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Contacts

Austin Office

111 Congress Avenue, Suite 1800
Austin, TX 78701-4068

[Chet A. Fenimore](#)

(512) 542-5004
cfenimore@hunton.com

[Zonnie Breckinridge](#)

(512) 542-5002
zbreckinridge@hunton.com

[Lowell W. Harrison](#)

(512) 542-5005
lharrison@hunton.com

TARP Capital Purchase Program — Subchapter S Corporation Term Sheet

Introduction

On January 14, 2009, the United States Department of Treasury (“Treasury”) issued its much anticipated Summary Term Sheet detailing the terms for participation in Treasury’s Troubled Asset Relief Program’s Capital Purchase Program (“CPP”) by bank and bank holding companies that have elected to be taxed under Subchapter S of Chapter 1 of the U. S. Internal Revenue Code (the “Code”). Subchapter S banks and bank holding companies interested in participating in the CPP must file their applications by February 13, 2009. Similar to the private (non-Subchapter S) and public company programs, Treasury will determine eligibility and allocation for applicants after consultation with their appropriate federal banking agency. As of January 14, 2009, Treasury has invested a total \$189 billion in 257 banks in 42 states and Puerto Rico. The largest investment was \$25 billion and the smallest investment was \$1 million.

In most respects, the material terms of the CPP for Subchapter S corporations are the same as the terms of the CPP for other privately-held financial institutions. The most significant difference is that the Treasury investment will take the form of subordinated debt rather than preferred stock to comply with the requirement of the Code that prohibits Subchapter S corporations

from having more than one class of stock outstanding. The key components of the CPP as they relate to Subchapter S institutions are summarized below.

Eligibility Considerations

Under the terms of the Subchapter S CPP, a “Qualified Financial Institution” is any bank, savings association or registered bank or savings association holding company that has made a valid election to be taxed under Subchapter S of the Code.

Summary of the Material Terms of the Private Bank Capital Purchase Program

Size of Investment

No changes have been made to the size of Treasury’s investment in Subchapter S institutions. Each investment will be no less than 1% nor more than 3% of the applicant’s total risk-weighted assets as of the date of the latest supervisory report filed by the applicant (subject to a maximum investment of \$25 million). Each investment will be in the form of subordinated debentures (“Senior Securities”).

Regulatory Capital Treatment

The Senior Securities will be deemed to count as Tier 1 capital for regulatory purposes at the holding company level. For Subchapter S banks that participate in the CPP that do not have holding companies,

the Senior Securities will count as Tier 2 capital. Treasury expects the federal banking agencies will issue an interim final rule designating the regulatory capital treatment for the Senior Securities. It is important to note that a direct injection of the CPP proceeds by a holding company into its subsidiary bank should count as Tier 1 capital at the bank level. Likewise, for holding companies that have total consolidated assets of less than \$500 million, the characterization of the Senior Securities for capital purposes is generally not relevant because these companies are not subject to the consolidated capital guidelines. However, holding companies with “no-debt commitments” and those that are pushing up against the small bank holding company debt-to-equity limitations should consult with the Federal Reserve regarding treatment of the Senior Securities for purposes of these limitations.

Maturity and Interest Rate

The Senior Securities will have a maturity of 30 years and bear interest at a rate of 7.7% per annum for the first five years, at which time the dividend rate will increase to 13.8% per annum. The interest payments on the Senior Securities will be tax deductible. By contrast, the dividend rate on the preferred securities issued under the CPP by non-Subchapter S and publicly-traded banks is 5% and 9%, respectively. The reason for the higher rates on the Senior Securities, as compared to the preferred securities issued by other participants, is Treasury’s attempt to equalize the after-tax cost of funds for all CPP participants. The interest on the Senior Securities is payable quarterly in arrears.

Interest Deferral

For holding companies, interest may be deferred on the Senior Securities for up to 20 quarters; however any unpaid interest will cumulate and compound at the then applicable interest rate in effect. 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 holding company. According to the term sheet, the right to defer interest does not apply to banks.

Restrictions on Acceleration

Principal and accrued interest on the Senior Securities may be accelerated (i) in the case of a holding company, upon its bankruptcy or liquidation, the receivership of a major bank subsidiary or deferral of interest on the securities by the company for more than 20 quarters, and (ii) in the case of a bank or thrift, upon its receivership.

Voting Rights

The Senior Securities are generally nonvoting; however, they will have class voting rights on matters affecting the rights of the Senior Securities, including a merger, exchange or similar transaction, and in the event the participating institution authorizes the issuance of any equity security that ranks senior to the Senior Securities. If dividends have not been paid for six interest periods (whether or not consecutive), Treasury would obtain the right to elect two directors to the board of the participant.

Redemption

The Senior Securities may not be redeemed for a period of three years except with the proceeds of a “Qualified Equity Offering” (generally defined as a sale of common stock or Tier 1

qualifying equity) for cash that results in aggregate gross proceeds equal to at least 25% of the purchase price for the Senior Securities. After the third year, the Senior Securities may be redeemed at any time, in whole or in part.

