

HEARTLAND PAYMENT SYSTEMS INC
Form 10-K
March 10, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 001-32594

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

22-3755714
(I.R.S. Employer
Identification Number)

90 Nassau Street, Princeton, New Jersey 08542

(Address of principal executive offices) (Zip Code)

(609) 683-3831

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class
Common Stock, \$0.001 par value

Name of each exchange on which registered
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

NONE

(title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES NO

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark if disclosure of delinquent filer pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES NO

The aggregate market value of the voting and non-voting common stock held by non-affiliates computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2009 was approximately \$341 million.

As of March 3, 2010, there were 37,656,225 shares of the registrant's common stock, \$0.001 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Specifically identified portions of the registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2010 annual meeting of shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K for fiscal year ended December 31, 2009.

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Heartland Payment Systems, Inc.

Annual Report on Form 10-K

For the Year Ended December 31, 2009

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FORWARD LOOKING STATEMENTS

Unless the context requires otherwise, references in this report to the Company, we, us, and our refer to Heartland Payment Systems, Inc. and our subsidiaries.

Some of the information in this Annual Report on Form 10-K may contain forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include the information concerning our possible or assumed future results of operations, the impact of the systems breach of our processing system, business strategies, financing plans, competitive position, industry environment, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts and can be identified by the use of forward-looking terminology such as the words believe, expect, anticipate, intend, plan, estimate or similar expressions.

Forward-looking statements involve risks, uncertainties and assumptions. Actual results may differ materially from those expressed in the forward-looking statements. You should understand that many important factors, in addition to those discussed elsewhere in this report, could cause our results to differ materially from those expressed in the forward-looking statements. Certain of these factors are described in Item 1A. Risk Factors and include, without limitation, the significantly unfavorable economic conditions facing the United States, the results and effects of the systems breach of our processing system including the outcome of our investigation, the extent of cardholder information compromised and the consequences to our business, including the effects on sales and costs in connection with the system breach, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our bank sponsor, our reliance on other bankcard payment processors, our inability to pass increased interchange fees along to our merchants, economic conditions, system failures and government regulation.

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PART I

ITEM 1. BUSINESS

Overview of Our Company

Delaware Corporation

We were incorporated in Delaware in June 2000. Our headquarters are located at 90 Nassau Street, Princeton, NJ 08542, and our telephone number is (609) 683-3831.

Our primary business is to provide bankcard payment processing services to merchants in the United States and Canada. This involves facilitating the exchange of information and funds between merchants and cardholders' financial institutions, providing end-to-end electronic payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant assistance and support and risk management. Our merchant customers primarily fall into two categories; our core small and mid-sized merchants (referred to as Small and Midsized Enterprises, or "SME merchants") and large national merchants, primarily in the petroleum industry. We also provide additional services to our merchants, such as payroll processing, gift and loyalty programs, prepaid and stored-value solutions, and paper check processing, and we sell and rent point-of-sale devices and supplies.

On January 20, 2009, we publicly announced the discovery of a criminal breach of our payment systems environment (the "Processing System Intrusion"). The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by us during the transaction authorization process. We believe the breach has been contained and did not extend beyond 2008. See "Processing System Intrusion" for more detail.

Bankcard Payment Processing

At December 31, 2009, we provided our bankcard payment processing services to approximately 173,400 active SME bankcard merchants located across the United States. This represents a 2.7% increase over the 168,850 active SME bankcard merchants at December 31, 2008. At December 31, 2009, we provided bankcard payment processing services to approximately 75 large national merchants with approximately 53,972 locations. Our total bankcard processing volume for the year ended December 31, 2009 was \$69.3 billion, a 3.5% increase from the \$66.9 billion processed during the year ended December 31, 2008. Our 2009 SME bankcard processing volume included increases for American Express and Discover card processing. Our Discover processing volume also benefited from our purchase of an existing merchant portfolio from Discover during the third quarter of 2009. Bankcard processing volume for 2009 includes \$9.9 billion of settled volume for large national merchants acquired with Network Services in May 2008, compared to \$8.7 billion for large national merchants for the seven months of 2008 we owned Network Services. In addition to settling Visa and MasterCard transactions, Network Services processes a wide range of payment transactions for its predominantly petroleum customer base, including providing approximately 2.4 billion transaction authorizations through its front-end card processing systems (primarily for Visa and MasterCard) in 2009 and 1.4 billion transactions during the period from the date we acquired it through December 31, 2008. We also provided bankcard processing services to over 6,600 merchants in Canada through our majority-owned subsidiary, Collective Point of Sale Solutions Ltd. ("CPOS"), which we acquired in March 2008. CPOS is a Canadian provider of payment processing services and secure point-of-sale solutions. With CPOS, we are able to service merchants that have locations in both the United States and Canada.

According to The Nilson Report, in 2008 we were the 4th largest card acquirer in the United States ranked by transaction volume and the 7th largest acquirer by processed dollar volume, which consists of both credit and debit Visa and MasterCard transactions. These rankings represented 2.4 billion transactions and 3.0% of the total bankcard processing market, respectively. In 2009, 2008 and 2007, our bankcard processing dollar volume was \$69.3 billion, \$66.9 billion and \$51.9 billion, respectively.

Our bankcard processing revenue is recurring in nature. We typically enter into three-year service contracts with our SME merchants that, in order to qualify for the agreed-upon pricing, require the achievement

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of agreed bankcard processing volume minimums from our merchants. Our SME gross bankcard processing revenue is driven by cardholders making purchases at our SME merchants using mostly Visa and MasterCard credit and signature-debit cards, but also pin-debit cards, American Express and Discover cards. We generally benefit from consumers' increasing use of bankcards in place of cash and checks, and sales growth (if any) experienced by our retained SME merchants. Most of our SME revenue is from gross processing fees, which are primarily a combination of a percentage of the dollar amount of each Visa and MasterCard card transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card issuing banks through Visa and MasterCard and dues, assessments and transaction authorization fees to Visa and MasterCard, and we retain the remainder of the revenue. For example, in a transaction using a Visa or MasterCard credit card, the allocation of funds resulting from a \$100 transaction is depicted below.

Our bankcard processing revenue from our large national merchants is also recurring in nature. However, in contrast to SME merchants, our processing revenues from large national merchants generally consist of a flat fee per transaction and thus are driven primarily by the number of transactions we process (whether settled, or only authorized), not bankcard processing volume.

In December 2007, we signed a sales and servicing program agreement (OnePoint) with American Express Travel Related Services Company, Inc. (American Express) under which we sign up and service new merchants on behalf of American Express. Under the terms of the program, we act as American Express' s agent in: (a) providing solicitation services by signing merchants directly with American Express; and (b) providing transactional support services on behalf of American Express. OnePoint became available to our sales organization effective January 1, 2009. Under OnePoint, we provide processing, settlement, customer support and reporting to merchants, in effect consolidating a merchant' s American Express card acceptance into the services we currently provide for their Visa, MasterCard and Discover transactions. OnePoint is also open to our existing bankcard merchants who do not currently accept American Express cards and who desire to add American Express card acceptance, so that we become their single point of contact for card processing. We expect to convert eligible existing American Express card acceptors to OnePoint in 2010.

In June 2008, we signed an agreement with DFS Services, LLC (formerly known as Discover Financial Services, LLC and referred to as Discover in this document) to offer bankcard merchants a streamlined process that enables them to accept Discover Network cards on our processing platform. We offer our new and existing customers an integrated processing solution that includes card acceptance pricing, funding, statement processing and customer service on one platform. Previously, to accept Discover Network cards, our merchants had to deal with two separate platforms one for Discover and one for all other cards. Merchants who sign up for our program will, in turn, be able to offer their customers the added benefit of Discover Network card acceptance with greater ease. This program became available to new merchants that boarded with Heartland in the second quarter of 2009. Additionally, in July 2009 we purchased the existing Discover merchant portfolio we were already processing and converted them to the streamlined process described above.

Under our new agreement with Discover, our revenue model is similar to Visa and MasterCard. The terms of the new American Express agreement have a compensation model which provides us a percentage-based residual on the American Express volume we process, plus fees for every transaction we process.

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We sell and market our bankcard payment processing services through a nationwide direct sales force of 1,749 sales professionals. Through this sales force, we establish a local sales and servicing presence, which we believe provides for enhanced referral opportunities and helps mitigate merchant attrition. We compensate our sales force primarily through commissions, based upon the performance of their merchant accounts. We believe that our sales force and our experience and knowledge in providing payment processing services gives us the ability to effectively evaluate and manage the payment processing needs and risks that are unique to these merchants. In 2009, our sales force generated over 55,700 bankcard merchant applications and installed over 47,900 new bankcard merchants. In 2008, our sales force generated over 63,500 bankcard merchant applications and installed over 55,000 new bankcard merchants.

We focus our sales efforts on low-risk bankcard merchants and have developed systems and procedures designed to minimize our exposure to potential merchant losses. In 2009, 2008 and 2007, we experienced such losses in amounts equal to 1.01 basis points (0.0101%), 0.88 basis points (0.0088%) and 0.54 basis points (0.0054%) of SME merchant Visa and MasterCard bankcard processing volume, respectively. We have developed significant expertise in industries that we believe present relatively low risks as the customers are generally present and the products or services are generally delivered at the time the transaction is processed. These industries include restaurants, brick and mortar retailers, convenience and liquor stores, automotive sales, repair shops and gas stations, professional service providers, lodging establishments and others. As of December 31, 2009, approximately 27.4% of our SME bankcard merchants were restaurants, approximately 19.3% were brick and mortar retailers, approximately 11.1% were convenience and liquor stores, approximately 7.6% were automotive sales and repair shops, approximately 9.5% were professional service providers, approximately 3.5% were lodging establishments, and approximately 2.1% were gas stations.

We have developed a number of proprietary payment processing systems to increase our operating efficiencies and distribute our processing and merchant data to our three main constituencies: our merchant base, our sales force and our customer service staff. We provide authorization and data capture services to our merchants through our own front-end processing system, which we call HPS Exchange. We provide clearing, settlement and merchant accounting services through our own internally developed back-end processing system, which we call Passport. Our control over our front-end and back-end systems enables us to more effectively customize these services to the needs of our Relationship Managers and merchants.

In mid-2009, we selected Voltage Security as a partner to develop end-to-end encryption (which we refer to as E3) software specifically suited to payments processing. Voltage is a global leader in information encryption. The objective of our E3 initiative is to develop a complete end-to-end encryption solution designed to protect cardholder data at all stages of a transaction from card swipe through delivery to the card brands, helping our merchants improve data security and reduce the cost of PCI compliance. The Voltage SecureData product line, based on its Format-Preserving Encryption and Identity-Based Encryption approaches, will power the software component of our E3 solution. We also employ Voltage SecureMail and Voltage SecureFile to protect personal information throughout our corporate and extended business network. We expect to roll out E3 products to merchants in early to mid 2010.

During the years ended December 31, 2009, 2008 and 2007, we processed approximately 88%, 83% and 75%, respectively, of our SME merchant transactions through HPS Exchange, which has decreased our operating costs per transaction. At December 31, 2009 and 2008, approximately 99% and 98%, respectively, of total SME merchants were processing on Passport. At December 31, 2009, our internally developed systems are providing substantially all aspects of a merchant's processing needs, excluding Network Services merchants.

Payroll Processing Services

Through our wholly-owned subsidiary, Heartland Payroll Company, we operate a full-service nationwide payroll processing service, including check printing, direct deposit, related federal, state and local tax deposits and providing accounting documentation. At December 31, 2009, 2008 and 2007, we processed payroll for 9,382, 7,738 customers and 6,209 customers, respectively.

Our nationwide direct sales force also sells our payroll processing services solely on a commission basis. Beginning in 2006, we began providing additional training regarding our payroll processing products and increased the focus of our sales force on selling these products. As a result, in 2009, 2008 and 2007, we installed 4,303, 4,406 and 4,395 new payroll processing customers, respectively, compared to 1,117 new installs in 2005.

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Other Products and Services

Other products and services which we offer, such as Electronic Check Processing Services, Micropayment, Campus Solutions, Loyalty and Heartland Gift Marketing, and Prepaid Calling Services are discussed in Our Services and Products.

Processing System Intrusion

On January 20, 2009, we publicly announced the discovery of a criminal breach of our payment systems environment (the Processing System Intrusion). The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by us during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. We had received confirmation of our compliance with the Payment Card Industry Data Security Standard (PCI-DSS) from a third-party assessor each year since the standard was announced, including in April 2008, before the discovery of the Processing System Intrusion. Subsequent to the discovery of the Processing System Intrusion, we were advised by Visa that based on Visa's investigation of the Processing System Intrusion, Visa had removed us from Visa's published list of PCI-DSS compliant service providers. We were similarly advised by MasterCard that, based on MasterCard's investigation of the Processing System Intrusion, MasterCard believed we were in violation of the MasterCard Standards and that, based on that belief, MasterCard removed us from MasterCard's published list of Compliant Service Providers. In April 2009, we were re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification was reviewed and approved by Visa. As such, we were returned to MasterCard's published list of Compliant Service Providers and Visa's Global List of PCI-DSS Validated Service Providers. Card data that could have been exposed by the Processing System Intrusion included card numbers, expiration dates, and certain other information from the magnetic stripe on the back of the payment card (including, for a small percentage of cards, the cardholder's name). However, the cardholder information that we process does not include addresses or Social Security numbers. Also, we believe that no unencrypted PIN data was captured. We believe the breach has been contained and did not extend beyond 2008.

For the year ended December 31, 2009, we expensed a total of \$128.9 million, or about \$2.16 per share, associated with the Processing System Intrusion. Approximately \$17.6 million of these charges were for legal fees and costs we incurred for investigations, defending various claims and actions, remedial actions and crisis management services. The majority of these charges, or approximately \$111.3 million, related to:

- (i) assessments imposed in April 2009 by MasterCard and Visa against our sponsor banks, which assessments were in turn withheld from us by our sponsor banks,
- (ii) settlement agreements and settlements reached with American Express (settled in December 2009) and Visa (agreement entered into on January 7, 2010). The settlement pursuant to the Visa agreement was consummated on February 18, 2010.
- (iii) settlement offers we made to certain claimants in an attempt to resolve certain of the claims asserted against us or our sponsor banks (who have asserted rights to indemnification from us pursuant to our agreements with them), and

- (iv) settlements deemed likely to be agreed upon in the near term with certain claimants, such as the cardholder class action.

Notwithstanding our belief that we have strong defenses against the claims that are the subject of the settlement offers and discussions described in (iii) and (iv) above, we decided to make the settlement offers and engage in settlement discussions in attempts to avoid the costs and uncertainty of litigation. We are prepared to vigorously defend ourselves against all the claims relating to the Processing System Intrusion that have been asserted against us and our sponsor banks to date.

The accrual of the settlements and settlement offers during the year ended December 31, 2009 resulted in our recognizing a \$99.9 million Reserve for Processing System Intrusion at December 31, 2009. To date, we have not reached a definitive agreement with respect to settlement offers and discussions noted in (iii) and (iv) above. Therefore, it should not be assumed that we will resolve the claims that are the subject of those settlement offers or the subject of settlement discussions for the amounts of the settlement offers or the settlement amounts deemed likely to be agreed upon. We understand that the reserve related to the settlement offers is required based solely on the fact we tendered offers of settlement in the amounts we have accrued. It is possible we will end up resolving the claims that are the subject of the settlement offers, either through settlements or pursuant to litigation, for

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amounts that are greater than the amount we have reserved to date. Moreover, even if the claims that are the subject of the settlement offers were resolved for the amount we have reserved, that would still leave unresolved a portion of the claims that have been asserted against us or our sponsor banks relating to the Processing System Intrusion. We feel we have strong defenses to all the claims that have been asserted against us and our sponsor banks relating to the Processing System Intrusion, including those claims that are not the subject of the settlement offers.

On December 17, 2009, we entered into a settlement agreement and release with American Express to resolve potential claims and other disputes among us and American Express (and its issuers) with respect to the Processing System Intrusion. We paid American Express approximately \$3.5 million in full and final satisfaction of any and all claims of American Express and its issuers arising from or relating to the Processing System Intrusion. Such settlement agreement and release contains mutual releases by and between us and American Express (on behalf of itself and its issuers) relating to the Processing System Intrusion.

On January 7, 2010, we, Heartland Bank, KeyBank National Association (KeyBank, and, together with Heartland Bank, the Sponsor Banks), and Visa U.S.A. Inc., Visa International Service Association and Visa Inc. (collectively, Visa) entered into a settlement agreement (the Settlement Agreement) to resolve potential claims and other disputes among us, the Sponsor Banks and Visa with respect to the potential rights and claims of Visa and certain issuers of Visa-branded credit and debit cards related to the Processing System Intrusion. After credit for fines previously collected by Visa during 2009, the maximum settlement amount under the Settlement Agreement would not exceed \$59.2 million. We had included costs of this settlement in our Provision for Processing System Intrusion on our Consolidated Statement of Operations for the year ended December 31, 2009 and in our Reserve for Processing System Intrusion on the Consolidated Balance Sheet as of December 31, 2009.

A condition of the Settlement Agreement was that we obtain a loan of at least \$53.0 million from the Sponsor Banks, the proceeds of which to be used to partially fund the settlement amount.

On February 18, 2010, we entered into a bridge loan agreement (the Bridge Loan Agreement) with KeyBank, as administrative agent, and KeyBank and Heartland Bank as bridge lenders. On that date, KeyBank made a bridge loan to us in the amount of \$20.0 million and Heartland Bank made a bridge loan in the amount of \$8.0 million (collectively, the Bridge Loan), which are the maximum amounts that we may borrow under the Bridge Loan Agreement. We must repay the Bridge Loan by February 17, 2011.

On February 18, 2010, we also entered into an amendment (the Amendment) to our Amended and Restated Credit Agreement dated as of May 30, 2008, with the lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent, swingline lender and issuing bank. The Amendment provided for, among other things, a release of the lender s lien on our Jeffersonville, IN Service Center and certain other assets relating to the ownership and occupancy of the Service Center.

On February 18, 2010, we also entered into a Commitment Increase Agreement pursuant to the Amended and Restated Credit Agreement (the Commitment Increase Agreement) whereby KeyBank as one of the lenders under the Amended and Restated Credit Agreement agreed to increase its revolving credit commitment to us under the Amended and Restated Credit Agreement by \$25.0 million (the Increased Credit Commitment). The terms of the Increased Credit Commitment are similar to the terms of the Revolving Credit Facility.

We used the proceeds of the Bridge Loan and the Increased Credit Commitment, along with some of our cash, to fund the Settlement with Visa. The Settlement Agreement was consummated on February 18, 2010.

While we have determined that the Processing System Intrusion has triggered other loss contingencies, to date, an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we would incur in the event of an unfavorable outcome on any such claim. Therefore, no reserve/liability has been recorded as of December 31, 2009 with respect to any such claim, except for the assessments actually imposed by MasterCard and Visa, the amounts of the settlement offers we made and the expected costs of settling with certain claimants as discussed above. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such probable loss that we will incur on that claim is reasonably estimable, we will record a reserve for the claim in question. If and when we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow.

Additional costs we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion will be recognized as incurred. Such costs could be material and could adversely impact our results of operations, financial condition and cash flow.

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Payment Processing Industry Overview

The payment processing industry provides merchants with credit, debit, gift and loyalty card and other payment processing services, along with related information services. The industry continues to grow as a result of wider merchant acceptance, increased consumer use of bankcards and advances in payment processing and telecommunications technology. According to The Nilson Report, total expenditures for all card type transactions by U.S. consumers were \$3.5 trillion in 2008, and are expected to grow to \$4.4 trillion by 2013. The proliferation of bankcards has made the acceptance of bankcard payments a virtual necessity for many businesses, regardless of size, in order to remain competitive. This use of bankcards, enhanced technology initiatives, efficiencies derived from economies of scale and the availability of more sophisticated products and services to all market segments has led to a highly competitive and specialized industry.

