FINANCIAL CRISIS RESPONSE TEAM

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Treasury's Capital Purchase Program Now Available to Certain Privately Held Financial Institutions — *Application Deadline Is December 8, 2008*

On October 14, 2008, the United States Department of the Treasury (Treasury) announced the availability of its voluntary Troubled Assets Relief Program (TARP) Capital Purchase Program (CPP) for qualifying U.S.-controlled banks, savings associations, and certain bank and savings-and-loan holding companies. Through the CPP, the Treasury seeks to enhance the capital bases of domestic financial institutions in an effort to thaw the credit markets and enable the flow of financing to businesses and consumers.

The CPP's first phase, which was oriented toward publicly traded financial institutions, had an application deadline of November 14, 2008. The Treasury has already dispersed more than $150 billion to participating publicly held financial institutions and continues to process such applications.

On November 17, 2008, the Treasury launched a second phase of the CPP by issuing a Term Sheet for **privately held institutions** participating in the program. The application deadline for privately held institutions is **December 8, 2008**. The primary provisions of the Term Sheet are summarized below.

Which Institutions Are Eligible?
Qualifying Financial Institutions (QFIs) include:

- Top-tier bank-holding companies or savings-and-loan holding companies that are not publicly traded
- Banks or savings associations, organized in a stock form, that are neither publicly traded nor controlled by a holding company
- Banks or savings associations that are both (a) not publicly traded and (b) controlled by a holding company that is not publicly traded. **However, S-corporations and mutual organizations are not eligible for the CPP at this time.**

What Is the Application Process?
An interested institution should contact its appropriate federal banking agency prior to filing an application. The Web site of each federal banking agency contains the application form and filing instructions.

The application form requires the provision of basic information about the institution, the amount of the preferred stock investment requested from the Treasury, and information about the amounts of authorized but unissued preferred and common stock currently available for purchase. The two-page application form can be found at: http://www.treasury.gov/initiatives/eesa/docs/application-guidelines.pdf

Applicants may request confidential treatment for separately bound portions of the application. However, any completed transactions (CPP investments) will be made public in electronic format within 48 hours of execution.

Although each participating institution will need to obtain internal board and/or shareholder approval, the Treasury permits such approvals to be obtained subsequent to the December 8, 2008 application deadline — provided that the delay is "robustly" explained on the application form.

Once an institution receives preliminary approval from the Treasury, the institution will have 30 days to submit the final documentation.

How Much Capital Can Be Obtained From the CPP?
Each QFI may issue an amount of perpetual preferred stock (preferred shares) between one percent and three percent of risk-weighted assets, subject to a maximum of $25 billion.

What Are the Preferred Stock Characteristics?
Each preferred share will have a liquidation preference of $1,000 per share, subject to adjustment if the QFI has insufficient authorized shares available.

Preferred stock will rank senior to common stock and equal to existing preferred shares, but senior to any preferred shares that, by their terms, rank junior to any existing preferred shares.

Preferred stock will be non-voting, except for certain votes affecting the rights of preferred shares or the issuance of shares senior to the preferred shares.

The Treasury investment in preferred shares will qualify as Tier 1 regulatory capital.

What Dividends Must Be Paid?
Each preferred share will pay quarterly dividends (on the 15th day of February, May, August, and November) at a rate of (i) five percent per annum until the fifth anniversary of the date of the investment, and (ii) nine percent per annum thereafter.

These dividends will be non-cumulative for banks that are not subsidiaries of holding companies, but will be cumulative for all other institutions.

If dividends on preferred shares are not paid in full for six dividend periods (whether or not such periods are consecutive), then the Treasury will have the right to elect two directors until such time as (i) all prior dividends are paid in full for cumulative shares, or (ii) all dividends are paid in full for four consecutive dividend periods for non-cumulative shares.

