

# Financial Services Alert

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## Special Edition

### ➤ Certain Matters for Banking Organizations to Consider When Deciding Whether to Raise Capital through the Troubled Asset Relief Program's Capital Purchase Program

The Emergency Economic Stabilization Act of 2008 (the "EESA"), enacted on October 3, 2008, established the Troubled Asset Relief Program ("TARP"), as reported in the October 3, 2008 *Alert*. Several programs are being created under the TARP, including the TARP Capital Purchase Program (the "CPP"), the Troubled Asset Auction Program ("TAAP") and the Program for Systematically Significant Failing Institutions ("PSSFI"). The CPP has been covered in greater detail in the October 14, 2008 *Alert* and the October 21, 2008 *Alert*. A future edition of the *Alert* will address the TAAP and the PSSFI as more details on these programs become available.

This Special Edition of the *Alert* provides preliminary commentary on a variety of considerations that will come into play as banking organizations and their advisors consider raising capital under the CPP. This *Alert* is the result of contributions from an integrated group of Goodwin Procter lawyers from practices across the firm, including: Banking, Securities & Corporate Finance, Corporate Governance, Mergers & Acquisitions, Private Equity, Tax, and ERISA, reflecting the interdisciplinary analysis necessary to evaluate participation in the CPP. Another source of capital we are assisting clients with in this regard is private equity investment in banks. Toward the end of this *Alert*, we will address issues to evaluate when considering raising capital from private equity investments as an alternative or a complement to raising capital under the CPP. In this and future *Alerts*, we aim to assist our readers in addressing the complex challenges presented by the current world economic situation.

## Overview

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Under the CPP, the Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms described in the CPP's term sheet ("Senior Preferred Shares"). The CPP currently is available to qualifying U.S.-controlled banks, savings associations, and certain bank and savings and loan holding companies engaged only in financial activities that elect to participate before 5:00 pm (EDT) on November 14, 2008, although the Financial Services Roundtable and other trade groups are seeking to broaden the eligible participants and extend the deadline. The Treasury has indicated that troubled institutions, generally institutions with a capital rating of 4 or 5, will not be approved for participation in the CPP. To date, there has been no definitive guidance as to how the CPP will apply in the case of financial organizations in mutual form or operated as S corporations. Future editions of the *Alert* will discuss rules relating to such organizations as they are developed. In addition to the largest banks, who announced participation in the CPP on October 14, 2008, PNC announced on October 24, 2008, that it will be participating in the CPP concurrent with its acquisition of National City. Today several regional banks announced their participation in the CPP, including SunTrust, Capital One, Huntington Bancshares, KeyCorp, Regions Financial and Northern Trust. However, banks certainly are seeking involvement in the CPP.

## Capital Planning

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Banking organizations facing the prospect of operating in a deep and prolonged recession will no doubt be attracted to the opportunity to raise a meaningful amount of regulatory capital under the CPP. Like any other decision relating to capitalization, the analysis of whether to issue Senior Preferred Shares and the requisite associated warrants (“Warrants”) under the CPP begins with an analysis of the “all in” relative cost of that capital and the opportunities to deploy it profitably and in a safe and sound manner.

The “cost of capital” analysis will require, among other things, modeling based on various assumptions regarding the ability to fund a call of the Senior Preferred Shares within the first five year period following issuance and sale. To address the possibility that conditions in the capital markets do not permit a call in that timeframe, the analysis should include modeling of the alternate scenarios in which the Senior Preferred Share dividend will increase from 5% to 9%. In both scenarios, the dilutive effect of the Warrants also must be considered.

If a 9% dividend turns out to be high relative to other capital alternatives after the fifth year, yet refunding with cheaper capital is not feasible and shrinking the balance sheet to eliminate that layer of Tier 1 capital is not an option, the equity market may punish the banking organization’s stock price because of the earnings dilution or in anticipation of an equity-dilutive refinancing with common equity. However, if the terms of the Treasury’s capital investment are in line with current “market,” and stability returns to the equity market, it is conceivable that alternative/competitive sources of capital will be available, providing opportunities to refinance at a relatively early date.

