

**January 20, 2009**

Last week the U.S. Treasury Department issued a long-awaited term sheet under the Capital Purchase Program (CPP) for banks organized as "S" corporations. A copy of the term sheet can be accessed on our website at [www.fridayfirm.com](http://www.fridayfirm.com).<sup>1</sup>

#### **Eligibility**

The S corporation term sheet is available to "qualifying financial institutions" (QFI) that have elected S corporation status for federal income tax purposes and are either (i) a top-tier bank holding company (BHC), (ii) a U.S. bank or savings association that is not controlled by a BHC, or (iii) a U.S. bank or savings association that is a wholly-owned "disregarded" subsidiary of a BHC that is an S corporation (i.e., a "qualified subchapter S subsidiary").

#### **Financial Terms**

S corporations may issue subordinated debentures ("Senior Debt") as opposed to preferred securities that are issued under the CPP by public firms and other non-public institutions. The Senior Debt is intended to not qualify as a second class of stock for federal income tax purposes - a classification that would invalidate an institution's S corporation status. The Senior Debt will rank senior to the QFI's common stock. Senior Debt issued by banks must be expressly subordinated to claims of depositors and other debts to unsecured creditors.

The following are the principal financial terms of the Senior Debt:

- \* Each QFI may issue an amount of Senior Debt of at least 1% of the QFI's risk-weighted assets but not more than 3% percent of its risk-weighted assets.
- \* The Senior Debt will be classified as Tier 2 capital for banks and savings associations and as Tier 1 for BHCs.<sup>2</sup>
- \* The Senior Debt has a maturity of 30-years.

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<sup>1</sup> This information is intended as a general summary of the law and does not constitute legal advice. You should consult with us or other counsel directly to determine all legal requirements applicable to your specific fact situation.

<sup>2</sup> Prior to its investment in Senior Debt issued by a BHC, the Treasury will require that the applicable federal regulator issue an interim rule designating the Senior Debt as Tier 1 capital.

- \* The Senior Debt will pay interest quarterly at a rate of 7.7% per annum until the fifth anniversary date of the investment and thereafter at a rate of 13.8%.<sup>3</sup>
- \* A BHC may defer interest payments on the Senior Debt for up to 20 quarters. No dividends may be paid on shares of equity or trust preferred securities during any deferral period.
- \* The terms of the Senior Debt may accelerate only (i) with respect to a BHC - upon its bankruptcy or liquidation, the receivership of a major bank subsidiary, or the deferral of interest for more than 20 quarters, or (ii) with respect to a bank - upon it being placed into receivership.

### **Redemption**

The Senior Debt generally may not be redeemed for three years. The exception is where the QFI raises additional funds at least equal to 25% of the original issue price of the Senior Debt in a "Qualified Securities Offering", which is essentially a capital raise under which the funds received qualify for at least the same tier or higher of regulatory capital.

### **Dividend Restrictions**

S corporations may continue to pay dividends on existing outstanding shares provided the QFI is current on dividend payments to holders of Senior Debt. The Treasury's consent is required for any increase in regularly paid common dividends per share until the third anniversary of the investment. Thereafter, and until the tenth anniversary date, the Treasury's consent will be required for any increase in aggregate common dividends per share in excess of 103% of prior year dividends. In most instances, these restrictions expire if all Senior Debt and Warrant Debt (discussed below) are redeemed or have been transferred to a third party. In addition, no dividends may be paid after the tenth anniversary date of the investment until all Senior Debt is redeemed.

Importantly, the Treasury's consent is not required for a dividend increase where the increase is solely proportionate to the increase in taxable income of the QFI and the increased amounts are distributed to the institution's shareholders as ordinary "tax" distributions.

### **Share Repurchases**

The Treasury's consent is generally required for any repurchases by the QFI of its equity securities or trust preferred securities until the tenth anniversary of the date of the investment unless all of the Senior Debt and the Warrant Debt are redeemed or have been transferred to a third party. This is consistent with the restrictions imposed under the non-public term sheet.

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<sup>3</sup> The Treasury explains that these rates are intended to equate to after-tax effective rates of 5% and 9%, respectively (assuming a marginal tax rate of 35%).

### **Voting Rights**

The Senior Debt is non-voting other than with respect to common statutory class voting rights. If interest payments are skipped for six quarters, whether or not consecutive and regardless of any interest deferral, then the holders of Senior Debt can elect two members to the board of directors of the institution.

### **Transferability**

Senior Debt will not be subject to any contractual or other transfer restrictions, including those in an existing stockholders' agreement among the institution and its shareholders.

### **Corporate Governance Restrictions**

The restrictions on corporate governance imposed under the original CPP term sheet will apply equally to S corporations participating in the program. These include prohibitions on "related party" transactions and restrictions on certain executive compensation practices.

### **Warrants to Purchase Preferred Shares**

In addition to the Senior Debt, the Treasury will receive warrants to purchase additional debentures (the "Warrant Debt") in an amount equal to 5% of the amount of Senior Debt issued. The exercise price for the Warrant Debt will be \$0.01 per note (representing a principal amount of \$1,000 per note). Treasury intends to immediately exercise the warrants.

The Warrant Debt will have the same rights, preferences, privileges, voting rights and other terms as the Senior Debt, except that the Warrant Debt will pay interest at the rate of 13.8% per annum and may not be redeemed until all of the Senior Debt has been redeemed in full.

### **Avoiding Warrants**

Unlike the non-public term sheet, QFIs operating as S corporations are not permitted to avoid issuing warrants by achieving certification as a community development financial institution (CDFI).

### **Application Deadline**

The deadline for submitting an application under the S corporation term sheet is February 13, 2009. The application is available on the Treasury's website at [www.treas.gov](http://www.treas.gov). Treasury has not posted the proposed form of transaction documents applicable to S corporations.

**Additional Information**

We will post updates concerning the Capital Purchase Program under the "News" section of our website at [www.fridayfirm.com](http://www.fridayfirm.com). Please contact one of the following attorneys should you have any questions:

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