Segmentation of Merchant Service Providers

The payment processing industry is dominated by a small number of large, fully-integrated payment processors that sell directly to, and handle the processing needs of, the nation's largest merchants. Large national merchants (i.e., those with multiple locations and high volumes of bankcard transactions) typically demand and receive the full range of payment processing services at low per-transaction costs.

Payment processing services are generally sold to the SME merchant market segment through banks and Independent Sales Organizations that generally procure most of the payment processing services they offer from large payment processors. It is difficult, however, for banks and Independent Sales Organizations to customize payment processing services for the SME merchant on a cost-effective basis or to provide sophisticated value-added services. Accordingly, services to the SME merchant market segment historically have been characterized by basic payment processing without the availability of the more customized and sophisticated processing, information-based services or customer service that is offered to large merchants. The continued growth in bankcard transactions is expected to cause SME merchants to increasingly value sophisticated payment processing and information services similar to those provided to large merchants.

The following table sets forth the typical range of services provided directly (in contrast to using outsourced providers) by fully integrated transaction processors, traditional Independent Sales Organizations and us.

- (a) HPS Exchange: 88% of our SME merchant bankcard transactions
- Passport: 99% of our SME merchants

We believe that the card-based payment processing industry will continue to benefit from the following trends:

Growth in Card Transactions

The proliferation in the uses and types of cards, including in particular debit and prepaid cards, the rapid growth of the Internet, significant technological advances in payment processing and financial incentives offered by issuers have contributed greatly to wider merchant acceptance and increased consumer use of such cards. The following chart illustrates the growth for card transactions for the periods indicated.

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Source: The Nilson Report. Card purchase volume includes VISA / MasterCard (debit and credit), American Express, Discover and Diners Club.

Note: Percentages inside bar represent year-over-year growth.

According to The Nilson Report and the New York State Forum for Information Resource Management, sources of increased bankcard payment volume include:

increasing acceptance of electronic payments by merchants who previously did not do so, such as quick service restaurants, government agencies and businesses that provide goods and services to other businesses;

increasing consumer acceptance of alternative forms of electronic payments, as demonstrated by the dramatic growth of debit cards, electronic benefit transfer, and prepaid and gift cards; and

continued displacement of checks with the use of cards and other methods of payment, including electronic, at the point of sale, as shown below.

Source: The Nilson Report

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Technology

At present, many large payment processors provide customer service and applications via legacy systems that are difficult and costly to alter or otherwise customize. In contrast to these systems, recent advances in scalable and networked computer systems, and relational database management systems, provide payment processors with the opportunity to deploy less costly technology that has improved flexibility and responsiveness. In addition, the use of fiber optic cables and advanced switching technology in telecommunications networks and competition among long-distance carriers, and the dramatic increase in merchants' use of the Internet to process their transactions, further enhance the ability of payment processors to provide faster and more reliable service at lower per-transaction costs than previously possible.

Advances in personal computers and point-of-sale terminal technology, including integrated cash registers and networked systems, have increasingly allowed access to a greater array of sophisticated services at the point of sale and have contributed to the demand for such services. These trends have created the opportunity for payment processors to leverage technology by developing business management and other software application products and services.

Consolidation

The payment processing industry has undergone significant consolidation. Merchant requirements for improved customer service, the risk of merchant fraud, and the demand for additional customer applications have made it difficult for community and regional banks to remain competitive in the merchant acquiring industry. Many of these providers are unwilling or unable to invest the capital required to meet these evolving demands, and have steadily exited the payment processing business or otherwise found partners to provide payment processing for their customers. Despite this consolidation, the industry remains fragmented with respect to the number of entities selling payment processing services, particularly to SME merchants.

Our Competitive Strengths

We believe our competitive strengths related to Bankcard Payment Processing include the following:

Large, Experienced, Efficient, Direct Sales Force

While many of our competitors rely on Independent Sales Organizations that often generate merchant accounts for multiple payment processing companies simultaneously, we market our services throughout the United States through our direct sales team of 1,749 Relationship Managers, Account Managers and sales managers who work exclusively for us. Our Relationship Managers have local merchant relationships and industry-specific knowledge that allow them to effectively compete for merchants. Our Relationship Managers are compensated primarily on commissions, receiving signing bonuses and ongoing residual commissions for generating new merchant accounts. These commissions are based upon the gross margin we estimate that we will receive from their merchants, calculated by deducting interchange fees, dues, assessments and fees and all of our costs incurred in underwriting, processing, servicing and managing the risk of the account from gross processing revenue. Our Relationship Managers have considerable latitude in pricing a new account, but we believe that the shared economics motivate them to sign attractively priced contracts with merchants generating significant bankcard processing volume. The residual commissions our Relationship Managers receive from their merchant accounts give them an incentive to maintain a continuing dialogue and servicing presence with their merchants; these relationships are also supported by our 331 Account Managers, who are focused on installing new merchants and responding to any ongoing servicing needs. We believe that our compensation structure is atypical in our industry and contributes to building profitable, long-term relationships with our merchants. Our sales compensation structure and marketing activities focus on recruiting and supporting our direct sales force, and we believe that the significant growth we have achieved in our merchant portfolio and bankcard processing volume are directly attributable to these efforts.

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Recurring and Predictable Revenue

We generate recurring revenue through our payment processing services. Our revenue is recurring in nature because we typically enter into three-year service contracts that require minimum volume commitments from our merchants to qualify for the agreed-upon pricing. Our recurring revenue grows as the number of transactions or dollar volume processed for a merchant increases or as our merchant count increases. In 2009, approximately 89% of our bankcard processing volume came from merchants we installed in 2008 and earlier.

Internal Growth

While many of our competitors in the payment processing industry had relied on acquisitions to expand their operations and improve their profitability, from 2001 through 2007, and in 2009, we grew our business primarily through internal expansion by generating new merchant contracts submitted by our own direct sales force. Every merchant we processed during that time was originally underwritten by our staff, and we have substantial experience responding to their processing needs and the risks associated with them. We believe this both enhances our merchant retention and reduces our risks. We believe that internally generated merchant contracts generally are of a higher quality and generally are more predictable than contracts acquired from third parties, and the costs associated with such contracts generally are lower than the costs associated with contracts acquired from third parties.

While we continue to pursue internal growth, we were able to take advantage of acquisition opportunities in 2008 and expand into other markets that we previously did not have the technical capabilities to support. See *Pursue Strategic Acquisitions* and *Our Services and Products* later in this section for descriptions of these acquisitions.

Strong Position and Substantial Experience in Our Target Markets

As of December 31, 2009, we were providing payment processing services to approximately 173,400 active SMEs located across the United States. We believe our understanding of the needs of SMEs and the risks inherent in doing business with them, combined with our efficient direct sales force, provides us with a competitive advantage over larger service providers that access this market segment indirectly. We also believe that we have a competitive advantage over service providers of a similar or smaller size that may lack our extensive experience and resources and which do not benefit from the economies of scale that we have achieved.

Industry Expertise

Historically, we have focused our sales efforts on SME merchants who have certain key attributes and on industries in which we believe our direct sales model is most effective and the risks associated with bankcard processing are relatively low. These attributes include owners who are typically on location, interact with customers in person, value a local sales and servicing presence and often consult with trade associations and other civic groups to help make purchasing decisions.

To further promote our products and services, we have entered into sponsoring arrangements with various trade associations, with an emphasis on state restaurant and hospitality groups. We believe that these sponsorships have enabled us to gain exposure and credibility within the restaurant industry and have provided us with opportunities to market our products to new merchants. On January 19, 2010, we formed a strategic partnership with The National Restaurant Association which will deliver a unified payments processing platform to the restaurant industry. This alliance is expected to provide restaurateurs nationwide with effective tools, solutions and resources that will help them reduce their expenses, improve operations and increase profitability all from one source with integrated technology product platforms.

In December 2009, the restaurant industry represented approximately 34.8% of our SME bankcard processing volume and 50.3% of our SME transactions. In December 2008 and December 2007, the restaurant industry represented approximately 37.5% and 38.8% of our bankcard processing volume and 52.1% and 53.3% of our transactions, respectively. We believe that the restaurant industry will remain an area of focus, though its

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growth will likely approximate the growth in the overall portfolio. Restaurants represent an attractive segment for us: according to a report by the National Restaurant Association, restaurant industry sales are expected to reach approximately \$580 billion in 2010, which would represent a 2.5% increase over projected industry sales for 2009 and the nineteenth consecutive year of growth. The projected restaurant industry growth for 2010 is in spite of a challenging economy and this steady growth profile, combined with the industry's low seasonality, makes restaurant merchant bankcard processing volume very stable and predictable. In addition, the incidence of chargebacks is very low among restaurants, as the service typically is provided before the card is used. Our industry focus not only differentiates us from other payment processors, but also allows us to forge relationships with key trade associations that attract merchants to our business. Our industry focus also allows us to better understand a merchant's needs and tailor our services accordingly.

Although we have historically focused significant sales and marketing efforts on the restaurant industry, our SME merchant base also includes a broad range of brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores, professional service providers, and gas stations. See [Our Merchant Base](#) for detail on December 2009 bankcard processing volume by merchant category.

Our historical focus on SME merchants has diversified our merchant portfolio and we believe has reduced the risks associated with revenue concentration. In 2009, no single SME merchant represented more than 0.87% of our total bankcard processing volume. In 2008 and 2007, no single SME merchant represented more than 0.56% and 0.44% of our total bankcard processing volume, respectively.

Our May 2008 acquisition of Network Services has further diversified our total merchant portfolio adding a substantial base of large national merchants, primarily in the petroleum industry.

Merchant Focused Culture

We have built a corporate culture and established practices that we believe improve the quality of services and products we provide to our merchants. This culture spans from our sales force, which maintains a local market presence to provide rapid, personalized customer service, through our service center which is segmented into regionalized teams to optimize responsiveness, and to our technology organization, which has developed a customer management interface and information system that alerts our Relationship Managers to any problems a merchant has reported and provides them with detailed information on the merchants in their portfolio. Additionally, we believe that we are one of the few companies that discloses, and does not unilaterally change, our pricing to merchants. Visa, MasterCard and Discover alter their interchange and other fees once or twice per year; we believe that we are one of the few companies that does not use such adjustments to increase our own margins. We think this is the best approach to building long-term merchant relationships. During 2006, we developed and endorsed The Merchant Bill of Rights, an advocacy initiative that details ten principles we believe should characterize all merchants' processing relationships. The Merchant Bill of Rights allows our sales team to differentiate our approach to bankcard processing from alternative approaches, and we believe that a focus on these principles by our merchants will enhance our merchant relationships. We believe that our culture and practices allow us to maintain strong merchant relationships and differentiate ourselves from our competitors in obtaining new merchants.

Scalable Operating Structure

Our scalable operating structure generally allows us to expand our operations without proportionally increasing our fixed and semi-fixed support costs. In addition, our technology platform, including both HPS Exchange and Passport, was designed with the flexibility to support significant growth and drive economies of scale with relatively low incremental costs. Most of our operating costs are related to the number of individuals we employ. We have in the past used, and expect in the future to use, technology to leverage our personnel, which should cause our personnel costs to increase at a slower rate than our bankcard processing volume.

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Advanced Technology

We employ information technology systems which use the Internet to improve management reporting, enrollment processes, customer service, sales management, productivity, merchant reporting and problem resolution.

In 2001, we began providing authorization and data capture services to our merchants through our internally-developed front-end processing system, HPS Exchange. This system incorporates real time reporting tools through interactive point-of-sale database maintenance via the Internet. These tools enable merchants, and our employees, to change the messages on credit card receipts and to view sale and return transactions entered into the point-of-sale device with a few second delay on any computer linked to the Internet. During the years ended December 31, 2009, 2008 and 2007, approximately 88%, 83% and 75%, respectively, of our SME transactions were processed through HPS Exchange.

In 2005, we began providing clearing, settlement and merchant accounting services through our own internally developed back-end processing system, Passport. Passport enables us to customize these services to the needs of our Relationship Managers and merchants. We completed converting substantially all of our SME bankcard merchants to Passport during the second quarter of 2006. At December 31, 2009 and 2008, approximately 99% and 98%, respectively, of total SME bankcard merchants were processing on Passport. At December 31, 2009 and 2008, our internally developed systems have been providing substantially all aspects of a merchant's processing needs for most of our SME merchants.

HPS Exchange, Passport and our other technology efforts have contributed to efficiency gains in our transaction processing costs. We intend to install 90% to 95% of our new SME merchants on HPS Exchange, and to convert to HPS Exchange as many merchants on third party front-end systems as possible. Some existing merchants will remain on TSYS Acquiring Solutions (TSYS) systems and those of our other third-party processors for front-end services for the duration of their relationship with us. Our Internet-based systems allow all of our merchant relationships to be documented and monitored in real time, which maximizes management information and customer service responsiveness. We believe that these systems help attract both new merchants and Relationship Managers and provide us with a competitive advantage over many of our competitors who rely on less flexible legacy systems.

Comprehensive Underwriting and Risk Management System

Through our experience in assessing risks associated with providing payment processing services to small- and medium-size merchants, we have developed procedures and systems that provide risk management and fraud prevention solutions designed to minimize losses. Our underwriting processes help us to evaluate merchant applications and balance the risks of accepting a merchant against the benefit of the bankcard processing volume we anticipate the merchant will generate. We believe our systems and procedures enable us to identify potentially fraudulent activity and other questionable business practices quickly, thereby minimizing both our losses and those of our merchants. As evidence of our ability to manage these risks, notwithstanding an increasingly challenging economic environment, we experienced losses of no more than 1.01 basis points of SME Visa and MasterCard bankcard processing volume for each of the years ended December 31, 2009, 2008 and 2007, which we believe is significantly lower than industry norms. The risks discussed in this paragraph are merchant fraudulent card activity that is not related to the Processing System Intrusion.

Proven Management Team

We have a strong senior management team, each with at least a decade of financial services and payment processing experience. Our Chief Executive Officer, Robert O. Carr, was a founding member of the Electronic Transactions Association, the leading trade association of the bankcard acquiring industry. Our management team has developed extensive contacts in the industry and with banks and value-added resellers. Our sales leaders have all sold merchant services for us prior to assuming management roles, and many have been with us throughout most of our first decade of existence. We believe that the strength and experience of our management team has helped us to attract additional sales professionals and add additional merchants, thereby contributing significantly to our growth.

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Our Strategy

Our current growth strategy is to increase our market share as a provider of payment processing services to merchants in the United States and Canada. We believe that the increasing use of bankcards, combined with our sales and marketing approaches, will continue to present us with significant growth opportunities. Additionally, we intend to continue growing our payroll processing business, and enhance our other products such as Electronic Check Processing, Micro Payments and Campus Solutions. Key elements of our strategy include:

Expand Our Direct Sales Force

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we have built a direct, commission-only sales force. As of December 31, 2009, 2008 and 2007, our sales force of Relationship Managers was 1,069, 1,166, and 1,117, respectively. We anticipate renewed growth in our sales force in the next few years in order to increase our share of our target markets, and have targeted achieving a level of 2,000 Relationship Managers within the next three to four years. Our sales model divides the United States into 15 primary geographic regions overseen by Regional Directors. The Regional Directors are primarily responsible for hiring Relationship Managers and increasing the number of installed merchants in their territory. Our Regional Directors' compensation is directly tied to the compensation of the Relationship Managers in their territory, providing a significant incentive for them to grow the number and productivity of Relationship Managers in their territory.

Further Penetrate Existing Target Markets and Enter Into New Markets

We believe that we have an opportunity to grow our business by further penetrating the SME market through our direct sales force and alliances with local trade organizations, banks and value-added resellers. During 2008, according to The Nilson Report, we processed approximately 3.0% of the dollar volume of all Visa and MasterCard transactions in the United States, up from approximately 2.4% in 2007, 2.3% in 2006, 2.2% in 2005 and 1.8% in 2004. In December 2009, the restaurant industry represented approximately 34.8% of our bankcard processing volume and 50.3% of our transactions. Our bankcard merchant base also includes a wide range of merchants, including brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores, professional service providers, and gas stations. We believe that our sales model, combined with our community-based strategy that involves our Relationship Managers building relationships with various trade groups and other associations in their territory, will enable our Relationship Managers to continuously add new merchants. We intend to further expand our bankcard processing sales efforts into new target markets with relatively low risk characteristics, including markets that have not traditionally accepted electronic payment methods. These markets include governments, schools and the business-to-business market. In addition, the scale economies we have achieved by converting to our own platforms now allows us to profitably compete for the business of larger merchants compared to our prior focus of primarily SME merchants.

Expand Our Services and Product Offerings

In recent years, we have focused on offering a broad set of payment-related products to our customers. In addition to payroll processing services (see [Our Services and Products Payroll Services](#) for a description of these services), our current product offerings include check processing services that allow merchants to electronically process paper checks, and prepaid, gift and loyalty card product solutions. In 2006, we added electronic check services (see [Our Services and Products Electronic Check Processing Services](#) for a description of these services) and micropayment systems (see [Our Services and Products Micropayment Systems](#) for a description of these services) to our products. In 2007, we added Campus Solutions (see [Our Services and Products Campus Solutions](#) for a description of these services) to our products. In 2008, we added Collective Point of Sale Solutions Ltd., Network Services and Chockstone, Inc. (see [Our Services and Products Large National Merchant Bankcard processing, Collective Point of Sale Solutions Ltd., and Loyalty and Heartland Gift Marketing](#) for more information).

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We also distribute products that will help our merchants reduce their costs and grow their businesses, such as age verification services that track driver's license data to verify an individual's age and identity. We may develop new products and services internally, enter into arrangements with third-party providers of these products or selectively acquire new technology and products. Many of these new service offerings are designed to work on the same point-of-sale devices that are currently in use, enabling merchants to purchase a greater volume of their services from us and eliminating their need to purchase additional hardware. We believe that these new products and services will enable us to leverage our existing infrastructure and create opportunities to cross-sell our products and services among our various merchant bases, as well as enhance merchant retention and increase processing revenue.

Leverage Our Technology

We intend to continue leveraging our technology to increase operating efficiencies and provide real-time processing and data to our merchants, Relationship Managers, Account Managers and customer service staff. Since our inception, we have been developing Internet-based systems to improve and streamline our information systems, including customer-use reporting, management reporting, enrollment, customer service, sales management and risk management reporting tools. We continually develop enriched back office solutions which allow merchants to integrate their payment processing data into any of the major small business accounting software packages, and remain on the leading edge of the merchant marketplace. We continue to make material investments in our payment processing capabilities, which allows us to offer a differentiated payment processing product that is faster, less expensive, and more comprehensive than competing products.

Enhance Merchant Retention

By providing our merchants with a consistently high level of service and support, we strive to enhance merchant retention. While increased bankcard use helps maintain our stable and recurring revenue base, we recognize that our ability to maintain strong merchant relationships is important to our continued growth. We believe that our practice of fully disclosing our pricing policies to our merchants creates goodwill. During 2006, we developed and endorsed The Merchant Bill of Rights, an advocacy initiative that details ten principles we believe should characterize all merchants' processing relationships. The Merchant Bill of Rights allows our sales team to differentiate our approach to bankcard processing from alternative approaches, and we believe that a focus on these principles by our merchants will enhance our merchant relationships.

As discussed in Sales, we have built a group of Account Managers who are teamed with Relationship Managers and handle field servicing responsibilities. We have developed a customer management interface that alerts our Relationship Managers and Account Managers to any problems an SME merchant has reported and provides them with detailed information on the merchants in their portfolio. In addition, we believe that the development of a more flexible back-end processing capability, such as Passport provides, will allow us to tailor our services to the needs of our sales force and merchants, which we believe will further enhance merchant retention. Passport will also allow us to enhance the information available to our merchants, and to offer new services to them.

