MICHAELS STORES INC
Form PRER14A
September 01, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
SCHEDULE 14A
Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934

Filed by the Registrant þ
Filed by a Party other than the Registrant ¨
Check the appropriate box:

þ Preliminary Proxy Statement
¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
¨ Definitive Proxy Statement
¨ Definitive Additional Materials
¨ Soliciting Material Pursuant to §240.14a-12

MICHAELS STORES, INC.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

o No fee required.
o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:
Common Stock, par value $0.10 per share, of Michaels Stores, Inc. (Common Stock)

(2) Aggregate number of securities to which transaction applies:
132,830,320 shares of Common Stock, including restricted shares
10,212,618 options to purchase shares of Common Stock with an exercise price less than $44.00

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):
The filing fee was determined based upon the sum of (A) 132,830,320 shares of Common Stock, including restricted shares, multiplied by $44.00 per share and (B) 10,212,618 options to purchase shares of Common Stock with an exercise price less than $44.00, multiplied by $17.64 per share (which is the difference between $44.00 and the weighted average exercise price per share). In accordance with Section 14(g)(1)(A) of the Securities Exchange Act of 1934, as amended, the filing fee was determined by multiplying $0.000107 by the sum of the preceding sentence.

(4) Proposed maximum aggregate value of transaction:
$6,024,684,662

(5) Total fee paid:
$644,641

þ Fee paid previously with preliminary materials.

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

Table of Contents

PRELIMINARY PROXY STATEMENT, SUBJECT TO COMPLETION

8000 Bent Branch Drive, Irving, Texas 75063

[ ], 2006

Dear Stockholder:

The board of directors of Michaels Stores, Inc. (Michaels, we, us or our) has unanimously approved a merger agreement providing for the merger of Michaels with affiliates of Bain Capital Partners, LLC and The Blackstone Group, which are private equity firms. If the merger is completed, you will receive $44.00 in cash, without interest, for each share of our common stock that you own, and Michaels will become wholly owned by entities sponsored by or co-investors with Bain Capital Partners, LLC and The Blackstone Group.

You will be asked, at a special meeting of the Michaels stockholders, to consider and vote on a proposal to adopt the merger agreement. After careful consideration, our board of directors approved the merger agreement, the merger and the other transactions contemplated by the merger agreement and unanimously declared that the merger agreement, the merger and the other transactions contemplated by the merger agreement are advisable and in the best interests of our stockholders. **THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE FOR THE ADOPTION OF THE MERGER AGREEMENT.**

The time, date and place of the special meeting to consider and vote upon the adoption of the merger agreement are as follows:

9:30 a.m., central daylight time, on October 5, 2006
8000 Bent Branch Drive, Irving, Texas 75063

The proxy statement attached to this letter provides you with information about the merger and the special meeting. A copy of the merger agreement is attached as Annex A to this proxy statement. A copy of the first amendment to the merger agreement is attached as Annex B to this proxy statement. We encourage you to read the entire proxy statement carefully. You may also obtain additional information on us from documents we have filed with the Securities and Exchange Commission.

Your vote is very important, regardless of the number of shares of our common stock you own. The merger cannot be completed unless holders of a majority of the outstanding shares of our common stock entitled to vote at the special meeting of stockholders vote for the adoption of the merger agreement. If you do not vote, it will have the same effect as a vote against the adoption of the merger agreement.

Whether or not you plan to attend the special meeting in person, please complete, sign, date and return promptly the enclosed proxy card. If you hold shares through a broker or other nominee, you should follow the procedures provided by your broker or nominee. These actions will not limit your right to vote in person if you wish to attend the special meeting and vote in person.

Thank you in advance for your cooperation and continued support.

On behalf of your Board of Directors,

Charles J. Wyly, Jr.
Chairman of the Board

THIS PROXY STATEMENT IS DATED [ ], 2006 AND IS FIRST BEING MAILED TO STOCKHOLDERS ON OR ABOUT [ ], 2006.

