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## TARP Capital Purchase Program — Term Sheet for Privately Held Companies

### Introduction

On November 17, 2008, the United States Department of the Treasury (“Treasury”) issued its much-anticipated Summary Term Sheet detailing the terms for participation by nonpublicly traded banks and bank holding companies in the Treasury’s Troubled Asset Relief Program’s Capital Purchase Program (“CPP”). In addition, the Treasury also issued a related Private Bank Program Q&A (“Q&A”). Privately held banks and bank holding companies interested in participating in the CPP must file their applications by December 8, 2008. The Treasury will determine eligibility and allocation for applicants after consultation with their appropriate federal banking agency.

The private-company term sheet applies to nonpublicly traded institutions only and specifically excludes banks, thrifts and their holding companies that have elected Subchapter S tax treatment, as well as mutual organizations. The Q&A makes it clear that the terms and deadline for participation in the program by these organizations are still under consideration.

The key components of the CPP as they relate to private banks and bank holding companies are summarized below.

### Eligibility Considerations and Definition of Private Company

All “Qualified Financial Institutions” are eligible to apply to participate in the CPP. The private-company term sheet, however, is limited to “nonpublic” companies other than Subchapter S institutions and mutual organizations, which remain under consideration by the Treasury.

### What is a “Nonpublic” Company?

It is important to note the distinction between “nonpublic” institutions and “publicly traded” institutions for purposes of the term sheet. The private-company term sheet defines “publicly traded” as a company (1) whose securities are traded on a national securities exchange **and** (2) that is required to file periodic reports with the Securities and Exchange Commission or its primary federal regulator. Accordingly, it appears that SEC-reporting companies are permitted to participate under the nonpublic-company term sheet so long as their securities are not listed on a national securities exchange.

### Participation by Nonbanks or Bank Holding Companies

Like the public company version of the CPP, the Q&A for the nonpublic-company program addresses the ability of companies that are not currently bank or thrift

holding companies to participate in the CPP. Under the Q&A, if a nonpublicly traded company has a bank or thrift holding company application on file with the appropriate regulatory authority on or before December 8, 2008, the company may apply, on a conditional basis, to participate in the CPP. This requirement means that the company should have an agreement in place to acquire an interest in a bank or savings association sufficient to deem the acquiring company a bank or thrift holding company (typically at least 15 percent of the financial institution's outstanding voting securities) by December 8, 2008. The holding company application must be approved by January 15, 2009, and the underlying acquisition must be consummated prior to the time that the company receives any funding through the CPP.

For an acquiring company to become a bank or thrift holding company, it is likely that its existing operations must be limited predominantly to activities that are financial in nature or otherwise permissible for bank or thrift holding companies. In addition, prior to pursuing this opportunity, applicants should carefully consider the regulatory implications of becoming a bank or thrift holding company. It is widely anticipated that the regulatory burden on bank and thrift holding companies, particularly those participating in the CPP, may increase in the future. Under the appropriate circumstances, however, this option can be very attractive for a financial services company in need of additional capital. Even holding companies for very small financial institutions may apply for a capital infusion of up to 3 percent of the proposed holding company's risk-weighted assets as of September 30, 2008. Applicants should note that approval of the holding company

application does not guarantee approval of its CPP application. For that reason, an acquiring company should consider making approval of its CPP application a condition to consummating its acquisition.

#### **Summary of the Material Terms of the Private-Bank Capital Purchase Program**

In many respects, the terms of the preferred stock to be issued by privately held institutions are the same as the terms applicable to their publicly held counterparts.

#### **Size of Investment**

No changes have been made to the size of the Treasury's investment in privately held institutions. Each investment will be no less than 1 percent nor more than 3 percent of the applicant's total risk-weighted assets, subject to a cap of \$25 billion. Each investment will be in the form of senior preferred stock ("Preferred Stock") and will be deemed to count as Tier 1 capital. It is important to note that holding companies having total consolidated assets of less than \$500 million are not subject to the consolidated capital guidelines and therefore the characterization of the capital is not material.

#### **Other Terms Applicable to Public- and Private-Company Investments**

Similar to publicly held institutions, participating privately held institutions will issue Preferred Stock that carries a priority greater than common stock and ranks equal to or greater than any other outstanding preferred stock. The Preferred Stock will pay cumulative dividends of 5 percent per year until the fifth year, at which time the dividend rate

will increase to 9 percent. For financial institutions that do not have holding companies, dividends will be noncumulative. Dividends on securities ranking junior to the Preferred Stock (including common stock) may be paid only if the company is current on dividends to the Treasury, and an issuer is not permitted to issue securities senior to the Preferred Stock.

