

Tax Considerations for Participants in U.S. Treasury's Capital Purchase Program

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Recent financial reports suggest that as many as 40% of the institutions in the banking and thrift industry will eventually participate in the U.S. Treasury Department's \$250 billion Capital Purchase Program (CPP). Although the level of interest may ultimately prove to be lower than this projection, it is conceivable that several thousand banks and thrifts may choose to participate. They may be joined by finance companies and other financial institutions that purchase, form, or convert into banks in order to be eligible for participation. It is also possible that, depending on the outcome of negotiations between Treasury and Congressional leaders concerning the potential expansion of CPP beyond the banking industry, the pool of participants may ultimately include various nonbank entities.

The resulting large number of issued and outstanding CPP securities heightens the need for program participants to understand not only the tax issues associated with their participation in the program but also those associated with the third-party purchase of CPP securities and the tax impact such securities may have on subsequent acquisitions of participants. Banks and thrifts considering participation in CPP should also understand the scope of tax benefits that may be available in connection with an acquisition of another bank or thrift, which could significantly lower the participant's cost of capital for the acquisition (or alternatively, significantly increase the acquiring company's rate of return on the acquisition). These tax benefits in turn may attract private equity investments in banks and thrifts.

Generally, only a bank holding company or a thrift holding company may acquire control of a bank or a thrift. Private investors such as private equity funds may acquire equity interests in one of these holding companies without being subject to federal regulation so long as the equity interest is below a certain level.

Recent regulatory developments appear aimed at paving the way for new private equity entrants into the banking arena. The Federal Reserve Board's September 22, 2008 Policy Statement on Equity Investments in Banks and Bank Holding Companies (which liberalizes the Board's position as to what constitutes "control" by an investor) and its regulatory embrace of the concept of an "inflatable charter" (which permits an investor to acquire control of a small bank, with regulatory acknowledgment that it intends to rapidly expand the business of the bank through the acquisition of troubled or failed banks) signal an improved environment for private equity investors.

Terms of CPP Securities

The terms of CPP securities are contained in a set of standardized term sheets released by the U.S. Treasury as part of the CPP application process. One term sheet relates to public issuers of CPP

securities (official CPP application deadline November 14, 2008) and the other to private issuers (official CPP application deadline December 8, 2008). In the case of public issuers, standardized stock designations and warrant agreements have also recently been released by the U.S. Treasury. A review of public filings for the handful of banks that have actually closed CPP securities issuances suggests that virtually no changes have been made to these forms prior to execution. Both CPP securities term sheets provide for the issuance of an investment unit consisting of nonvoting, nonparticipating preferred stock (CPP Preferred) and detachable stock warrants (CPP Warrants) (the CPP Preferred and CPP Warrants, collectively, are the CPP Securities).

Highlights of the terms of the CPP Preferred and CPP Warrants include the following:

CPP Preferred

- CPP Preferred carries a 5% quarterly cumulative dividend (noncumulative for stand-alone banks) increasing to 9% after five years.
- CPP Preferred carries a \$1,000 per share liquidation preference.
- CPP Preferred is *pari passu* with all pre-existing preferred stock that is not by its terms junior to another class of preferred.
- CPP Preferred must be between 1% of risk weighted assets (minimum) and the lesser of 3% of risk weighted assets and \$25 billion (maximum).
- CPP Preferred is nonvoting other than voting on major corporate transactions. However, the holder acquires the right to elect two directors if dividends are not paid for six quarters, whether or not consecutive, and such right ends when dividends have been paid for four consecutive quarters.
- Issuer may not increase common dividends for three years and is not to pay dividends on junior securities until all CPP Preferred dividends are paid.
- Issuer may not repurchase CPP Preferred or other securities for at least three years, unless there is an interim equity capital infusion of at least 25% of the CPP Preferred issue price.
- CPP Preferred is callable three years after issue at par plus accrued and unpaid dividends.
- U.S. Treasury may sell CPP Preferred stock to a third party at any time, subject to certain restrictions through December 31, 2009; private issuer CPP Preferred may not be transferred so as to trigger SEC reporting obligations.
- U.S. Treasury may “unilaterally amend” any term of CPP Preferred stock if the amendment is based on a change in federal statute. This provision is expected by the industry to ultimately result in amendments requiring that CPP capital be used for lending or to make acquisitions.