Pursue Strategic Acquisitions

Although we intend to continue to pursue growth through the efforts of our direct sales force, we may also expand our merchant base or gain access to other target markets by acquiring complementary businesses, products or technologies, including other providers of payment processing. Our 2006 acquisition of Debitex, Inc. and 2007 acquisition of General Meters Corp. are examples of expanding by acquiring complementary businesses. In 2008, we acquired Collective Point of Sale Solutions Ltd., a Canadian provider of payment processing services and secure point-of-sale solutions that provided us with an entrance into the Canadian credit and debit card processing market. We are now able to service merchants that have locations in both the United States and Canada. In 2008, we also acquired the Network Services unit of Alliance Data Systems that handles a wide range of payment transactions for its predominantly petroleum customer base. Our latest acquisition of Chockstone in 2008 provided for expansion into the loyalty marketing and gift card solutions market.

On July 31, 2009, the Company purchased the existing Discover merchant portfolio for \$3.2 million, which the Company was already processing. This purchase related to the Company's 2008 agreement with Discover, which enables the Company to offer bankcard merchants a streamlined process that enables them to accept Discover Network cards on the Company's processing platform.

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Our Services and Products

SME Merchant Bankcard Payment Processing

We derive the majority of our SME processing revenues from fee income relating to Visa and MasterCard payment processing, which is primarily comprised of a percentage of the dollar amount of each transaction we process, as well as a flat fee per transaction. The percentage we charge is typically a fixed margin over interchange, which is the percentage set by Visa and MasterCard depending on the type of card used and the way the transaction is handled by the merchant. On average, the gross revenue we generate from processing a Visa or MasterCard transaction equals approximately \$2.49 for every \$100 we process. We also receive fees from American Express, Discover, and JCB for facilitating their transactions with our SME merchants. The terms of our new American Express agreement have a compensation model which provides us percentage-based residual on the American Express volume we process, plus fees for every transaction we process. Under our new agreement with Discover, which made this program available to our merchants in the second quarter of 2009, our revenue model is similar to Visa and MasterCard.

We receive revenues as compensation for providing bankcard payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant support and chargeback resolution. In 2005, we began providing clearing, settlement and accounting services through Passport, our own internally developed back-end processing system. Passport enables us to customize these services to the needs of our Relationship Managers and merchants. At December 31, 2009 and 2008, approximately 99% and 98%, respectively, of our SME bankcard merchants were processing on Passport. In addition, we sell and rent point-of-sale devices and supplies and provide additional services to our merchants, such as gift and loyalty programs, paper check authorization and chargeback processing. These payment-related services and products are described in more detail below:

Merchant Set-up and Training After we establish a contract with a merchant, we create the software configuration that is downloaded to the merchant's existing, newly purchased or rented point-of-sale terminal, cash register or computer. This configuration includes the merchant identification number, which allows the merchant to accept Visa and MasterCard as well as any other cards, such as American Express, Discover and JCB, provided for in the contract. The configuration might also accommodate check verification, gift and loyalty programs and allow the terminal or computer to communicate with a pin-pad or other device. Once the download has been completed by the Relationship Manager or Account Manager, we conduct a training session on use of the system. We also offer our merchants flexible low-cost financing options for point-of-sale terminals, including installment sale and monthly rental programs.

Authorization and Draft Capture We provide electronic payment authorization and draft capture services for all major bankcards. Authorization generally involves approving a cardholder's purchase at the point of sale after verifying that the bankcard is not lost or stolen and that the purchase amount is within the cardholder's credit or account limit. The electronic authorization process for a bankcard transaction begins when the merchant swipes the card through its point-of-sale terminal and enters the dollar amount of the purchase. After capturing the data, the point-of-sale terminal transmits the authorization request through HPS Exchange or the third-party processor to the card-issuing bank for authorization. The transaction is approved or declined by the card-issuing bank and the response is transmitted back through HPS Exchange or the third-party processor to the merchant. At the end of each day, and, in certain cases, more frequently, the merchant will batch out a group of authorized transactions, transmitting them through us to Visa and MasterCard for payment.

We introduced HPS Exchange, our internally developed front-end processing system, in August 2001. During the years ended December 31, 2009, 2008 and 2007, approximately 88%, 83% and 75%, respectively, of our SME transactions were processed through HPS Exchange. The remainder of our front-end processing is outsourced to third-party processors, primarily TSYS Acquiring Solutions, but also including First Data Corporation, Chase Paymentech Solutions and Global Payments Inc. Although we will continue to install new SME merchants on TSYS and other third-party processors' systems, we anticipate that the percentage of SME transactions that are outsourced to third-party processors will decline as we install a high percentage of new merchants on HPS Exchange, and convert merchants on third party systems to HPS Exchange.

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Clearing and Settlement Clearing and settlement processes, along with Merchant Accounting, represent the back-end of a transaction. Once a transaction has been batched out for payment, the payment processor transfers the merchant data to Visa or MasterCard who then collect funds from the card issuing banks. This is typically referred to as clearing. After a transaction has been cleared, the transaction is settled by Visa or MasterCard by payment of funds to the payment processor's sponsor bank the next day. The payment processor creates an electronic payment file in ACH format for that day's cleared activity and sends the ACH file to its sponsor bank. The ACH payments system generates a credit to the merchant's bank accounts for the value of the file. The merchant thereby receives payment for the value of the purchased goods or services, generally two business days after the sale. Under the terms of the new Agreement with American Express and Discover, the process will be substantially similar to the Visa and MasterCard process, and the merchant will receive one deposit for all cards accepted, in contrast to the previously existing arrangement, where an acceptor of Visa and MasterCard, American Express and Discover will receive three deposits.

Passport, our internally developed back-end system, enables us to customize these services to the needs of our merchants and Relationship Managers. For example, Passport enables us to provide Next Day Funding to our SME merchants who have banking relationships with certain banks. In January 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with TD BankNorth, in July 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Bremer Bank, in December 2007 we commenced Next Day Funding for merchants who maintain a deposit relationship with Heartland Bank (an unrelated third party), in September 2008 we commenced Next Day Funding for merchants who maintain a deposit relationship with Central Pacific Bank, in December 2008 we commenced Next Day Funding for merchants who maintain a deposit relationship with Gateway Bank, and in June 2009 we commenced Next Day Funding for merchants who maintain a deposit relationship with Commerce Bank Harrisburg. Under Next Day Funding, these merchants are paid for their transactions one day earlier than possible when we were processing on a third party back-end platform.

Merchant Accounting Utilizing Passport, we organize our SME merchants' transaction data into various files for merchant accounting and billing purposes. We send our SME merchants detailed monthly statements itemizing daily deposits and fees, and summarizing activity by bankcard type. These detailed statements allow our SME merchants to monitor sales performance, control expenses, disseminate information and track profitability. We also provide information related to exception item processing and various other items of information, such as volume, discounts, chargebacks, interchange qualification levels and funds held for reserves to help them track their account activity. SME merchants may access this archived information through our customer service representatives or online through our internet-based customer service reporting system.

Merchant Support Services We provide merchants with ongoing service and support for their processing needs. Customer service and support includes answering billing questions, responding to requests for supplies, resolving failed payment transactions, troubleshooting and repair of equipment, educating merchants on Visa and MasterCard compliance and assisting merchants with pricing changes and purchases of additional products and services. We maintain a toll-free help-line 24 hours a day, seven days a week, which is staffed by our customer service representatives and during 2009 answered an average of approximately 119,000 customer calls per month. The information access and retrieval capabilities of our intranet-based systems provide our customer service representatives prompt access to merchant account information and call history. This data allows them to quickly respond to inquiries relating to fees, charges and funding of accounts, as well as technical issues.

Chargeback Services In the event of a billing dispute between a cardholder and a merchant, we assist the merchant in investigating and resolving the dispute as quickly and accurately as possible with card issuers or the bankcard networks, which determine the outcome of the dispute. In most cases, before we process a debit to a merchant's account for the chargeback, we offer the merchant the opportunity to demonstrate to the bankcard network or the card issuer that the transaction was valid. If the merchant is unable to demonstrate that the transaction was valid and the dispute is resolved by the bankcard network or the card issuer in favor of the cardholder, the transaction is charged back to the merchant. After a merchant incurs three chargebacks in a year, we typically charge our merchants a \$25 fee for each subsequent chargeback they incur.

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Large National Merchant Bankcard Payment Processing

In May 2008, we acquired Network Services from Alliance Data Systems Corporation. Network Services is a provider of payment processing solutions, serving large national merchants in a variety of industries such as petroleum, convenience store, parking and retail. Services include payment processing, prepaid services, POS terminal, helpdesk services and merchant bankcard services. This acquisition provides us with a substantial portfolio of merchants in the petroleum industry segment. In addition to Visa and MasterCard transactions, Network Services handles a wide range of payment transactions for its predominantly petroleum customer base. Network Services processes authorizations of large national merchants transactions through Fujitsu America, which acquired Alliance Data Systems Corporation's processing business in 2009, and processes the settlement of large national merchant transactions through Fifth Third Processing Solutions.

Our bankcard processing revenue from large national merchants is recurring in nature. In contrast to SME merchants, our processing revenues from large national merchants generally consist of a flat fee per transaction and thus are primarily driven by the number of transactions we process (whether settled, or only authorized), not processing volume.

Authorization and Draft Capture Network Services provides electronic payment authorization and draft capture for all major bankcards, client private label cards and fleet cards. Authorization generally involves approving a cardholder's purchase at the point of sale after verifying that the card is not lost or stolen and that the purchase amount is within the cardholder's credit or account limit. The electronic authorization process for a card transaction begins when the merchant swipes the card through its point-of-sale terminal and enters the dollar amount of the purchase. Network Services offers two front-end processing hosts, VAPS and NWS. After capturing the data, the point-of-sale terminal transmits the authorization request through the VAPS or NWS hosts or the third-party processor to the card-issuing entity for authorization. The transaction is approved or declined by the card-issuing entity and the response is transmitted back through the VAPS/NWS host or the third-party processor to the merchant. At the end of each day, and, in certain cases, more frequently, the merchant will batch out a group of authorized transactions, transmitting them through us to Visa and MasterCard for payment.

VAPS and NWS provide distinct functionality and processing options for our large corporate customers. These hosts provide efficient transaction payment processing and real-time authorizations using fully redundant routing paths. Our merchants can rely on quick response times and high availability. We maintain two redundant data centers for our large national merchant transaction processing. If one site fails, the other site is capable of supporting 100% of the workload so this assures uninterrupted transaction processing. Each data center maintains direct connections to Visa, MasterCard, Discover, Fiserv and American Express. The Fiserv connection is our gateway for debit and EBT processing.

Clearing and Settlement Clearing and settlement processes represent the back-end of a transaction. Once a transaction has been batched out for payment, we transfer the completed transaction detail file to Fifth Third Processing Solutions, which is our outsourced processor for clearing and settlement. During the clearing process, the transaction detail is split out and sent to Visa or MasterCard who then collect funds from the card issuing banks. After a transaction has been cleared, the transaction is settled by Visa or MasterCard by payment of funds to our sponsor bank the next day. HPS then creates either electronic payment files for wire or ACH for that day's cleared activity and sends the files to its sponsor bank. The payments system generates a wire or credit to the merchant's bank accounts for the value of the file.

We provide deposit information to our large national merchants each day via our Internet-based settlement reporting system. Deposits are broken out by card type and show gross sales, less chargebacks, interchange, and miscellaneous adjustments.

Merchant Boarding The Merchant Support area supports new site setup requests, changes to existing locations, and any deletions. In addition, we provide large national merchants with a web-based system, Prometheus, that allows merchants to manage their sites' data in the mainframe database after their initial setup has been completed. The benefits of Prometheus include reducing complexity, decreasing delay in boarding, allowing merchants to control their data entry, and minimizing the learning curve and data entry. The only requirements are Windows and a user ID. Boarding merchants using Prometheus access allows direct connect into Prometheus through a TCP/IP connection.

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Merchant Reporting We provide three types of reporting options to large national merchants.

Data Warehouse Merchants interested in flexible reporting alternatives have been satisfied with our Data Warehouse. A data warehouse is an architecture that consists of various technologies, which include relational and multi-dimensional databases, file servers, extraction and transformation programs, user query and reporting tools, and more. Other than a suitable web browser, no additional software is required to access Data Warehouse. Users can access Data Warehouse from any location anywhere and at any time from any PC that has access to the Internet.

Doc Web Provides multiple reports with multiple filtering options. There is no investment in new hardware or software required to view reports only a Web browser that supports HTML. Availability for filtered reports for quick adaptation to changing market conditions is available to merchants 24 hours a day, seven days a week.

Direct Settlement Reporting Direct is a java based application that links the merchant directly with the settlement processing systems for viewing transaction and chargeback data.

Help Desk Services The large national merchant Help Desk manages merchant trouble ticket initiation, escalation and resolution. The Help Desk also provides vendor and technician support, password resets, completes supply orders, and special projects.

Our Help Desk's operating philosophy focuses on providing the highest level of quality support to our customers. To provide this high level of support, we train our Help Desk agents to focus on resolving the caller's issue or concern during the first call. As a result, our agents are not limited by restrictive and unproductive talk time limits so that they can focus on delivering a working solution to the caller. Our merchant Help Desk is open 24 hours a day, seven days a week with full Help Desk support.

The Help Desk provides three possible levels of support on all point-of-sale (POS) solutions that are certified to process on our network:

1st level support includes full support of all of the POS functions, downloading of the POS, and replacement of the POS (when applicable), as well as all of the support functions provided at 2nd and 3rd level.

2nd level support includes full support of the communication between the POS and the HPS network and minor support of the POS functions, mostly limited to those functions related to communication or network identification, as well as any support provided at 3rd level.

3rd level support includes research and analysis of data being sent by the POS to the HPS network.

Chargeback Services Visa, MasterCard and Discover chargebacks for large national merchants are sent to Fifth Third Processing Solutions as part of the daily interchange confirmation files from the card networks. to Fifth Third Processing Solutions provides a number of reports that help the merchant manage chargebacks. All merchants utilizing settlement services have access to these reports. to Fifth Third Processing Solutions processes chargebacks in compliance with card network rules, determines the validity of the chargeback, and to the extent possible, resolves the chargeback without involving the merchant. Merchants are notified of chargebacks and requested to submit any information regarding the transaction within 15 days to Fifth Third Processing Solutions to facilitate resolution of the chargeback. During this time, the merchant is not debited for a chargeback. If to Fifth Third Processing Solutions Bank does not receive the required information within the timeframe allowed, the merchant will be debited for the chargeback.

Collective Point of Sale Solutions Ltd.

In March 2008, we acquired a majority interest in Collective Point of Sale Solutions Ltd. (CPOS), a Canadian provider of bankcard payment processing services and secure point-of-sale solutions. This acquisition provides us with an entrance into the Canadian credit and debit bankcard processing market. We are now able to service merchants that have locations in both the United States and Canada. CPOS employs call center

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and field sales personnel to sign new processing relationships. As of December 31, 2009 and 2008, we provided bankcard processing services to over 6,600 and 5,500 merchants, respectively, in Canada.

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Payroll Processing Services

Through our wholly-owned subsidiary, Heartland Payroll Company, we operate a full-service nationwide payroll processing service. Our payroll services include check printing, direct deposit, related federal, state and local tax deposits and providing accounting documentation. In addition, we offer a PayAdvantage card, which provides employees the opportunity to have all, or a portion, of their payroll deposited to a Visa debit card account. In order to improve operating efficiencies and ease-of-use for our customers and to decrease our own processing costs, we offer electronic and paperless payroll processing that allows an employer to submit its periodic payroll information to us via the Internet or through a personal computer-based, direct-connect option. If a customer chooses either of these online options, all reports and interactions between the employer and us can be managed electronically, eliminating the need for cumbersome paperwork. Approximately 47% of our payroll customers currently submit their information electronically. However, if a customer chooses not to submit their payroll data online, they may submit such information via phone or facsimile. Regardless of input method, clients can choose to have Heartland print and ship their payroll package or to receive this information electronically. As of December 31, 2009, 2008 and 2007, we provided payroll processing services to 9,382, 7,738 and 6,209 customers, respectively.

We developed a new comprehensive payroll management system, which we refer to as PlusOne Payroll, that streamlines all aspects of the payroll process to enable time and cost savings. PlusOne Payroll is being rolled out to both new and existing customers beginning in the first quarter of 2010. We consider our PlusOne Payroll platform to be state-of-the art, enabling us to process payroll on a large scale and provide customizable solutions for businesses of all sizes. PlusOne Payroll enables faster processing and continuous updates to help businesses remain compliant with payroll, tax and human resources regulations. The platform features web-hosted access, enabling businesses and their accountants to securely access all payroll data from virtually anywhere with SSL-encryption protection. It also provides robust, easy-to-use reporting for better business analysis. PlusOne Payroll is equipped to interface with the leading providers of accounting and time and attendance applications, as well as restaurant and retail point-of-sale (POS) systems.

Electronic Check Processing Services

We offer electronic check processing services, which we refer to as Express Funds, to merchants. Express Funds allows our merchants to quickly and easily scan all of their checks at their place of business, using a scanner sold or rented by us, to capture the image of the front and back of the check, store those images, and transmit the image to us for clearing through banking channels. Our merchants do not have to change their local banking arrangements. We clear checks on their behalf, and deposit collected funds at their own bank as soon as the next banking day. Express Funds also performs security checks and ensures that the image file is balanced before it is sent to us. Merchants often benefit from checks clearing faster and receiving a return notification earlier. The merchant no longer has to manually prepare a deposit slip, photocopy checks, balance all deposits by store, lane, and cashier, or go to the bank to make the deposit. We also offer a late deposit deadline and comprehensive reporting on the status of all checks and deposits.

During 2009, we enhanced this product to provide additional value-added functionality, ease of use, and support to our check processing merchants. The enhanced Express Funds platform is now capable of automatically posting check activity to many popular accounting packages, and coupled with a new bank reconciliation feature, these represent significant improvements in efficiency, particularly for merchants with multiple deposits. Our platform now offers a Service Oriented Architecture that allows a software partner or enterprise business the ability to embed our check management platform into the merchant's programs giving them a direct interface. We have also created a new interface referred to as Express Funds Online Lockbox that assists with remittance processing, complex data management, full page document scanning and the ability to manage split allocations.

Micropayments

We began providing payment solutions within the small value transaction market in 2006. We also manufacture and sell electronic cash systems utilizing smart (chip) card and off-line magnetic stripe card technology. Our electronic cash systems serve coin-operated vending machines and cash registers within closed-

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loop environments, such as corporate and university food cafeterias and penitentiaries, and in multi-vendor/multi-application environments. These systems offer consumers convenient ways to either purchase or reload electronic cash cards, ways to spend the value on the card for small value purchases in both attended and unattended point of sale locations, and offer merchants financial settlement between the value (electronic cash card) issuer and the vendor/merchant who accepts the card as payment. We believe that there is increasing consumer demand for, and merchant interest in, card-based solutions for small denomination transactions, and expect to make additional investments in the future in developing solutions in this area.

Campus Solutions

We initiated our campus solutions product in 2007. Our campus solutions product establishes an open or closed network payments solution for a campus to efficiently process electronic transactions. In addition to providing processing and tracking of electronic payments transactions, personal identification and door access (including security), and data accumulation, our campus solutions are combined with our Give Something Back Network to offer convenient financial services to the students, faculty, staff and community merchants of an educational institution. The Give Something Back Network provides an Internet and phone accessible debit account to store funds. Our campus solution product uses improved technology to replace traditional plastic identification cards with a Give Something Back Network OneCard and a contactless cell phone tag. These cards and tags can be used to access meal plans, enter buildings, and make cashless payments at campus stores, vending machines, laundry machines, copiers, and at participating merchants in the community. We also manufacture some of the equipment used in our campus solutions products. We currently have 132 OneCard college and university accounts.

In October 2007, we acquired the assets, business and campus customers of General Meters Corporation, a provider of multi-purpose card systems for college and university campuses. This acquisition provides us with a ready customer base of colleges and universities for our campus solutions product, as well as some of the software and systems required for a complete campus solutions product line.

