



## Client Alert

# Financial Markets Developments

### Troubled Asset Relief Program—Capital Purchase Program Summary

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#### I. Background and Summary

On October 3, 2008, Congress passed and President Bush signed into law the bipartisan Emergency Economic Stabilization Act of 2008 (“EESA”). The EESA provides the immediate authority and means to the secretary (“Secretary”) of the US Department of the Treasury (“Treasury”) to restore liquidity and stability to the US financial system. A key element of the EESA permits the Secretary to establish the Troubled Asset Relief Program (“TARP”), under which Treasury is permitted to borrow up to US\$700 billion to purchase, from eligible financial institutions, “troubled assets”—illiquid mortgages, securities and other financial instruments—that have weakened and frozen the US financial system and credit markets. However, the US financial crisis escalated in the days following the passage of the EESA and the US government sought a more aggressive approach to tackle the crisis.

On October 14, 2008, under its broad authority provided by the TARP, Treasury announced the voluntary Capital Purchase Program (“CPP”). The CPP is designed to encourage US financial institutions to build capital to increase the flow of financing to US businesses and consumers and to support the US economy. Under the CPP, Treasury will purchase up to US\$250 billion of senior preferred shares of qualifying US controlled banks, savings associations and bank and savings and loan holding companies that elect to participate. The deadline to participate is November 14, 2008, 5:00 p.m. (EST). In contrast to other aspects of the TARP, financial institutions controlled by a foreign bank or company will not be eligible to participate in the CPP. The US\$250 billion will be taken out of the US\$700 billion made available by the TARP. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency.

Treasury has released a CPP Term Sheet (“Term Sheet”), which specifies that Treasury will take non-voting senior preferred shares (“Senior Preferred”) in the participating banks, redeemable after three years. Qualifying Financial Institutions (“QFI”) may issue an amount of Senior Preferred equal to between one percent (1%) and three percent (3%) of their risk-weighted assets, with an overall cap of US\$25 billion. Senior Preferred will qualify as Tier 1 capital and will rank senior to common stock and *pari passu*, which is an equal level in the capital structure with existing preferred shares, other than preferred shares which by their terms rank junior to any other existing preferred shares. The Senior Preferred will pay an annual dividend rate of five percent (5%) that rises to nine percent (9%) after the first five years.



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The government will receive warrants to convert the Senior Preferred into common stock with an aggregate market price equal to 15 percent (15%) of the Senior Preferred investment. The exercise price on the warrants will be the market price of the participating institution's common stock at the time of the issuance, calculated on a 20-trading day trailing average. There will also be restrictions on executive compensation for participating companies. Nine of the nation's top financial institutions have already agreed to participate and will reportedly receive about half of the allocated funds, or US\$125 billion.

On October 20, 2008, Treasury Secretary Henry Paulson provided an update on the CPP and outlined a streamlined process by which institutions can apply to be a part of the program. Mr. Paulson indicated that sufficient capital has been allocated so that all qualifying banks can participate and that the CPP is not being implemented on a first-come first-served basis. Details of the Senior Preferred terms, the warrant terms and the application process follow.

## II. Senior Preferred Terms

- **QFIs.** QFIs include certain US controlled banks, savings associations and certain bank and savings and loan holding companies engaged only in financial activities. Institutions controlled by a foreign bank or company do not qualify. Treasury will determine eligibility and allocation for QFIs after consultation with the appropriate Federal banking agency. *Term Sheet* at 1.<sup>1</sup>
  - **Nine Participating Institutions.** The following nine financial institutions have agreed to participate in the CPP and will reportedly receive about half of the allocated funds, or US\$125 billion: Goldman Sachs Group, Inc., Morgan Stanley, JP Morgan Chase & Co., Bank of America Corp., Merrill Lynch, Citigroup, Inc., Wells Fargo & Co., Bank of New York Mellon and State Street Corp.
- **Deadline.** All applications must be submitted by 5:00 p.m. (EST), November 14, 2008. *Term Sheet* at 1.