Some bankers at well-capitalized organizations have expressed concern about the feasibility of deploying additional capital prudently to expand lending in a recessionary environment. Many bankers, however, also believe that their organizations may well face unexpected losses as well as unprecedented acquisition opportunities. In these circumstances, additional capital will be an important resource.

## Exchange/Nasdaq Listing

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Banking organizations contemplating participation in the CPP should proactively address the listing qualifications of the securities proposed to be issued to the Treasury in connection with the CPP. For example, Nasdaq-listed issuers that are required to obtain shareholder approval in connection with their issuance of the CPP securities (because those securities would represent more than 20% of the issuer’s outstanding stock) may need to modify the terms of the securities as currently proposed by the Treasury in order to comply with Nasdaq rules relating to such shareholder votes. Failure to adhere to these rules can result in delisting of the issuer’s securities from Nasdaq.

## SEC Reporting

### **MD&A Disclosure Considerations**

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Going forward, public issuers’ periodic reports will need to factor CPP-related issues in crafting MD&A disclosure that is responsive to various items of SEC Regulation S-K, liquidity and capital resources (Item 303) and market risk (Item 305). Disclosure of specific action by an issuer as to its decision whether to participate in the CPP (*i.e.* “applied”, “did not apply,” or “applied and was turned down”) will not be *per se* required.

However, CPP-related items may be relevant to drafting robust and transparent MD&A disclosure under “normal” Item 303 and 305 analysis. While there is nothing normal about current market conditions or the very existence of the CPP, MD&A will continue to be expected to address the adequacy of internal and external funding to meet current, longer-term and contingent commitments, as well as reasonably anticipated uncertainties as to both sources and uses of capital. For example, if a banking organization’s liquidity, capital resources and exposure to market risk are such that the banking organization needs to raise capital from external sources but either decided not to apply or was turned down, what alternatives will be pursued? If the banking organization applied and was approved, will the capital provided be sufficient? Forward-looking disclosure relating to the issuance of Senior Preferred Shares and Warrants will also have to be developed over time, including the impact on results of operations (cost, dilution) and on financial condition (use of proceeds, refunding plans).

### **Other SEC Reporting and Compliance Considerations**

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The Senior Preferred Shares, the Warrants and the common stock underlying the Warrants issued under the CPP implicate a number of considerations under the Securities Exchange Act of 1934, including Sections 13 and 16. For example, attention will need to be given to potential (a) Section 13 and 16 reporting of the Senior Preferred Shares should they become registered under the Exchange Act, (b) potential Section 13 and 16 reporting of the common stock underlying the Warrants, and (c) the treatment of such common stock at stockholder meetings (*i.e.*, although the CPP Term Sheet provides that the Treasury will not vote this common stock, it remains unclear whether the stock could be counted for quorum purposes and/or voted proportionately in the same manner as the other shares voted at the meeting). If the capital available under the CPP was “priced” correctly by the Treasury and a secondary market develops at or close to par for the securities issued as part of the CPP, investors other than the Treasury could accumulate a significant block of Senior Preferred Shares and/or Warrants.

### **Mergers and Acquisitions**

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Commentators have speculated that the financial institutions industry is now going to enter a phase of accelerated consolidation. Participation in the CPP, like our bank clients who have reviewed private equity investment, may enhance a participating financial institution’s capital position to pursue acquisitions, particularly acquisitions of failing or troubled banks or thrifts. Recently, Secretary Paulson has publicly confirmed that CPP funds may be used for acquisitions and cited the potential stabilizing value of such merger and acquisitions activity. In particular, certain financial institutions will find it strategically beneficial to acquire troubled financial institutions to augment their base of core deposits.

