

FINANCIAL SERVICES REGULATORY & ENFORCEMENT, GLOBAL FINANCIAL MARKETS INITIATIVE, TAX TRANSACTIONS UPDATE

US Treasury Announces TARP Capital Purchase Program; IRS Issues Related Tax Guidance

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On October 14, 2008, the United States Department of the Treasury (Treasury) announced a Capital Purchase Program (the "Program"), through which Treasury will purchase up to US\$250 billion of senior preferred shares of certain qualifying financial institutions. The measure, which is intended to increase liquidity in the financial markets and the flow of financing to US businesses and consumers, will be available to certain US banks, savings associations, and bank and savings and loan holding companies. Additionally, on the same day, the IRS released guidance meant to ensure that Treasury investments made under the Program will not cause or contribute to causing eligible institutions to be restricted in their ability to use any current net operating losses, existing net operating loss carryforwards or recognized built-in losses.

Treasury released a term sheet for the senior preferred shares that addresses a number of key issues related to the Program, including: eligibility criteria; characteristics of the senior preferred shares; executive compensation restrictions on participating institutions; and Treasury's right to warrants for the purchase of common stock of participating

institutions. Additionally, on October 15, Treasury issued an interim final rule (Interim Rule) to provide guidance on the executive compensation provisions of the Program.

Treasury has publicly stated that nine of the largest US financial institutions have agreed to participate in the Program. In total, these institutions are expected to receive up to US\$125 billion. The remaining US\$125 billion will be available to certain other US banks, savings associations, and US bank and savings and loan holding companies. Eligible institutions will have until 5:00 p.m. (EDT) on November 14, 2008, to elect to participate in the Program, and institutions interested in participating should contact their primary federal regulator. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency.

Over the next few weeks, eligible financial institutions will need to carefully consider whether they want to participate in the Program. While the Program provides institutions with the opportunity to raise capital with fewer private investors, this capital comes with some noteworthy costs and restrictions. In addition, participating

in the Program will undoubtedly have an impact on the institution's existing holders of common and preferred stock.

Background

On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008 ("EESA" or the "Act"). A central feature of the Act was its grant of authority to Treasury to establish the Troubled Assets Relief Program (TARP), through which Treasury is authorized to purchase up to US\$700 billion in troubled assets from financial institutions. For purposes of the Act, "troubled assets" include not only mortgage loans and related financial instruments but also "any other financial instrument" that Treasury, after consultation with the Board of Governors of the Federal Reserve System, "determines the purchase of which is necessary to promote financial market stability." Pursuant to this grant of authority, Treasury has announced its intention to purchase under terms of the Program up to US\$250 billion of senior preferred shares from qualifying financial institutions.

Eligibility Criteria

Participation in the Program is restricted to qualified financial institutions (QFIs). The term sheet defines a QFI as:

- (1) any U.S. bank or savings association that is not controlled by a bank holding company ("BHC") or savings and loan holding company ("SLHC");
- (2) any U.S. BHC or SLHC that engages only in "financial activities" permitted for financial

holdings companies under Section 4(k) of the Bank Holding Company Act ("BHCA"), and any U.S. bank or savings association controlled by such a BHC or SLHC; and

- (3) any U.S. BHC or SLHC whose U.S. depository institution subsidiaries are the subject of an application under Section 4(c)(8) of the BHCA.

For purposes of the QFI definition, an institution must be organized under the laws of the United States or any state of the United States in order to qualify as a "US" bank, savings association or holding company.

The definition of QFI raises several interesting issues. First, the eligibility of industrial loan companies, credit card banks and certain other FDIC-insured institutions that are not "banks" for purposes of the BHCA but are owned by non-financial companies is unclear under the QFI definition. Second, the savings association subsidiary of a grandfathered "unitary" SLHC that engages in commercial activities apparently would not be eligible to participate. Third, the term sheet specifically excludes from the definition of QFI any bank, savings association, BHC or SLHC that is "controlled by a foreign bank or company." However, the term sheet does not define "control" or otherwise elaborate on the exclusion. Unless otherwise indicated, we would expect that Treasury would interpret "control" in a manner consistent with the BHCA. This would exclude a US-based financial institution in which a foreign bank or company holds 25 percent

or more of any class of voting securities. Lower ownership interests could also result in control of an institution especially if coupled with the right to appoint directors or other indicia of a controlling influence.