CPP Warrants

- CPP Warrants are exercisable for 10 years after issuance. In the case of public issuers, CPP Warrants are for the purchase of a number of common shares having a value equal to 15% of the CPP Preferred issued with the CPP Warrants. The CPP Warrant exercise price for public issuers is the fair market value of the underlying issuer common stock on the date of issuance of the CPP Warrant (subject to adjustments). By contrast, CPP Warrants of private issuers are for the purchase of preferred stock of the issuer having an aggregate liquidation preference equal to 5% of the liquidation preference of the CPP Preferred, and carrying a 9% dividend. The CPP Warrant exercise price for private issuers is a penny per share and the applicable term sheet provides that the U.S. Treasury intends to immediately exercise the CPP Warrants after issuance.

- CPP Warrants and underlying securities are fully transferable at any time, separate from CPP Preferred, subject to restrictions through December 31, 2009, and to limitations if a private issuer is involved.
- For public issuers or issuers that become public, all CPP Preferred and CPP Warrants (as well as the underlying issuer securities) must be registered with the SEC.
- For public issuers, the U.S. Treasury agrees not to vote any common stock purchased pursuant to a CPP Warrant.

CPP Tax Considerations

Although CPP terms are developing quickly and many details concerning the program are still unresolved, the IRS and U.S. Treasury have attempted to address some of the tax issues associated with the financial crisis through the issuance of several notices of intent to promulgate Treasury regulations. While these notices generally offer taxpayer favorable treatment for CPP participation, there are still important technical questions unresolved, as well as various other tax considerations. CPP participants, third-party purchasers of CPP Securities, any bank or thrift that is considering acquiring (or being acquired by) another bank or thrift, and any private equity investors contemplating a bank or thrift acquisition should carefully consider these notices and various other tax considerations associated with participating in the CPP.

Acquiring Bank's Use of Target Bank's Built-In Tax Losses

Many banks will use CPP funds to acquire other banks. One key tax incentive for such acquisitions is that, pursuant to Notice 2008-83 recently issued by the U.S. Treasury, the acquiring bank's use of the target's unrealized tax losses inherent in the target's loan portfolio will not be restricted by the normal "ownership change" limitations under Internal Revenue Code (IRC) section 382. This special relief applies to any acquisition of a "bank," which for this purpose includes both a commercial bank and a thrift institution. However, questions have been raised as to the Treasury's authority for issuing this notice. Senator Chuck Grassley (R-Iowa) has asked for an investigation by the Treasury's Inspector General. Furthermore, House Ways and Means Committee member Rep. Lloyd Doggett (D-Texas) introduced a bill on November 20, 2008 that would overrule Notice 2008-83. Understanding the intricacies of any regulations that are ultimately promulgated pursuant to the Notice (if it survives the aforementioned political challenges) as well the other tax attribute limitation provisions not addressed by the Notice, and related tax planning, will be critical to the acquisition or sale of any bank.

Application of "Ownership Change" Restrictions upon Treasury's CPP Investment

Several other notices of proposed rulemaking have been issued as to the interaction of section 382 of the IRC with the CPP. Notice 2008-100 expresses the intent for the U.S. Treasury investment in CPP Preferred or CPP Warrants to be treated as a nonevent for the purpose of the complex issuer ownership calculations required by section 382. Since CPP Preferred is likely ignored for ownership change purposes (that is, until any right to elect directors is triggered from nonpayment of dividends) and CPP Warrants are likely ignored for ownership change purposes until exercised, the main concern is whether common stock acquired pursuant to CPP Warrants will trigger an ownership change. In that event, Notice 2008-84 provides that an ownership change will not result so long as Treasury owns more than 50% of the issuer. Until regulations are promulgated, there are a number of technical section 382 compliance questions left unaddressed, especially in the event that Treasury acquires a greater than 50% interest in common stock and that interest later dips below 50%.

S Corporation Banks

Many private community banks are classified as Subchapter S corporations for federal income tax purposes. The CPP requires that applications be made at the highest-tier entity level. Due to the eligible shareholder requirements and the prohibition on S corporations issuing multiple classes of stock, such banks would lose their S classification status in the event they issue CPP Preferred to the U.S. Treasury. The CPP private issuer term sheet provides that S corporations are not currently eligible to apply and that such participants “are still under consideration” by the U.S. Treasury. Banks classified as S corporations may consider converting to C corporations in order to apply as a participant in CPP by the December 8, 2008 deadline, given the uncertainty of whether the CPP will be modified to preserve the tax status of S corporation applicants and whether sufficient CPP funds will remain after the wave of C corporation applicants. A C corporation conversion can be implemented easily through an S election revocation procedure requiring shareholders holding more than one-half of the shares of stock of the S corporation to consent to the revocation.