Potential buyers have begun to question how they will handle Senior Preferred Shares and Warrants issued to the Treasury by an acquisition target. Although merger and acquisition activity is not directly addressed, certain conclusions can be drawn from the CPP term sheet. Buyers will have the option of (a) structuring a deal in which the Senior Preferred Shares remain outstanding on the same terms or (b) cashing out the Senior Preferred Shares at par value plus unpaid dividends through a concurrent redemption of these securities funded by a common share issuance to the buyer. Neither option will require the target to obtain the consent of the Treasury. The buyer’s choice will be dictated by its particular circumstances and objectives; however, if the post-transaction entity is not publicly-traded, then keeping the Senior Preferred Shares outstanding will conflict with the target’s covenants to keep a shelf registration effective and to list the shares on a national securities exchange if requested by the Treasury. If the Senior Preferred Shares are cashed out, then the target will have the right to repurchase the Warrants at fair market value. Otherwise, the Warrants will likely adjust to represent the right to

receive the same amount and type of consideration as a common shareholder received in the transaction. If the target is no longer listed on a national securities exchange, then Treasury has the right to exchange the Warrant for senior term debt or another security such that Treasury is appropriately compensated for the value of the Warrant, as determined by Treasury.

### **Tax Guidance**

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As discussed in the October 21, 2008 *Alert*, the Internal Revenue Service (the “IRS”) issued Notices 2008-100 and 2008-101 (the “Notices”) to provide guidance to banks participating in the CPP. The Notices provide for exceptions to the application of certain provisions of Sections 382 and 597 of the Internal Revenue Code of 1986 (the “Code”) in the case of capital infusions from the Treasury pursuant to the CPP. Notice 2008-100 provides guidance to corporations regarding the application of Section 382 of the Code relating to ownership change and limitations on deductions of certain losses. Notice 2008-101 provides guidance regarding the application of the “Federal financial assistance” provision contained in Section 597 of the Code. (As also reported in the October 7, 2008 *Alert* the IRS issued Notice 2008-83 that enables a private acquirer of a bank to avoid some of the adverse net operating loss tax consequences normally associated with a change in control.)

Notice 2008-100 provides that any shares of stock of a bank acquired by the Treasury pursuant to the CPP shall not be considered to have caused an ownership change with respect to the Treasury’s ownership of the stock of such bank. In general, Section 382 of the Code limits a corporation’s deduction for net operating loss carryovers and recognized built-in losses subsequent to an ownership change. An ownership change, as defined in section 382(g) of the Code, is, generally, a change of 50% or more of the ownership of a corporation within a three-year period. Prior to Notice 2008-100, the Treasury’s acquisition of certain stock of a bank under the CPP could have resulted in an ownership change, thereby limiting the bank’s ability to utilize prior losses to reduce its taxable income.

Additionally, Notice 2008-100 provides that shares of stock of a bank redeemed from the Treasury shall be treated as if they had never been outstanding for purposes of determining if such redemption has effected an ownership change with respect to other shareholders. Furthermore, Notice 2008-100 provides guidance concerning (i) the effect of the CPP on a bank’s status as a member or parent of an affiliated group, (ii) the Treasury’s acquisition of warrants to purchase bank stock, and (iii) the treatment of options acquired by the Treasury. Notice 2008-100 further provides that, for purposes of Section 382(1)(1) of the Code, any capital infusion made by the Treasury in a bank pursuant to the CPP shall not be considered to have been made as part of a plan a principal purpose of which was to avoid or increase any limitation imposed by Section 382 of the Code.

Notice 2008-101 provides that no amount furnished by the Treasury to a bank pursuant to the TARP shall be treated as “Federal financial assistance” within the meaning of Section 597 of the Code. Section 597 of the Code generally treats money and other property received by a bank from the FDIC as “Federal financial assistance.” Such assistance is generally treated as taxable income to the recipient bank and, prior to Notice 2008-101, could have included the Treasury’s acquisition of certain stock of the bank under the TARP.