Table of Contents

8000 Bent Branch Drive, Irving, Texas 75063

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS
TO BE HELD ON OCTOBER 5, 2006

TO THE STOCKHOLDERS OF MICHAELS STORES, INC.:

A special meeting of stockholders of Michaels Stores, Inc., a Delaware corporation (Michaels, we, us or our), w be held at 8000 Bent Branch Drive, Irving, Texas 75063, on October 5, 2006, beginning at 9:30 a.m., central daylight time, for the following purposes:

1. **Adoption of the Merger Agreement.** To consider and vote on a proposal to adopt the Agreement and Plan of Merger, dated as of June 30, 2006, as amended, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc., pursuant to which, upon the merger becoming effective, each outstanding share of Michaels common stock, par value $0.10 per share (other than shares held in our treasury or owned by Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC or Blackstone Paste Finco, LLC, shares held by stockholders who properly demand statutory appraisal rights and rollover shares) will be converted into the right to receive $44.00 in cash, without interest.

2. **Adjournment or Postponement of the Special Meeting.** To approve the adjournment or postponement of the special meeting, if necessary or appropriate, to solicit additional proxies if there are insufficient votes at the time of the meeting to adopt the merger agreement.

3. **Other Matters.** To transact such other business as may properly come before the special meeting or any adjournment thereof.

Only stockholders of record of our common stock as of the close of business on September 1, 2006, will be entitled to notice of, and to vote at, the special meeting and any adjournment or postponement of the special meeting. All stockholders of record are cordially invited to attend the special meeting in person.

Your vote is very important, regardless of the number of shares of our common stock you own. The adoption of the merger agreement requires the affirmative vote of the holders of a majority of the outstanding shares of our common stock on the record date for the special meeting. Even if you plan to attend the meeting in person, we request that you complete, sign, date and return the enclosed proxy in the envelope provided and thus ensure that your shares will be represented at the meeting if you are unable to attend. If you sign, date and mail your proxy card without indicating how you wish to vote, your vote will be counted as a vote **FOR** the adoption of the merger agreement.

If you fail to vote by proxy or in person, the effect will be that your shares will not be counted for purposes of determining whether a quorum is present at the special meeting and, if a quorum is present, will have the same effect as a vote against the adoption of the merger agreement. If you are a stockholder of record and wish to vote in person at the special meeting, you may withdraw your proxy and vote in person.

Stockholders of Michaels who do not vote in favor of the adoption of the merger agreement will have the right to seek appraisal of the fair value of their shares if the merger is completed, but only if they submit a written demand for appraisal to Michaels before the vote is taken on the merger agreement and comply with all requirements of Delaware law, which are summarized in the accompanying proxy statement under the caption *Appraisal Rights* beginning on page 63.

By order of the board of directors,

Mark V. Beasley
Secretary

[ ], 2006

TABLE OF CONTENTS

SUMMARY	1
QUESTIONS AND ANSWERS ABOUT THE SPECIAL MEETING AND THE MERGER	10
CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS	13
THE PARTIES TO THE MERGER AGREEMENT	14
THE SPECIAL MEETING	15
Time, Place and Purpose of the Special Meeting	15
Record Date and Quorum	15
Required Vote	15
Proxies; Revocation	15
Adjournments and Postponements	16
Solicitation of Proxies	16
THE MERGER	17
Background of the Merger	17
Reasons for the Merger	20
Recommendation of Our Board of Directors	22
Opinion of JPMorgan	22
Opinion of Goldman Sachs	28
Financing	35
Interests of Our Directors and Executive Officers in the Merger	36
Appraisal Rights	42
Delisting and Deregistration of Our Common Stock	42
Material United States Federal Income Tax Consequences of the Merger	42
Regulatory Approvals	44
Litigation Concerning the Merger	
THE MERGER AGREEMENT	45
Effective Time; The Marketing Period	45
Structure	46
Treatment of Stock and Options	47
Exchange and Payment Procedures	47
Representations and Warranties	48
Conduct of Our Business Pending the Merger	50
Stockholders Meeting	53
No Solicitation of Transactions	53
Employee Benefits	55
Agreement to Use Reasonable Best Efforts	56
Financing Commitments; Cooperation of Michaels	56
Conditions to the Merger	58
Termination	59
Fees and Expenses	60
Amendment and Waiver	62
Specific Performance	62
APPRAISAL RIGHTS	63
MARKET PRICE OF OUR STOCK	65
SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT	66
MULTIPLE STOCKHOLDERS SHARING ONE ADDRESS	68
SUBMISSION OF STOCKHOLDER PROPOSALS	68
WHERE YOU CAN FIND MORE INFORMATION	69