Loyalty and Heartland Gift Marketing

In November 2008, we acquired Chockstone, Inc., a provider of gift card programs and loyalty solutions. Our acquisition of this premier niche provider expands our ability to equip businesses nationwide with enhanced gift card and loyalty programs. Chockstone delivers its processing services to merchant locations through real-time communications with the merchant point-of-sale, enabling us to leverage existing installations across our merchant base. Chockstone historically focused on larger, national brands, including Subway® Restaurants and Ticketmaster Entertainment Inc.

In September 2009, we initiated a gift card program called Heartland Gift Marketing, which strengthens an SME merchant's marketing initiatives by combining traditional, loyalty and promotional gift card features into one integrated gift card program. Merchants are using Heartland Gift Marketing to increase customer loyalty and acquire new customers through the use of real-time offers and rewards delivered at the merchant point-of-sale. As of December 31, 2009, Heartland Gift Marketing has signed 1,300 merchant locations and loaded \$1.8 million onto approximately 80,000 activated consumer gift cards.

Prepaid Calling Services

In August of 2009, we began reselling top-up minutes from the major prepaid wireless and long distance providers across the nation through our e-PIN It! Program. E-PIN It! Prepaid Services enables a Heartland merchant to dispense electronic products and services through their existing point of sale terminal, using a Heartland proprietary application. Business owners can download the program directly to their terminal and sell a large assortment of products and services without the need to carry inventory. Customers access the minutes by calling a toll-free number and inputting the Personal Identification Number (PIN) printed on the terminal generated receipt.

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Sales

We sell and market our products and services to our SME merchants exclusively through our sales force. As of December 31, 2009, we employed 1,749 Relationship Managers, Account Managers and sales managers in 50 states plus the District of Columbia. We have implemented a geographic sales model that divides the United States into 15 regions overseen by Regional Directors, who are primarily responsible for hiring Relationship Managers and increasing the number of installed merchants in their territory. Regional Directors manage their territories through Division Managers and Territory Managers. Division Managers do not sell our products and services. Instead, their sole responsibility is to hire, train and manage Territory and Relationship Managers in their territory. In contrast, Territory Managers are Relationship Managers who are also responsible for hiring and training a small number of Relationship Managers in their territory. Our Relationship Managers employ a community-based strategy that involves cold calling, obtaining referrals from existing merchants and building relationships with various trade groups, banks and value-added resellers to create sales opportunities.

The following graphic sets forth the number of Relationship Managers, Account Managers, sales managers and other salespersons we employed by state as of December 31, 2009. Additionally, CPOS employs eight sales people in Canada.

Our compensation structure is designed to motivate our Relationship Managers to establish profitable long-term relationships with low-risk merchants and create a predictable and recurring revenue stream. Compensation for Relationship Managers is entirely commission-based, as a percentage of the financial value of new merchant accounts installed, which is measured in terms of the annual gross margin we estimate we will receive from the merchant accounts installed. Gross Margin is calculated by deducting interchange fees, dues, assessments and fees and all of our costs incurred in underwriting, processing and servicing an account from gross processing revenues. Relationship Managers are permitted to price accounts as they deem appropriate, subject to minimum and maximum gross margin guidelines. The expected volume, pricing and other relevant details are entered into an online margin calculator, which calculates the estimated annual gross margin on the account.

We pay our Relationship Managers, Territory Managers, Division Managers, and Regional Directors a percentage of the gross margin we derive from the payments we process for the SME merchant accounts they

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generate and service. Typically, when a new merchant account is signed at an acceptable estimated gross margin level, the Relationship Manager will be paid a signing bonus equal to 50% of the first 12 months' estimated gross margin. The Relationship Manager will also receive 15% of the gross margin generated from the merchant each month as residual commissions for as long as the merchant remains our customer, and in situations where there is no Account Manager assigned to the merchant account, 5% of gross margin is paid for the Relationship Manager's continued servicing of the account. In addition, the Division Manager will receive an amount equal to 25% of the amount paid to the Relationship Manager (split with a Territory Manager, if one exists for the account), and the Regional Director will receive an amount equal to 25% of the amount paid to the Division Manager. For example, if a merchant account has \$1,000 of estimated annual gross margin for the first twelve months and estimated monthly gross margin of \$83.33, our sales force would be compensated as follows:

Signing Bonus:		
Estimated Gross Margin for first 12 months	\$ 1,000	
Signing bonus paid to:		
Relationship Manager	\$ 500	50.0%
Division Manager (plus Territory Manager)	\$ 125	12.5%
Regional Director	\$ 31	3.125%
Residual Commission:		
Estimated monthly Gross Margin	\$ 83.33	
Monthly residual commission paid to:		
Relationship Manager	\$ 12.50	15.00%
Division Manager	\$ 3.12	3.75%
Regional Director	\$ 0.78	0.94%

In certain cases, no signing bonus will be paid to a Relationship Manager, but the residual commission is 30% (excluding the 5% servicing fee) of the ongoing monthly gross margin generated by such merchant.

When a Relationship Manager has established merchant relationships that generate the equivalent of \$10,000 of monthly gross margin, he or she will be deemed to have a vested equity interest (known as portfolio equity), and will be guaranteed the owned portion (all but the 5% servicing portion) of the ongoing monthly gross margin generated by such merchants for as long as the merchant processes with us. See Management's Discussion And Analysis of Financial Condition And Results of Operations Critical Accounting Policies Accrued Buyout Liability for more information regarding portfolio equity. At the end of the first 12 months of processing for a new merchant, we compare the actual gross margin generated from that merchant with the estimated gross margin used to calculate the signing bonus. If the merchant was more profitable than expected, we increase the signing bonus amount paid to the Relationship Manager. However, if the merchant was less profitable than anticipated, the Relationship Manager must return a pro-rata portion of his or her signing bonus to us. See Management's Discussion And Analysis of Financial Condition And Results of Operations Critical Accounting Policies Capitalized Customer Acquisition Costs for more information regarding signing bonuses.

We have built a group of Account Managers who are teamed with one or more Relationship Managers to handle the new merchant installation requirements, as well as other servicing responsibilities, for those Relationship Managers. The majority of the Account Manager's compensation represents a shift of the 5% servicing portion associated with the merchants he or she is servicing. The 5% is distributed in compensation to the Account Manager in the form of a weekly salary, a monthly expense allotment and monthly bonus. In addition, the Account Manager received compensation for installing new merchant accounts and the generation of merchant referrals that become new customers. Compensation for these activities is deducted from the Relationship Manager compensation. Account Managers are assigned a specific geographic territory that they are responsible for servicing and completing installation activities. We believe that the creation of the Account Manager role allows the Relationship Managers to leverage his or her sales efforts, while allowing us to offer merchants two local relationship contacts including an Account Manager who is more attuned to the merchant's service needs. At December 31, 2009 and 2008, we had 331 and 293 Account Managers, respectively.

In late 2008, we established a small team of sales professionals to directly solicit mid-market and large national accounts. At the end of 2009, this team consisted of one Senior Director of National Accounts and four national account sales representatives. All members of the National Account team are on draw against a

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commission plan that includes Signing Bonus compensation and relationship management compensation. Signing Bonuses are determined after calculating the cost and internal support requirements to support each large national account's custom needs, which is then deducted from the traditional gross margin calculations before commissions are paid.

In November of 2009, we introduced, as a pilot, our Industry Specialization Model (which we refer to as ISM). ISM is a focused selling and cross-selling approach in targeted vertical markets with geographic territories. Relationship Managers receive a protected territory in a specific vertical market in exchange for calling on every merchant in the chosen vertical assigned to their territory each year. Under the ISM program Relationship Managers are required to complete any requested industry specific training, maintain a minimum number of face to face visits each day, and report required data elements and sales activity into our CRM system on a daily basis. The pilot began in six states and by December 31, 2009 had expanded to a total of sixteen states participating in the program.

In addition to our commission-based compensation structure, we use various sales contests to reward strong sales performance. Sales compensation in connection with these contests includes stock options, trips and incentive points. In 2007, we implemented a points based incentive program. Under this program, we award our salespersons and sales managers specific point values for achieving exemplary year-over-year sales growth in installed gross margin and for achieving targets for multi-product sales. These points are redeemable for custom rewards, such as travel, personal goods, and business tools. We also award stock options to our sales persons and sales managers who achieve significant, targeted growth in the realized gross margin in their territory. During the years ended December 31, 2009, 2008 and 2007, our Board of Directors authorized and issued options to purchase an aggregate of 24,000, 60,424 and 49,233 shares of our common stock, respectively, to some of our sales persons and sales managers as part of these contests. Options granted in connection with these contests in 2009 represented 0.9% of the total options awarded, in 2008 represented 2.2% of the total options awarded, and in 2007 represented 15.6% of the options awarded.

Marketing

Our marketing efforts have historically focused on industry verticals and marketing partnerships. We focus our marketing efforts on industries in which we believe our direct sales model is most effective and on merchants with certain key attributes. These attributes include owners who are typically on location, interact with customers, value a local sales presence, and consult with trade associations and other civic groups to make purchasing decisions. We also determine which additional markets to enter into based on the following criteria:

average potential customer revenue;

number of locations to be serviced;

underwriting risk; and

required technological upgrades.

We have focused significantly on the hospitality industry and, in particular, independent restaurants. The number of independent restaurants to which we provide our products and services were 47,500 as of December 31, 2009 and 48,600 as of December 31, 2008. In December 2009, the restaurant industry represented approximately 34.8% of our SME bankcard processing volume and 50.3% of our SME transactions. In December 2008 and December 2007, the restaurant industry represented approximately 37.5% and 38.8% of our bankcard processing volume and 52.1% and 53.3% of our transactions, respectively. In addition to restaurants, our merchant base includes brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores, and professional service providers.

We have historically had success in marketing our products and services through relationships with key trade associations, agent banks and value-added resellers.

Trade Associations

On January 19, 2010, we formed a strategic partnership with The National Restaurant Association which will deliver a unified payments processing platform to the restaurant industry. This alliance is expected to provide restaurateurs nationwide with effective tools, solutions and

resources that will help them reduce their

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expenses, improve operations and increase profitability all from one source with integrated technology product platforms. Referred to as Full Course Business SolutionsSM, the partnership's offering is initially launching in early 2010 with an exclusively endorsed suite of payments products including card processing, check management, payroll and tip management, reporting and compliance services. This suite of solutions is supported by our national sales and servicing organization of 1,749 professionals located in communities across America and our 1,130 service, information technology and administrative employees. Founded in 1919, The National Restaurant Association is the leading business association for the restaurant industry, which is comprised of 945,000 restaurant and foodservice outlets and a work force of 13 million employees.

As of December 31, 2009, we also had preferred partner agreements with more than 170 trade associations, approximately 40% of which are in the hospitality industry. Of these partnerships, 40 are state restaurant associations and another 37 are state lodging associations. In addition, Heartland is the American Hotel & Lodging Association's official preferred provider of card processing, check management, payroll and tip management services. Our agreements with trade associations typically include our commitment to be a member of the association, a sponsor of the association's events and an advertiser in the association's publications. In exchange for an association's recommendation of our products and services to their members, upon the installation of a new merchant that is a member of the association we pay to the trade association a portion of the signing bonus or residual payments that otherwise would be paid to the Relationship Manager responsible for that merchant.

Agent Banks

Many community banks find it difficult to provide their merchant servicing personnel with the training and support they need to serve their customer base, and are willing to assume transaction risk. As a result, some of these banks enter into arrangements with payment processors to service their merchant portfolios. As of December 31, 2009, we provided these services to over 290 community banks in the United States. In exchange for a bank's endorsement of our products and services, upon the installation of a new merchant referred by the bank we typically pay the bank a portion of the signing bonus or residual payment that otherwise would be paid to the Relationship Manager responsible for that merchant.

Additionally, we have entered into arrangements with Heartland Bank (St. Louis, MO), Bremer Bank (St. Paul, MN), Central Pacific Bank (Honolulu, HI), Gateway Bank (Elizabeth, NC) and Commerce Bank Harrisburg (Harrisburg, PA) providing for the conversion, in some cases, of their existing merchant processing customers onto our processing systems. In each case, these relationships are cross-referral, so that we and the banks benefit from these arrangements by gaining access to new customers. The banks retain existing deposit relationships and add new deposit relationships as new merchants are signed up. Merchants who maintain deposit relationships with these banks gain Next Day Funding for their bankcard transaction processing. Under Next Day Funding, these merchants are paid for their transactions one day earlier than is typically available.

Value-Added Resellers and Third-Party Software Providers

In order to further market our products and services, we enter into arrangements with value-added resellers and third-party software developers. Value-added resellers typically sell complementary products and services such as hardware and software applications and point-of-sale hardware, software and communication network services to merchants in markets similar to ours. Our agreements with value-added resellers provide that, in exchange for their endorsement of our products and services and upon the installation of a new merchant referred by them we will pay the value-added reseller a portion of the signing bonus and residual payment that otherwise would be paid to the Relationship Manager responsible for that merchant. As we continue to expand our product offerings, we intend to introduce capabilities that will allow our systems to be compatible with those of our value-added resellers and other third-party software developers, enabling them to embed our payment modules within their systems. As of December 31, 2009, we had arrangements with over 1,600 value-added resellers and referral services providers, including agreements with many third-party developers in the hospitality industry. From time to time, we have also entered into direct alliances with original equipment manufacturers and vendors.

In 2009, in addition to the above-focused marketing efforts, we continued to enhance the visibility of The Merchant Bill of Rights, an advocacy initiative that educates business owners about the complexities and

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costs of card acceptance. In launching and endorsing The Merchant Bill of Rights in 2006, we committed to supporting full disclosure regarding pricing and the existence of any transaction middlemen, and for provision of dedicated customer support and high levels of security and fraud monitoring. This initiative has been very well received in the merchant community, and many organizations have endorsed its principles. We believe we are uniquely positioned to commit to such high customer service standards, and that our focus on this approach will continue fostering success at establishing a payment processing brand that is not easily duplicated by competitors using indirect sales models, or who do not match our focus.

Relationships with Sponsors and Processors

In order to provide payment processing services for Visa and MasterCard transactions, we must be sponsored by a financial institution that is a principal member of the Visa and MasterCard networks. The sponsor bank must register us with Visa as an Independent Sales Organization and with MasterCard as a Member Service Provider. We also contract with third-party processors to provide critical payment processing services.

Sponsor Banks

Our primary sponsor bank for SME merchant processing is KeyBank, National Association, referred to as *KeyBank* in this document. We currently have an agreement with KeyBank to sponsor us for membership in the Visa and MasterCard networks. Under this agreement, KeyBank settles bankcard transactions for our SME merchants, and also funds our merchants the portion of our daily interchange expenses that we do not fund from our own cash. Either KeyBank or we can terminate the agreement if the other party materially breaches the agreement, including non-payment of fees due for processing our monthly settlement of transactions. The agreement may also be terminated if the other party enters bankruptcy or files for bankruptcy, if either party is required to discontinue performing its services under the agreement based upon a final order of a state or federal court or regulatory body or if there is a change in the majority ownership of the other party. KeyBank may terminate the agreement with us if we breach the by-laws and regulations of Visa or MasterCard, if either our registration or KeyBank's membership with Visa or MasterCard terminates, if any federal or state regulatory authority requests that the agreement be terminated or that KeyBank terminate its services or if applicable laws or regulations change to prevent KeyBank from performing its services under the agreement. Upon termination of the agreement for any reason, we will have 180 days to convert to another sponsor bank. Although we expect that we would be able to secure a new sponsor bank, the cost of entering into a new sponsorship agreement may be different than under our current agreement with KeyBank. The agreement, which we entered into with KeyBank on April 1, 1999, expires in March 2012.

In 2007, we entered into a second sponsor bank agreement, this one with Heartland Bank, which is based in Saint Louis, Missouri. Heartland Bank is not related to, or associated with Heartland Payment Systems. Our agreement with Heartland Bank involves substantially the same terms as apply with KeyBank and it expires in September 2010.

In 2008, the acquisition of Network Services resulted in the addition of World Financial Network National Bank (*WFNNB*) as the sponsor bank for Network Services' large national merchant processing. In August 2008, we entered into a sponsorship agreement with SunTrust Bank. In February 2009, we transferred the required BINs and ICAs from WFNNB to SunTrust Bank to replace World Financial Network National Bank as our sponsor bank for Network Services' large national merchant processing. In August 2009, SunTrust Bank provided twelve months' notice to the Company of its intent to withdraw its sponsorship of the Company's large national merchants processing portfolio. In November 2009, we entered into a sponsorship agreement with The Bancorp Bank and transferred the sponsorship from SunTrust Bank in February 2010. The agreement with The Bancorp Bank expires in November 2014.

Third-Party Processors

We have agreements with several third-party processors to provide to us on a non-exclusive basis payment processing and transmittal, transaction authorization and data capture services, and access to various reporting tools. These third-party processors include Fifth Third Processing Solutions, Fujitsu America, TSYS, First Data Corporation, Chase Paymentech Solutions and Global Payments, Inc. Our agreements with third-party processors require us to submit a minimum monthly number of transactions or volume for processing. If we

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submit a number of transactions or volume that is lower than the minimum, we are required to pay them the fees that they would have received if we had submitted the required minimum number or volume of transactions. The majority of our agreements with third-party processors may be terminated by the third-party processors if we materially breach certain sections of the agreements, including our failure to pay fees due, and we do not cure the breach within 30 days, if our registration with Visa or MasterCard terminates, or if we enter bankruptcy or file for bankruptcy.

Our Merchant Base

Our merchant customers primarily fall into two categories; our core small and mid-sized merchants (referred to as Small and Midsized Enterprises, or SME) and large national merchants, primarily in the petroleum industry. At December 31, 2009, we provided our bankcard payment processing services to approximately 173,400 active SME bankcard merchants located across the United States. This represents a 2.7% increase over the 168,850 active SME bankcard merchants at December 31, 2008. At December 31, 2009, we provided bankcard payment processing services to approximately 75 large national merchants with approximately 53,972 locations.

SME Merchant Base

While restaurants represent a significant portion of our SME merchant base, we also provide payment processing services to a wide variety of merchants, with a focus on those merchants whose typical customer is present when using a bankcard to pay for products or services. We define SME merchants as generating annual Visa and MasterCard bankcard processing volume between \$50,000 and \$5,000,000. With the added functionality and cost benefits that our back-end processing system, Passport, affords us, we have begun marketing to merchants with annual processing volume above \$5,000,000.

The following chart summarizes our SME processing volume by merchant category for the month of December 2009, compared to the months of December 2008 and December 2007.

Table of Contents**Processing Volume by Merchant Category****December 2009**

	2009	Month of December 2008	2007
Restaurants	34.8%	37.5%	38.8%
Retail	19.0%	18.9%	20.1%
Convenience, Fast Food & Liquor	10.5%	10.6%	9.7%
Automotive	7.7%	7.1%	6.4%
Professional Services	6.5%	5.7%	4.7%
Lodging	4.3%	4.8%	4.9%
Petroleum	2.1%	1.7%	2.7%
Other	15.1%	13.7%	12.7%
Total SME processing volume	\$ 4.9 billion	\$ 4.8 billion	\$ 4.7 billion

No single SME merchant accounted for more than 0.87% of our total SME Visa and MasterCard bankcard processing volume in 2009, and during 2009, our top 25 merchants represented only 3.0% of our Visa and MasterCard bankcard processing volume and 2.4% of our gross processing revenue. In 2008 and 2007, no single merchant represented more than 0.56% and 0.44% of our total bankcard processing volume, respectively. In both 2008 and 2007 our top 25 merchants represented only 3.1% and 2.7%, respectively, of our bankcard processing volume and 2.5%, respectively, of our gross processing revenue.