Banks may rely on the guidance contained in the Notices unless and until the IRS issues further guidance. While the IRS intends to issue regulations that set forth the rules described in Notice 2008-100, such regulations will not apply, however, to acquisitions by the Treasury prior to the publication of such regulations or pursuant to written binding contracts entered into prior to the publication of such regulations.

## **Merger-Related Tax Considerations**

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Parties to merger and acquisition transactions where the target institution has outstanding Senior Preferred Shares should consider the implications of redeeming the Senior Preferred Shares on the ability of the transaction to qualify as a tax-free reorganization under Section 368 of the Code.

## **Investor Tax Considerations**

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We are aware of situations in which existing investors in financial institutions that are applying to participate in the CPP have preemptive or other rights to invest their own capital on the same terms as the Treasury. Any such investors that are U.S. taxpayers should be aware that, due to the structure of the securities proposed by the Treasury, their investment could be subject to certain tax liabilities beyond taxes payable on any gain on sale of the investment. For example, the value of the Warrants may have to be recognized as income (i.e., preferred stock “original issue discount”) to the investor subject to tax over the five year period before the yield on the Senior Preferred Shares increases from 5% to 9%. In addition, in a case where a required stockholder approval relating to the shares underlying the Warrants is not obtained and the proposed exchange provision becomes operative (pursuant to which the Warrants will be exchanged for senior term debt or another security that preserves the economic value of the Warrants), the exchange may be fully taxable with gain recognized to the extent the Warrants have increased in value between the date of issuance and the time of exchange. Any investor contemplating purchasing CPP securities alongside the Treasury should consult with their tax advisors.

## **Executive Compensation**

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Financial institutions participating in the CPP will be faced with the following executive compensation restrictions and must amend their executive compensation arrangements and programs to comply with these restrictions.

The executive compensation restrictions apply to a participating financial institution’s senior executive officers (“SEOs”) – including the chief executive officer, chief financial officer and three most highly compensated executive officers, determined generally in the same manner as the identification of the five “named executive officers” reported in a public company’s annual proxy statement. Like public financial institutions, private financial institutions who participate in the CPP also will need to follow the SEC proxy rules to determine their SEOs for each year that the institution is subject to the rules. It should also be noted that the SEO test is a current year determination. Therefore, the financial institution must use its best efforts to identify the three most highly compensated executive officers for the current fiscal year.

## **Duration of Restrictions Considerations**

The compensation restrictions apply as long as the Treasury holds a debt or equity position in the institution. Assuming that the Warrants are considered an equity position, then it is possible that the restrictions can be imposed for up to ten years. On the other hand, if the Treasury redeems and/or sells its debt and equity position very quickly, then the duration of the compensation restrictions can be quite short and the compensation restrictions will not be particularly meaningful.

### **Risk Assessment Considerations**

Within 90 days after initial participation in the CPP and annually thereafter, the financial institution's compensation committee must certify that it has reviewed SEO incentive compensation arrangements with the institution's senior risk officer to ensure that the arrangements do not encourage SEOs to take unnecessary and excessive risks.

This requirement of the TARP will cause compensation committees to closely examine participating financial institutions' incentive programs and particularly, the performance metrics of short-term programs. This could encourage participating financial institutions to adopt performance plans with three- or five-year terms, rather than annual plans that encourage focus on short-term profitability or gains. This provision may also have the perverse effect of shifting more of executives' compensation from performance compensation to fixed compensation.

### **Clawback Considerations**

Financial institutions that participate in the CPP must have the ability to recoup incentive compensation paid to SEOs that is based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate.

This clawback provision is much broader than the clawback provision imposed by Section 304 of the Sarbanes-Oxley Act of 2002. The TARP clawback provision applies to all SEOs, not just the CEO and the CFO, is not exclusively triggered by an accounting restatement, does not limit the recovery period and covers more than material inaccuracies relating to financial reporting. This provision will encourage CFOs in particular to be more conservative in preparing financial statements and other financial metrics that are used to determine bonuses.