ANNEX A	Agreement and Plan of Merger, dated as of June 30, 2006, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc.
ANNEX B	First Amendment to Agreement and Plan of Merger, dated as of September 1, 2006, among Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC, Blackstone Paste Finco, LLC and Michaels Stores, Inc.
ANNEX C	Opinion of J.P. Morgan Securities Inc.
ANNEX D	Opinion of Goldman, Sachs & Co.
ANNEX E	Section 262 of the General Corporation Law of the State of Delaware

Table of Contents

SUMMARY

This summary highlights selected information from this proxy statement and may not contain all of the information that is important to you. To understand the merger fully, and for a more complete description of the legal terms of the merger, you should carefully read this entire proxy statement, the annexes attached to this proxy statement and the documents referred to or incorporated by reference in this proxy statement. We have included page references in parentheses to direct you to the appropriate place in this proxy statement for a more complete description of the topics presented in this summary. In this proxy statement, the terms Michaels, we, us and our refer to Michaels Stores, Inc

The Parties to the Merger Agreement (page 14)

Michaels Stores, Inc.
8000 Bent Branch Drive
Irving, TX 75063
(972) 409-1300

Michaels, a Delaware corporation, is the largest arts and crafts specialty retailer in the United States. As of July 21, 2006, we operate 902 Michaels retail stores in 48 states and Canada and 165 Aaron Brothers stores in 11 states, offering framing supplies and services and a wide selection of art supplies. Recollections, our scrapbooking/paper crafting retail concept, operates 11 stores located in Arizona, Maryland, Texas, and Virginia as of July 21, 2006. In addition, we own and operate four Star Decorators Wholesale stores located in Arizona, California, Georgia, and Texas as of July 21, 2006, offering merchandise primarily to interior decorators/designers, wedding/event planners, florists, hotels, restaurants and commercial display companies.

Bain Paste Mergerco, Inc.
Bain Paste Finco, LLC
c/o Bain Capital Partners, LLC
111 Huntington Avenue
Boston, MA 02199
(617) 516-2000

Bain Paste Mergerco, Inc. is a Delaware corporation formed by a private equity fund sponsored by Bain Capital Partners, LLC (Bain) in anticipation of the merger. Subject to the terms and conditions of the merger agreement and in accordance with Delaware law, at the effective time of the merger, Bain Paste Mergerco, Inc. will merge with and into Michaels Stores, Inc. Bain Paste Mergerco, Inc. has de minimis assets and no operations. Bain Paste Finco, LLC is a Delaware limited liability company formed by a private equity fund sponsored by Bain in anticipation of the merger. Bain is part of Bain Capital, LLC, a global private investment firm that manages several pools of capital including private equity, venture capital, public equity, and leveraged debt assets with more than $38 billion in assets under management. Since its inception in 1984, Bain has made private equity investments and add-on acquisitions in over 230 companies around the world, including such leading retailers and consumer companies as Toys R Us, Burger King, Staples, Burlington Coat Factory, Shopper s Drug Mart, Brookstone, Domino s Pizza, Dollarama, Sealy Corp., Sports Authority and Duane Reade. Headquartered in Boston, Bain has offices in New York, London, Munich, Hong Kong, Shanghai and Tokyo.

Blackstone Paste Mergerco, Inc.
Blackstone Paste Finco, LLC
c/o The Blackstone Group
345 Park Avenue, 31st Floor
New York, NY 10154
(212) 583-5000

Blackstone Paste Mergerco, Inc. is a Delaware corporation formed by a private equity fund sponsored by The Blackstone Group (Blackstone) in anticipation of the merger. Subject to the terms and conditions of the

merger agreement and in accordance with Delaware law, at the effective time of the merger, Blackstone Paste Mergerco, Inc. will merge with and into Michaels Stores, Inc. Blackstone Paste Mergerco, Inc. has de minimis assets and no operations. Blackstone Paste Finco, LLC is a Delaware limited liability company formed by a private equity fund sponsored by Blackstone in anticipation of the merger. Blackstone, a global private investment and advisory firm, was founded in 1985. The firm has raised a total of more then $63 billion for alternative asset investing since its formation, of which approximately $30 billion has been for private equity investing. Blackstone s private equity group is currently investing its fifth general private equity fund with commitments of $15.6 billion, and has over 60 experienced professionals with broad sector expertise. Blackstone s other core businesses include private real estate investing, corporate debt investing, hedge funds, mutual fund management, private placement, marketable alternative asset management and investment banking advisory services.