In December 2009, SME merchants in California represented 11.8%, in New York represented 6.3%, in Texas represented 5.1%, in Florida represented 4.8%, and in New Jersey represented 4.4% of our SME bankcard processing volume. No other state represented more than 4% of our total bankcard processing volume. Our geographic concentration tends to reflect the states with the highest economic activity, as well as certain states where we have historically maintained a stronger sales force. This merchant and geographic diversification makes us less sensitive to changing economic conditions in any particular industry or region. We believe that the loss of any single merchant would not have a material adverse effect on our financial condition or results of operations.

Generally, our agreements with SME merchants are for three years and automatically renew for additional one-year periods unless otherwise terminated. Our sponsor bank is also a party to these agreements. The merchants are obligated to pay for all chargebacks, fines, assessments, and fees associated with their account, and in some cases, annual fees. Our sponsor bank may terminate a merchant agreement for any reason on 30 days' notice, and the merchant may terminate the agreement at any time without notice, subject to the payment of any applicable early termination fees. Typically, the agreement may also be terminated immediately upon a breach by the merchant of any of its terms. The agreement may not be assigned by the merchant without the prior written consent of the sponsor bank and us.

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Large National Merchants

At December 31, 2009, we provided bankcard payment processing services to approximately 75 large national merchants with approximately 53,972 locations. Our large national merchant portfolio was acquired in the May 2008 acquisition of Network Services.

Network Services provides processing of credit and debit cards to large national merchants, primarily in the petroleum industry. For the month of December 2009, approximately 94% of Network Services large national merchant processing volume was in the petroleum industry. In addition to settling Visa and MasterCard transactions, Network Services processes a wide range of payment transactions, including providing approximately 2.4 billion transaction authorizations through its front-end card processing systems (primarily for Visa and MasterCard) in 2009. Network Services added \$9.9 billion to our bankcard processing volume on 462 million transactions in 2009.

Risk Management

We believe that we have significant experience in assessing the risks associated with providing payment processing services to small- and medium-sized merchants. These risks include the limited operating history of many of the small- and medium-sized merchants we serve and the risk that these merchants could be subject to a higher rate of insolvency, which could adversely affect us financially. We apply varying levels of scrutiny in our application evaluation and underwriting of prospective merchant accounts, ranging from basic due diligence for merchants with a low risk profile to a more thorough and detailed review for higher risk merchants. In addition, through Network Services, we are also one of the leading providers of payment processing to the petroleum industry.

Merchant attrition is expected in the payment processing industry in the ordinary course of business. During 2009, 2008, and 2007, we experienced average annual attrition of 22.6%, 17.3%, and 12.6% respectively of our SME bankcard processing volume. Much of our attrition is related to business closures, which accelerated in 2009 due to weak economic conditions, and in 2009 our volume attrition was significantly impacted by overall contraction in same stores sales. See Management's Discussion and Analysis of Financial Condition and Results of Operations Overview General for a discussion of same stores sales.

As a result of our exposure to potential liability for merchant fraud, chargebacks, reject and other losses created by our merchant services business, we view our risk management and fraud avoidance practices as integral to our operations and overall success. We believe that the risks associated with our merchant base are generally not significant as our merchants consist primarily of companies conducting card-present transactions and whose chargeback levels are generally not significant as a percentage of their sales volume. As a result of their low risk profile, we can employ underwriting and set-up procedures that are less extensive than if these merchants had higher risk profiles and can typically ensure that these merchants will be approved and set up on our systems within 24 hours of our receiving their application.

However, for our merchants conducting card-not-present transactions, which we view as having a higher risk profile, we employ an extended underwriting and due diligence period and special account monitoring procedures. The underwriting process for these merchants' applications may take three to five days while we evaluate the applicants' financials, previous processing history and credit reports/OFAC (Office of Foreign Assets Control).

Effective risk management helps us minimize merchant losses for the mutual benefit of our merchants and ourselves. Our risk management procedures also help protect us from fraud perpetrated by our merchants. We believe our knowledge and experience in dealing with attempted fraud has resulted in our development and implementation of effective risk management and fraud prevention systems and procedures for the types of fraud discussed in this section. In 2009, 2008 and 2007, we experienced losses of 1.01 basis points, 0.88 basis points and 0.54 basis points, respectively, of our SME bankcard processing volume.

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We employ the following systems and procedures to minimize our exposure to merchant and transaction fraud:

Underwriting

Our Relationship Managers send new applications for low-risk merchants to their regional service team for scoring and account set up. Higher-risk applications are routed to our underwriting department for review and screening. Our underwriting department's review of these applications serves as the basis for our decision whether to accept or reject a merchant account. The review also provides the criteria for establishing cash deposit or letter of credit requirements, processing limits, average transaction amounts and pricing, which assist us in monitoring merchant transactions for those accounts that exceed those pre-determined thresholds. The criteria set by our underwriting department also assist our risk management staff in advising merchants with respect to identifying and avoiding fraudulent transactions. Depending upon their experience level, our underwriting staff has the authority to render judgment on new applications or to take additional actions such as adjusting processing limits supported by obtained processing history, analyzing average charge per transaction information or defining cash deposit/letter of credit, reserves, and delayed funding requirements for new and existing merchants. Our underwriting department prepares accounts that are risk sensitive for our credit committee review. The Credit Committee consists of a Manager of Underwriting, Manager of Risk Review and Executive Director of Core Support Group. Merchant accounts that exceed certain committee thresholds are reviewed by either our CEO, COO, CFO or Chief Portfolio Officer. Our sponsor bank also reviews and approves our merchant underwriting policies and procedures to ensure compliance with Visa and MasterCard operating rules and regulations.

Merchant Monitoring

We employ several levels of merchant account monitoring to help us identify suspicious transactions and trends. Daily merchant activity is obtained from two sources; HPS Exchange (where the information is downloaded from HPS Exchange to our monitoring systems) and TSYS (where the information is downloaded from our third-party processors onto TSYS risk system and then accessed by us on the Internet), and is sorted into a number of customized reports by our systems. Our risk management team reviews any unusual activity highlighted by these reports, such as larger than normal transactions or credits, and monitors other parameters that are helpful in identifying suspicious activity. We have a daily window of 10:00 a.m. to 6:00 p.m. Eastern time to decide if any transactions should be held for further review, which provides us time to interview a merchant or issuing bank to determine the validity of suspicious transactions. We have also developed a fraud management system for HPS Exchange that is fully integrated with our internal customer relationship management software and has detailed review capabilities to further streamline our monitoring of those transactions. We also place merchants who require special monitoring on alert status and have engaged a web crawling solution that scans all merchant websites for content and integrity.

Investigation and Loss Prevention

If a merchant exceeds any parameters established by our underwriting and/or risk management staff or violates regulations established by the applicable bankcard network or the terms of our merchant agreement, one of our investigators will identify the incident and take appropriate action to reduce our exposure to loss and the exposure of our merchant. This action may include requesting additional transaction information, withholding or diverting funds, verifying delivery of merchandise or even deactivating the merchant account. Additionally, Account Managers or Relationship Managers may be instructed to retrieve equipment.

Collateral

We require some of our merchants to establish cash deposits or letters of credit that we use to offset against liabilities we may incur. We hold such cash deposits or letters of credit for as long as we are exposed to a loss resulting from a merchant's payment processing activity. In addition, we maintain a 5-day delayed deposit policy on transactions processed by our Internet merchants and newly established merchants who have not previously processed bankcards to allow for additional risk monitoring. We also place a hold on batches containing questionable transactions, diverting the funds to a separate account pending review. As of December 31, 2009, these cash deposits, delayed and held batches, and letters of credit totaled approximately \$26.3 million.

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Servicing Technology

We have developed a number of systems that are designed to improve the effectiveness of our sales force, customer service and the management of our business. In 2009, 2008 and 2007 we spent \$8.1 million, \$5.9 million and \$4.2 million, respectively, on capitalized software development costs to make electronic payments easier for our sales force and merchants. Many of the following systems are accessible over the Internet through www.HeartlandPaymentSystems.com:

Portfolio Manager

Portfolio Manager is designed to allow each of our Relationship Managers to manage many aspects of his or her business, including portfolio monitoring and management, compensation review, training and professional development and the ability to communicate with others within our company. Portfolio Manager consists of a set of merchant relationship management tools. These tools include detailed merchant data, such as historical bankcard processing volume, updates on merchant contracts that will soon expire, losses, merchants who may have attrited and data that can be used by our Relationship Managers to assist merchants in understanding interchange fee structures and the risks associated with certain types of transactions. Portfolio Manager also includes an estimated gross margin calculator and a merchant profitability analysis that allows Relationship Managers to optimize gross margin generated from a new SME merchant account. In addition, Portfolio Manager provides our Relationship Managers with the ability to view their residual commission stream from their merchant portfolio, track their productivity and compare their sales statistics with those of other Relationship Managers.

Merchant Center

Merchant Center is designed to improve our merchants' efficiency, cash management and dispute resolution by providing them with real-time access to their transaction data, including clearinghouse records, deposits and transactions. Merchant Center can replace paper merchant statements and provide automated customer self-service. Approximately 57% of our SME merchants, as of December 31, 2009, had signed up for this product. Affiliate Manager also provides similar information tools to our strategic relationships, such as trade associations, banks and value-added resellers.

Client Manager

Information regarding all of our interactions with our SME merchants and all of their documents and transaction records are immediately available to our customer service department and management through Client Manager. Each new account is entered into this database during the initial application and underwriting process, and all documents regarding a merchant are scanned into the database. Subsequently, all of a merchant's transactions and statements, and records of all calls to our customer service representatives as well as their resolution, are maintained in the database. Client Manager is also the tool by which we make any pricing adjustments and manage any equipment-related transactions. Integrating many of our customer management tools into one database provides service center employees with the same information regarding a merchant, which enables us to provide consistent, rapid problem resolution and optimal customer service. We believe that reliance on the system has allowed considerable productivity gains in recent years.

Processing Technology

HPS Exchange

Our front-end system, HPS Exchange, provides us greater control of the electronic transaction process, allows us to offer our merchants (through our Relationship Managers) a differentiated product offering, and offers economies of scale that we expect will increase our long-term profitability.

On January 20, 2009, we publicly announced the discovery of the Processing System Intrusion, which apparently had occurred during some portion of 2008. The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being

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processed by us during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. Card data that could have been exposed by the Processing System Intrusion included card numbers, expiration dates, and certain other information from the magnetic stripe on the back of the payment card (including, for a small percentage of transactions, the cardholder's name). However, the cardholder information that we process does not include addresses or Social Security numbers. Also, we believe that no unencrypted PIN data was captured. We believe the breach has been contained and did not extend beyond 2008. Our investigation of the Processing System Intrusion is ongoing. We have taken a number of steps, since discovering the Processing System Intrusion, to further enhance the security of our computer system.

During 2009, approximately 88% of the transactions of our SME merchants were processed on HPS Exchange, and 92% of all merchant accounts established in 2009 were placed on the system. When a merchant uses HPS Exchange on certain hardware platforms, the resulting authorization speed for dial-up transactions can be six seconds or less and IP transactions can be two seconds or less, which we believe is faster than industry norms for comparable terminals. This increased speed not only benefits the merchant but also reduces the telecommunications costs we incur in connection with a transaction.

HPS Exchange enables us to provide more customized solutions to SME merchants, target larger merchants that demand customized front-end solutions and take advantage of new terminal hardware platforms and technology like End-to-End Encryption as they become available. HPS Exchange is customized for each merchant and will allow us to provide our merchants with differentiated value-added features, including the following:

Merchant/Cardholder Selected Debit or Credit. Merchants have the ability to convert a Visa Check or Master Money card to a pin-based debit transaction, which is typically less expensive for the merchant.

Real-Time Transaction Monitoring. Using their personal computers, merchants using Merchant Manager can observe open batches of payment transactions at any of their locations, allowing early detection of problem transactions, such as abnormally large tickets or credits, and changes in business volume.

Cash Back on Debit. Merchants have the ability to offer a cash-back option to their customers for pin-based debit transactions.

On-line Download Maintenance. On-line Download Maintenance is an Internet interface to a merchant's point-of-sale terminal download system that allows a merchant to change the parameters that control how its point-of-sale terminal functions as opposed to having to call the service center to request such changes. This enables a merchant to more easily change its receipt message each day and assists a merchant in preventing employee fraud by setting parameters that restrict the actions that can be taken by various employees.

While we will continue to utilize third-party front-end systems, we plan to continue incorporating additional functionality into HPS Exchange and to install an increasing percentage of new merchants onto HPS Exchange.

We believe that we are one of the first payment processors to develop all of our systems to take advantage of recent technological advancements in network and distributed computing, such as relational databases and Internet technologies. This offers significant benefits to us in terms of cost, data manipulation and distribution, flexibility and scalability. We further believe that these systems help attract both new merchants and Relationship Managers and provide us with a competitive advantage over many of our competitors who rely on less flexible legacy systems. With more widespread availability and usage of the internet, increasing numbers of merchants are using the web as a transport medium. In December 2009, 44% of all transactions processed through HPS Exchange were transmitted through the Internet. These transactions represent a significantly lower overall cost to HPS, since no dial-up costs are incurred.

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Passport

Our internally-designed back-end processing system, Passport, provides us with significant cost savings and results in greater economies of scale, by replacing third party processors' per-transaction charges with more of a fixed-cost structure. This structure allows per-transaction savings as increasing numbers of transactions are processed on Passport. In addition, our conversion to Passport provides us with the opportunity over time to offer our merchants significantly greater amounts of information regarding their processing characteristics, in more usable formats and to offer our services to larger merchants. In July 2005, we commenced converting bankcard merchants to Passport, and we completed the conversion of substantially all of our SME bankcard merchants to Passport in the second quarter of 2006. At December 31, 2009 and 2008, approximately 99% and 98%, respectively, of our SME merchants were processing on Passport.

Network Services Technology

We operate Network Services' platforms in two geographically dispersed data centers that are the focal point for hosting all Network Services transaction processing and network activity. We establish system service level thresholds based on our large national merchants' requirements. System availability of 99.5% uptime is our standard large national merchant metric, which Network Services exceeded in 2009. To achieve this standard, transactions are mirrored between data centers, and each center has the capacity to handle our full merchant transaction load. This ensures uninterrupted transaction processing during maintenance windows and other times processing may not be available.

Authorization We route authorization and capture transactions through Access Engine, where it is assigned to one of two payment engines: VAPS and NWS. After routing a transaction to the appropriate payment engine, it is then sent to Auth Engine which passes the transaction to the card networks for authorization.

Settlement For those large national merchants whose NWS and VAPS authorized transactions we settle, we have a contract with Fifth Third Processing Solutions to process settlement. A file of transactions is created and sent to Fifth Third Processing Solutions, which sends the transactions to the Card Brands. The Card Brands collect settlement funds from the card issuing banks, and forwards those funds to Fifth Third Processing Solutions, which then sends the funds to the sponsor bank to ultimately pay the large national merchants.

Network Security

In the course of our operations, we compile and maintain a large database of information relating to our merchants and their transactions, and large amounts of card information crosses our network as we authorize transactions. We have placed significant emphasis on maintaining a high level of security in order to attempt to protect the information of our merchants and their customers. We maintain current updates of network and operating system security releases and virus definitions, and have engaged a third party to regularly test our systems for vulnerability to unauthorized access. Further, we encrypt the cardholder numbers and merchant data that are stored in our databases using the highest commercially available encryption methods.

Our internal network configuration provides multiple layers of security to isolate our databases from unauthorized access and implements detailed security rules to limit access to all critical systems. In November 2003, we were certified by Visa as having successfully completed their Cardholder Information Security Program (CISP) review of our payment processing and Internet-based reporting systems. In 2004, the Visa CISP requirements were combined with security guidelines of the other card networks into a comprehensive Payment Card Industry Data Security Standard (PCI-DSS). We received confirmation of our compliance with PCI-DSS from a third party assessor in April 2008. Notwithstanding our implementation and utilization of the network security measures described in this section, we suffered the Processing System Intrusion described elsewhere in this annual report. Subsequent to the discovery of the Processing System Intrusion, we were advised by Visa that based on Visa's investigation of the Processing System Intrusion, Visa had removed us from Visa's published list of PCI-DSS compliant service providers. We were similarly advised by MasterCard that, based on MasterCard's investigation of the Processing System Intrusion MasterCard believed we were in violation of the MasterCard Standards and that, based on that belief, MasterCard removed us from MasterCard's published list of Compliant Service Providers. In April 2009, we were re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification was reviewed and approved by Visa.

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Visa placed us in a probationary status for the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa operating regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system. MasterCard returned us to its published list of Compliant Service Providers.

Visa, Star, NYCE and other debit card networks have established security guidelines for PIN-based debit transaction processing that is based upon ANSI standards that are published as the ASC X9 TG-3 PIN Security Compliance Guideline. We have regularly scheduled Security Review of our Key Management Procedures against this standard that is performed by an external auditor.

We also have engaged external auditors to perform an annual SAS-70 review and publish our Report on Controls Placed in Operation and Tests of Operating Effectiveness.

Disaster Recovery and Back-up Systems

We have implemented an alternative data center and disaster recovery plan for HPS Exchange and Passport systems to ensure business continuity in the event of a system failure. As part of this plan, we have established a passive processing site in Houston, Texas that has the same functionality as our primary data center in Allen, Texas. In the event of a failure at our Allen data center, we would switch our processing immediately to the Houston data center. This scenario was successfully tested during a full Disaster Recovery test in January 2010.

We also rely on connections to the systems of our third-party front-end and back-end processing providers. In many cases, they have installed or developed communications circuits with backup connectivity to overcome telecommunications problems. In addition, our service center has installed redundant power sources and our administrative systems are backed up and archived daily.

Competition

The payment processing industry is highly competitive. We compete with other providers of payment processing services on the basis of the following factors:

quality of service;

reliability of service;

Professional Association endorsements;

ability to evaluate, undertake and manage risk;

speed in approving merchant applications; and

price.

We compete with both small and large companies in providing payment processing and related services to a wide range of merchants. Our competitors sell their services either through a direct sales force, generally concentrating on larger accounts, or through Independent Sales Organizations, telemarketers or banks, generally concentrating on smaller accounts.

There are a number of large payment processors, including First Data Corporation, Global Payments Inc., Fifth Third Processing Solutions, Chase Paymentech Solutions and Elavon, Inc., a subsidiary of U.S. Bancorp, that serve a broad market spectrum from large to small merchants; further, certain of these provide banking, ATM and other payment-related services and systems in addition to bankcard payment processing. There are also a large number of smaller payment processors that provide various services to small- and medium-sized merchants.

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Some of our competitors have substantially greater capital resources than we have and operate as subsidiaries of financial institutions or bank holding companies, which may allow them on a consolidated basis to own and conduct depository and other banking activities that we do not have the regulatory authority to own or conduct. Since they are affiliated with financial institutions or banks, these competitors do not incur the costs

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associated with being sponsored by a bank for registration with card networks and they can settle transactions quickly for their own merchants. We do not, however, currently contemplate acquiring or merging with a financial institution in order to increase our competitiveness. We believe that our specific direct sales focus on SME merchants, in addition to our understanding of the needs and risks associated with providing payment processing services to those merchants, gives us a competitive advantage over larger competitors, which do not have our focus, and over competitors of a similar or smaller size that may lack our experience and sales resources.

Intellectual Property

We own or are pursuing several patents with the United States Patent and Trademark Office. In addition, we own various trademarks and have applied for numerous others. Most of our services and products are based on proprietary software or processes that are updated to meet merchant needs and remain competitive. Protecting our rights to our proprietary software is critical, as it allows us to offer distinctive services and products to merchants, which differentiates us from our competitors.

Employees

As of December 31, 2009, we employed 3,055 full- and part-time personnel, including 747 customer service, risk management, financial and operations support and underwriting employees, 270 systems and technology employees, 109 payroll services employees, 65 prepaid and stored-value solutions employees, 115 accounting and administration employees and 1,749 sales and marketing employees. None of our employees are represented by a labor union, and we have experienced no work stoppages. We consider our employee relations to be good.

