



## Alerts

### Small Business Lending Fund (SBLF) Terms for Subchapter S Corporations and Mutuals

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*Hinshaw Alert*

On September 22, 2010, President Obama signed into law the Small Business Jobs Act of 2010, a package of small business incentives. Part of these incentives included the creation of a capital program, administered by the U.S. Department of Treasury (Treasury), to provide up to \$30 billion of capital funds to eligible community banks in order to promote lending to small businesses—the Small Business Lending Fund (SBLF).

The initial guidelines, which were issued on December 22, 2010, did not include terms that would apply to qualified Subchapter S corporations and mutual institutions. On May 13, 2011, the Treasury issued [rules that allow qualified Subchapter S corporations and mutual institutions to apply for access to SBLF funds](#).

The Treasury rules provide that qualified Subchapter S corporations, mutual institutions and mutual holding companies without a midtier stock holding company will issue senior securities under the SBLF. Mutual holding companies with a midtier stock holding company will issue senior preferred stock. This memo discusses the terms of the senior securities. The terms of the senior preferred stock were discussed in on the [January 5, 2011, issue of Hinshaw's Corporate / Financial Institutions Alert](#).

All applications should be filed with the Treasury as soon as possible. While capital funding from the SBLF will be available through September 27, 2011, the Treasury has specifically indicated that all applications for Subchapter S corporations and mutuals should be filed no later than June 6, 2011. The Treasury will determine, after consulting with the applicant's primary federal/state regulator, whether to accept the application.

As discussed below, the Treasury may condition acceptance of an application on the additional requirement that an applicant raise matching capital from private sources.

Even if an application is accepted by the Treasury for inclusion in the SBLF funding program, there is no requirement that the applicant must actually complete or accept the SBLF funds. The SBLF application can be withdrawn at any time by a Subchapter S corporation or mutual institution prior to actual funding by the Treasury.

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This memorandum discusses key terms and conditions that apply to eligible Subchapter S or mutual institutions (including mutual holding companies without a midtier stock holding company) that wish to participate in the SBLF program.

### **Eligibility**

For purposes of the Subchapter S corporation and mutual application, the Treasury has defined the term “issuer” to include any insured depository institution with *less than \$10 billion in assets that is not controlled by a bank holding company or savings and loan holding company or any bank holding company or savings and loan holding company with combined assets of less than \$10 billion. The holding company will be required to submit the SBLF application and supporting information.* For purposes of this memo, an issuer is a Subchapter S corporation, mutual or mutual holding company without a midtier stock holding company that is eligible to participate in the SBLF program.

In addition to the \$10-billion ceiling, an issuer will not be eligible if the insurer depository institution or any holding-company subsidiary bank currently or within the previous 90-day period has been identified as a “problem bank” by the Federal Deposit Insurance Corporation (FDIC). In general, an application by an insured depository institution (or a holding company that owns a bank) that has a composite “4” or “5” CAMEL rating (or had such a rating within the preceding 90 days) will not be considered.

### **Eligibility Open to TARP CPP/CDCI Recipients**

The SBLF program is also open to issuers that are participants in the Treasury’s Capital Purchase Program (CPP) or Community Development Capital Incentive (CDCI). In order to participate in the SBLF program, the issuer will be required to either repay or refinance all outstanding CPP or CDCI securities.

As a prerequisite to any refinancing of CPP or CDCI securities under the SBLF program, applicants must be current with dividend payments to the Treasury and must not previously have defaulted on more than one dividend payment. If the CPP or CDCI securities have not been fully repaid, the refinanced amount of CPP/CDCI securities will be deducted from the amount of capital otherwise available to the bank or bank holding company from the SBLF program.

### **SBLF Funds—Available Amounts**

The maximum amount of SBLF capital funds that are available is determined on an a sliding scale that takes into consideration both the applicant’s total consolidated assets and the amount of risk-weighted assets as of the end of the fourth quarter of 2009. Eligible issuers with consolidated assets of less than \$1 billion may apply to issue a total amount of senior securities in an amount up to 5 percent of its risk-weighted assets. Risk-weighted assets are to be measured as reported in the most recent CALL Report.

Issuers with between \$1 billion and \$10 billion in consolidated assets are limited to issuing senior securities equal to no more than 3 percent of their risk-weighted assets in exchange for SBLF capital funds.

### **SBLF Funds—Tier II Capital**

The Treasury will purchase the senior securities (in the form of unsecured subordinated debentures) from the issuers.