The Special Meeting

Time, Place and Date (page 15)

The special meeting will be held on October 5, 2006, beginning at 9:30 a.m., central daylight time, at 8000 Bent Branch Drive, Irving, Texas 75063.

Purpose (page 15)

You will be asked to consider and vote on a proposal to adopt an Agreement and Plan of Merger, dated as of June 30, 2006 (as amended, the merger agreement), among Bain Paste Mergerco, Inc. (Bain Mergerco), Blackstone Paste Mergerco, Inc. (Blackstone Mergerco and, together with Bain Mergerco, the Mergercos), Bain Paste Finco, LLC (Bain Finco), Blackstone Paste Finco, LLC (Blackstone Finco and, together with Bain Finco, the Fincos ; the Mergercos and Fincos, collectively, the Sponsor Entities) and Michaels. The merger agreement provides that the Mergercos will be merged with and into Michaels (the merger), with Michaels being the surviving corporation in the merger (the surviving corporation). Each outstanding share of Michaels common stock (other than shares held in our treasury or owned by any of the Sponsor Entities, shares held by stockholders who properly demand statutory appraisal rights and rollover shares) will be converted into the right to receive $44.00 in cash, without interest.

The persons named in the accompanying proxy card will also have discretionary authority to vote upon other business, if any, that properly comes before the special meeting and any adjournments or postponements of the special meeting.

Record Date and Quorum (page 15)

You are entitled to vote at the special meeting if you owned shares of our common stock at the close of business on September 1, 2006, the record date for the special meeting. You will have one vote for each share of Michaels common stock that you owned on the record date. As of the record date, there were [ ] shares of our common stock entitled to be voted.

The holders of a majority of the outstanding shares of our common stock at the close of business on the record date represented in person or by proxy will constitute a quorum for purposes of the special meeting.

Required Vote (page 15)

Completion of the merger requires the adoption of the merger agreement by the affirmative vote of the holders of a majority of the outstanding shares of our common stock at the close of business on the record date for the special meeting. A failure to vote your shares of our common stock or an abstention will have the same effect as voting against the merger.

Share Ownership of Directors and Executive Officers (page 66)

As of the record date for the special meeting, the directors and executive officers of Michaels beneficially owned, in the aggregate, [ ] shares of our common stock, or approximately [ ]% of the outstanding shares of our common stock. The directors and executive officers have informed us that they intend to vote all of their shares of Michaels common stock **FOR** the adoption of the merger agreement and **FOR** any adjournment or postponement of the special meeting, if necessary or appropriate, to solicit additional proxies.

Voting and Proxies (page 15)

Any Michaels stockholder of record entitled to vote may submit a proxy by returning a signed proxy card by mail, or may vote in person by appearing at the special meeting. If your shares are held in street name by your broker, you should instruct your broker on how to vote your shares using the instructions provided by your broker. If you do not provide your broker with instructions, your shares will not be voted and that will have the same effect as voting against the merger.

Revocability of Proxy (page 15)

Any Michaels stockholder of record who executes and returns a proxy card may revoke the proxy at any time before it is voted in any one of the following ways:

- filing with Computershare Investor Services, L.L.C., 3020 Legacy Drive, Suite 100-307, Plano, Texas 75023, at or before the special meeting, a written notice of revocation that is dated a later date than the proxy;
- sending a later-dated proxy card relating to the same shares to Computershare Investor Services, L.L.C., at or before the special meeting; or
- attending the special meeting and voting in person.

Simply attending the special meeting will not constitute revocation of a proxy. If you have instructed your broker to vote your shares, the above-described options for revoking your proxy do not apply and instead you must follow the directions provided by your broker to change your vote.