WHERE YOU CAN GET ADDITIONAL INFORMATION

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy our reports or other filings made with the SEC at the SEC's Public Reference Room, located at 100 F Street, N.E., Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. You can also access these reports and other filings electronically on the SEC's web site, www.sec.gov.

In addition, certain of our SEC filings, including our Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, can be viewed and printed from the investor information section of our website at www.heartlandpaymentsystems.com, as soon as reasonably practicable after filing with the SEC. Certain materials relating to our corporate governance, including our senior financial officers' code of ethics, are also available in the investor relations section of our website.

The information on the websites listed above, is not and should not be considered part of this Annual Report on Form 10-K and is not incorporated by reference in this document. These websites are, and are only intended to be, inactive textual references.

In August 2009, we submitted to the New York Stock Exchange the CEO certification required by Section 303A.12(a) of the New York Stock Exchange Listed Company Manual without qualification.

ITEM 1A. RISK FACTORS

An investment in our common stock involves a high degree of risk. You should consider carefully the following risks and other information contained in this Annual Report on Form 10-K and other SEC filings before you decide whether to buy our common stock. If any of the events contemplated by the following discussion of risks should occur, our business, results of operations and financial condition could suffer significantly. As a result, the market price of our common stock could decline, and you may lose all or part of the money you paid to buy our common stock.

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Risks Relating to Our Business

Unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems (such as the Processing System Intrusion) or otherwise, could expose us to liability and protracted and costly litigation.

On January 20, 2009, we publicly announced the Processing System Intrusion. The Processing System Intrusion involved malicious software that appears to have been used to collect in-transit, unencrypted payment card data while it was being processed by us during the transaction authorization process. Such data is not required to be encrypted while in transit under current payment card industry guidelines. Card data that could have been exposed by the Processing System Intrusion included card numbers, expiration dates, and certain other information from the magnetic stripe on the back of the payment card (including, for a small percentage of transactions, the cardholder's name). We have taken a number of steps to contain the Processing System Intrusion and to further enhance the security of our computer system. Nevertheless, there can be no assurance that we will not suffer an additional security breach in the future.

To date, we have had several claims and lawsuits filed against us and additional lawsuits may be filed against us in the future. Several government agencies have either made inquiries to us or initiated investigations of us related to Processing System Intrusion. For more information concerning these lawsuits and government inquiries and investigations, see Item 3. Legal Proceedings. The amounts of the claims we expect to be asserted and amounts we may be required to pay as a result of, or in order to defend, the claims, lawsuits and government investigations and inquiries described above is likely to be substantial. It is possible that the amounts required to resolve and defend these claims, lawsuits and government inquiries and investigations could exceed our ability to pay such amounts from our cash flow and we may be required to seek financing to make such payments. Given some degree of uncertainty in the financial markets and the impact the Processing System Intrusion may have on our business and financial condition, we cannot provide any assurance that we will be able to obtain such financing on reasonable terms or at all.

We collect and store sensitive data about merchants, including names, addresses, social security numbers, driver's license numbers and checking account numbers. In addition, we maintain a database of cardholder data relating to specific transactions, including bankcard numbers, in order to process the transactions and for fraud prevention. Any loss of cardholder data by us or our merchants could result in significant fines and sanctions by Visa, MasterCard or governmental bodies, which could have a material adverse effect upon our financial position and/or results of operations. In addition, a significant breach could result in our being prohibited from processing transactions for Visa and MasterCard.

Our computer systems have been, and could be in the future, subject to penetration by hackers and our encryption of data may not prevent unauthorized use. In this event, we may be subject to liability, including claims for unauthorized purchases with misappropriated bankcard information, impersonation or other similar fraud claims. We could also be subject to liability for claims relating to misuse of personal information, such as unauthorized marketing purposes. These claims also could result in protracted and costly litigation. In addition, we could be subject to penalties or sanctions from the Visa and MasterCard networks.

Although we generally require that our agreements with our service providers who have access to merchant and customer data include confidentiality obligations that restrict these parties from using or disclosing any customer or merchant data except as necessary to perform their services under the applicable agreements, we cannot assure you that these contractual measures will prevent the unauthorized use or disclosure of data. In addition, our agreements with financial institutions require us to take certain protective measures to ensure the confidentiality of merchant and consumer data. Any failure to adequately enforce these protective measures could result in protracted and costly litigation.

Our actual losses and costs to mitigate the Processing System Intrusion have proven to be a material amount, which could grow and could have a material adverse effect on our operating results, financial condition and cash flow.

The accrual of settlements and settlement offers related to the Processing System Intrusion during the year ended December 31, 2009 resulted in our creating a \$99.9 million Reserve for Processing System Intrusion

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at December 31, 2009. To date, we have not reached definitive agreements with respect to all settlement offers we made or claims which are the subject of settlement discussions. Therefore, it should not be assumed that we will resolve the claims that are the subject of those settlement offers or the subject of settlement discussions for the amounts of the settlement offers or the settlement amounts deemed likely to be agreed upon. We understand that the reserve related to the settlement offers is required based solely on the fact we tendered offers of settlement in the amounts we have accrued. It is possible we will end up resolving the claims that are the subject of the settlement offers, either through settlements or pursuant to litigation, for amounts that are significantly greater than the amount we have reserved to date. Moreover, even if the claims that are the subject of the settlement offers were resolved for the amount we have reserved, that would still leave unresolved a significant portion of the claims that have been asserted against us or our sponsor banks relating to the Processing System Intrusion. If and when, we record additional reserves for these claims, they could be material and could adversely impact our results of operations, financial condition and cash flow. While we have established the Reserve for Processing System Intrusion, actual payments to the claimants will, to the extent they exceed our cash resources including insurance proceeds, require that we obtain additional funding from third parties. There can be no assurance that such funding will be available to us, or that the financing terms will not adversely affect our financial condition, results of operations or cash flow.

Amounts we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion that will be performed after December 31, 2009 will be recognized as incurred. Such costs could be material and could adversely impact our results of operations, financial condition and cash flow.

If we fail to comply with the applicable requirements of the Visa and MasterCard bankcard networks, Visa or MasterCard could seek to fine us, suspend us or terminate our registrations. Fines could have an adverse effect on our operating results and financial condition, and if these registrations are terminated, we will not be able to conduct our business.

If we are unable to comply with Visa and MasterCard bankcard network requirements, Visa or MasterCard could seek to fine us, suspend us or terminate our registrations. On occasion, we have received notices of non-compliance and fines, which have typically related to excessive chargebacks by a merchant or data security failures on the part of a merchant. If we are unable to recover fines from our merchants, we would experience a financial loss. The termination of our registration, or any changes in the Visa or MasterCard rules that would impair our registration, could require us to stop providing Visa and MasterCard payment processing services, which would make it impossible for us to conduct our business.

Subsequent to the discovery of the Processing System Intrusion, we were advised by Visa that based on Visa's investigation of the Processing System Intrusion, Visa had removed us from Visa's published list of PCI-DSS compliant service providers. We were similarly advised by MasterCard that, based on MasterCard's investigation of the Processing System Intrusion MasterCard believed we were in violation of the MasterCard Standards and that, based on that belief, MasterCard removed us from MasterCard's published list of Compliant Service Providers. In April 2009, we were re-certified as PCI-DSS compliant and the assessor's report attesting to such re-certification was reviewed and approved by Visa. Visa placed us in a probationary status for the two years following our re-certification as being PCI-DSS compliant, during which time our failure to comply with the probationary requirements set forth by Visa or with the Visa operating regulations may result in Visa seeking to impose further risk conditions on us, including but not limited to our disconnection from VisaNet or our disqualification from the Visa payment system. MasterCard returned us to its published list of Compliant Service Providers.

We are subject to the business cycles and credit risk of our merchants, which could negatively impact our financial results.

A recessionary economic environment could have a negative impact on our merchants, which could, in turn, negatively impact our financial results, particularly if the recessionary environment disproportionately affects some of the market segments that represent a larger portion of our bankcard processing volume, like restaurants. If our merchants make fewer sales of their products and services, we will have fewer transactions to process, resulting in lower revenue. In addition, we have a certain amount of fixed and semi-fixed costs, including rent, processing contractual minimums and salaries, which could limit our ability to quickly adjust costs and respond to changes in our business and the economy.

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In a recessionary environment our merchants could also experience a higher rate of business closures, which could adversely affect our business and financial condition. During the recession prior to the current recession, we experienced a slowdown in the rate of same-store sales growth and an increase in business closures. During the current recession, we have experienced a reduction in same-store sales when compared to the growth in 2008, and we could experience a higher rate of merchant closures. In the event of a closure of a merchant, we are unlikely to receive our fees for any transactions processed by that merchant in its final month of operation.

While we service a broad range of merchants, restaurants represent a significant portion of our merchant base. The failure rate of restaurants is typically high, which increases our merchant attrition and reject losses. A reduction in consumer spending, particularly at restaurants, would further increase our rate of merchant attrition and reject losses.

The payment processing industry is highly competitive and we compete with certain firms that are larger and that have greater financial resources. Such competition could increase, which would adversely influence our prices to merchants, and as a result, our operating margins.

The market for payment processing services is highly competitive. Other providers of payment processing services have established a sizable market share in the small- and medium-size merchant processing sector. Maintaining our historic growth will depend on a combination of the continued growth in electronic payment transactions and our ability to increase our market share. The current recession could cause future growth in electronic payment transactions to slow compared to historical rates of growth and the Processing System Intrusion could negatively impact our ability to increase our market share. According to The Nilson Report, we accounted for approximately 3.0% of the 2.2 trillion of total dollar volume (which we refer to as bankcard processing volume) processed by all bankcard acquirers in 2008. This competition may influence the prices we are able to charge. If the competition causes us to reduce the prices we charge, we will have to aggressively control our costs in order to maintain acceptable profit margins. In addition, some of our competitors are financial institutions, subsidiaries of financial institutions or well-established payment processing companies, including First Data Corporation, Global Payments, Inc., Fifth Third Processing Solutions, Chase Paymentech Solutions and Elavon, Inc., a subsidiary of U.S. Bancorp. Our competitors that are financial institutions or subsidiaries of financial institutions do not incur the costs associated with being sponsored by a bank for registration with the card networks and can settle transactions more quickly for their merchants than we can for ours. These competitors have substantially greater financial, technological, management and marketing resources than we have. This may allow our competitors to offer more attractive fees to our current and prospective merchants, or other products or services that we do not offer. This could result in a loss of customers, greater difficulty attracting new customers, and a reduction in the price we can charge for our services.

We have faced, and will in the future face, chargeback liability when our merchants refuse or cannot reimburse chargebacks resolved in favor of their customers, and reject losses when our merchants go out of business. We cannot accurately anticipate these liabilities, which may adversely affect our results of operations and financial condition.

In the event a billing dispute between a cardholder and a merchant is not resolved in favor of the merchant, the transaction is normally charged back to the merchant and the purchase price is credited or otherwise refunded to the cardholder. If we or our clearing banks are unable to collect such amounts from the merchant's account, or if the merchant refuses or is unable, due to closure, bankruptcy or other reasons, to reimburse us for the chargeback, we bear the loss for the amount of the refund paid to the cardholder. The risk of chargebacks is typically greater with those merchants that promise future delivery of goods and services rather than delivering goods or rendering services at the time of payment. We may experience significant losses from chargebacks in the future. Any increase in chargebacks not paid by our merchants may adversely affect our financial condition and results of operations.

Reject losses arise from the fact that we collect our fees from our SME merchants on the first day after the monthly billing period. This results in the build-up of a substantial receivable from our customers, which significantly exceeds the receivables of any of our competitors which assess their fees on a daily basis. If a merchant has gone out of business during the billing period, we may be unable to collect such fees. In addition, if our sponsor bank is unable, due to system disruption or other failure, to collect our fees from our merchants, we would face a substantial loss.

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We incurred charges relating to chargebacks and reject losses of \$5.9 million, \$5.3 million and \$2.8 million in the years ended December 31, 2009, 2008 and 2007, respectively.

We have faced, and will in the future face, merchant fraud, which could have an adverse effect on our operating results and financial condition.

We have potential liability for fraudulent bankcard transactions initiated by merchants. Merchant fraud occurs when a merchant knowingly uses a stolen or counterfeit bankcard or card number to record a false sales transaction, processes an invalid bankcard or intentionally fails to deliver the merchandise or services sold in an otherwise valid transaction. Examples of merchant fraud we have faced include a manager of a franchised motel who applied for a merchant account that proved to be a second account for that motel, and processed duplicate charges in his office, and an antique repair service owner who continued accepting deposits on cards for repairs, but stopped doing the repairs. We have established systems and procedures designed to detect and reduce the impact of merchant fraud, but we cannot assure you that these measures are or will be effective. It is possible that incidents of fraud could increase in the future. Failure to effectively manage risk and prevent fraud would increase our chargeback liability. Increases in chargebacks could have an adverse effect on our operating results and financial condition.

Increased merchant attrition that we cannot offset with increased bankcard processing volume or new accounts would cause our revenues to decline.

We experience attrition in merchant bankcard processing volume resulting from several factors, including business closures, transfers of merchants' accounts to our competitors and account closures that we initiate due to heightened credit risks relating to, or contract breaches by, merchants, and when applicable same store sales contraction. During 2009, 2008, and 2007, we experienced average annual attrition of 22.6%, 17.3%, and 12.6% respectively. Substantially all of our processing contracts may be terminated by either party on relatively short notice. We cannot predict the level of attrition in the future, and it could increase. Increased attrition in merchant bankcard processing volume may have an adverse effect on our financial condition and results of operations. If we are unable to establish accounts with new merchants or otherwise increase our bankcard processing volume in order to counter the effect of this attrition, our revenues will decline.

We rely on sponsor banks, which have substantial discretion with respect to certain elements of our business practices, in order to process bankcard transactions. If these sponsorships are terminated and we are unable to secure new bank sponsors, we will not be able to conduct our business.

Over 95% of our revenue is derived from Visa and MasterCard bankcard transactions. Because we are not a bank, we are not eligible for membership in the Visa and MasterCard networks and are, therefore, unable to directly access the bankcard networks, which are required to process Visa and MasterCard transactions. Visa and MasterCard operating regulations require us to be sponsored by a bank in order to process bankcard transactions. We are currently registered with Visa and MasterCard through KeyBank, which has maintained that registration since 1999, Heartland Bank, which has been a sponsor since December 2007, and Bancorp, which has been a sponsor since February 2010 (replacing SunTrust Bank, who started processing in February 2009). If our sponsorships are terminated and we are unable to secure another bank sponsor or sponsors, we will not be able to process Visa and MasterCard transactions. Furthermore, our agreements with KeyBank and Heartland Bank give them substantial discretion in approving certain aspects of our business practices, including our solicitation, application and qualification procedures for merchants, the terms of our agreements with merchants and our customer service levels. In August 2009, SunTrust Bank provided twelve months notice to the Company of its intent to withdraw its sponsorship of the Company's large national merchants processing portfolio. In November 2009, we entered into a sponsorship agreement with The Bancorp Bank and transferred the sponsorship from SunTrust Bank in February 2010. The agreement with The Bancorp Bank expires in November 2014. Our sponsor banks' discretionary actions under these agreements could be detrimental to our operations. It is possible that our sponsor banks could claim that the Processing System Intrusion gives them the right to terminate our agreements with them.

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Current or future bankcard network rules and practices could adversely affect our business.

We are registered with the Visa and MasterCard networks through our bank sponsors as an Independent Sales Organization with Visa and a Member Service Provider with MasterCard. We are currently a sales agent for Discover and American Express. Under the new American Express agreement we will remain a sales agent; however, under the new Discover agreement we will be registered as an Acquirer. The rules of the bankcard networks are set by their boards, which may be strongly influenced by banks that own their stock and, in the case of Discover and American Express, by the card issuers, and some of those banks and issuers are our competitors with respect to these processing services. Many banks directly or indirectly sell processing services to merchants in direct competition with us. These banks could attempt, by virtue of their membership in the network, to alter the networks' rules or policies to the detriment of non-members like us. The bankcard networks or issuers who maintain our registrations or arrangements or the current bankcard network or issuer rules allowing us to market and provide payment processing services may not remain in effect. The termination of our registration or our status as an Independent Sales Organization or Member Service Provider, or any changes in card network or issuer rules that limit our ability to provide payment processing services, could have an adverse effect on our bankcard processing volumes, revenues or operating costs. In addition, if we were precluded from processing Visa and MasterCard bankcard transactions, we would lose substantially all of our revenues.

Our systems and our third-party providers' systems may fail due to factors beyond our control, which could interrupt our service, cause us to lose business and increase our costs.

We depend on the efficient and uninterrupted operation of our computer network systems, software, data center and telecommunications networks, as well as the systems of third parties. Our systems and operations or those of our third-party providers could be exposed to damage or interruption from, among other things, fire, natural disaster, power loss, telecommunications failure, unauthorized entry and computer viruses. Our property and business interruption insurance may not be adequate to compensate us for all losses or failures that may occur. Defects in our systems or those of third parties, errors or delays in the processing of payment transactions, telecommunications failures or other difficulties could result in:

loss of revenues;

loss of merchants, although our contracts with merchants do not expressly provide a right to terminate for business interruptions;

loss of merchant and cardholder data;

harm to our business or reputation;

exposure to fraud losses or other liabilities;

negative publicity;

additional operating and development costs; and/or

diversion of technical and other resources.

If we fail to protect our intellectual property rights and defend our self from potential patent infringement claims, our competitive advantages may diminish or our ability to offer services to our customers could be restricted.

Our patents, trademarks, proprietary software and other intellectual property are critical to our future success. We rely on proprietary technology. It is possible that others will independently develop the same or similar technologies. Assurance of protecting our rights and

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proprietary information cannot be guaranteed. Our patents could be challenged, invalidated or circumvented by others and may not be of sufficient scope or strength to provide any meaningful protection or advantage. If we are unable to maintain the proprietary nature of our technologies, the Company could lose competitive advantages and be materially adversely affected. Adverse determinations in judicial or administrative proceedings could prevent us from selling our services or prevent us from precluding others from selling competing services, and thereby may have a material adverse affect on the business and results of operations. Additionally, claims have been made, are currently pending, and other claims may be made in the future, with regard to our technology infringing on a patent or other intellectual property rights of others. Unfavorable resolution of these claims could either result in our being restricted from delivering the related service or result in an unfavorable settlement that could be material to our operating results, financial condition and cash flow.

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Adverse conditions in markets in which we obtain a substantial amount of our bankcard processing volume, such as our largest SME merchant markets of California, New York, Texas, Florida, and New Jersey, could negatively affect our results of operations.

Adverse economic or other conditions in California, New York, Texas, Florida, and New Jersey would negatively affect our revenue and could materially and adversely affect our results of operations. In December 2009, SME merchants in California represented 11.8%, in New York represented 6.3%, in Texas represented 5.1%, in Florida represented 4.8%, and in New Jersey represented 4.4% of our SME bankcard processing volume. As a result of this geographic concentration of our merchants in these markets, we are exposed to the risks of downturns in these local economies and to other local conditions, which could adversely affect the operating results of our merchants in these markets. No other state represented more than 4% of our SME bankcard processing volume in December 2009.

If we lose key personnel or are unable to attract additional qualified personnel as we grow, our business could be adversely affected.

We are dependent upon the ability and experience of a number of our key personnel who have substantial experience with our operations, the rapidly changing payment processing industry and the selected markets in which we offer our services. It is possible that the loss of the services of one or a combination of our senior executives or key managers, particularly Robert O. Carr, our Chief Executive Officer, would have an adverse effect on our operations. Our success also depends on our ability to continue to attract, manage and retain other qualified middle management and technical and clerical personnel as we grow. We may not continue to attract or retain such personnel.

If we are unable to attract and retain qualified sales people, our business and financial results may suffer.

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we rely on a direct sales force whose compensation is entirely commission-based. Through our direct sales force of approximately 1,069 Relationship Managers, we seek to increase the number of merchants using our products and services. We intend to significantly increase the size of our sales force. Our success partially depends on the skill and experience of our sales force. If we are unable to retain and attract sufficiently experienced and capable Relationship Managers, our business and financial results may suffer.