The Preferred Stock generally will be nonvoting except with respect to class voting on matters affecting the rights of the Preferred Stock, including a merger or similar transaction involving the participant. If dividends have not been paid for six dividend periods (whether consecutive or not), the Treasury would obtain the right to elect two directors to the board of the participant.

#### **Terms Applicable to Private-Company Investments**

The Preferred Stock to be issued by privately held institutions will also be subject to certain terms that differ slightly from the terms applicable to public institutions, as noted below:

- **Redemption.** As a general matter, the redemption features on the Preferred Stock will be substantially identical to the preferred stock issued by publicly held institutions. The Preferred Stock may not be redeemed for a period of three years except with the proceeds of a "Qualified Equity Offering" (generally defined as a sale of common stock or Tier 1 qualifying preferred stock), that results in aggregate gross proceeds equal to at least 25 percent of the purchase price for the Preferred Stock. After the third year, the Preferred Stock may be redeemed at any time, in whole

or in part. However, for privately held institutions, a “Qualified Equity Offering” specifically excludes any sales made pursuant to offerings announced on or prior to November 17, 2008.

- **Restrictions on Dividends.** The Treasury’s consent is required for any increase in dividends on common stock for the first three years. After the third year, but prior to the tenth year, privately held participants are further restricted from increasing common stock dividends greater than 3 percent annually and no dividend increases are permitted as a result of dividends paid in common shares, any stock split or a similar transaction.
- **Repurchases.** While publicly held participants in the CPP are generally restricted from repurchasing equity securities or trust preferred securities until the third anniversary without obtaining the Treasury’s prior consent, privately held institutions will be subject to this repurchase restriction for ten years unless all the Preferred Stock (including the Warrant Preferred stock described below) has been redeemed or otherwise transferred by the Treasury to third parties.
- **Other Dividend and Repurchase Restrictions.** One new feature prohibits privately held participants, after the tenth year, from paying dividends on common stock or repurchasing any equity securities or trust preferred securities until the Preferred Stock (including the Warrant Preferred stock described below) has been redeemed or oth-

erwise transferred by the Treasury to third parties.

- **Transferability.** Like the preferred stock to be issued to publicly held institutions, the Preferred Stock issued by private companies must not be subject to contractual transfer restrictions, including any shareholders’ agreement or similar arrangement that may be in effect at the time of the investment by the Treasury. The Treasury will agree not to effect any transfers of the Preferred Stock that would require the institution to become subject to SEC periodic reporting requirements (i.e., causing the company to have 500 or more shareholders).

Unlike the preferred stock to be issued by public-company participants, there are no registration requirements related to the Preferred Stock issued by privately held institutions. Rather, the company will only be required to file a shelf registration for the Preferred Stock if it otherwise becomes a publicly held institution.

- **Related-party Transactions.** Privately held participants will be subject to an additional restriction against engaging in related-party transactions unless the transactions are on terms that could be obtained from unaffiliated third parties and have been approved by the audit committee or similar committee of independent directors.
- **Warrant Preferred.** One of the most significant differences between the public- and private-company term sheets is the form of “equity kicker” received by the Treasury. In the public-company

program, the Treasury receives warrants to purchase shares of common stock of the company with an aggregate market price equal to 15 percent of the Treasury’s senior preferred investment. Presumably, in an effort to address the concerns associated with valuing shares of privately held banks and holding companies, the private-company term sheet provides for the issuance of warrants to acquire additional shares of preferred stock (the “Warrant Preferred”) having an aggregate liquidation amount equal to 5 percent of the amount of Preferred Stock purchased by the Treasury. The exercise price for the Warrant Preferred will be \$0.01 per share or such greater amount as may be required under the charter documents of the institution (such as an amount equal to the par value of the stock, if required). As a general matter, the Warrant Preferred will have the same rights and preferences as the standard Preferred Stock, except that it will carry a 9 percent annual dividend and may not be redeemed until all the standard Preferred Stock has first been redeemed. The Treasury has indicated that it intends to exercise all warrants immediately upon issuance.

Unlike in the public-company program, private-company participants have no ability to reduce the amount of Warrant Preferred by raising additional capital in a Qualified Equity Offering. However, as discussed in more detail below, any private company that issues \$50 million or less in Preferred Stock and that otherwise qualifies as a certified Community

Development Financial Institution (“CDFI”) will not be required to issue Warrant Preferred in connection with its participation in the CPP.