Restrictions on Dividends and Tax Distributions

Treasury’s consent is required for any increase in dividends on common stock for the first three years, except for an increase in dividends that is solely proportionate to the increase of taxable income of the S Corporation and such distributions are paid to shareholders to fund their tax liabilities. After the third year, but prior to the tenth year, privately-held participants are further restricted from increasing common stock dividends greater than 103% of the prior year’s dividend rate without Treasury’s approval. Similar to the CPP for other privately-held companies, after the tenth year, Subchapter S corporations are prohibited from paying dividends on common stock or repurchasing any equity securities or trust preferred securities until the Senior Securities (including the warrant securities described below) have been redeemed or otherwise transferred by Treasury to third parties.

Repurchases

A participating institution is generally restricted from repurchasing its equity securities and any of its outstanding trust preferred securities without Treasury’s approval. The participant will be subject to this repurchase restriction for ten years unless all of the Senior Securities (including the warrant securities described below) have been redeemed or otherwise transferred by Treasury to a third party.

Transferability and Registration Requirements

Like the preferred stock to be issued to other participating institutions, the Senior Securities issued by Subchapter S companies may not be subject to contractual transfer restrictions, including any shareholders' agreement or similar arrangement that may be in effect at the time of the investment by Treasury. Treasury will agree not to effect any transfers of the Senior Securities that would require the institution to become subject to SEC periodic reporting requirements.

Similar to the terms of the preferred stock issued by other private-company participants, there will be no registration requirements related to the Senior Securities issued by Subchapter S corporations. Rather, the company will be required to file a shelf registration for the Senior Securities only if it otherwise becomes a publicly-held institution.

Affiliate Transactions

The participants will be subject to a restriction against engaging in related-party transactions unless the transactions are on terms that could be obtained from unaffiliated third parties and have been approved by the audit committee or similar committee of independent directors. If the participant does not have any "independent directors," then such transaction may be approved by the board of directors, provided the board maintains written documentation that supports the arms-length terms of the affiliate transaction.

Warrant Securities

Similar to the CPP for other privately-held companies, the Treasury will receive an equity kicker that will take

the form of a warrant to purchase additional Senior Securities (the "Warrant Securities") in an amount equal to 5% of the amount of Senior Securities purchased by Treasury. The exercise price for the Warrant Securities will be \$0.01 per note. As a general matter, the Warrant Securities will have the same rights and preferences as the Senior Securities, except that they will bear interest at a rate of 13.8% per annum and may not be redeemed until all of the Senior Securities have first been redeemed. Treasury has indicated that it intends to exercise all warrants immediately upon issuance.

Limits on Executive Compensation

Similar to the participation requirements for public and other privately-held companies, Subchapter S corporations that participate in the CPP must agree to certain restrictions on executive compensation. Specifically, during the time that the Senior Securities are outstanding, the issuer must:

- certify that the contracts of the top five senior executives do not encourage or reward unnecessary and excessive risk-taking that threatens the value of the financial institution;
- agree to recover or "clawback" any bonus or incentive compensation paid to the top five senior executives based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate (this is similar to the provisions of the Sarbanes-Oxley Act of 2002 for CEOs and CFOs);
- not make any golden parachute payment to the top five senior executives; and

- agree not to deduct for tax purposes executive compensation in excess of \$500,000 for each of the top five senior executives.

Treasury has indicated that it will publish regulations on these issues within the next two months. Likewise, on January 9, 2009, Congressman Barney Frank introduced legislation that, if enacted, could place further restrictions on executive compensation. More detailed information about this proposed legislation can be found in the Hunton & Williams Client Alert entitled, *Loan Now or Else: Congress Proposes to "Fix" TARP*, at www.huntonfinancialindustryrecovery.com.

Application Process

Subchapter S corporations that desire to participate in the CPP must submit a completed application on the form provided by Treasury to the appropriate federal banking agency by **February 13, 2009**. An applicant that is a holding company should submit a completed application to its holding company regulator and to the primary federal regulator of the largest insured depository institution that it controls. An applicant that is a stand-alone financial institution (i.e., no holding company) should submit a completed application to its primary federal regulator. The federal banking agencies will review the applications and will make recommendations to Treasury, which will make the ultimate funding decision.

For Subchapter S corporations that have already applied, it is not necessary to re-apply. However, the amount of Treasury's investment must be between 1% and 3% of an institution's risk-weighted assets based on information contained in the latest

quarterly supervisory report filed by the applicant with its appropriate federal banking agency, updated to reflect events materially affecting the financial condition of the applicant occurring since the filing of such report. As such, we recommend that those institutions that have previously filed an application contact their federal regulator and inquire as to whether a supplement to the initial application will be required in light of the recently released information applicable to Subchapter S corporations.

Operative Documents and Proposed Investment Agreements

At this point, the form of investment agreement for Subchapter S CPP investments has not been released. To that end, we have assumed that most of the general terms contained in the investment agreements for the non-Subchapter S participants will apply with the appropriate modifications discussed in this article. Once the documents are released, it will be important to review the terms carefully to ensure that the institution can meet all of the obligations, representations

and covenants before agreeing to move forward with the program.

Updates

We have established a website at www.huntonfinancialindustryrecovery.com. The website is updated frequently with information regarding the Emergency Economic Stabilization Act of 2008, the Troubled Asset Relief Program, pronouncements from Treasury, the Federal Reserve Board and the FDIC and other related information. Please feel free to visit our website for additional information on these issues.

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