If we cannot pass increases in bankcard network interchange fees along to our merchants, our operating margins will be reduced.

We pay interchange fees and other network fees set by the bankcard networks to the card issuing bank for each transaction we process involving their bankcards. From time to time, the bankcard networks increase the interchange fees and other network fees that they charge payment processors and the sponsoring banks. At its sole discretion, our sponsoring bank has the right to pass any increases in interchange fees on to us and it has consistently done so in the past. We are allowed to, and in the past we have been able to, pass these fee increases along to our merchants through corresponding increases in our processing fees. However, if we are unable to do so in the future, our operating margins will be reduced.

Any acquisitions or portfolio buyouts that we make could disrupt our business and harm our financial condition.

We expect to evaluate potential strategic acquisitions of complementary businesses, products or technologies. We may not be able to successfully finance or integrate any businesses, products or technologies that we acquire. Furthermore, the integration of any acquisition may divert management's time and resources from our core business and disrupt our operations. We may spend time and money on projects that do not increase our revenue. To the extent we pay the purchase price of any acquisition in cash, it would reduce our cash reserves, and to the extent the purchase price is paid with our stock, it could be dilutive to our stockholders. While we, from time to time, evaluate potential acquisitions of businesses, products and technologies, and anticipate continuing to make these evaluations, we have no present understandings, commitments or agreements with respect to any acquisitions.

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We also regularly buy out the residual commissions of our Relationship Managers and sales managers, at multiples that typically amount to 2 to 2 1/2 years of such commissions. If the merchants included in the portfolios we purchase do not generate sufficient incremental margin after the purchase, we will not achieve a positive return on the cash expended.

Governmental regulations designed to protect or limit access to consumer information could adversely affect our ability to effectively provide our services to merchants.

Governmental bodies in the United States and abroad have adopted, or are considering the adoption of, laws and regulations restricting the transfer of, and safeguarding, non-public personal information. For example, in the United States, all financial institutions must undertake certain steps to ensure the privacy and security of consumer financial information. While our operations are subject to certain provisions of these privacy laws, we have limited our use of consumer information solely to providing services to other businesses and financial institutions. We limit sharing of non-public personal information to that necessary to complete the transactions on behalf of the consumer and the merchant and to that permitted by federal and state laws. In connection with providing services to the merchants and financial institutions that use our services, we are required by regulations and contracts with our merchants to provide assurances regarding the confidentiality and security of non-public consumer information. These contracts require periodic audits by independent companies regarding our compliance with industry standards and best practices established by regulatory guidelines. The compliance standards relate to our infrastructure, components, and operational procedures designed to safeguard the confidentiality and security of non-public consumer personal information shared by our clients with us. Our ability to maintain compliance with these standards and satisfy these audits will affect our ability to attract and maintain business in the future. The cost of such systems and procedures may increase in the future and could adversely affect our ability to compete effectively with other similarly situated service providers.

Our operating results are subject to seasonality, which could result in fluctuations in our quarterly net income.

We have experienced in the past, and expect to continue to experience, seasonal fluctuations in our revenues as a result of consumer spending patterns. Historically our revenues have been strongest in our second and third quarters, and weakest in our first quarter.

We may become subject to additional U.S., state or local taxes that cannot be passed through to our merchants, which could negatively affect our results of operations.

Companies in the payment processing industry, including us, may become subject to taxation in various tax jurisdictions on our net income or revenues. Application of these taxes is an emerging issue in our industry and taxing jurisdictions have not yet adopted uniform positions on this topic. If we are required to pay additional taxes and are unable to pass the tax expense through to our merchants, our costs would increase and our net income would be reduced.

We may need to raise additional funds to finance our future capital needs, which may prevent us from growing our business.

We may need to raise additional funds to finance our future capital needs, including funding costs associated with the Processing System Intrusion, developing new products and technologies, and operating expenses. We may need additional financing earlier than we anticipate if we:

experience material costs to mitigate the impacts of and resolve the claims originating from, the Processing System Intrusion;

expand faster than our internally generated cash flow can support;

purchase portfolio equity (the portion of our commissions that we have committed to our sales force for as long as the merchant processes with us, which we may buy out at an agreed multiple) from a large number of Relationship Managers or sales managers;

add new merchant accounts faster than expected;

need to reduce pricing in response to competition;

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repurchase our common stock; or

acquire complementary products, businesses or technologies.

If we raise additional funds through the sale of equity securities, these transactions may dilute the value of our outstanding common stock. We may also decide to issue securities, including debt securities that have rights, preferences and privileges senior to our common stock. We may be unable to raise additional funds on terms favorable to us or at all. If financing is not available or is not available on acceptable terms, we may be unable to fund our future needs. This may prevent us from increasing our market share, capitalizing on new business opportunities or remaining competitive in our industry.

Risks Related to Our Company

Borrowings under our Amended and Restated Credit Agreement and Bridge Loan Agreement could adversely affect our financial condition, and the related debt service obligations may adversely affect our cash flow and ability to invest in and grow our businesses.

We funded our acquisition of Network Services by borrowing under our Amended and Restated Credit Agreement and we funded the majority of our the Settlement Agreement with Visa by borrowing under our Amended and Restated Credit Agreement and Bridge Loan Agreement. The interest rates on this debt are floating based on the LIBOR rate; accordingly, if the LIBOR rate increases, our interest expense would be higher. We intend to fulfill our total debt service obligations by obtaining replacement funding from third parties and from cash generated by our operations. Such funds will not be available to use in future operations, or investing in our businesses. This may adversely impact our ability to expand our businesses or make other investments.

There can be no assurance that such replacement funding will be available to us, or that the financing terms will not adversely affect our financial condition, results of operations or cash flow. If we are unable to meet our debt obligations, we could be forced to sell assets, which we may not be able to do on satisfactory terms or at all. As a result, we could default on those obligations and in the event of such default, our lenders could accelerate our debt or take other actions that could restrict our operations. If we incur significant costs to defend, or are required to book a significant reserve for, claims arising out of the Processing System Intrusion, such costs or reserve could cause us to violate certain of the financial covenants in our Amended and Restated Credit Agreement.

Our borrowing agreements contain restrictions which may limit our flexibility in operating and growing our business.

Our borrowing agreements contain covenants, including the maintenance of certain leverage and fixed charge coverage ratios, limitations on the amount of our indebtedness, liens on our properties and assets, investments in, and loans to, other business units, our ability to enter into business combinations and asset sales, and certain other financial and non-financial covenants. In accordance with the August 3, 2009 amendment to the Amended and Restated Credit Agreement, the Company was in compliance with these covenants as of December 31, 2009.

These covenants limit our ability to engage in specified types of transactions, including among other things:

incur additional indebtedness or issue equity;

pay dividends on, repurchase or make distributions in respect of our common stock;

make certain investments;

sell certain assets;

create liens;

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consolidate, merge, sell or otherwise dispose of all or substantially all of the Company's assets; and

enter into certain transactions with respect to our subsidiaries.

Future sales of our common stock, or the perception in the public markets that these sales may occur, could depress our stock price.

Sales of substantial amounts of our common stock in the public market, or the perception in the public markets that these sales may occur, could cause the market price of our common stock to decline. This could also impair our ability to raise additional capital through the sale of our equity securities. At December 31, 2009, we

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had 37,524,298 shares of our common stock outstanding. In addition, as of December 31, 2009, we had outstanding stock options and restricted share units totaling 7,872,424 shares issued under our 2008 Incentive Stock Option Plan and our 2000 Incentive Stock Option Plan, of which 2,242,560 were vested. Assuming the exercise of all outstanding options to acquire our common stock and the vesting of all restricted share units, our current stockholders would own on a fully-diluted basis 82.7% of the outstanding shares of our common stock, and the number of shares of our common stock available to trade could cause the market price of our common stock to decline. In addition to the adverse effect a price decline could have on holders of our common stock, such a decline could impede our ability to raise capital or to make acquisitions through the issuance of additional shares of our common stock or other equity securities.

Provisions in our charter documents and Delaware law could discourage a takeover that our shareholders may consider favorable or could cause current management to become entrenched and difficult to replace.

Provisions in our amended and restated certificate of incorporation, in our bylaws and under Delaware law could make it more difficult for other companies to acquire us, even if doing so would benefit our stockholders. Our amended and restated certificate of incorporation and bylaws contain the following provisions, among others, which may inhibit an acquisition of our company by a third party:

advance notification procedures for matters to be brought before stockholder meetings;

a limitation on who may call stockholder meetings;

a prohibition on stockholder action by written consent; and

the ability of our Board of Directors to issue up to 10 million shares of preferred stock without a stockholder vote.

If any shares of preferred stock are issued that contain an extraordinary dividend or special voting power, a change in control could be impeded.

We are also subject to provisions of Delaware law that prohibit us from engaging in any business combination with any interested stockholder, meaning, generally, that a stockholder who beneficially owns more than 15% of our stock cannot acquire us for a period of three years from the date this person became an interested stockholder unless various conditions are met, such as approval of the transaction by our Board of Directors. Any of these restrictions could have the effect of delaying or preventing a change in control.

We may be unable or we may decide not to pay dividends on our common stock at a level anticipated by shareholders, which could depress our stock price.

The payment of dividends on our common stock in the future will be at the discretion of our Board of Directors and will depend on, among other factors, our earnings, stockholders' equity, cash position and financial condition. No assurance can be given that we will be able to or will choose to pay any dividends in the foreseeable future.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 2. PROPERTIES

At December 31, 2009, we owned one facility and leased twelve facilities which we use for operational, sales and administrative purposes.

Our principal executive offices are located in approximately 9,300 square feet of leased office space on Nassau Street in Princeton, New Jersey. The Nassau Street lease expires in May 2013.

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We own 35 acres of land in Jeffersonville, Indiana, on which we have completed constructing our credit card operations and service center. The state-of-the-art facility is comprised of 238,000 square feet of space supporting customer service, operations, deployment, day care, fitness, cafeteria, and large company meetings.

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We also leased the following facilities as of December 31, 2009:

Location	Square Feet	Expiration
Alpharetta, Georgia	3,008	November 30, 2010
Chattanooga, Tennessee	9,461	September 30, 2014
Cleveland, Ohio	21,729	June 30, 2012
Colorado Springs, Colorado	9,920	March 1, 2014
Johnson City, Tennessee	45,000	October 22, 2010
Phoenix, Arizona	1,284	March 31, 2011
Plano, Texas	49,015	May 31, 2015 for 26,988 square feet. January 14, 2019 for 22,207 square feet.
Portland, Oregon	11,564	September 30, 2013
Toronto, Ontario, Canada	14,094	July 31, 2020
West Windsor Township, New Jersey	5,288	May 31, 2013
Woodbridge, Ontario, Canada	2,205	February 28, 2010

We believe that our facilities are suitable and adequate for our current business operations and, if necessary, could be replaced with little disruption to our company. We periodically review our space requirements and may acquire new space to meet our business needs or consolidate and dispose of or sublet facilities which are no longer required.

ITEM 3. LEGAL PROCEEDINGS***Processing System Intrusion Legal Proceedings***

To date, we have had several lawsuits filed against us and additional lawsuits may be filed. These include lawsuits which assert claims against us by cardholders (including various putative class actions seeking in the aggregate to represent all cardholders in the United States whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion) and banks that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion (including various putative class actions seeking to represent all financial institutions that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion), seeking damages allegedly arising out of the Processing System Intrusion and other related relief. The actions generally assert various common-law claims such as claims for negligence and breach of contract, as well as, in some cases, statutory claims such as violation of the Fair Credit Reporting Act, state data breach notification statutes, and state unfair and deceptive practices statutes. The putative cardholder class actions seek various forms of relief including damages, injunctive relief, multiple or punitive damages, attorneys' fees and costs. The putative financial institution class actions seek compensatory damages, including recovery of the cost of issuance of replacement cards and losses by reason of unauthorized transactions, as well as injunctive relief, attorneys' fees and costs.

On June 10, 2009, the Judicial Panel on Multidistrict Litigation (the JPML) entered an order centralizing these cases for pre-trial proceedings before the United States District Court for the Southern District of Texas, under the caption *In re Heartland Payment Systems, Inc. Data Security Breach Litigation*, MDL No. 2046, 4:09-md-2046. On August 24, 2009, the court appointed interim co-lead and liaison counsel for the financial institution and consumer plaintiffs. On September 23, 2009, the financial institution plaintiffs filed a Master Complaint in the MDL proceedings, which we moved to dismiss on October 23, 2009. Briefing on that motion to dismiss concluded on February 1, 2010 and the motion remains pending. On December 18, 2009, the Company and interim counsel for the consumer plaintiffs filed with the Court a proposed settlement agreement, subject to court approval, of the consumer class action claims. The putative consumer class actions and putative financial institution class actions filed against us and pending through March 9, 2010 are described in Legal Proceedings Processing System Intrusion Legal Proceedings.

Other actions have been filed against us seeking damages allegedly arising out of the Processing System Intrusion and other related relief on an individual basis. On October 14, 2009, the Clark County Indiana Teachers Federal Credit Union filed a complaint in the Clark Circuit Superior Court of the State of Indiana. This action is captioned *Clark County Indiana Teachers Federal Credit Union v. Heartland Payment Systems, Inc.*, Civ. No. 10D02-0910-LL-1209, and asserts claims for negligence and breach of contract. We have not yet

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responded to the complaint. On December 28, 2009, Putnam Bank of Putnam, Connecticut filed a complaint in Connecticut Superior Court, *Putnam Bank v. Heartland Payment Systems, Inc.*, case no. WWM-CV-10-6001208-S. On January 20, 2010, we removed the action to the United States District Court for the District of Connecticut, case no. 3:10-cv-0061 (JBA), and, on January 27, 2010, filed a Notice of Potential Tag-Along Action, requesting centralization of the action with the MDL proceedings. On February 9, 2010, OmniAmerican Bank filed a complaint in the District Court for Collin County, Texas, Civ. No. 380-00563-2012. The complaint identifies as a party in interest the Federal Insurance Company, which is alleged to have insured plaintiff and reimbursed it for \$1,005,077.50, less a \$100,000 deductible. On February 18, 2010, Quad City Bank and Trust filed a complaint in the District Court for Collin County, Texas, Civ. No. 380-00721-2010.

Putative Consumer Class Actions

Name of the Court	Date Filed	Principal Parties
United States District Court for the District of New Jersey	January 23, 2009	<i>Sansom and Engel v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00335
United States District Court for the Northern District of Florida	January 26, 2009	<i>Read v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00035
United States District Court for the District of Arizona	January 29, 2009	<i>Swenka v. Heartland Payment Systems, Inc. et al.</i> , 2:09-cv-00179
United States District Court for the District of Kansas	January 29, 2009	<i>Barrett v. Heartland Payment Systems, Inc. et al.</i> , 09-cv-2053
United States District Court for the District of New Jersey	January 29, 2009	<i>Merino v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00439
United States District Court for the Middle District of Alabama	February 2, 2009	<i>Brown, Latham and Spencer v. Heartland Payment Systems, Inc. et al.</i> , 2:09-cv-00086
United States District Court for the Eastern District of California	February 2, 2009	<i>Hilliard v. Heartland Payment Systems, Inc. et al.</i> , 1:09-cv-00179
United States District Court for the District of New Jersey	February 2, 2009	<i>Kaissi v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00540
United States District Court for the Northern District of Ohio	February 3, 2009	<i>McGinty and Carr v. Heartland Payment Systems, Inc. et al.</i> , 1:09-cv-00244
United States District Court for the Southern District of Texas	February 4, 2009	<i>Watson v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-00325
United States District Court for the Eastern District of Wisconsin	February 4, 2009	<i>Anderson and Hoven v. Heartland Payment Systems, Inc. et al.</i> , 2:09-cv-00113
United States District Court for the Southern District of Florida	February 6, 2009	<i>Balloveras v. Heartland Payment Systems, Inc. et al.</i> , 1:09-cv-20326
United States District Court for the Southern District of California	February 25, 2009	<i>Mata v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00376
United States District Court for the Western District of Missouri	February 26, 2009	<i>McLaughlin v. Heartland Payment Systems, Inc. et al.</i> , 6:09-cv-3069
United States District Court for the District of New Jersey	February 27, 2009	<i>Rose v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00917

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Name of the Court	Date Filed	Principal Parties
United States District Court for the Southern District of Illinois	April 21, 2009	<i>Leavell v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00270
United States District Court for the Eastern District of Arkansas	April 30, 2009	<i>Brown v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-00384

Putative Financial Institution Class Actions

Name of the Court	Date Filed	Principal Parties
United States District Court for the District of New Jersey	February 6, 2009	<i>Lone Summit Bank v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00581
United States District Court for the District of New Jersey	February 13, 2009	<i>TriCentury Bank et al. v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00697
United States District Court for the Southern District of Texas	February 16, 2009	<i>Lone Star National Bank v. Heartland Payment Systems, Inc. et al.</i> , 7:09-cv-00064
United States District Court for the District of New Jersey	February 20, 2009	<i>Amalgamated Bank et al. v. Heartland Payment Systems, Inc. et al.</i> , 3:09-cv-00776
United States District Court for the Southern District of Florida	March 19, 2009	<i>First Bankers Trust Co., N.A. v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-00825
United States District Court for the Southern District of Florida	March 31, 2009	<i>PBC Credit Union et al. v. Heartland Payment Systems, Inc. et al.</i> , 9:09-cv-80481
United States District Court for the Southern District of Texas	April 22, 2009	<i>Community West Credit Union, et al. v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-01201
United States District Court for the Southern District of Texas	April 22, 2009	<i>Eden Financial Corp. v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-01203
United States District Court for the Southern District of Texas	April 28, 2009	<i>Heritage Trust Federal Credit Union v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-01284
United States District Court for the Southern District of Texas	May 1, 2009	<i>Pennsylvania State Employees Credit Union v. Heartland Payment Systems, Inc. et al.</i> , 4:09-cv-01330

On January 19, 2010, financial institution plaintiffs, including certain of the named plaintiffs in the MDL proceedings, commenced an action against our sponsor banks in the United States District Court for the Southern District of Texas, captioned *Lonestar National Bank, N.A. et al. v. KeyBank NA, et al.*, Civ. No. 4:10-cv-00171. This action against our sponsor banks asserts common-law claims similar to those asserted against us, and likewise seeks to represent all financial institutions that issued payment cards to cardholders whose transaction information is alleged to have been placed at risk in the course of the Processing System Intrusion. On March 4, 2010, this action was transferred to the judge overseeing the MDL proceedings. The sponsor banks could seek indemnification from us in regard to the claims asserted in this action.

Four securities class action complaints were filed in the United States District Court for the District of New Jersey: *Davis v. Heartland Payment Systems, Inc. et al.*, 3:09-cv-01043-AET-TJB (March 6, 2009); *Ivy v. Heartland Payment Systems, Inc. et al.*, 3:09-cv-01264-AET-JJH (March 19, 2009); *Ladensack v. Heartland Payment Systems, Inc. et al.*, 3:09-cv-01632-FLW-TJB (April 3, 2009); and *Morr v. Heartland Payment Systems, Inc. et al.*, 3:09-cv-01818-JAP-LHG (April 16, 2009). All four complaints contained similar allegations that we and two of our officers, Chief Executive Officer Robert O. Carr and President and Chief Financial Officer Robert H. B. Baldwin, Jr. violated Sections 10(b) and/or 20(a) of the Securities Exchange Act of 1934 (the Exchange Act) by making material misrepresentations and/or omissions to our securities holders concerning the Processing System Intrusion, and that four of our insiders had engaged in insider trading. On May 7, 2009, *Ladensack* was voluntarily dismissed by plaintiffs without prejudice. On May 27, 2009, the three remaining securities class actions were consolidated into *In re Heartland Payment Systems, Inc. Securities Litigation*, 3:09-cv-01043-AET-TJB (the Consolidated Securities Class Action). The Teamsters Local Union No. 727 Pension Fund and Genesee County Employees Retirement System were appointed Co-Lead Plaintiffs for the purported class pursuant to 15 U.S.C. § 78u-4(a)(3)(B).