What Restrictions Apply to Other Preferred or Common Shares?
As long as any of the preferred shares are outstanding, no dividends may be declared or paid on common shares, junior preferred shares, or equally ranked preferred shares (except on a pro rata basis with the preferred shares), unless all dividends (cumulative or non-cumulative, as applicable) have been paid in full on the preferred shares.

No common, junior preferred, or equally ranked preferred shares may be repurchased or redeemed unless all unpaid dividends (cumulative or non-cumulative, as applicable) are paid in full for the preferred shares.

Until the 10th anniversary of the CPP investment, such repurchases also require the Treasury's consent (except for certain repurchases in connection with benefit plans in the ordinary course of business, consistent with past practice). After the 10th anniversary, the preferred shares must be redeemed in whole before any common dividends may be paid or any common or other preferred shares can be repurchased.

Also, until the preferred shares and warrant preferred shares (described further below) are fully redeemed, the Treasury's consent is required for (a) any increase in common dividends per share during the first three years, and (b) any increase in common dividends per share of greater than three percent per annum from the third anniversary until the 10th anniversary of the investment.

The restrictions described in the preceding two paragraphs are not applicable if the Treasury transfers all of the preferred shares and warrants to "third parties," which suggests that the Treasury may later decide to transfer shares and/or warrants to outside investors. Consistent with this, the Term Sheet provides that preferred shares will not be subject to any contractual restrictions on transfer (except that the Treasury and its transferees will not effect any transfer that requires the participating institution to become subject to periodic reporting requirements under Sections 13 or 15(d) of the Securities Exchange Act).

How and When May the Preferred Stock Be Redeemed?
After the third anniversary of the investment, the preferred shares may be redeemed at the option of the QFI at any time and in any series of transactions. All redemptions must be at 100 percent of the issue price, plus (i) any accrued and unpaid dividends, in the case of cumulative preferred shares, or (ii) any unpaid dividends for the then-current dividend period, in the case of non-cumulative preferred shares.

A QFI may redeem the Treasury's preferred shares prior to the third anniversary only by using the proceeds from the sale of Tier 1 qualifying preferred stock for cash, defined as a Qualified Equity Offering (QEI), and then only if the aggregate gross proceeds from the QEI amount to 25 percent or more of the issue price of the Treasury's preferred shares.

What Warrants Are Required?
In connection with an institution's issuance of preferred shares, the Treasury will receive warrants to purchase additional preferred shares (warrant preferred shares) having an aggregate liquidation preference equal to five percent of the amount of the original preferred shares. For example, if the Treasury makes a $10-million investment in the preferred shares of a QFI, the Treasury also will receive warrants to purchase warrant preferred shares totaling $500,000.

The exercise price for each warrant will be $0.01 per share, or a greater amount if required by the QFI's charter. Warrants will have a 10-year term, will be immediately exercisable (in whole or in part) by the Treasury, and will not be subject to any contractual restrictions on their transfer.

The warrant preferred shares will have the same rights and other terms as the original preferred shares, except that (i) dividends will be paid at a rate of nine percent per annum (rather than starting at five percent as in the case of preferred shares), and (ii) no warrant preferred shares may be redeemed until all of the preferred shares have been redeemed.

The Treasury has announced one exception to the warrant requirement. Warrants will not be required from a QFI that both (a) receives Treasury investment of $50 million or less and (b) has received, or applies for (at or prior to the time of filing the CPP application) and receives, designation as a Community Development Financial Institution (CDFI). Information about becoming a CDFI is available at www.cdfifund.gov.

What Are the Restrictions on Executive Compensation and Governance?
As a condition of accepting an equity infusion from the Treasury, the QFI must agree to certain restrictions on executive compensation. These restrictions apply for as long as the Treasury holds any equity or debt securities of the QFI, and apply to the chief executive officer (CEO), chief financial officer (CFO), and the three other most highly compensated senior executives in the QFI's controlled group (rather than the QFI alone).

