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CaPP: Subchapter S-Corporations

On January 14, 2009, Treasury released a standard form term sheet detailing the terms and conditions for its direct investment in banking institutions organized as subchapter S-corporations (S-Corps) pursuant to the Troubled Assets Relief Program (TARP) Capital Purchase Program (CaPP). Since Treasury announced the CaPP, the program through which it intends to make capital investments in private and public banking institutions, Treasury has released term sheets detailing the terms and conditions of preferred stock and warrant offerings by both public and private institutions.

We discuss below the currently available details on the new term sheet released by Treasury regarding participation in the CaPP by S-Corps. For a detailed discussion of the TARP, recent action by the Federal Reserve and the FDIC, impact of the Emergency Economic Stabilization Act of 2008 and tax impacts and considerations, consult our recent Client Alert [“TARP and the Various Federal Tent Poles: Will it be Enough?”](#). Additional details regarding the CaPP are available in our recent Client Alerts [“New Liquidity and Capital Alternatives for Financial Institutions: Treasury’s TARP Capital Purchase Program; FDIC’s Temporary Liquidity Guarantee Program”](#) and [“CaPP: Private Bank Program”](#).

Capital Purchase Program for Subchapter S-Corporations

As with the terms for the other CaPP programs, the terms of the CaPP for S-Corps are standardized. Any qualified financial institution may elect to participate in the CaPP by notifying its primary federal banking agency by February 13, 2009. The eligibility criteria for S-Corps are substantially the same as those for the private bank program if the institution in question is a corporation that has made a valid election to be taxed under subchapter S of Chapter 1 of the U.S. Internal Revenue Code. A standard term sheet for mutual organizations is still under consideration. As of this time, Treasury has not announced the final funding date for the CaPP for S-Corps.

The principal terms of the CaPP for S-Corps are, in many respects, consistent with the terms for the other programs, especially the program for other private banking institutions. As with the CaPP for nonpublic, or private, banking institutions, the minimum subscription amount is 1% of risk-weighted assets and the maximum amount is the lesser of \$25 billion or 3% of risk-weighted assets. In addition, S-Corps will be subject to the executive compensation requirements to which any direct seller of assets under TARP is subject, including public and private qualified financial institutions. The material differences of the CaPP for S-Corps are based primarily on the statutory structure of S-Corps, not on the nature of the offering. For example, the securities to be offered are subordinated debentures and warrants as opposed to preferred stock and warrants. Under the Internal Revenue Code, S-Corps may issue only one class of stock. In addition, the government is not an eligible stockholder of an S-Corp.¹ If Treasury were to be purchasing preferred stock in this program, the S-Corp would probably lose such tax status.

¹ Eligible shareholders of S-Corps include individuals, decedents’ estates, estates of individuals in bankruptcy, certain trusts and tax-exempt organizations. In general, a government will not qualify as an eligible S-Corp shareholder.

Other differences exist to make sure that the different structures do not give S-Corps better terms. For example, unless expressly provided otherwise, the subordinated debentures issued by S-Corps are expressly subordinated to claims by depositors and general and secured creditors or to senior indebtedness, depending on the type of S-Corp in question. An entity's depositors and other creditors have superior claims to its assets than the entity's preferred stockholders. In addition, the interest rates payable by the S-Corps are higher than the dividends payable by other qualified financial institutions in recognition of the fact that interest payments on debt securities are deductible for tax purposes but dividend payments on preferred stock are not.²

Certain other noticeable differences between the S-Corp program compared to the CaPP for other private banking institutions follow.

- The capital status of securities issued by S-Corps that are banks or savings associations qualify as Tier 2. The securities issued by S-Corps that are top-tier bank holding companies or top-tier savings and loan holding companies (Holding Companies) qualify as Tier 1; however, prior to any closing of an offering by an S-Corp, it will be necessary for the appropriate Federal banking agency to issue an interim final rule designating the senior securities issuable by such institutions as Tier 1 capital.
- The senior securities have a 30-year term; the preferred stock is perpetual.
- The senior securities will pay interest at a rate of 7.7% per annum until the fifth anniversary of the investment date and thereafter at a rate of 13.8% per annum. The dividend rates for the preferred stock issuable in the other programs is 5% and 9%, respectively.
- S-Corps that are Holding Companies may defer interest on the senior securities for up to 20 quarters; however, any unpaid interest shall cumulate and compound at the then applicable interest rate in effect. For so long as any interest deferral is in effect, an S-Corp may not pay dividends on shares of equity or trust preferred securities.
- Notwithstanding the restrictions relating to increases in dividend amounts by S-Corps participating in the CaPP, Treasury's consent shall not be required for any increase in dividends where such increase is solely proportionate to the increase in taxable income of the S-Corp and such increased dividends are distributed to shareholders of the S-Corp in order to fund their individual tax payments on their allocable shares of the S-Corp's taxable income.
- Principal and accrued interest of the senior securities may only become immediately due and payable (i.e., accelerate) (i) in the case of a Holding Company, upon the bankruptcy or liquidation of the 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.

One interesting difference in the CaPP for S-Corps is notable more for the insight it may offer regarding the future administration by Treasury of the CaPP program than for its effect on the offerings. Under the CaPP program, Treasury's consent right with respect to the increase in dividend rates by a participating qualified financial institution terminates if the securities purchased from the qualified financial institution have been redeemed in whole or if Treasury transfers all of the securities to third parties. The CaPP for S-Corps clarifies that the latter clause refers to a transfer by Treasury to unaffiliated third parties and that the term "unaffiliated third parties" does not include a securitization vehicle or investment pool in which Treasury is an initial sponsor or participant so long as Treasury has an economic interest in such vehicle or pool. Last December, Chairman Cox wrote an editorial stressing the importance of the federal government having an exit strategy with respect to its growing equity stake in qualified financial institutions.³ We doubt that Treasury has formalized its exit strategy at this time, but any indications regarding the ultimate disposition of the securities acquired in connection with the CaPP

² The adjustment assumes a 35% tax rate for the qualified financial institutions.

³ Christopher Cox, *We Need a Bailout Exit Strategy: Let's Not Forget That Free Markets Made America Strong*, THE WALL STREET JOURNAL, December 11, 2008, available at <http://www.sec.gov/news/speech/2008/spch121108cc.htm>.

will grab the attention of market participants and other practitioners, especially when the term “securitization” is used.

We expect that additional details will be forthcoming, including updates to the published Q&A, forms of transaction documents and, potentially, announcement of the final date by which the investments will be made.

The Treasury materials are available at: <http://www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf> and <http://www.treas.gov/initiatives/eesa/faqs.shtml>. A link to the materials will be available on the Morrison & Foerster LLP Financial Crisis web site.

Contacts

Amy Moorhus Baumgardner
(202) 887-1532
abaumgardner@mofocom

Joseph R. Magnas
(212) 336-4170
jmagnas@mofocom

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