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VIEWPOINT

Change Capital Program to Protect Private Money

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Treasury Secretary Henry Paulson announced last week that the Treasury Department is contemplating a new program for investing additional Tarp funds in banks and, potentially, nonbank financial institutions.

That program could include a requirement that a matching investment of private capital be raised by institutions seeking funds under the new Capital Purchase Program.

A program like that would be an attractive opportunity for private-equity funds looking to invest in financial institutions to put capital to work alongside a cushion of attractively priced financing from the Treasury. To date the government's relatively inexpensive, passive money ironically has sometimes competed with private-equity funds for deal flow.

With opportunity comes risk, including some potential downsides to co-investing with the government. One issue of particular note is the breadth of the Treasury's right to amend its deal with banks that take money after the fact. The amendment provision in the investment documents says: "The Investor [i.e., the Treasury Department] may unilaterally amend any provision of this Agreement to the extent required to comply

with any changes after the Signing Date in applicable federal statutes."

Banks contemplating participating in the program have been so concerned about the potential negative ramifications of this provision that the American Association of Bank Directors sent Mr. Paulson a letter Nov. 3 lobbying for its deletion.

Notwithstanding concerns over the breadth of the Treasury's amendment rights, the nation's largest banking organizations — already heavily regulated — have accepted it or have been encouraged into it as part of the current CPP. We would expect any private-sector investor to be far more concerned about participating in an investment that affords the government such broad discretion.

Whereas the interests of banking institutions and the Treasury are largely aligned, the government certainly does not have a similar stake in the safety and soundness of private-equity and other funds. Such investors may be rightly concerned that political exigencies and increasing financial distress could lead the Treasury to protect its investment (and that of the taxpayers) first and foremost.

Leveraging private capital to enhance the impact of the CPP has a lot to offer as part of the overall economic recovery plan. Among other things, it may allow the

Treasury, which has limited staff resources, to outsource much of its due diligence function to experts in the private-equity community.

In any case, the shift toward a new CPP, in lieu of the originally planned purchases of troubled assets, at least signals that the Treasury is not careening blindly ahead with a hastily developed plan. Instead, it is continuing to determine what approaches seem most likely to succeed, in light of the latest information.

To further this enhancement, any new CPP should be developed with input from the private investment community, which may result in a modification of the broad amendment provision, as well as other arrangements with the Treasury for the protection of co-investors, as would be customary among private parties.

At a minimum, as is customary in other corporate contexts, the amendment provision should be modified to make clear that any change will not adversely affect the rights of investors before the amendment. Such actions should enhance the role the private sector can play in reversing the decline in our financial infrastructure.

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