### **Severance Payment Considerations**

Financial institutions participating in the CPP are prohibited from making any "golden parachute payments" (generally, severance payments in excess of three times the SEO's prior five year average compensation) to its SEOs. The restrictions on golden parachute payments are not as severe as they appear. Financial institutions participating in the CPP can still pay severance up to three times the SEO's prior five-year average compensation without restriction (although such payments may not be fully deductible under Section 162(m) of the Code). Newly hired executives may also negotiate large up-front signing or retention bonuses in lieu of severance payments.

### **Section 162(m) Deduction Considerations**

A participating financial institution is subject to an annual limit on its federal tax deduction of \$500,000 per SEO. In addition, unlike the deduction under Section 162(m) of the Code applicable to other public companies, the limit applies to both public and private institutions, there is no exception for performance compensation such as stock options, and the limit applies even if the remuneration is paid in later years.

The loss of a tax deduction on annual compensation in excess of \$500,000 may not be a material issue for many financial institutions, as many of them have millions, if not billions, in losses. In such instances, this cap on tax deduction will reduce loss carry forwards, but will not increase current taxes owed.

While TARP imposes a number of restrictions on executive compensation, they are not as draconian as they could have been. For instance, there is no cap on compensation and financial institutions are still at liberty to compensate their executives richly, albeit on a nondeductible basis. Further, these restrictions apply only to compensation payable to the top five SEOs and not to other top level

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**IRS Circular 230 Notice:**

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executives. In addition, if a financial institution that participates in the CPP is acquired by an unrelated buyer, the buyer's management team will not become subject to the restrictions solely as a result of the acquisition and the target's CEOs will continue to be subject to the prohibition on "golden parachute payments" for one year after the acquisition.

**The Private Equity Alternative**

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Many banking institutions weighing participation in the CPP may also be considering an investment by private equity investors as an alternative, or complement, to CPP participation. Financial institutions considering private equity investment are likely to find that both the structure and process associated with private investment differs from CPP participation in several notable respects including:

- more "expensive" economic terms compared to those available under the CPP;
- a robust due diligence process that likely extends to the portfolio-level;
- board representation, negative and affirmative operational covenants and other post-investment controls, all carefully structured to stay within regulatory limits; and
- significant conditions to the closing of the investment.

The due diligence process, negotiation and documentation of the investment and satisfaction of the conditions to the closing of the investment are, in many cases, likely to require management attention and resources significantly in excess of the management resources required to close an equivalent CPP investment. For these, and other, reasons, we believe that many banking institutions that can qualify for CPP funds will choose government investment over private investment.

Notwithstanding the favorable attributes of CPP investment, some financial institutions may still find private equity an attractive alternative, or complement, to CPP participation. First, financial institutions that do not qualify for CPP investment may find private equity the only viable source of available capital. In addition, a financial institution may benefit from both the public validation that accompanies investment by a seasoned and sophisticated private equity investor as well as the strategic expertise that such an investor can lend to the banking institution on a post-closing basis. Finally, a financial institution may wish to raise capital in excess of the amounts available under the CPP to build additional regulatory cushion and/or to deploy opportunistically to take advantage of the current market dislocation.

Additional factors relevant to private equity investment in financial institutions were discussed in the May 27, 2008 *Alert* and the FRB's guidance on minority investments in banks was discussed in the September 23, 2008 *Alert*. In addition, beginning Tuesday, October 28, a video of Goodwin Procter's October 2 seminar on *Private Equity Investing in Banks: Opportunities in a Perfect Storm* will be available at [www.goodwinprocter.com](http://www.goodwinprocter.com).

**Conclusion**

In the current environment, the CPP provides financial institutions with an important source of additional capital to absorb losses, expand lending, and take advantage of strategic opportunities to build for the future. The foregoing is a discussion of some of the general considerations to be addressed as organizations prepare to participate in this program. Taking advantage of this opportunity, however, requires careful analysis of a range of considerations specific to each institution's situation. We will continue to cover any TARP-related developments in future editions of the *Alert*.