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On August 20, 2009, Lead Plaintiffs in the Consolidated Securities Class Action filed an Amended Consolidated Class Action Complaint for Violations of the Federal Securities Laws (the Amended Securities Complaint), purporting to represent all individuals who bought our common stock between February 13, 2008 and February 23, 2009. The Amended Complaint alleged that we and Messrs. Carr and Baldwin made material misrepresentations and/or omissions to our shareholders concerning our network security and the Processing System Intrusion in violation of Sections 10(b) and/or 20(a) of the Exchange Act. Lead Plaintiffs sought various forms of relief, including damages, attorneys' fees, and costs and expenses. On September 25, 2009, we moved to dismiss the Amended Securities Complaint. On December 7, 2009, the Court granted our motion to dismiss and dismissed the Amended Securities Complaint with prejudice. Lead Plaintiffs did not appeal the dismissal within the time prescribed by the Federal Rules of Appellate Procedure, rendering the Court's dismissal a final judgment on the merits and terminating the Consolidated Securities Class Action.

On May 20, 2009, we received a letter from counsel purporting to represent Heartland shareholders Charles Lee and Paul Miele demanding that we initiate suit against the members of our Board of Directors and Messrs. Carr and Baldwin to recover damages for alleged breaches of fiduciary duty and to correct supposed deficiencies in our internal controls. Our Board of Directors formed an independent Special Committee, represented by independent counsel, to investigate the allegations in the demand letter and recommend to our Board of Directors whether suit should be filed or what other action, if any, should be taken in response to the demand. The Special Committee also was charged with investigating and making recommendations to our Board of Directors concerning the allegations in derivative complaints subsequently filed by Messrs. Lee and Miele and by our alleged shareholder Eric Kirkham, described below. On February 18, 2010, after conducting an investigation, the Special Committee issued a Confidential Report to the independent members of our Board of Directors, in which it concluded that the interests of us and our stockholders would not be served by pursuing claims against our directors and officers. The Special Committee recommended that our Board of Directors seek dismissal of the derivative litigation pending as of the date of the Confidential Report.

On July 14, 2009, our alleged shareholder, Eric Kirkham, filed a Verified Shareholder Derivative Complaint in the United States District Court, District of New Jersey, *Kirkham v. Carr et al.*, 3:09-cv-03444-AET-DEA (D.N.J.) (the *Kirkham* Action), purportedly for the benefit of nominal defendant Heartland, the members of our Board of Directors and Messrs. Carr and Baldwin as individual defendants. The *Kirkham* Complaint asserted claims for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets, alleging that our Board members and Messrs. Carr and Baldwin caused Heartland to disseminate to our shareholders materially misleading and inaccurate information, ignored supposed inadequacies within our internal controls, practices and procedures, and failed to make a good faith effort to correct the problems or prevent their recurrence from February 13, 2008 through July 14, 2009. The plaintiff sought various forms of relief, including damages, injunctive relief, restitution, attorneys' fees, and costs and expenses. On September 11, 2009, our alleged shareholder, Paul Miele, filed a Verified Shareholder Derivative Complaint in the United States District Court, District of New Jersey, *Miele v. Carr et al.*, 3:09-cv-04687-JAP-LHG (D.N.J.) (the *Miele* Action), purportedly for the benefit of nominal defendant Heartland. On September 14, 2009, our alleged shareholder, Charles Lee, filed a virtually identical Verified Shareholder Derivative Complaint in the United States District Court, District of New Jersey, *Lee v. Carr et al.*, 3:09-cv-04729-FLW-LHG (D.N.J.) (the *Lee* Action), also purportedly for the benefit of nominal defendant Heartland. Both complaints named the members of our Board of Directors and Messrs. Carr and Baldwin as individual defendants and asserted a single claim for breach of fiduciary duty, alleging that our Board members and Messrs. Carr and Baldwin knowingly failed to establish and maintain adequate network security, concealed news about security breaches and our network security from our shareholders, and then failed to correct network security problems and/or prevent their recurrence, during the period December 30, 2007 through January 20, 2009. The plaintiffs in the *Miele* and *Lee* Actions sought various forms of relief, including damages, attorneys' fees, and costs and expenses.

On November 25, 2009, the Court consolidated the *Miele* and *Lee* Actions into *Miele et al. v. Carr et al.*, Master File No. 3:09-cv-04687-AET-LHG (D.N.J.) (the Consolidated *Miele* Action) and set a coordinated briefing schedule for the Consolidated *Miele* Action and the *Kirkham* Action.

On December 4, 2009, Plaintiffs Miele and Lee filed a Verified Consolidated Shareholder Derivative Complaint in the Consolidated *Miele* Action (the Consolidated *Miele* Complaint), and Plaintiff Kirkham filed a Verified Amended Shareholder Derivative Complaint in the *Kirkham* Action (the Amended *Kirkham* Complaint). The Consolidated *Miele* Complaint is substantively identical to the original *Miele* and *Lee*

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Complaints. The Amended *Kirkham* Complaint added a number of additional factual allegations, and added one new individual defendant (Alan Sims, Chief Technology Officer). It also expanded the period during which plaintiff alleged wrongdoing by defendants to February 2008 through the date the Amended *Kirkham* Complaint was filed, December 4, 2009. Like the original *Kirkham* complaint, it made claims for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets, alleging that our Board members and the other individual defendants caused Heartland to disseminate to our shareholders materially misleading and inaccurate information, ignored supposed inadequacies within our internal controls practices and procedures, and failed to make a good faith effort to correct the problems or prevent their recurrence. The plaintiff continued to seek various forms of relief, including damages, injunctive relief, restitution, attorneys' fees, and costs and expenses.

On January 20, 2010, we separately moved to dismiss the Consolidated *Miele* Complaint and the Amended *Kirkham* Complaint for failure to meet the pre-suit demand requirements of Rule 23.1 of the Federal Rules of Civil Procedure. On February 11, 2010, plaintiff in the *Kirkham* Action filed a stipulation for dismissal of the action with prejudice. Pursuant to that stipulation, the Court dismissed the Amended *Kirkham* Complaint with prejudice on February 12, 2010. On February 19, 2010, the Court granted a Joint Stipulation to extend the schedule for the motion to dismiss briefing in the Consolidated *Miele* Action. On March 9, 2010, the Court granted another Joint Stipulation further revising the motion schedule, under which Plaintiffs in the Consolidated *Miele* Action must file any opposition to our motion to dismiss no later than March 19, 2010 and we must file any reply to Plaintiffs' opposition no later than April 2, 2010.

In addition, a putative merchant class action has been commenced that seeks to represent all merchants against whom we assert or have asserted a claim for chargebacks or fines related to compromised credit card data since 2006. Filed on March 9, 2009 in the Circuit Court of the City of Saint Louis, Missouri, the action is captioned *S.M. Corporation, d/b/a Mike Shannon's Steak & Seafood v. Orbit POS Systems, Inc. and Heartland Payment Systems, Inc.*, Case No. 0822-CC07833. The action asserts various common-law claims, including for breach of contract, unjust enrichment, fraudulent misrepresentation, and breach of the duty of good faith and fair dealing, and seeks various forms of relief including damages, injunctive relief, and attorneys' fees. We moved to dismiss that action on June 8, 2009 and the court denied our motion on December 7, 2009. Separately, we have asserted various common-law claims, including for breach of contract, against the named merchant plaintiff in the Missouri action in an action captioned *Heartland Payment Systems, Inc v. Mike Shannon, individually, and S.M. Corporation, d/b/a Mike Shannon's Steak & Seafood*, Civ. No. L-6619-08 in New Jersey Superior Court. This action seeks to recover from the merchant certain fines and fees that were assessed by Visa and MasterCard and paid by the Company, along with attorneys' fees and costs. The Missouri and New Jersey actions were dismissed without prejudice on March 1, 2010, pursuant to a settlement between S.M. Corporation, Mike Shannon and us. The Missouri action was so dismissed, on an individual basis, prior to any motion for class certification. Also, the New Jersey action was dismissed with prejudice as against Mike Shannon individually. Under the settlement, SM Corporation will continue the Missouri action as against Orbit POS Systems, Inc. and, from any recovery, pay us up to approximately \$265,600 (the amount of the fees and fines claimed by us in the New Jersey action). Upon resolution of SM Corporation's action against Orbit POS Systems, Inc., if the amount so recovered by SM Corporation does not reach approximately \$265,600, then SM Corporation will also pay us the difference up to that amount. SM Corporation can institute litigation against us only if we reinstate the New Jersey action or sue to enforce the settlement. All claims of SM Corporation and our company against each other are tolled by agreement in the meantime, but, upon SM Corporation's payment of the approximately \$265,000 to us, then our company, SM Corporation and Mike Shannon will exchange mutual releases.

We have been advised by the SEC that it has commenced an informal inquiry and we have been advised by the United States Attorney for the District of New Jersey that it has commenced an investigation, in each case to determine whether there have been any violations of the federal securities laws in connection with our disclosure of the Processing Systems Intrusion and the alleged trading in our securities by certain of our employees, including certain executive officers. We are cooperating with these inquiries.

We have been contacted by the Federal Financial Institutions Examination Council and informed that it will be making inquiries into the Processing System Intrusion, and the Federal Trade Commission, by letter dated February 19, 2009, has requested that we provide information about our information security practices. Additionally, we have received written or telephonic inquiries relating to the Processing System Intrusion from a number of state Attorneys General's offices, including a Civil Investigative Demand from the Louisiana Department of Justice Office of the Attorney General, the Canadian Privacy Commission, and other government officials. We are cooperating with the government officials in response to each of these inquiries. Additional lawsuits may be filed against us relating to the Processing System Intrusion and that additional inquiries from governmental agencies may be received or investigations may be commenced.

Although we intend to defend the lawsuits, investigations and inquiries described above vigorously, we cannot predict the outcome of such lawsuits, investigations and inquiries. Apart from damages claimed in such lawsuits and in other lawsuits relating to the Processing System Intrusion that may be filed, we may be subject to fines or other obligations as a result of the government inquiries and investigations described above and additional governmental inquiries or investigations relating to the Processing System Intrusion that may be commenced. The card brands with whom we have not reached a settlement (the Non-Settling Card Brands) have also asserted claims seeking to impose fines, penalties, and other

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assessments against us or our sponsor banks (who would seek indemnification from us pursuant to our agreements with them) based upon the Processing System Intrusion. By these claims, the Non-Settling Card Brands seek to recover from us, or from our sponsor banks (who would in turn seek to recover from us) assessments in respect of fraud losses and operating expenses (including card reissuance costs and non-ordinary-course account monitoring expenses) that such card brands believe either themselves or their issuers to have incurred by reason of the Processing System Intrusion, as well as fines and/or penalties by reason of our alleged failure to comply with such card brands' operating regulations. The amounts we are required to pay to defend against and/or resolve the claims by the Non-Settling Card Brands described above could have a material adverse effect on our results of operations and financial condition.

For the year ended December 31, 2009, we expensed a total of \$128.9 million, or about \$2.16 per share, associated with the Processing System Intrusion. Approximately \$17.6 million of these charges were for legal fees and costs we incurred for investigations, defending various claims and actions, remedial actions and crisis management services. The majority of these charges, or approximately \$111.3 million, related to:

- (i) assessments imposed in April 2009 by MasterCard and Visa against our sponsor banks, which assessments were in turn withheld from us by our sponsor banks,
- (ii) settlement agreements and settlements reached with American Express (settled in December 2009) and Visa (agreement entered into on January 7, 2010). The settlement pursuant to the Visa agreement was consummated on February 18, 2010.
- (iii) settlement offers we made to certain claimants in an attempt to resolve certain of the claims asserted against us or our sponsor banks (who have asserted rights to indemnification from us pursuant to our agreements with them), and
- (iv) settlements deemed likely to be agreed upon in the near term with certain claimants, such as the cardholder class action.

Notwithstanding our belief that we have strong defenses against the claims that are the subject of the settlement offers and discussions described in (iii) and (iv) above, we decided to make the settlement offers and engage in settlement discussions in attempts to avoid the costs and uncertainty of litigation. We are prepared to vigorously defend ourselves against all the claims relating to the Processing System Intrusion that have been asserted against us and our sponsor banks to date.

The accrual of the settlements and settlement offers during the year ended December 31, 2009 resulted in our recognizing a \$99.9 million Reserve for Processing System Intrusion at December 31, 2009. To date, we have not reached a definitive agreement with respect to settlement offers and discussions noted in (iii) and (iv) above. Therefore, it should not be assumed that we will resolve the claims that are the subject of those settlement offers or the subject of settlement discussions for the amounts of the settlement offers or the settlement amounts deemed likely to be agreed upon. We understand that the reserve related to the settlement offers is required based solely on the fact we tendered offers of settlement in the amounts we have accrued. It is possible we will end up resolving the claims that are the subject of the settlement offers, either through settlements or pursuant to litigation, for amounts that are greater than the amount we have reserved to date. Moreover, even if the claims that are the subject of the settlement offers were resolved for the amount we have reserved, that would still leave unresolved a portion of the claims that have been asserted against us or our sponsor banks relating to the Processing System Intrusion. We feel we have strong defenses to all the claims that have been asserted against us and our sponsor banks relating to the Processing System Intrusion, including those claims that are not the subject of the settlement offers.

On December 17, 2009, we entered into a settlement agreement and release with American Express to resolve potential claims and other disputes among us and American Express (and its issuers) with respect to the Processing System Intrusion. We paid American Express approximately \$3.5 million in full and final satisfaction of any and all claims of American Express and its issuers arising from or relating to the Processing System Intrusion. Such settlement agreement and release contains mutual releases by and between us and American Express (on behalf of itself and its issuers) relating to the Processing System Intrusion.

On January 7, 2010, we, Heartland Bank, KeyBank National Association (KeyBank, and, together with Heartland Bank, the Sponsor Banks), and Visa U.S.A. Inc., Visa International Service Association and Visa Inc. (collectively, Visa) entered into a settlement agreement (the Settlement Agreement) to resolve potential claims and other disputes among us, the Sponsor Banks and Visa with respect to the potential rights and claims of Visa and certain issuers of Visa-branded credit and debit cards related to the Processing System Intrusion. After credit for fines previously collected by Visa during 2009, the maximum settlement amount under the Settlement Agreement would not exceed \$59.2 million. We had included costs of this settlement in our Provision for Processing System Intrusion on our Consolidated Statement of Operations for the

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year ended December 31, 2009 and in our Reserve for Processing System Intrusion on the Consolidated Balance Sheet as of December 31, 2009.

A condition of the Settlement Agreement was that we obtain a loan of at least \$53.0 million from the Sponsor Banks, the proceeds of which to be used to partially fund the settlement amount.

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On February 18, 2010, we entered into a bridge loan agreement (the *Bridge Loan Agreement*) with KeyBank, as administrative agent, and KeyBank and Heartland Bank as bridge lenders. On that date, KeyBank made a bridge loan to us in the amount of \$20.0 million and Heartland Bank made a bridge loan in the amount of \$8.0 million (collectively, the *Bridge Loan*), which are the maximum amounts that we may borrow under the *Bridge Loan Agreement*. We must repay the *Bridge Loan* by February 17, 2011.

On February 18, 2010, we also entered into an amendment (the *Amendment*) to our Amended and Restated Credit Agreement dated as of May 30, 2008, with the lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent, swingline lender and issuing bank. The *Amendment* provided for, among other things, a release of the lender's lien on our Jeffersonville, IN Service Center and certain other assets relating to the ownership and occupancy of the Service Center.

On February 18, 2010, we also entered into a Commitment Increase Agreement pursuant to the Amended and Restated Credit Agreement (the *Commitment Increase Agreement*) whereby KeyBank as one of the lenders under the Amended and Restated Credit Agreement agreed to increase its revolving credit commitment to us under the Amended and Restated Credit Agreement by \$25.0 million (the *Increased Credit Commitment*). The terms of the *Increased Credit Commitment* are similar to the terms of the *Revolving Credit Facility*.

We used the proceeds of the *Bridge Loan* and the *Increased Credit Commitment*, along with some of our cash, to fund the Settlement with Visa. The Settlement Agreement was consummated on February 18, 2010.

While we have determined that the Processing System Intrusion has triggered other loss contingencies, to date, an unfavorable outcome is not believed by us to be probable on those claims that are pending or have been threatened against us, or that we consider to be probable of assertion against us, and we do not have sufficient information to reasonably estimate the loss we would incur in the event of an unfavorable outcome on any such claim. Therefore, no reserve/liability has been recorded as of December 31, 2009 with respect to any such claim, except for the assessments actually imposed by MasterCard and Visa, the amounts of the settlement offers we made and the expected costs of settling with certain claimants as discussed above. As more information becomes available, if we should determine that an unfavorable outcome is probable on such a claim and that the amount of such probable loss that we will incur on that claim is reasonably estimable, we will record a reserve for the claim in question. If and when, we record such a reserve, it could be material and could adversely impact our results of operations, financial condition and cash flow.

Additional costs we expect to incur for investigations, remedial actions, legal fees, and crisis management services related to the Processing System Intrusion will be recognized as incurred. Such costs are expected to be material and could adversely impact our results of operations, financial condition and cash flow.

As previously disclosed, we were advised by Visa that, based on Visa's investigation of the Processing System Intrusion Visa believes we are in violation of the Visa Operating Regulations and that, based on that belief, Visa removed us from Visa's published Global List of PCI DSS Validated Service Providers. We were similarly advised by MasterCard that, based on MasterCard's investigation of the Processing System Intrusion MasterCard believed we were in violation of the MasterCard Standards and that, based on that belief, MasterCard removed us from MasterCard's published list of Compliant Service Providers. On April 30, 2009, following the completion of our annual PCI DSS assessment, we successfully validated our compliance with PCI DSS. As such, we were returned to MasterCard's list of Compliant Service Providers and Visa's List of PCI DSS Validated Service Providers.

Although we have insurance that we believe may cover some of the costs and losses that we may incur in connection with the above-described pending and potential lawsuits, inquiries, investigations and claims, we cannot now confirm that such coverage will, in fact, be provided or the extent of such coverage, if it is provided.

Other Legal Proceedings

On December 16, 2008, a putative class action was filed against us in the Superior Court of California, County of San Diego, *Ryan McInerney, Hossein Vazir Zand v. Heartland Payment Systems, Inc.* The plaintiffs

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purport to represent a putative class of individuals who allegedly were not reimbursed by us for business expenses and whose compensation was allegedly reduced for their costs of doing business. The plaintiffs seek unspecified monetary damages, penalties, injunctive and declaratory relief, and attorneys' fees and costs.

On September 9, 2009, VeriFone Israel Ltd. filed a lawsuit in the Northern District of California alleging patent infringement of U.S. Patent No. 6,853,093 by our prototype NP3000 payment terminals. VeriFone Israel seeks injunctive relief against the alleged infringement and damages, including enhanced damages for willfulness and reasonable attorneys' fees. On October 13, 2009, VeriFone Israel Ltd. amended its complaint to add an additional plaintiff, VeriFone Holdings, Inc., and seeking declaratory judgment that VeriFone Holdings was not involved in certain unfair business activity including tortious interference with contract and prospective economic advantage, tortious refusal to deal, breach of contract, breach of implied duty of good faith and fair dealing, unfair competition and defamation. These declaratory judgment counts regarding VeriFone's unfair business activities correspond to affirmative claims we brought against VeriFone Holdings in New Jersey State Court, previously. VeriFone voluntarily dismissed these claims on February 15, 2010. We filed a declaratory judgment action in the Northern District of California on February 16, 2010 seeking a judgment that we do not infringe U.S. Patent No. 6,853,093 and that the patent is not valid.

On November 6, 2009, we filed a separate lawsuit against VeriFone Holdings, Inc. in United States District Court, District of New Jersey