Characteristics of the Senior Preferred Shares

A participating QFI will be permitted to issue nonvoting senior preferred shares for sale to Treasury in an amount equal to not less than 1 percent of the QFI's risk-weighted assets and not more than the lesser of (i) US\$25 billion and (ii) 3 percent of its risk-weighted assets. The shares will qualify as Tier 1 capital and will rank senior to common stock and *pari passu* with existing preferred shares (other than preferred shares which by their terms rank junior to any other existing preferred shares).

Dividends. Senior preferred shares issued pursuant to terms of the Program will pay cumulative dividends at a rate of 5 percent for the first five years and 9 percent per year thereafter. Shares issued by banks that are not subsidiaries of holding companies will pay non-cumulative dividends at a rate of 5 percent for the first five years and 9 percent per year thereafter. These provisions of the term sheet may be inconsistent with existing regulatory capital guidelines, under which cumulative perpetual preferred stock counts as Tier 1 capital only for bank holding companies; it must be non-cumulative to count as Tier 1 capital if issued at the bank or thrift level.

A participating QFI will be barred from declaring or paying a dividend on junior preferred shares, preferred shares ranking

pari passu with the senior preferred, or common shares unless the QFI has satisfied its dividend obligations with respect to the senior preferred. Furthermore, Treasury consent is required for any increase in the common share dividends for the first three years unless Treasury has transferred the senior preferred shares to third parties.

Redemption. The QFI can freely redeem senior preferred shares issued under the Program after three years. Until that time, the shares may only be redeemed with the proceeds from a qualified equity offering (QEO) resulting in aggregate gross proceeds to the QFI of not less than 25 percent of the issue price of the senior preferred shares. A QEO is defined as a sale by a QFI of Tier 1-qualifying perpetual preferred stock or common stock for cash. All redemptions are subject to the approval of the QFI's primary federal banking regulator. Any redemptions can be at par.

Transferability. Senior preferred shares issued pursuant to terms of the Program will not be subject to any contractual restrictions on transferability. Treasury will have the ability to hold or sell these senior preferred shares. Participating QFIs will be required to file a shelf registration statement covering the shares and to grant Treasury piggyback registration rights for the shares. The term sheet also requires participating QFIs to take any reasonable steps requested by Treasury to facilitate transfer of the shares, including in particular making reasonable efforts to list the shares on a national securities exchange.

Voting Rights. The senior preferred shares will be non-voting securities, other than

class voting rights on (i) any authorization or issuance of shares ranking senior to the senior preferred shares, (ii) any amendment to the rights of senior preferred shares, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the senior preferred shares. If dividends are not paid in full for six periods, the senior preferred shares will have the right to elect two directors.

Executive Compensation

A participating QFI and its senior executives will be required to comply with the direct purchase restrictions on executive compensation set forth in section 111 of EESA from the time of closing on the senior preferred shares transaction and for so long as Treasury holds any equity of the QFI.

EESA Restrictions for Direct Purchases.

This provision will require a participating QFI to have in place: (i) limits on compensation that will exclude incentives for senior executive officers to take unnecessary and excessive risks; (ii) a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; (iii) a prohibition on the financial institution making any golden parachute payments to senior executive officers; and (iv) an agreement not to deduct for tax purposes any executive compensation in excess of US\$500,000 for each senior executive officer. In addition, a participating QFI and its senior executive officers will be required to grant Treasury a waiver against any claims related to the executive compensation restrictions.