### Limits on Executive Compensation

Similar to the participation requirements for public companies, privately held companies that participate in the CPP must agree to certain restrictions on executive compensation. Specifically, during the time that the Preferred Stock is outstanding, the issuer must:

- 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;
- agree to recover or claw back 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);
- not make any golden parachute payment to the top five senior executives; and
- agree not to deduct for tax purposes executive compensation in excess of \$500,000 for each of the top five senior executives.

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

### Limited Exception to the Warrant Preferred Shares Requirement

As noted above, a limited class of eligible privately held institutions may participate in the CPP without issuing any Warrant Preferred shares. Pursuant to its discretionary authority under the Emergency Economic Stabilization Act of 2008, the Treasury will exempt certain participating institutions from the Warrant Preferred requirements if they (i) receive CPP funding of \$50 million or less and (ii) are certified Community Development Financial Institutions.

A CDFI is a specialized financial institution that works in market niches that are underserved by traditional financial institutions. For example, a CDFI might provide mortgage financing for low-income and first-time homebuyers or for not-for-profit developers. To become a CDFI, a company must submit to the Community Development Financial Institution Fund (“CDFI Fund”) a completed application for certification demonstrating that the company (i) is a legal entity at the time of the application, (ii) has a primary mission of promoting community development, (iii) is a financing entity, (iv) primarily serves one or more economically distressed target markets, (v) maintains accountability to its defined target market and (vi) is a non-government entity that is not under the control of any government entity.

To qualify for the CDFI exemption from the Treasury’s warrant requirements, a company must have a CDFI certification application on file no later than December 8, 2008, and prior to the time that it files its application to participate in the CPP. The CDFI application must be approved at or prior to the closing of the CPP funding. If a company has applied for CDFI certification and is

eligible for funding under the CPP, the Treasury may conditionally approve the company’s application to participate in the CPP, contingent upon the company’s receipt of CDFI certification (which must be approved by January 15, 2009).

More information about becoming a CDFI can be found at [www.cdfifund.gov](http://www.cdfifund.gov). CDFI eligibility requirements are more fully described in the CDFI regulations at 12 C.F.R. § 1805.200 *et. seq.*

### Financial and Economic Consequences

The financial and economic consequences of a private-company CPP investment are best illustrated by an example. Consider a privately held financial institution with \$480 million of total assets of which \$400 million are risk-weighted assets. In this case, the financial institution may issue Preferred Stock up to the maximum allotment of 3 percent of its risk-weighted assets, or \$12 million. In addition, under the private-company term sheet, the institution would be required to issue an additional \$600,000 of Warrant Preferred to the Treasury (against a nominal exercise price).

That institution would be required to pay dividends on the initial balance of the Preferred Stock of \$150,000 per quarter, or \$600,000 per year (5 percent of the \$12 million Preferred Stock issuance), during each of the first five years that the Preferred Stock is outstanding. In addition, the institution would be required to pay quarterly dividends on the Warrant Preferred equal to \$13,500 per quarter, or \$54,000 per year (9 percent of the \$600,000 Warrant Preferred).

Assuming the Preferred Stock remains outstanding for more than five years, the



dividends would increase on the initial principal balance of the Preferred Stock to \$270,000 per quarter, or \$1,080,000 per year (9 percent of the \$12 million preferred stock issuance), but the dividend rate on the Warrant Preferred would remain unchanged.

The effective cost of the Preferred Stock, together with the Warrant Preferred, is approximately 6.3 percent per year, assuming the stock remains outstanding for five years. The cost increases to approximately 7.0 percent per year if redeemed after three years because the repurchase cost of the Warrant Preferred is effectively amortized over a shorter period. The effective cost of the stock increases to approximately 7.5 percent per year after ten years as dividends on the initial Preferred Stock accrue at the stepped-up rate of 9 percent. Please note that preferred stock dividends are not tax deductible and you should consider the tax-equivalent costs of other sources of funding, and the regulatory capital treatment of those funding sources, when evaluating the Preferred Stock investment.

#### **Application Process**

Privately held institutions that desire to participate in the CPP must submit to the appropriate federal banking agency by 5:00 p.m. (Eastern Time) on December 8, 2008, a completed application on the form provided by the Treasury. An applicant that is a bank holding company should submit a completed application to its holding company regulator and to the primary federal regulator of the largest insured depository institution that it controls. An applicant that is a stand-alone financial institution (i.e., no holding company)

should submit a completed application to its primary federal regulator. The federal banking agencies will review the applications and will make recommendations to the Treasury, which will make the ultimate funding decision.

