal to 15% of the Senior Preferred. Presumably it is the underlying shares that must have the requisite market value. It is currently unknown what Treasury would use for the market value of a private company. Potential issuers should discuss with their accountants how the warrants will be valued and what impact the warrants may have on common equity.

The number of shares subject to warrants will be reduced by half if the issuer raises capital (in the form of either common or perpetual preferred) equal to 100% of the issuance price of the Senior Preferred (in one or more offerings) prior to December 31, 2009. The exercise price of the warrants also will be reduced in the event shareholders do not authorize sufficient shares for issuance upon exercise of the warrants, but there are safeguards to Treasury in such case.

In the event a financial institution or holding company is no longer listed on an exchange or shareholder consent for the authorization of shares subject to the warrant is not provided within 18 months, the warrants are exchangeable for senior term debt or other interest in the issuer. Such exchange is at the option of Treasury and is to provide the Treasury with appropriate compensation for the value of the warrant.

Executive Compensation

TARP establishes limitations on executive compensation for companies that participate in TARP by receipt of a "meaningful" (not defined) debt or equity stake. Specifically, during the term of the Senior Preferred *and* the warrants, the issuer must:

a. certify that the contracts of the top five senior executives do not encourage or reward unnecessary and excessive risk-taking that threatens the value of the financial institution;

b. agree to recover or clawback any bonus or incentive compensation paid to the top five senior executives based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate (this is similar to the provisions of the Sarbanes-Oxley Act of 2002 for CEOs and CFOs);

c. not make any golden parachute payment to the top five senior executives; and

d. agree not to deduct for tax purposes executive compensation in excess of $500,000 for each of the top five senior executives.

Treasury has indicated that it will publish regulations on these issues within the next two months.

Eligibility

Not every financial institution will be eligible for TARP. Treasury has indicated that nonpublic financial institutions and their holding companies will be eligible. For Subchapter S companies, however, there is an issue of whether the Senior Preferred would be deemed to be a second class of stock. It would certainly seem so. As of the date of this writing, the IRS has not commented on Treasury's proposal. Absent such an interpretation, a Subchapter S corporation company could participate only if it were willing to convert to a C corporation.

The pronouncement regarding TARP makes it very clear that "Treasury will determine eligibility and allocation for QFIs [qualifying financial institutions] after consultation with the appropriate Federal banking agency." The Emergency Economic Stabilization Act of 2008 (the "EESA") specifically requires Treasury to consider "the long term viability of the financial institution." Does that mean a CAMELS-3 rated bank will not qualify? What about a bank on the FDIC problem bank list? Again, Treasury has said it will make this determination in conjunction with the bank regulators.

Perhaps there is enough capital from Treasury to go around. After all, the EESA requires Treasury to ensure that "all financial institutions are eligible to participate in the program, without discrimination based on size, geography, or form of organization." We cannot help thinking, however, that Treasury may need some encouragement to pick some companies.

There may be ways in which to maximize the likelihood that Treasury will place Senior Preferred with a company. It is worthwhile to review the EESA for guidance. The EESA makes clear that its purposes are "to ensure" that Treasury uses the authority granted by the statute to:

- protect home values, college funds, retirement accounts and life savings; and
- preserve home ownership and promote job and economic growth.

The EESA also provides for maximizing returns to taxpayers and providing public accountability, but the focus is on protecting home values and preserving home ownership on the one hand, and promoting jobs and economic growth, on the other hand.

Consequently, an institution's request to Treasury for placement of Senior Preferred should emphasize the benefits to keeping families in their homes if the financial institution receives funding. Alternatively, the request can indicate how funding will enable the financial institution to "stabilize" its community. In addition, it is worthwhile for institutions experiencing economic difficulties to indicate that on a pro forma basis the Senior Preferred will enable the institution to remain viable.

Application to Private Companies

How TARP will apply to private companies is unclear. The warrants to be issued are to have a market price set by the 20 trading day trailing average of a company's common stock. How will market price be set for companies without trading in their stock? The issuers are to file a shelf registration and an exchange listing of the warrants and the shares of common stock underlying the warrants. This would be extraordinarily burdensome (and a shelf registration would not be available) for a private company. TARP provides that if the stock of a company is not traded on a national exchange, Treasury would have the option to require the issuer to substitute senior term debt or another economic instrument or security to provide Treasury with appropriate compensation for the lack of marketability of the warrants in the underlying shares of common stock. This could defeat the benefit of having cheaply priced shares of Senior Preferred and Tier I capital (or it could be positive by providing a tax benefit). These issues need to be resolved if private companies truly are to benefit from TARP.

Drawbacks

The Senior Preferred provided under the TARP is not all positive. Certainly, a 5% dividend coupon is remarkably inexpensive relative to current funding alternatives. Nonetheless, it is still a tax-effective 7.5% or higher rate (depending upon applicable state tax). In addition, that does not include the dilution associated with the warrants.

Certain financial institutions have suggested that there may be a public stigma to accepting a "bail out." It is obviously too early to tell how the public will react to institutions accepting federal funds. To date, the public seems to have moved business to those institutions on the theory that the government was not likely to allow such institutions to fail.

The TARP also limits corporate flexibility, especially concerning compensation of insiders during the term of the Treasury's ownership of any security, even the warrants.

Process

Treasury has set a November 14, 2008 deadline for applications. Treasury is also in the process of creating a procedure for applications. Presumably, applicants will be required to commit to, among other things, the compensation limits discussed above.

What To Do Now

Our recommendation is that those institutions who believe the economics of the Senior Preferred and the warrants are acceptable should prepare a package for submission to Treasury and the bank regulators. Of course, financial institutions can wait until the Treasury puts its "application form" out for comment. There may, however, be a benefit (at a minimum in terms of a quicker capital injection) for filing the application quickly.

Companies should also review their executive compensation plans for the top five most highly compensated individuals to determine if changes or waivers are needed. The issuer must certify compliance with the EESA's compensation provisions.

Companies should also be calculating whether the economics of the Senior Preferred are worthwhile. If so, they should evaluate the best level for the capital injection between the 1% and 3% floor and ceiling.

Institutions which need capital should not rely solely on Treasury. Instead, we recommend that they pursue parallel paths in the event that they are not able to issue Senior Preferred.

Updates

We have established a website at www.huntonfinancialindustryrecovery.com. The website is updated frequently with information regarding the Emergency Economic Stabilization Act of 2008, the Troubled Asset Relief Program, pronouncements from Treasury, the Federal Reserve Board and the FDIC and other related information. Please feel free to visit our website for additional information on these issues.

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