

Client Advisory

TARP Capital Purchase Program Expanded to Include Qualifying S Corporations

On January 14, the U.S. Treasury Department (UST) published guidelines for S corporations (S-Corps) to receive TARP funds under the Capital Purchase Program (CPP).¹ The program was previously only available to publicly traded and privately held financial institutions that were not organized as S-Corps.² Applications under the expanded CPP program must be filed by February 13 by any Qualifying Financial Institution (QFI), which is defined to mean any bank, savings association, bank holding company, or savings and loan holding company that has made a valid election to be taxed under Subchapter S of Chapter 1 of the U.S. Internal Revenue Code and is also one of the following:

- (i) a top-tier Bank Holding Company (BHC) or top-tier Savings and Loan Holding Company (SLHC) that engages solely or predominately in activities permissible for financial holding companies under relevant law;
- (ii) a U.S. bank or U.S. savings association that is not controlled by a BHC or an SLHC; or
- (iii) a U.S. bank or U.S. savings association that is controlled by a BHC or SLHC which is itself an S-Corp and which does not engage solely or predominately in activities that are permitted for financial holding companies under relevant law.

Program Terms

Many of the terms of the CPP for S-Corps are similar to those for other financial institutions. However, because S-Corps may only have one class of equity which, subject to limited exceptions, can only be held by natural persons, the UST is unable to purchase preferred shares in QFIs that are S-Corps. Instead, under the CPP for S-Corps, the UST will purchase subordinated debentures (Senior Securities) that are senior to the QFI's common stock but subordinated to any claims of depositors and to the QFI's other debt obligations. The following are the main terms of the CPP for S-Corps:

- Each QFI may issue and sell to the UST Senior Securities in an amount equal to not less than 1% of its risk-weighted assets and not more than the lesser of (i) \$25 billion or (ii) 3% of its risk-weighted assets.
- The Senior Securities will have a maturity of 30 years and will pay interest at a rate of 7.7% per annum for five years, and a rate of 13.8% per annum thereafter.³ Interest will be payable quarterly in arrears on February 15, May 15, August 15 and November 15 of each year.

¹ The guidelines, available on the UST's website at <http://www.treasury.gov/press/releases/hp1354.htm>, include a term sheet and answers to a set of frequently asked questions.

² The CPP is still not available to mutually held financial institutions, although the UST is developing a program for these types of entities.

³ The interest rates payable on the Senior Securities by QFIs that are S-Corps are equal to after-tax effective rates (assuming a 35% tax rate) of 5% per annum and 9% per annum, which are the same as the dividend rates payable on the preferred shares issued by institutions receiving funds under the Non S-Corp CPP.

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- The Senior Securities will be entitled to Tier 2 regulatory capital status for banks and savings associations, subject to a limit on all subordinate debt of 50% of Tier 1 capital, but will be entitled to Tier 1 status for holding companies (provided that the appropriate Federal banking agency must issue an interim final rule designating the Senior Securities as Tier 1 capital for holding companies).
- If a QFI is a holding company it may defer interest on the Senior Securities for up to 20 quarters but any unpaid interest will cumulate and compound at the then applicable interest rate, and for as long as any interest deferral is in effect, no dividends may be paid on shares of equity or trust preferred securities of the QFI. It should be noted that these interest deferral and related dividend restriction provisions are only applicable to QFIs that are S-Corps.
- The Senior Securities will be non-voting (except for class voting rights on authorizing or issuing equity securities that purport to be senior to the Senior Securities, amendments to the rights of the Senior Securities, or significant matters such as mergers that would adversely affect the rights of the Senior Securities).
- If interest is not paid on the Senior Securities in full for six interest periods, whether or not consecutive, the holders of the Senior Securities will have the right to elect two directors; this right will end when full interest has been paid for all prior interest periods.
- The UST may transfer its interest in the Senior Securities; provided that the UST will use commercially reasonable efforts to not effect a transfer that would require the QFI to become subject to the periodic reporting requirements of Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the Exchange Act).

Restrictions on Redemptions, Affiliate Transactions, Dividends and Repurchases

The Senior Securities are generally not redeemable for three years. Issuing QFIs, however, may redeem the Senior Securities prior to the end of three years with and to the extent of the net proceeds from an offering of any capital for cash which qualifies for the same tier or higher of regulatory capital as the Senior Securities which results in aggregate gross proceeds to the institution of not less than 25% of the issue price of the Senior Securities (however, such an offering must not have been entered into, approved by the QFI's board of directors, or publicly announced, on or prior to January 15, 2009).

