

TARP Auctions: Considerations for Private Equity Fund Managers

PENpoints

A private fund planning to purchase TARP preferred stock auctioned by the U.S. Treasury should keep in mind the regulatory implications of owning equity in a bank holding company.

During 2008 and 2009, the U.S. Treasury Department (Treasury) purchased cumulative preferred stock from more than 700 U.S. bank holding companies (BHCs) as part of the Capital Purchase Program established under its Troubled Asset Relief Program (TARP).

By the end of 2011, Treasury had exited approximately half of these positions and announced that it had reached breakeven on its aggregate bank investments. With all future proceeds now constituting profit, Treasury engaged financial advisers to explore alternatives for refinancing or selling the remaining TARP preferred stock. In March 2012, Treasury announced completion of an auction under which it sold the TARP preferred stock of six BHCs, with two of those companies repurchasing their own TARP preferred stock at discounts of 5.6% and 6.9%, and third-party investors purchasing the other four TARP positions at discounts ranging from 8.5% to 18%.¹

On May 3, 2012, the Assistant Treasury Secretary announced that the TARP preferred stock auctions would continue as part of the TARP winddown. Additionally, at least 12 BHCs have filed registration statements covering TARP preferred stock since completion of the March auction, sending a strong signal that additional auctions will be held over the next few months.

With a dividend rate that increases from 5% to 9% over the next two years, and purchase discounts of up to 18% or more, TARP preferred stock may be an attractive potential investment for a private fund seeking mid-to-high-teen returns. When formulating a bid for TARP preferred stock, however, a private fund manager should understand the regulatory and similar limitations that may affect the value of such an investment, particularly those relating to dividend payments, redemptions and “control” of a BHC.

Dividend Payments

Almost half of the remaining TARP issuers have missed at least one dividend payment, in part due to regulatory

limitations on the ability of a BHC and its subsidiary banks to pay dividends.²

Guidance from regulators suggests that a BHC’s board of directors should not approve a dividend if it exceeds (a) earnings for the past four quarters less (b) dividends paid during that period. Banking regulators also have imposed formal and informal restrictions on many banks and BHCs requiring regulatory approval of all dividend payments and prescribing significantly higher capital ratios. As loan losses diminish, bank earnings solidify and capital levels increase, we expect regulators to reduce or remove these additional restrictions, but banking regulators’ resolve and the inclination of many TARP participants to maintain high levels of capital and retain excess cash may persist.

Although dividends under the TARP preferred stock accumulate, there is risk that dividends will not be paid in a timely manner.

Redemptions

Typically, the Federal Reserve must approve any stock redemption by a BHC that would (a) reduce its consolidated net worth by 10% or more or (b) have a material adverse impact on the level or composition of its capital. For most of the remaining TARP participants, at least one of these two conditions will exist unless they raise additional common equity or non-cumulative preferred stock, and many issuers have been unwilling or unable to raise this type of equity.³

Furthermore, once Treasury transfers TARP preferred to a third party, certain contractual restrictions on the BHC in favor of Treasury – which otherwise would incentivize the BHC to redeem the TARP preferred stock – are eliminated, including (i) limits on executive

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compensation, (ii) the requirement that Treasury approve dividend increases in excess of 3% (or, after the tenth anniversary, the prohibition on the payment of any dividends) and (iii) the prohibition on the redemption or purchase of equity securities other than pursuant to prior contractual commitments (or, after the tenth anniversary, the prohibition on any redemptions or purchases of equity).⁴

Private fund managers should be mindful that TARP preferred stock is a perpetual security and does not include redemption rights exercisable at the holder's option.

A Control Determination

Although TARP preferred stock is non-voting, a private fund may risk being deemed to "control" the BHC issuer if its TARP preferred stock constitutes 25% or more of the issuer's total capital, which could be the case for many of the TARP issuers in question. In

addition, a private fund may be deemed to control the BHC because the terms of the TARP preferred stock permit its holder to appoint two directors to the BHC's board of directors if six dividend payments are not made.

If the Federal Reserve determines that a private fund is in "control" of a BHC, the private fund itself could be subject to regulation under the Bank Holding Company Act.