The SBLF funds received by the issuers will be treated as tier II capital. The senior securities that are to be purchased by the Treasury must rank senior to common stock and any other class of equity of the issuer. The senior securities issued in exchange for the SBLF capital funds must be:

1. expressly subordinate to claims of depositors and other debt obligations of the issuer’s general and secured creditors, if issued by a bank or savings and loan association; and
2. expressly subordinate to the other senior indebtedness of the issuer, if issued by a bank holding company or savings and loan holding company.



The issuer is allowed, however, to issue senior securities that are either expressly *pari passu* or superior to its other debt obligations (other than claims of depositors).

The senior securities will have a maturity of 10 years from the date of the Treasury purchase and will pay cumulative quarterly interest.

Senior securities will be nonvoting, except as to rights granted to the Treasury with respect to: (1) issuance of securities ranking senior to the senior securities; (2) any amendment to the rights granted to holders of the senior securities; or (3) any transaction related to a merger, exchange, dissolution or similar transaction by the issuer that would effect the senior securities holder's rights. The issuance of the senior securities will have no effect upon the issuer's right to merge, sell or assign all or substantially all of its assets, provided that any such transaction provides that the obligations represented by the senior securities are also transferred and assumed. If the issuer is placed into bankruptcy, receivership or liquidation, the principal and all accrued interest on the senior securities shall become immediately due and payable.

Issuers planning to apply for funding should review their charters to make certain that they do not contain any provisions prohibiting the issuance of the senior securities. If not, they will be required to amend their charters to authorize the issuance of the senior securities. They will also need to review existing credit agreements to determine if such agreements might otherwise prohibit the issuance of the senior securities.

#### **Quarterly Interest Calculation—Terms and Conditions**

*General.* The quarterly interest shall be computed on the basis of a 360-day year consisting of 12 30-day months. The interest rate paid to the Treasury on the senior securities will depend on the amount of the applicant's additional lending to qualified small businesses.

As a part of application process, issuers will be required to establish a baseline for measuring increases to small-business lending. This baseline will be calculated by taking into consideration the average amount of qualified small-business loans made during the four calendar quarters ending on June 30, 2010. It may be adjusted to add any loans that are subsequently obtained through a merger or acquisition transaction or for those that are simply purchased by the issuer. The adjustment to the baseline will discount these loans from the quarterly dividend rate calculation.

On and after the investment date by the Treasury, the issuer will be required to prepare and submit supplemental reports that calculate any increase in small-business lending over the baseline amount. Using this method, the interest rate to be paid for the first nine quarters after SBLF capital funding will be determined and will range on a graduated scale.

*Senior-Securities Interest Rate—First Nine Quarters.* During each of the first nine calendar quarters after funding, the issuer will be required to recalculate the quarterly interest rate by comparing the baseline small-business loan amounts against the amount identified on the CALL report filed in the immediately preceding quarter. Therefore, the interest rate to be paid on the senior securities during the first nine calendar quarters will fluctuate up or down for each quarter between the high 7.7 percent interest rate and the 1.5 percent low interest rate.

For example, an increase in small-business lending of 2.5 percent but less than 5 percent will result in a quarterly interest rate of 6.2 percent. A lending increase of 5 percent but less than 7.5 percent will provide for a quarterly interest rate of 4.6 percent. An increase in small-business lending between 7.5 percent but less than 10 percent will result in a quarterly interest rate of 3.1 percent. Any increase in small-business lending of 10 percent or more will result in a quarterly interest rate of just 1.5 percent.

During this initial nine quarters, any decrease in the interest rate below 7.7 percent will only apply to the actual dollar amount of increased small-business loans above the baseline amount. For example, if SBLF capital funding is made in the amount of \$5 million and small-business loans increase \$4 million (representing a 10 percent increase over the baseline amount of \$40 million), the applicable quarterly interest rate on the first \$4 million of SBLF capital would be at the lowest 1.5 percent rate. The remaining \$1 million of SBLF capital would have a senior-securities interest rate set at 7.7 percent.



**Senior-Securities Interest Rates—10th Quarter; 18th Quarter.** Beginning in the 10th calendar quarter, the interest rate calculated will remain in effect as a fixed interest rate for the next two years. If this 10th quarter dividend rate calculation demonstrates that there has been no increase in small-business lending against the baseline amount or if there has been a decrease below the baseline, the quarterly dividend rate will be fixed at 10.8 percent for the next eight calendar quarters.

If the issuer has not redeemed the senior securities within four and one-half years, the quarterly dividend rate will automatically increase to 13.8 percent beginning in the 18th quarter after funding.