For so long as the UST holds any debt or equity securities of the QFI (including the Senior Securities), neither the QFI nor any of its subsidiaries may enter into a transaction with related persons (within the meaning of Item 404 of Regulation S-K) unless such transaction (i) is on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated party, and (ii) have been approved by the audit committee or comparable body of independent directors of the QFI, or if there are no independent directors, by the board of directors of the QFI subject to supporting written documentation.

The UST's consent is required for any repurchases of equity securities or trust preferred securities until the tenth anniversary of the date of investment. Also, subject to certain exceptions, for as long as any Senior Securities are outstanding, no dividends may be declared or paid on any shares of equity or trust preferred securities nor may the QFI repurchase or redeem any shares of equity or trust preferred securities unless all accrued and unpaid interest for all past interest periods on the Senior Securities is fully paid.

The UST's consent is required for any increase in regularly paid common dividends per share until the third anniversary of the date of the investment and (i) after the third anniversary and before the tenth anniversary, the UST's consent also is required for any increase in aggregate common dividends per share greater than 103% of the prior year's dividend rate per annum, and (ii) no increase in common dividends may be made as a result of any dividend paid in common shares, any stock split or similar transaction. However, these restrictions do not apply if the Senior Securities and Warrant Securities (as defined below) have been redeemed in whole or the UST has transferred all the Senior Securities and Warrant Securities to unaffiliated third parties, unless those parties are securitization vehicles or investment pools in which the UST is an initial sponsor or participant so long as the UST has an economic interest in such vehicles or pools. Also, the UST's consent is not needed for a dividend increase where the increase is solely proportionate to the increase in taxable income of the QFI and such increased dividends are distributed to shareholders in order to fund their individual tax payments on such allocable income.

From and after the tenth anniversary of the date of investment, the QFI may not pay common dividends or repurchase any equity securities or trust preferred securities until all Senior Securities and Warrant Securities held by the UST are redeemed in whole.

Finally, principal and accrued interest can only accelerate (i.e., become immediately due and payable) (i) in the case of a holding company, upon the bankruptcy or liquidation of that holding company, the receivership of a major bank subsidiary of the holding company, or deferral of interest on the Senior Securities for more than 20 quarters or (ii) in the case of a bank or savings association, upon the receivership of the bank or savings association.

Warrant Terms for S Corporations

The UST will receive warrants that will entitle it to purchase, upon net settlement, a number of additional Senior Securities (Warrant Securities), in an amount equal to 5% of the Senior Securities purchased on the date of investment. The initial exercise price for the Warrant Securities will be \$0.01 per note representing a Warrant Security and the UST intends to immediately exercise the warrants.

The warrants, like the warrants on common stock for institutions that are not S-Corps participating in the CPP, will have a term of 10 years, and the Warrant Securities will have the same rights, preferences, privileges, voting rights and other terms as the Senior Securities, except that the Warrant Securities (i) will pay interest at a rate of 13.8% per annum and (ii) may not be redeemed until all the Senior Securities have been redeemed. The UST may transfer its interest in the Warrant Securities, provided that no transfer may be made that would require the QFI to become subject to the periodic reporting requirements of Section 13 or Section 15(d) of the Exchange Act.

Executive Compensation

The executive compensation provisions under the CPP for S-Corps are identical to those under the CPP for other institutions. For the period during which the UST holds any equity or debt securities (including the Senior Securities) of a QFI, the QFI must adopt the standards for executive compensation and corporate governance that were set forth in Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA). In addition, the UST has the authority to require additional executive compensation and corporate governance standards to be implemented by QFIs.

The standards specified under EESA apply to the QFI's "senior executive officers" (i.e., the chief executive officer, chief financial officer and the next three most highly compensated executive officers) and generally include: (i) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (ii) requiring repayment or "clawback" provisions for 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) prohibiting the QFI from making any "golden parachute" payment to a senior executive officer; and (iv) disallowing tax deductions for compensation paid to each senior executive officer in excess of \$500,000 per year and eliminating the Section 162(m) exemption for performance-based compensation. These requirements may require modification or waivers of existing contracts and severance arrangements.

Katten's TARP Task Force

Katten Muchin Rosenman LLP's multidisciplinary TARP Task Force advises clients on the UST's Troubled Asset Relief Program created under the Emergency Economic Stabilization Act of 2008. Katten's TARP Task Force advises clients on participating in the TARP Capital Purchase Program, issuing the necessary Senior Securities and Warrants, determining how the executive compensation rules apply to them, and structuring their compensation arrangements appropriately.

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