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It's Not Too Late for TARP — What To Do Now That The Capital Purchase Program Has Reopened?

In October 2008, we prepared an article entitled “A Look at TARP — What to do now?” Since the date of that article, more than 600 financial institutions, ranging in size from several billion dollars down to a few million dollars, have elected to participate in the Capital Purchase Program (“CPP”) established under the Department of the Treasury’s (the “Treasury”) [Troubled Asset Relief Program](#) (“TARP”). The Treasury has issued terms sheets for publicly traded financial institutions, privately held financial institutions and Subchapter S financial institutions. Since October 2008, several hundred financial institutions have elected to participate in the CPP.

In a speech delivered in May 2009 to the Independent Community Bankers of America, Treasury Secretary Timothy Geithner hinted that the Treasury would reopen the CPP, as several financial institutions have begun repaying the CPP funds received in late 2008 and early 2009. Furthermore, this “reopening” of the CPP would be focused more on community banks than on financial institutions in general.

In June 2009, the Treasury did, in fact, reopen the CPP program to all eligible participants, with certain restrictions and changes. Qualifying financial institutions with less than \$500 million in assets may still apply (or reapply) for participation in the CPP. Now, qualifying institutions may

receive CPP funds of up to 5 percent of total risk-weighted assets (as compared to only 3 percent in the first round). Furthermore, the additional 2 percent is on better economic terms. More complete information about the terms and procedures for applying (or reapplying) for the CPP is discussed in more detail below.

Terms of the Treasury Investment

This article focuses on privately held and Subchapter S financial institutions, as there are many more of these types of financial institutions than publicly traded financial institutions. Moreover, there are few true publicly traded financial institutions with less than \$500 million in total assets. While the terms of the Treasury’s investment have been covered under previous articles, a brief summary will be helpful for this article.

Under the CPP’s original terms, the Treasury made investments in the financial institution of up to 3 percent of the financial institution’s risk-weighted assets by purchasing either preferred stock or senior subordinated debentures from the financial institution.

The preferred stock pays cumulative dividends of 5 percent per year until the fifth year, at which point the dividend rate increases to 9 percent. The senior subordinated debentures, because interest payments are deductible, pay interest at

7.7 percent per year for the first five years and then at 13.8 percent per year thereafter. The tax-adjusted rates on the senior subordinated debentures are 5 percent and 9 percent, respectively, which are equal to the before-tax dividend rates on the preferred stock.

In either case, the Treasury investment may be redeemed by the financial institution at any time, subject to regulatory approval. The financial institution is no longer required to redeem the Treasury investment only with the proceeds of a "Qualified Equity Offering" during the first three years, as initially required.

Dividends on securities junior to the preferred stock and senior subordinated securities can be paid only if the company is current on dividends or interest, as applicable, to the Treasury. In addition, even if dividends or interest payments are current to the Treasury, the financial institution cannot increase dividend payments on other equity during the first three years of the Treasury's investment. After the third year, Treasury consent is required to increase dividends by more than 3 percent, subject to exceptions to enable Subchapter S corporations to pay tax distributions to shareholders, which are generally permitted. Finally, stock repurchases generally cannot be made without the Treasury's consent.

The preferred stock and senior subordinated debentures are nonvoting, unless dividends have not been paid for six periods, whether or not consecutive, in which case, the Treasury has the right to elect two directors. Notwithstanding the preceding, the Treasury has the right to vote on matters that generally would affect the Treasury's investment position in the financial institution.

Warrants

With certain exceptions, whether the investment is in the form of preferred

stock or senior subordinated debentures, the issuer must grant Treasury warrants with a 10-year term. The warrants provide for the purchase of a number of shares of preferred stock or additional senior subordinated debentures having an aggregate value equal to 5 percent of the Treasury's overall investment in the financial institution. The preferred stock warrant pays a 9 percent annual dividend, while the senior subordinated debenture warrant pays a 13.8 percent annual interest rate (a tax-adjusted rate of 9 percent). The warrants may not be redeemed unless and until the preferred stock or senior subordinated debentures, as applicable, are redeemed in full. In all cases, the Treasury has immediately exercised the warrants.

Executive Compensation Limitations

The Emergency Economic Stabilization Act of 2008 ("EESA"), under which TARP and CPP were authorized and established, as later amended by the American Recovery and Reinvestment Act of 2009 ("ARRA"), established limitations and restrictions on executive compensation for companies that participate in the CPP. These limitations and restrictions have been covered in more detail in a previous article. However, the Treasury recently issued further guidance on the restrictions and limitations that will be discussed in more detail in a subsequent article that will be available very shortly.