In addition to resulting loss in single-level income tax treatment, S corporation banks should consider the other tax issues associated with C corporation conversion, such as the potential forfeiture of suspended S corporation losses and forced changes in accounting methods.

Mutual Organizations

Mutual organizations also are not currently permitted to participate in CPP. Their possible participation is also “still under consideration” by the U.S. Treasury. Mutuals that wish to participate in CPP should consider converting to stock companies and dealing with the resulting tax issues. In general, such conversions can be structured as tax-deferred “reorganizations” but there may be some ancillary tax issues raised by such conversions (e.g., the tax treatment of subscription rights received by share account holders in the conversion).

Ability of Participant to Be Acquired in Tax-Free Merger

The CPP issuance of nonvoting stock to the U.S. Treasury creates complications for a later acquisition by a strategic buyer in what is intended to be a tax-free “reorganization” (a common acquisition fact pattern for banks). These complications involve the requirement of the more commonly used tax-free reorganizations that “voting stock” be issued to the outstanding preferred stockholders in the reorganization. If the U.S. Treasury insists on receiving nonvoting stock from an acquirer in such an acquisition, it will be difficult to structure the acquisition in a tax-free manner unless a more exotic structure is used. However, often these more exotic acquisition structures (e.g., a “double dummy” structure in which both the target and acquirer merge with a new holding company or its subsidiary) raise commercial and legal issues that do not make the acquisition feasible. Although issuing the U.S. Treasury preferred stock in an acquirer that technically carries the right to vote for directors but for which the U.S. Treasury agrees not to vote may solve the “voting stock” issue, this will require at least some negotiation with the U.S. Treasury as part of the CPP funding. Unfortunately, it has been our experience that the CPP documents are not negotiable to any extent. This tax issue is recognized in the proxy for Bank of America’s acquisition of Merrill Lynch.

Possible Phantom Income from CPP Preferred

The terms of the CPP Preferred and CPP Warrants create a risk that the CPP Preferred will be treated as having been issued at a discount for tax purposes, depending on how the CPP Warrants are valued. That

is, to the extent that the CPP Warrants are considered to have value, the CPP Preferred will have a corresponding excess of liquidation preference over issue price, or discount. Such discount could result in “phantom” dividend income to any taxable holder who purchases the CPP Preferred from the U.S. Treasury if it is “more likely than not” that the issuer will call the CPP Preferred at some future point. There are several safe harbors for avoiding the “more likely than not” determination, none of which seems applicable here. Given the increase in dividend rates if the CPP Preferred is not called within five years, an issuer call of this stock may very well be likely, depending on the issuer’s cashflows and the cost of replacement debt and equity capital at such time.

As the strike price for the CPP Warrants issued by a publicly traded participant is intended to be based on the fair market value of the underlying issuer securities, the amount of discount may be relatively small. Accordingly, an exception to phantom dividend treatment for a *de minimis* amount of discount may apply in this case of public CPP participants. However, the risk of phantom dividend treatment is more applicable to the CPP Warrants issued by private participants where the strike price is a penny and the resulting discount is likely to exceed the *de minimis* threshold. Issuers of CPP Securities and any future taxable holders of these securities should be aware of the potential tax issues and tax reporting obligations associated with the CPP Securities.

Effect of Later Redemption of CPP Preferred

Although there is no available tax planning for this issue today, potential CPP Securities issuers should be aware that a redemption of CPP Preferred may create a deemed taxable dividend to the issuer’s nonredeeming shareholders depending on how the redemption is structured.

Conclusion

CPP participants should be aware of the many unresolved tax issues associated with the issuance, holding, and disposition of CPP Securities. In many instances, careful tax planning may be necessary to maximize certain tax benefits associated with CPP, and to avoid the more than a few potential pitfalls within the program. As a full-service international law firm with strong financial service industry, tax, and M&A representations, and direct client experience with the CPP application process, Morgan Lewis is well positioned to counsel any client through these issues.

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