- **Capital Eligible for Purchase.** Senior Preferred will qualify as Tier 1 capital and will rank senior to common stock and *pari passu*, which is an equal level in the capital structure with existing preferred shares, other than preferred shares which by their terms rank junior to any other existing preferred shares. With respect to a banking organization that has a bank holding company or a savings and loan holding company, all capital purchases will occur at the highest-tier holding company. In these cases, the capital eligible for purchase by Treasury under the CPP is cumulative perpetual preferred stock of the highest tier holding company and the shares must be *pari passu* with the most senior preferred shares available by the applicant. In the case of an insured depository institution that is not controlled by a company, the capital eligible for purchase is non-cumulative perpetual preferred stock of the insured depository institution. The shares must be *pari passu* with the most senior preferred shares available by the applicant. *Id.* at 1-2.
- **Amount of Capital Purchased.** Each QFI may issue an amount of Senior Preferred equal to between one percent and three percent of its risk-weighted assets, with an overall cap of US\$25 billion. *Id.* at 1.
- **Redemption.** Senior Preferred may not be redeemed for a period of three years from the date of the investment, except with the proceeds from a "Qualified Equity Offering" which results in aggregate gross proceeds to the QFI not less than 25 percent of the issue price of the Senior Preferred. A "Qualified Equity Offering" means the sale by the QFI after the date of the investment of Tier 1 qualifying perpetual preferred stock or common stock for cash. *Id.* at 2.
- **Dividends.** The Senior Preferred will pay cumulative dividends at a rate of five percent per annum that rises to nine percent after the first five years. For Senior Preferred issued by banks which are not subsidiaries of holding companies, the Senior Preferred will pay non-cumulative dividends at a rate of five percent per annum that rises to nine percent after first five years. *Id.* at 2.

- **Dividend Restrictions.** For as long as any Senior Preferred is outstanding, no dividends may be declared or paid on junior preferred shares, preferred shares ranking *pari passu* with the Senior Preferred, or common shares (other than in the case of *pari passu* preferred shares, dividends on a pro rata basis with the Senior Preferred), nor may the QFI repurchase or redeem any junior preferred shares, preferred shares ranking *pari passu* with the Senior Preferred or common shares, unless (i) in the case of cumulative Senior Preferred all accrued and unpaid dividends for all past dividend periods on the Senior Preferred are fully paid or (ii) in the case of non-cumulative Senior Preferred the full dividend for the latest completed dividend period has been declared and paid in full. *Id.* at 3.
- **Repurchases.** Treasury's consent shall be required for any share repurchases until the third anniversary of the day of the investment. Exceptions include repurchases of the Senior Preferred and repurchases of junior preferred shares or common shares in connection with any benefit plan in the ordinary course of business consistent with best practice. *Id.*
- **Voting Rights.** Senior Preferred shall be non-voting. *Id.*
- **Transferability.** The initial holder is the Treasury. The Senior Preferred will not be subject to any contractual restrictions on transfer and will carry mandatory registration rights. *Id.* at 4.
- **Executive Compensation.** As a condition to the closing of the investment, the CPP requires the QFI to comply with rules on executive compensation provided in the EESA. Specifically, the QFI and its senior executive officers covered by the EESA shall modify or terminate all benefit plans, arrangements and agreements (including golden parachute agreements) to the extent necessary to be in compliance with EESA for so long as Treasury holds any equity or debt securities of the QFI. Section 111 of the EESA includes the following standards: (1) limits on compensation that exclude incentives for senior executive officers ("SEOs") of financial institutions to take unnecessary risks that threaten the value of the financial institution; (2) required recovery of any bonus or incentive compensation paid to

an SEO based on a statement of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) prohibition on the financial institution from making any golden parachute payment to any SEO; and (4) agreement to limit a claim to a federal income tax deduction for certain executive remuneration. *Id.* at 4; *see also Interim Final Rule on Treasury's Capital Purchase Program.*

