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Treasury Announces Capital Purchase Program for S Corporations

On January 14, 2009, the U.S. Treasury Department ("Treasury") released the terms for participation in the Capital Purchase Program ("CPP") by qualified financial institutions that are S Corporations.

S Corporation

An "S Corporation" is a corporation that passes-through net income or losses to shareholders under and in accordance with Internal Revenue Code, Chapter 1, Subchapter S (an "S-Corp"). An S-Corp is not subject to corporate tax rates. Instead, an S-Corp passes-through profit (or net losses) to shareholders. The business profits are taxed at individual tax rates on each shareholder's Form 1040. The pass-through (sometimes called flow-through) nature of the income means that the corporation's profits are only taxed once – at the shareholder level.

A corporation may choose to be taxed as an S Corporation if it meets the following criteria: (i) the company is (A) a domestic corporation, or (B) a domestic entity eligible to elect to be treated as a corporation; (ii) the company has no more than 100 shareholders; (iii) the only shareholders are individuals, estates, certain exempt organizations, or certain trusts; (iv) the company has no nonresident alien shareholders. (That is, the only shareholders are US citizens and resident aliens; (v) the company has only one class of stock; (vi) It is not one of the following ineligible corporations: (A) a bank or thrift institution that uses the reserve method of accounting for bad debts under section 585, (B) an insurance company subject to tax under subchapter L of the Code, (C) a corporation that has elected to be treated as a possessions corporation under section 936, or (D) a domestic international sales corporation ("DISC") or former DISC; (vii) it has or will adopt or change to one of the following tax years: (A) a tax year ending December 31, (B) a natural business year, (C) an ownership tax year, (D) a tax year elected under section 444, (E) a 52-53-week tax year ending with reference to a year listed above, or (F) any other tax year (including a 52-53-week tax year) for which the corporation establishes a business purpose; and (viii) each shareholder consents to the S Corporation election.

As indicated above, an S-Corp cannot issue a second class of stock such as the preferred stock issued to Treasury by other qualified financial institutions under the CPP.

Terms that are Similar to the Public Bank CPP and Private Bank CPP

Except for the primary distinction that S-Corps will be funded with subordinated debt (which the Treasury refers to as "Senior Securities") instead of preferred stock and as otherwise noted below, many of the terms of the S-Corp CPP are the same as the programs in place for publicly held institutions and private institutions. For example, (i) the definition of Qualified Financial Institutions remains the same; (ii) participants will issue Senior Securities in an amount not less than 1 percent nor more than 3 percent of the issuer's risk adjusted assets, up to \$25 billion; (iii) the Senior Securities will be non-voting, unless the interest on the Senior Securities is not paid in full for six interest periods, in which case the Treasury can elect two directors; (iv) no redemption is permitted during the first three years, unless part of a qualified equity offering of not less than 25 percent of the issue price of the Senior Securities; (v) the participating companies are subject to dividend, share repurchase and executive compensation limitations; (vi) there are no restrictions on transferability; and (vii) the issuer also will grant the Treasury a warrant to purchase an additional 5 percent of the Senior Securities on substantially the same terms and conditions as the other CPP programs.

Excluded Companies

The S-Corp CPP specifically excludes mutually owned thrifts or mutual holding companies. The Treasury stated that they are continuing to develop a program for these institutions. Unfortunately, no timetable has been given as to when the Treasury will release details on participation for mutual institutions.

Terms That Are Unique To The S-Corp CPP

Subordinated Debt

As indicated above, S-Corps can only have one class of equity and their equity can only be held by natural persons. Treasury cannot own preferred stock in these companies without upsetting the S-Corp status. Therefore, Treasury has attempted to structure an economically equivalent security that meets certain regulatory capital requirements and is sensitive to the restrictions applicable to S-Corps – the Senior Securities.

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Treasury Announces Capital Purchase Program for S Corporations (cont'd.)**Ranking**

Although the Senior Securities are subordinated to other debt, they are senior to the S-Corp's common stock and any other class of equity.

Capital Status

The Senior Securities are designed to count as capital under the guidelines issued by the federal banking agencies. They should meet state law and FDIC Tier 2 capital requirements as they are subordinate to depositor claims. The Senior Securities should count as Tier 1 capital for holding companies and as Tier 2 capital for stand-alone banks or savings associations. For a stand-alone bank or savings association, the amount of Senior Securities that may be included in Tier 2 capital in combination with any other subordinated debt issued by the bank is limited to 50 percent of Tier 1. This will be useful to Bank Holding Companies but less so to Savings and Loan Holding Companies that have no consolidated capital requirement. It is anticipated that most participants will issue the Senior Securities at the holding company level and downstream the proceeds as equity to the S Bank thereby satisfying the S Bank's capital requirement.

This, however, leaves S Banks without a holding company without capital relief. The response to the Treasury FAQs accompanying the term sheet anticipates some form of capital relief by primary federal bank regulators. Conversations with Assistant Secretary Kashkari and Federal Reserve Board Staff indicate some relief will be provided before an approved applicant must make a final decision to accept the CPP funds. An inclusion of debt as qualifying Tier 1 capital will be a significant reversal of Congressional intention to abolish the use of synthetic capital as embodied in FIRREA, the 1989 S&L bailout law.

Interest Rate

The Senior Securities will pay interest at a rate of 7.7 percent per annum until the 5th anniversary of the date of the investment and thereafter at a rate of 13.8 percent per annum, provided, however, interest may be deferred for 20 quarters. The interest rates differ from the 5 percent and 9 percent rates that are applied to securities issued by other classes of institutions participating in the CPP, in that the interest rates have been adjusted to recognize that the interest payment can be deducted for tax purposes while dividend payment cannot. The goal is to provide for interest rates which equate to after-tax effective rates of 5 percent and 9 percent, respectively.

Maturity

30 years. The debt is accelerated on receivership, bankruptcy or the failure to make interest payments for 20 quarters. The 20 quarters need not be consecutive.

Warrants

Like the CPP program for publicly held banks warrants must be issued to the Treasury except the warrants are for more debt, exercisable for 10 years at .01 of a dollar for a thousand dollar note for 5 percent of the total dollar amount of notes issued. It is anticipated that Treasury will exercise the warrants immediately.

Deadline

Applications under the S-Corp CPP must be filed with the primary federal regulator by February 13, 2009. It is not necessary to reapply if a company has already submitted an application to the applicable federal banking agency.

About the Authors

Douglas P. Faucette is a banking attorney in LLB&L's corporate department and co-head of the TARP Group. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions.

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David C. Heit concentrates his practice in commercial real estate law. He represents developers, borrowers, lenders and institutional investors in a range of matters, including the acquisition, disposition, financing, and leasing of commercial real property, joint venture arrangements and mezzanine financings.

John B. Truskowski has more than 35 years of experience in the areas of taxation, estate planning and corporate law. In the federal income tax area, Mr. Truskowski has devoted special attention to partnership tax matters, S corporations, limited liability companies, tax-exempt organizations and accounting matters. He has also provided tax advice on reorganizations and the sales and acquisitions of business assets.