To avoid such a determination, a private fund may be required to execute passivity commitments and/or waive its right to appoint one or both of the directors before it acquires any TARP preferred stock. Private fund managers should become familiar with the limitations imposed under passivity commitments and the recent actions that the Federal Reserve has taken to prevent the exercise of influence by investors that have not obtained required approvals.

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- 1 Prior to the March TARP auction, most cases in which Treasury accepted a discount on the disposition of TARP preferred stock involved private equity firms providing capital to a severely troubled BHC on the condition that the BHC redeem its TARP preferred stock (for cash or for publicly traded common stock) at a deep discount.
 - 2 Because a BHC typically pays dividends out of the dividends received from its bank subsidiary, restrictions on a bank's payment of dividends to the BHC directly impact the BHC's ability to pay dividends.
 - 3 Under Dodd-Frank Wall Street Reform and Consumer Protection Act Section 171, cumulative preferred stock issued after May 2010 (other than TARP preferred stock) will not qualify for tier one capital treatment.
 - 4 TARP preferred stock terms restricting any payment (whether by dividend or redemption) in respect of junior securities, including a BHC's common stock, when the dividends on the TARP preferred are not current will survive any transfer to a third party.
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If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

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PENnotes

The EU Financial Crisis: Paradoxes and Global Imbalances
New York, New York
May 10, 2012

In this Kirkland-sponsored event, the Columbia Business School Club of New York's International Committee will host a panel discussion, moderated by Bloomberg TV's Pimm Fox, on the current financial crisis in the EU in the context of unique global economic developments. Click [here](#) for more information and to register for this event.

IPO Preparation – What You Need to Know in 2012 Webinar
May 15, 2012

Kirkland joins with NASDAQ, RR Donnelley and Protiviti to present a webinar on "IPO Preparation – What You Need to Know in 2012" on May 15. A panel including Kirkland partner Gerald Nowak will discuss the dynamics of the new economic landscape and identify key steps in planning for an IPO in 2012. Click [here](#) for more information and to attend this webinar.

31st Annual Chicago-Kent Federal Tax Institute
Chicago, Illinois
May 17-18, 2012

The IIT Chicago-Kent College of Law is hosting its 31st Annual Federal Tax Institute on May 17-18 in Chicago. At this conference, nationally recognized tax advisers will provide a comprehensive update on cutting-edge legal, legislative and policy developments and their impact on tax planning, compliance and controversy techniques. Kirkland partners Thomas Geraghty and Donald Rocap will lead a discussion titled "Corporate: Fund Formation, Private Equity Overview." Click [here](#) for more information and to register for this event.

PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures, & Other Strategic Alliances 2012
New York, New York
May 22-24, 2012
San Francisco, California
June 13-15, 2012

The Practising Law Institute is holding its Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures, & Other Strategic Alliances 2012 seminar from May 22-24 in New York and from June 13-15 in San Francisco. These three-day seminars will trace partnership tax rules from the birth of a partnership through its operating life, with an emphasis on tax issues, planning strategies and opportunities. The seminars will also cover exit strategies and tax planning possibilities in unwinding. Kirkland partners Donald Rocap and Keith Villmow will speak at the seminars, in New York and San Francisco, respectively, on the "Formation of Partnerships Including Joint Ventures of Operating Businesses." Click [here](#) for more information and to register for this event.

Deloitte Directors' Series and M&A Roundtable
Chicago, Illinois
June 14, 2012

Kirkland and Deloitte will co-host an "M&A and the Board" roundtable discussion on June 14 in Chicago to directly follow the live broadcast of Deloitte's Directors' Series Discussion. In this session, panelists will explore the role of the board in M&A and will feature leading practices in improving the success rate for some of the most challenging and rewarding decisions with which the board may be faced. Kirkland partner Gerald Nowak will participate on the panel. Click [here](#) for more information on the Directors' Series. Click [here](#) to register for the M&A Roundtable.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 300 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" for 2012 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm in the United States" at *World Finance's* 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR Americas Awards*.

The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011*, and has consistently received top rankings among law firms in Private Equity by Chambers & Partners, *The Legal 500*, the Practical Law Company and *IFLR*, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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