**Interest Rate—CPP Refinancing.** If the issuer has used SBLF capital funds to refinance CPP securities and the quarterly calculation for the 10th SBLF quarter indicates that there has not been an increase in small-business lending, the Treasury will impose an additional lending incentive fee of 3.1 percent per annum on the total outstanding senior securities. This additional lending incentive fee will be assessed until the end of the 18th calendar quarter.

### **Calculation of Qualified Small-Business Lending**

The SBLF definition of “small-business lending” differs from that commonly used in the CALL reports that are filed. However, subject to further conditions discussed below, the following loans that fall within the CALL report categories qualify as small-business lending for purposes of SBLF: (1) commercial and industrial loans; (2) loans secured by owner-occupied nonfarm, nonresidential real estate; (3) agricultural production financing or other loans to farmers; and (4) loans secured by farmland.

SBLF-qualified loans in any one or more of the four general categories identified above are further conditioned by the requirement that they may not be greater than \$10 million in original principal commitment and must only be made to businesses that have no more than \$50 million in annual revenues. The business’s annual revenues are calculated at the end of the most recent fiscal year end that is immediately prior to the small-business loan origination date.

To calculate the maximum \$10 million amount of lending that will qualify as small-business lending for purposes of SBLF, the bank will be required to aggregate loan commitments made to the same borrower or its affiliates and must treat these separate commitments as a single loan. The aggregated loans must not exceed the \$10 million maximum for inclusion as qualified “small-business lending”. In addition, when calculating the maximum loan amount that will qualify for purposes of SBLF, a bank may exclude the portion guaranteed by the U.S. from the loan amounts. If a third party has assumed an economic interest in any part of a loan, that portion is also excluded.

### **SBLF Application**

Although the SBLF has been established as a one-year program, the Treasury has indicated a preference that all applications that are submitted by issuers *should be filed no later than June 6, 2011*. Submitting an application to the Treasury does not obligate the applicant to actually complete the process or require it to accept the SBLF funds, if it is approved.

The Treasury has created a short [SBLF application form](#) that is to be used by issuers. The fully completed form is required to be filed electronically via e-mail to the Treasury.

The single-page application requires: (1) the applicant’s name, type of charter or formation, primary federal/state regulatory agency, assets as of the end of the fourth quarter 2009; (2) an indication of whether the SBLF capital will be used to refinance CPP or CDCI securities previously issued; and (3) the amount of the requested SBLF investment sought from the Treasury. The application must be executed by an official of the issuer.

### **Small-Business Lending Plan**

In addition to the application form, *applicants must submit to their primary federal/state regulatory agency* a small-business lending plan (Plan). This Plan requires the applicant to specifically identify how its proposed participation in the



SBLF will address the needs of small businesses located in the bank's market area. The applicant must also project the increase in small-business lending that will be achieved or obtained during the first two years following the bank's receipt of SBLF funds. The Treasury has indicated that applicants should explain their small-business lending goals and describe how the projected increase in lending is reasonable in context of the applicant's size and market area. Lastly, the applicant must identify the manner in which it will publicize the availability of the small-business loans to its market area or how it will otherwise complete community outreach to organizations, trade associations and individuals that represent or work with women, minorities and veterans.

*The Plan is not submitted to the Treasury.* Instead, it must be filed at the same time as the SBLF application is filed with the Treasury with the applicant's primary federal regulatory agency and, if the issuer is a state-chartered financial institution, with the appropriate state regulatory agency.

The Treasury will consult with these primary regulatory agencies in making a final determination on approval of the SBLF application. Holding companies must submit the Plan to their regional Federal Reserve Bank. [Contacts for each of the Federal Reserve Banks who can provide additional information on the SBLF filing process](#) are listed on the Treasury's website.

The Plan will be deemed to be confidential supervisory information. Individual small-business lending fund plans will not be disclosed. Information contained in the Plan will be used only in the context of the SBLF. The Plan will not substitute for any other supervisory request for information or required filing.

## **Application Process**

Following review of the application and the Plan, the Treasury will notify the applicant whether approval has been given. If the applicant elects to continue, the Treasury will assign an outside law firm as its representative to complete the closing of the Treasury's purchase of the senior securities by means of a definitive agreement.

As an alternative to full approval, the Treasury may condition participation in the SBLF program on the applicant's raising matching capital from private nongovernmental sources. If a matching-fund condition is imposed by the Treasury, the maximum amount of SBLF capital funds that will be available to the issuer will be limited to 3 percent of risk-weighted assets.