### III. Warrant Terms

- **Warrant.** Treasury will receive warrants to purchase a number of shares of common stock of the QFI having an aggregate market price equal to 15 percent of the Senior Preferred amount on the date of the investment, subject to reduction (discussed below). The exercise price on the warrants will be the market price of the participating institution's common stock at the time of the issuance, calculated on a 20-trading day trailing average. *Id.* at 5.
- **Term.** Ten years. *Id.*
- **Exercisability.** Immediately exercisable, in whole or in part. *Id.*
- **Transferability.** The warrants will not be subject to any contractual restrictions on transfer; provided that Treasury may only transfer or exercise an aggregate of one-half of the warrants prior to the earlier of (1) the date on which the QFI has received aggregate gross proceeds of not less than 100 percent of the issue price of the Senior Preferred from one or more Qualified Equity Offerings (defined above) and (2) December 31, 2009. The warrants will carry mandatory registration rights. *Id.*
- **Voting.** Treasury will agree not to exercise voting power with respect to any shares of common stock of the QFI issued to it upon exercise of the warrants. *Id.*
- **Reduction.** In the event that the QFI has received aggregate gross proceeds of not less than 100 percent of the issue price of the Senior Preferred from one or more Qualified Equity Offerings on or prior to December 31, 2009, the

number of shares of common stock underlying the warrants then held by Treasury shall be reduced by the number of shares equal to the product of (1) the number of shares originally underlying the warrants (taking into account all adjustments) and (2) 0.5. *Id.* at 6.

- **Consent.** If the QFI does not have sufficient available authorized shares of common stock to reserve for issuance upon exercise of the warrants and/or stockholder approval is required for such issuance, the QFI shall call a shareholder meeting as soon as practicable after the date of the investment to increase the number of authorized shares of common stock and to take other actions deemed necessary by the Treasury to allow the exercise of the warrants into common stock. *Id.*
- **Substitution.** If the QFI is no longer listed or traded on a national securities exchange or a securities association, or the requisite consent of the QFI stockholders has not been received within 18 months after the issuance date of the warrants, the warrants will be exchangeable (at the option of Treasury) for senior term debt or another economic instrument or security of the QFI, such that Treasury is appropriately compensated for the value of the warrant. *Id.*

#### IV. Application Process

On October 20, 2008, Treasury announced a streamlined, systematic process for all QFIs wishing to participate in the CPP. There is a single application form that QFIs will submit to their primary regulator—the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of Currency or the Office of Thrift Division. Regulators have established streamlined evaluation procedures so that all applications are reviewed consistently. Once a regulator has reviewed the application, it will send the application along with its recommendation to the Office of Financial Stability at the Treasury. Treasury will then review the application and determine whether or not to make the capital purchase. All transactions will be publicly announced within 48 hours of execution. Applications that are withdrawn or denied will not be announced. *HP-1223: Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program*, US DEPT. OF THE TREASURY PRESS ROOM, Oct. 20, 2008.

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1. The Term Sheet defines “QFI” to mean “(i) any US bank or US savings association not controlled by a Bank Holding Company (“BHC”) or Savings and Loan Holding Company (“SLHC”); (ii) any US BHC, or any US SLHC which engages only in activities permitted for financial holdings companies under Section 4(k) of the Bank Holding Company Act and any US bank or US savings association controlled by such a qualifying US BHC or US SLHC; and (iii) any US BHC or US SLHC whose US depository institution subsidiaries are the subject of an application under Section 4(c)(8) of the Bank Holding Company Act; except that QFI shall not mean any BHC, SLHC, bank or savings association that is controlled by a foreign bank or company. For purposes of this program, “US bank,” “US savings association,” “US BHC” or “US SLHC” means a bank, savings association, BHC or SLHC organized under the laws of the United States or any State of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa, or the Virgin Islands.” *Id.*

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