What's Changed With the "Reopened" CPP?

With this general summary of the CPP provisions and the terms of the Treasury's investment in privately held and Subchapter S financial institutions, we will turn now to the "reopened" CPP.

The Treasury reopened the CPP in June 2009 for qualifying financial institutions with total assets of less than

\$500 million. In addition to reopening the CPP, the Treasury increased the amount of funds for which these financial institutions may apply from 3 percent of risk-weighted assets to 5 percent of risk-weighted assets. Furthermore, the Treasury's investment representing the additional 2 percent of risk-weighted assets does not carry the warrant, making this additional 2 percent of capital slightly cheaper than the initial 3 percent.

Except for the increase from 3 percent of risk-weighted assets to 5 percent of risk-weighted assets and the elimination of the warrant for the additional 2 percent investment, the terms of the CPP are otherwise unchanged from those described above.

Process

The reopened CPP is not available to all financial institutions. Rather, the Treasury has directed the reopened CPP toward traditional community banks. Any financial institution with less than \$500 million in total assets may apply to the reopened CPP, and may apply (or reapply) for up to 5 percent of risk-weighted assets. If the institution is a holding company with more than one subsidiary bank, the holding company must have less than \$500 million in total assets.

The Treasury is accepting applications (or reapplications) from eligible financial institutions until November 21, 2009. The application process is the same as it was under the original CPP: apply to your primary federal regulatory (FDIC, OCC, OTS or Federal Reserve). We also recommend copying your state regulator, if the applicant is a state bank.

If you did not previously apply under the CPP, this is your opportunity to do so. If you have applied but have not yet received approval and desire to increase the investment to up to 5 percent of risk-

weighted assets, you should call your primary regulator and inform it of your request. If you have received CPP funds and want to apply for the additional 2 percent, you should fill out another application for that additional 2 percent of risk-weighted assets and submit that application to your primary regulator. We can assist you with this process should you desire to increase the investment.

We understand that in every case, the Treasury is working on establishing an expedited approval process. Once approval is received, the financial institution has six months to close the transaction, but it must close no later than December 31, 2009. The financial institution is not required to immediately accept the funds. Consequently, approval acts as a "line of credit" should the financial institution later determine that a boost to capital is needed. On this basis, every bank should therefore apply (or reapply) for CPP funds. Furthermore, if the bank desires to form a holding company to take advantage of the reopened CPP, the entity must be *approved* as a holding company by November 21, 2009 (note: not *apply* to become a holding company by November 21, 2009).

What To Do Now

Our recommendation is that those financial institutions that believed, or believe, that the economics of the Treasury investment are or were acceptable should prepare a package for submission to its primary regulator to either apply initially or reapply for additional CPP funds. This is an opportunity to obtain or increase fairly inexpensive capital from the Treasury at a time when "margin of error" or "insurance" capital might be well worth considering.

In light of the bank regulators' recent tendency to require reclassifications of assets, greater loan loss reserves and more capital in general, this is an opportunity to shore up the financial institution's capital position. We have had many clients participate in the CPP, some of whom initially bristled at the thought of having the federal government as a regular houseguest. If you can use the funds, you could simply "hold your nose and turn away" as you close the transaction. For many of our clients, it was the compensation limitations that presented a major concern, but in retrospect, those concerns were probably unfounded, or were at least workable. We have had no clients express regret that they participated in the CPP. In any event,

remember that the funds can be repaid at any time with regulatory approval.

It is important to note, however, that institutions in need of capital should not rely solely on the reopened CPP. Instead, we recommend that they pursue parallel paths in the event that they are unable, for whatever reason, to participate in the reopened CPP. Such means may include, but not be limited to, a capital offering (such as a rights offering to existing shareholders and then to new investors), a debt offering to local interested investors that carries a market rate of return or a bank-stock loan from a correspondent lender. In this economic environment, "dry powder" and "insurance capital" should be carefully and strongly considered.

We have established a website at www.huntonfinancialindustryrecovery.com.

The website is updated frequently with information regarding EESA, ARRA, TARP and CPP; pronouncements from the Treasury, the Federal Reserve Board and the FDIC; and other related information. Please visit our website for additional information on these issues. We are also happy to talk to you or your institution's board of directors about any aspect of TARP participation. Please do not hesitate to call us if we can be of assistance.



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