Lastly, the Treasury may determine, after consultation with the applicant's primary federal/state regulatory agency that the applicant is not eligible for participation in the SBLF program. In that event, the Treasury will notify the applicant that the application is considered to have been withdrawn.

The mere filing of an application does not bind any applicant to continue with the SBLF program. An application may be unilaterally withdrawn at any time prior to closing of a definitive agreement.

## **Downstreaming of SBLF Funding**

When an issuer is a holding company, the application submitted for participation in the SBLF must be made by the holding company. Upon closing of the SBLF funding, the holding company must downstream no less than 90 percent of the SBLF capital funds to its subsidiary insured institution(s). If the holding company controls more than one eligible insured subsidiary, no single insured subsidiary may receive SBLF capital in an amount that is more than the applicable 3-percent or 5-percent risk-weighted funding limits discussed above.

## **Post-SBLF Funding Conditions**

While the SBLF's general terms and conditions do not prohibit issuers (in the case of a Subchapter S corporation) from making or continuing dividends on their securities or redeeming such securities, or (in the case of mutuals) paying interest on or repurchasing mutual capital certificates or paying extraordinary dividends on deposit accounts, there are several



conditions that may affect these dividends, redemptions or interest payments. During participation in the SBLF program, any interest or dividend payment or capital instrument redemption must not result in more than a 10-percent decrease in the issuer's total risk-based capital from a level existing immediately after the closing of the SBLF definitive agreement. Any charge off of loans or any partial repayment of the SBLF capital funds will be excluded from the risk-based capital threshold.

Beginning in the 10th quarter and continuing through the 10th year, an additional 10-percent decrease in required risk-based capital threshold will be allowed for each 1-percent increase in small-business lending. Beginning on the 10th anniversary of the Treasury's investment and continuing until full redemption of the senior securities by the issuer, the issuer will be prohibited from making any repurchases or payment of interest on other capital instruments.

### **Interest Defaults**

If the issuer is unable to pay the required quarterly interest on the senior securities, senior management must provide the Treasury with written notice and an explanation as to the cause of any interest default. In addition, during any default quarter and for the following three quarters, the issuer (in the case of a Subchapter S corporation) will be prohibited from paying dividends on its securities or redeeming such securities, or (in the case of mutuals) paying interest on or repurchasing mutual capital certificates or paying extraordinary dividends on deposit accounts, until all accrued interest on the senior securities have been paid in full.

If interest defaults continue for four quarters, the issuer's board must certify to the Treasury that it has used its best efforts to declare and pay such interest. Any interest default that continues for five quarters, whether or not consecutive, will provide the Treasury with a right to appoint an observer to the issuer's board of directors.

If the interest default continues for six quarters, whether or not consecutive, and the total senior securities outstanding equal \$25 million, the Treasury has the right to elect two directors to the issuer's board of directors. The Treasury's right to appoint directors will expire once full interest has been paid for four subsequent quarters.

### **Post-SBLF Funding Reporting Requirements**

Issuers that participate in the SBLF will be required to submit both quarterly interest rate calculations and a quarterly certification signed by the issuer's chief executive officer, its chief financial officer and by each of the directors that the information provided is accurate.

For the period covering the first 10 quarters following the Treasury's investment, issuers must submit an annual certification from their auditors that the processes and controls used to generate the quarterly supplemental reports are accurate.

In addition, participating issuers must annually certify that the principals of the businesses that receive qualified small-business loans have neither been convicted or pled *nolo contendere* to a sex offense against a minor and that the issuer is in compliance with customer identification requirements. Lastly, participating issuers must annually certify that they are in compliance with federal Customer Identification Program requirements.

### **Redemption of Senior Securities**

The senior securities may be redeemed at any time, subject to prior approval by the issuer's primary federal regulator. Partial redemptions equal to at least 25 percent of the original senior securities is also allowed. Any redemption must include all accrued and unpaid interest dividends for the current dividend period.

### **Distinctions From TARP**

The Treasury has made a concerted effort to distinguish the SBLF from the previous Troubled Asset Relief Program (TARP) initiatives and to eliminate negative conditions and connotations that were attributed to TARP-related funding. Issuers that elect to participate in the SBLF program are not subject to executive compensation or absolute dividend





restrictions. Warrants will not be issued in connection with the SBLF program. Lastly, unlike the TARP, the SBLF program terms and conditions may only be changed by a subsequent change in the Small Business Jobs Act of 2010. The Treasury has no unilateral authority to impose any additional terms or conditions to the SBLF program.

For further information, please contact [Michael D. Morehead](#), [Timothy Sullivan](#) or your regular [Hinshaw attorney](#).

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