When the Merger Will be Completed (page 45)

We are working to complete the merger as soon as possible. We anticipate completing the merger by the end of 2006, subject to adoption of the merger agreement by our stockholders and the satisfaction of the other closing conditions. In addition, the Mergercos are not obligated to complete the merger until the expiration of a 30 consecutive calendar day marketing period throughout which the Fincos shall have the financial information that we are required to provide pursuant to the merger agreement to complete the debt financing of the merger. So long as we have provided all required financial information to the Fincos for purposes of them completing their debt financing, the marketing period will begin to run on the later of (i) the adoption of the merger agreement by our stockholders and (ii) September 4, 2006.

Effects of the Merger (page 46)

If the merger agreement is adopted by our stockholders and the other conditions to closing are satisfied, the Mergercos will merge with and into Michaels. The separate corporate existences of the Mergercos will cease, and Michaels will continue as the surviving corporation, wholly owned by entities sponsored by or co-investors with Bain and Blackstone. Upon completion of the merger, our common stock will be converted into the right to receive $44.00 per share, without interest and less any required withholding taxes. The surviving corporation will be a

privately held corporation, and you will cease to have any ownership interest in the surviving corporation or any rights as its stockholder.

Recommendation of Our Board of Directors (page 22)

After careful consideration, our board of directors unanimously approved the merger agreement, the merger and the other transactions contemplated by the merger agreement and unanimously declared that the merger agreement, the merger and the other transactions contemplated by the merger agreement are advisable and in the best interests of our stockholders. **ACCORDINGLY, OUR BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR THE ADOPTION OF THE MERGER AGREEMENT.**

In reaching its decision, our board of directors evaluated a variety of business, financial and market factors and consulted with our management team and legal and financial advisors. In considering the recommendation of our board of directors with respect to the merger, you should be aware that certain of our directors and executive officers have interests in the merger that differ from, or are in addition to, your interests as a stockholder. See *The Merger Interests of Our Directors and Executive Officers in the Merger* beginning on page 36.

For the factors considered by our board of directors in reaching its decision to approve the merger agreement and the merger, see *The Merger Reasons for the Merger* beginning on page 20.

Opinion of JPMorgan (page 22 and Annex C)

J.P. Morgan Securities Inc. (JPMorgan) delivered its opinion to our board of directors that, as of the date of its opinion and based upon and subject to the factors and assumptions set forth in its opinion, the merger consideration of $44.00 in cash per share to be received by our stockholders in the merger was fair, from a financial point of view, to such stockholders.

The full text of the written opinion of JPMorgan, dated June 30, 2006, which sets forth the assumptions made, matters considered and limitations on the review undertaken in connection with the opinion, is attached as Annex C to this proxy statement. Our stockholders are urged to read the opinion carefully in its entirety. JPMorgan s written opinion is addressed to our board of directors, and is directed only to the consideration to be received in the merger and does not constitute a recommendation to any of our stockholders as to how such stockholder should vote at the special meeting. Pursuant to an engagement letter between our board of directors and JPMorgan, we have agreed to pay JPMorgan a transaction fee of 0.40% of the aggregate consideration to be paid in the transaction, or approximately $24 million, all of which is payable upon consummation of the transaction.

Opinion of Goldman Sachs (page 28 and Annex D)

Goldman, Sachs & Co. (Goldman Sachs) delivered its opinion to the special advisory committee of our board of directors and our board of directors that, as of the date of its opinion and based upon and subject to the factors and assumptions set forth in its opinion, the merger consideration of $44.00 in cash per share to be received by our stockholders in the merger was fair, from a financial point of view, to such stockholders.

The full text of the written opinion of Goldman Sachs, dated June 30, 2006, which sets forth the assumptions made, procedures followed, matters considered and limitations on the review undertaken in connection with the opinion, is attached as Annex D to this proxy statement. Goldman Sachs provided its opinion for the information and assistance of the special advisory committee of our board of directors and our board of directors in connection with their consideration of the transaction. Goldman Sachs opinion is not a recommendation as to how any holder of our common stock should vote at the special meeting. Pursuant to an engagement letter between the special advisory committee of our board of directors and Goldman Sachs, we have agreed to pay Goldman Sachs a transaction fee of 0.15% of the aggregate consideration paid in the transaction, or approximately $9.0 million, with one-third of the transaction fee payable upon signing of the merger agreement, one-third of the transaction fee payable upon the stockholder vote for the transaction and the remainder of the transaction fee payable upon consummation of the transaction.