Compliance. The Interim Rule clarifies the steps that a financial institution must undertake to exclude incentives for senior executive officers to take unnecessary and excessive risks. It requires the following: (1) within 90 days after the purchase under the Program, the QFI's compensation committee must review the Senior Executive Officer incentive compensation to ensure that the arrangements do not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) thereafter, the compensation committee must meet at least annually with senior risk officers to discuss and review the relationship between the financial institution's risk management policies and practices and the Senior Executive Officer incentive compensation arrangements; and (3) the compensation committee must certify that it has completed the reviews of the Senior Executive Officer incentive compensation. These standards appear to be exclusively qualitative in nature with no quantitative or other objective benchmarks

Golden Parachute. The Interim Rule adopts the Internal Revenue Code's definition of "golden parachute payment," which covers any payment in the nature of compensation to (or for the benefit of) a Senior Executive Officer — made on account of an applicable severance from employment — to the extent the aggregate present value of such payments equals or exceeds an amount equal to three times the Senior Executive Officer's base amount.

Acquisitions, mergers, or reorganizations.

The Interim Rule provides that an institution acquiring a QFI, which has participated in the Program, will not become subject to the

executive compensation restrictions merely as a result of the acquisition. However, any employees of the acquired QFI who are senior executive officers at the time of the acquisition will remain subject to the golden parachute restrictions for one year following the acquisition.

Warrants for the Purchase of Common Stock

In conjunction with the purchase of senior preferred shares, Treasury will receive a warrant to purchase a participating QFI's common stock, with an aggregate market price equal to 15 percent of the amount of Treasury's investment in the senior preferred shares of the QFI. The exercise price on the warrants will be the market price of the participating QFI's common stock at the time of issuance, calculated on a 20-trading day trailing average. The warrants will be immediately exercisable, in whole or in part, for a term of ten years. Treasury will not exercise any voting rights with respect to any common shares issued to it upon the exercise of the warrants. It is unclear how this warrant requirement will be implemented for BHCs, SLHCs, banks and savings associations without publicly traded common stock.

Certain Tax Guidance Relating to the Program

Also in conjunction with the Program, on October 14, 2008, the Internal Revenue Service (IRS) issued Notice 2008-100 (the "Notice"). This guidance is intended to ameliorate the potential adverse effects, under section 382 of the Internal Revenue Code (Code), on the ability of eligible institutions to use current net operating

losses (NOLs), existing NOL carryforwards and recognized built-in losses (BILs) as a result of Treasury's investments in such institutions under the Program.

In general, Code section 382 limits the amount of taxable income that may be offset against a loss corporation's NOLs and BILs in taxable years after the corporation has undergone an ownership change. An ownership change generally occurs if the percentage of the corporation owned by one or more five-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of such corporation owned by those shareholders at any time during a three-year rolling testing period.

The Notice provides that the shares of any loss corporation acquired by Treasury, either directly or by exercise of an option, pursuant to the Program will not cause Treasury's (equity) ownership in the loss corporation to have increased over its lowest percentage on any earlier date (e.g., zero), for purposes of determining whether an "ownership change" has or will be incurred by the corporation. Such shares will generally be considered outstanding for purposes of determining the percentage of loss-corporation stock that is owned by other five-percent shareholders on a testing date.

The Notice also provides that shares acquired and held by Treasury in loss corporations that are later redeemed by such entities will be treated as if they had never been outstanding. Moreover, for all Federal income tax purposes, preferred stock that is acquired by Treasury pursuant to the Program, whether owned by Treasury

or another person, will be treated as stock described in Code section 1504(a)(4) (i.e., as so-called “plain-vanilla preferred”) and warrants to purchase stock of a loss corporation will be treated as options (and not stock).

Finally, any option (within the meaning of Treas. Reg. § 1.382-4(d)(9)) will not be deemed exercised under Treas. Reg. § 1.382-4(d)(2), and capital contributions made by Treasury to a loss corporation pursuant to the Program will not be considered under section 382(l)(1) to have been made as part of a plan to avoid or increase any Code section 382 limitation.

The Notice states that the IRS and Treasury intend to issue regulations that set forth rules as described above, and that taxpayers may rely on the Notice for purposes of applying Code section 382 with respect to loss corporations, unless and until there is additional guidance. The Notice also provides that any future contrary tax guidance will not apply to instruments (i) held by Treasury that were acquired pursuant to the Program prior to the publication of that future tax guidance, or (ii) issued to Treasury pursuant to the Program under written binding contracts entered into prior to the publication of that guidance.

If you have questions regarding this Program, please contact the Mayer Brown attorney with whom you normally communicate or any of the attorneys below.

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