Although the Treasury has not yet issued guidance specific to privately held institutions, the following four limitations applicable to publicly held institutions are indicative of the Treasury's likely approach:

1. The prohibition of bonuses or incentives that reward senior executive officers (SEOs) for taking "unnecessary and excessive risks" that "threaten the value" of the financial institution.

- Treasury regulations require the QFI's Compensation Committee to identify features in the institution's incentive compensation arrangements that could lead to executives taking unnecessary and excessive risks that could threaten the value of the institution.
- The Compensation Committee must review the QFI's compensation arrangements with the institution's senior risk officers (or other personnel acting similarly), to ensure that SEOs are not encouraged to take unnecessary and excessive risks (whether short-term or long-term risks).
- This review must occur within 90 days of accepting investment from the Treasury.
- Thereafter, the Compensation Committee must meet at least annually with senior risk officers to discuss and review the relationship between the institution's risk management policies and practices and the SEO's incentive compensation arrangements.
- The Compensation Committee must identify and limit compensation arrangement features that could lead to unnecessary and excessive risk-taking.
- Finally, the Treasury requires the Compensation Committee to certify that it has completed these reviews and has "made reasonable efforts to ensure that such arrangements do not encourage SEOs to take unnecessary/excessive risks that threaten the value of the financial institution," and to include such a certification in its proxy statement compensation discussion and analysis (CD&A). This process likely will suggest obtaining expert advice to support this conclusion and to minimize the Compensation Committee's risk.

2. Required "clawbacks" of any SEO bonus or incentive compensation based upon financial statements or criteria that are later proven materially inaccurate. This (a) applies to all SEOs (not just CEO and CFO); (b) has no time limit on the recovery period, and (c) is not limited just to inaccurate financial statements.

3. Prohibition of the financial institution making any "golden parachute payment" to any SEO.

- "Golden parachute payment" is defined to mean any compensation exceeding three times the SEO's average annual W-2 compensation.
- The restriction applies not only to change-in-control payments, but also to any severance payment by reason of an "involuntary termination" or in connection with a bankruptcy, insolvency, or receivership.
- "Involuntary termination" means independent exercise of unilateral authority of the employer to terminate the SEO, other than due to the SEO's implicit or explicit request to terminate employment, where the SEO was willing and able to continue performing services. This includes (a) non-renewal of an employment contract if the executive is willing and able to continue, (b) an executive's voluntary termination if the termination is for "good reason" because of a negative change in the employment relationship, and (c) an executive's voluntary "anticipatory" termination where the facts and circumstances indicate that the SEO would have been terminated and knew he or she would be terminated.

4. The QFI must agree to limit a claim for any federal tax deduction for any compensation to an SEO that exceeds $500,000 per year (whether actual or deferred). It does not matter if the compensation is "performance based" or not.

What Other Restrictions Apply to QFIs?

Holding Company Status

Any bank-holding company or thrift holding company that receives CPP funding must maintain its holding-company status for as long as the Treasury holds preferred stock and/or warrants in the company. A holding company seeking to terminate its status must fully redeem all preferred stock and warrants held by the Treasury.

Related-Party Transactions

For as long as the Treasury holds any equity securities of the QFI, the QFI and its subsidiaries may not enter into transactions with related persons unless such transactions (i) are on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated third party, **and** (ii) have been approved by the Audit Committee or comparable body of independent directors of the QFI.

Conclusion

The preceding sections summarize the key provisions of the CPP Term Sheet applicable to privately held institutions. Because each financial institution faces unique circumstances, please consult with legal and financial counsel on any questions about the CPP and meeting the application deadline of December 8, 2008.

Treasury Document Links:

Term Sheet: http://www.treas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf

Private Bank Program Q&A: http://www.treas.gov/press/releases/reports/faq%20111708%20%20private.pdf

Application Guidelines for TARP Capital Purchase Program and Application Form:
http://www.treasury.gov/initiatives/eesa/docs/application-guidelines.pdf

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