The Treasury has not provided a separate form of application or instructions for privately held institutions. The form of CPP application for publicly held institutions can be found on the Treasury's website.<sup>1</sup> Although this form can be used at this point under the private-company program, please make sure to note applicable exceptions, including that the forms of agreements for privately held institutions have not yet been received. The form itself is only two pages and is relatively straightforward. However, institutions with significant asset-quality concerns, that are subject to administrative actions, or that otherwise have any material unresolved regulatory issues should provide supplementary information regarding the resolution of these issues. Depending on the regulator, other information may be required as well.

We recognize that some privately held institutions may have already submitted a CPP application. We recommend that those institutions contact their federal regulator and inquire if a supplement to the initial application will be required in light of the recently released information applicable to private companies.

Finally, all applicants should remember to enclose with their CPP application a separate letter requesting confidential treatment for those portions of the application that, if disclosed, might

<sup>1</sup> The form of CPP application can be found on the Treasury's website at <http://www.treas.gov/initiatives/eesa/application-documents.shtml>.

subject the institution to a competitive disadvantage.

More detailed information about the CPP application process can be found in the Hunton & Williams Client Alert entitled *Application Guidelines for TARP Capital Purchase Program*, at [www.huntonfinancialindustryrecovery.com](http://www.huntonfinancialindustryrecovery.com).

#### **Operative Documents and Proposed Investment Agreements**

At this point, the form of investment agreement for private-company CPP investments has not been released. To that end, we have assumed that most of the same general terms in the public-company agreements will apply with the appropriate modifications discussed in this article. Once the documents are released, it will be important to review the terms carefully to ensure that the institution can meet all the obligations, representations and covenants before agreeing to move forward with the program.

#### **Other Considerations**

##### **Shareholder Approvals and Corporate Governance Matters**

Although participation in the CPP itself does not require shareholder approval, a financial institution that does not have sufficient, or the right type of, authorized preferred stock will likely be required to seek the approval of its shareholders to amend its articles of incorporation or charter document. Financial institutions desiring to participate should review their charter documents to ensure that they (i) authorize the issuance of a sufficient number of preferred shares to cover the initial issuance of preferred stock to the Treasury and the additional preferred shares upon the Treasury's

exercise of the warrants and (ii) that they provide the board of directors with authority to issue “blank check” preferred stock. “Blank check” authorization permits the board of directors to set specific terms of the preferred shares, without seeking additional shareholder approval.

The Preferred Stock and Warrant Preferred to be issued to the Treasury under the CPP cannot be subject to any contractual restrictions on transfer. Accordingly, institutions desiring to participate in the CPP should also review their corporate documents and any existing shareholders’ or other agreements to ensure that there are no provisions that might restrict the transferability of the stock or otherwise conflict with the Treasury’s requirements.

#### **Government Modification Risk**

Many bankers and commentators have expressed concern over a provision in the Securities Purchase Agreement, under the public-company version of the CPP, that allows the Treasury to unilaterally modify the terms of the agreement in response to a change in applicable federal statutes. While the Treasury has not yet published the definitive agreements for the nonpublic-company version of the CPP, these agreements

may too well be substantially similar to the public-company documents. Some commentators have suggested that Congress might require more stringent limits on executive compensation or mandate certain lending activities for participants in the CPP, which could result in unilateral amendments to the CPP documents after they have been signed. Applicants to the CPP should consider this unusual counterparty risk prior to closing (but not necessarily prior to applying for) the sale of the Preferred Shares.

#### **Important Note for Companies Considering Subchapter S**

Participants should take special care to evaluate the implication of a Preferred Stock investment if they are considering a Subchapter S election within the next few years. In order to qualify for a Subchapter S election, a company may not have more than one class of stock outstanding. By participating in the CPP, the ability for C corporations to make a Subchapter S election will be significantly impaired for the first three years of the investment due to the limitations on redemption. Unless the company is able to redeem the Preferred Stock with the proceeds of a “Qualified Equity Offering” during this time, C corporations should be prepared to postpone their plans to convert to

Subchapter S status for as long as the Preferred Stock remains outstanding. Of course, the terms for Subchapter S companies, when they are issued, may address this issue.

#### **Summary**

Until the Treasury publishes or releases the private-company investment documents, we will have some unanswered questions regarding the entire scope of the CPP and its long-term implications for participating institutions. Nonetheless, we believe at this juncture the potential economic benefit of the CPP merits consideration for all private banks and bank holding companies that may benefit from the additional capital, whether to provide the necessary cushion to absorb potential loan losses or to take advantage of potential acquisition opportunities.

#### **Updates**

We have established a website at [www.huntonfinancialindustryrecovery.com](http://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 the 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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