Financing (page 35)

The Sponsor Entities estimate the total amount of funds necessary to complete the merger and the related transactions to be approximately $6.164 billion, which includes approximately $5.920 billion to be paid out to our stockholders and holders of other equity-based interests in Michaels, with the remainder to be applied to pay related fees and expenses in connection with the merger, the financing arrangements and the related transactions. These payments are expected to be funded by a combination of equity contributions by entities sponsored by or co-investors with Bain and Blackstone and debt financing, as well as our available cash.

In connection with the execution and delivery of the merger agreement, Bain Finco, Blackstone Finco, Bain Capital Fund IX, LLC and Blackstone Capital Partners V L.P. have obtained commitments to provide up to $4.8 billion in debt financing, consisting of (1) a senior secured asset-based revolving facility with a maximum availability of $1.0 billion, (2) a senior secured term loan facility in an aggregate principal amount of $2.4 billion, (3) a senior unsecured bridge loan facility in an aggregate principal amount of up to $700 million and (4) a senior subordinated unsecured bridge loan facility in an aggregate principal amount of up to $700 million, to finance, in part, the payment of the merger consideration, the repayment or refinancing of certain of our debt outstanding on the closing date of the merger and to pay fees and expenses in connection with the merger, financing and related transactions and, in the case of the asset-based revolving facility, for general corporate purposes after the closing date of the merger. The Sponsor Entities have agreed to use their reasonable best efforts to arrange the debt financing on the terms and conditions described in the commitments. In addition, the Mergercos have obtained an aggregate of $2.18 billion in equity commitments from Bain Capital Fund IX, LLC and Blackstone Capital Partners V L.P. and their respective affiliates. The facilities and notes contemplated by the debt financing commitments are subject to various conditions, as described in further detail under *The Merger Financing Debt Financing* beginning on page 35.

The closing of the merger is not conditioned on the receipt of the debt financing by the Fincos. The Mergercos, however, are not required to consummate the merger until after the completion of the marketing period, as described above under *When the Merger Will be Completed* and in further detail under *The Merger Agreement Effective Time; The Marketing Period* beginning on page 45.

Treatment of Stock Options and Restricted Stock (page 36)

Each outstanding option to purchase shares of our common stock (other than rollover options), whether or not then exercisable, will be canceled and converted into the right to receive a cash payment equal to the excess (if any) of the $44.00 per share cash merger consideration over the exercise price per share of the option, multiplied by the number of shares subject to the option, without interest and less any applicable withholding taxes, and all outstanding shares of restricted stock (other than rollover shares) will be converted into the right to receive $44.00 per share in cash, without interest and less any applicable withholding taxes.

Interests of Our Directors and Executive Officers in the Merger (page 36)

Our directors and executive officers may have interests in the merger that are different from, or in addition to, yours, including the following:

- our directors and executive officers will receive cash consideration for their vested and unvested stock options in connection with the merger;

- each of our current executive officers (other than those executive officers who are also members of our board of directors) is a party to a change in control severance agreement with us that provides for (1) continued employment in an equivalent position for two years following completion of the merger, unless earlier terminated, (2) base compensation, cash bonus awards, long-term incentive opportunities and retirement, welfare and fringe benefits at levels at least equal to the compensation and benefits received by the executive immediately prior to completion of the merger for two years following completion of the merger (unless earlier terminated), (3) comprehensive officer liability insurance coverage and continued indemnification rights, (4) severance benefits (including cash severance payments and continued welfare and fringe benefits or cash in lieu thereof) if the executive s employment with us is

terminated in anticipation of the completion of the merger or if, during the two-year period after completion of the merger, the executive is terminated without cause or resigns for good reason, (5) gross-ups in respect of certain golden parachute excise taxes payable by the executive and certain other taxes, interest and penalties that may be imposed on nonqualified deferred compensation and (6) reimbursement of certain legal fees and related expenses;

each of our current executive officers (other than those executive officers who are also members of our board of directors) is eligible to receive a change in control retention bonus equal to $125,000 if he is still employed on the first anniversary of the completion of the merger or he is terminated without cause prior to such date;

each of our current executive officers (other than those executive officers who are also members of our board of directors) will be entitled to a guaranteed payout under our Fiscal Year 2006 Bonus Plan at one level below target and will be eligible to receive an additional bonus payment of up to 75% of each individual s target annual bonus, provided that he is still employed on the date that bonuses are paid;

within 30 days following the completion of the merger, we will terminate our nonqualified deferred compensation plan and will cause all accounts thereunder to be paid out to participants in cash;

the merger agreement provides that, during the two-year period following completion of the merger, the surviving corporation will maintain certain benefit plans and will continue to provide certain compensation and benefits;

the merger agreement provides for indemnification and liability insurance arrangements for each of our current and former directors and officers; and

while no agreements, arrangements or understandings have been entered into as of the date of this proxy statement, members of our management may enter into employment agreements with the surviving corporation and may participate in the equity of the surviving corporation, as described more fully under *Merger Agreement Arrangements with the Sponsor Entities* beginning on page 42.

Our board of directors was aware of these interests and considered them, among other matters, in making its decisions.

Material United States Federal Income Tax Consequences of the Merger (page 42)

For U.S. federal income tax purposes, the merger will be treated as a sale of the shares of our common stock for cash by each of our stockholders. As a result, in general, each stockholder will recognize gain or loss equal to the difference, if any, between the amount of cash received in the merger and such stockholder s adjusted tax basis in the shares surrendered. Such gain or loss will be capital gain or loss if the shares of common stock surrendered are held as a capital asset in the hands of the stockholder, and will be long-term capital gain or loss if the shares of common stock have a holding period of more than one year at the time of the merger. **Stockholders are urged to consult their own tax advisors as to the particular tax consequences to them of the merger.**

Regulatory Approvals (page 44)

The Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the Hart-Scott-Rodino Act), provides that transactions such as the merger may not be completed until certain information has been submitted to the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice and certain waiting period requirements have been satisfied. Michaels and an entity to be formed to invest in the Mergercos filed notification reports with the Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Act on August 28, 2006 and August 24, 2006, respectively.

Except as noted above with respect to the required filings under the Hart-Scott-Rodino Act and the filing of a certificate of merger in Delaware at or before the effective date of the merger, we are unaware of any material

federal, state or foreign regulatory requirements or approvals required for the execution of the merger agreement or completion of the merger.

Procedure for Receiving Merger Consideration (page 47)

Within two business days after the effective time of the merger, a paying agent will mail a letter of transmittal and instructions to you and the other Michaels stockholders. The letter of transmittal and instructions will tell you how to surrender your stock certificates in exchange for the merger consideration. **You should not return your stock certificates with the enclosed proxy card, and you should not forward your stock certificates to the paying agent without a letter of transmittal.**

No Solicitation of Transactions (page 53)

The merger agreement restricts our ability to solicit or engage in discussions or negotiations with a third party regarding specified transactions involving Michaels. Notwithstanding these restrictions, under certain limited circumstances required for our board of directors to comply with its fiduciary duties, our board of directors may respond to a bona fide written proposal for an alternative acquisition or terminate the merger agreement and enter into an agreement with respect to a superior proposal after paying the termination fee specified in the merger agreement.

Conditions to Closing (page 58)

Before we can complete the merger, a number of conditions must be satisfied. These include:

- the adoption of the merger agreement by our stockholders;
- the expiration or termination of the waiting period under the Hart-Scott-Rodino Act;
- the absence of governmental judgments or orders that have the effect of enjoining or otherwise prohibiting the consummation of the merger;
- performance by each of the parties of its material obligations under the merger agreement in all material respects;
- the accuracy of the representations and warranties of each of the parties to the merger agreement, except to the extent the failure of such representations and warranties to be true and correct would not constitute a material adverse effect; and
- the delivery of closing certificates by each of the parties with respect to the satisfaction of the conditions relating to its representations and warranties and material obligations.

Other than the conditions pertaining to the stockholder approval, the absence of governmental orders and the expiration or termination of the Hart-Scott-Rodino Act waiting period, either Michaels, on the one hand, or the Mergercos (on behalf of themselves and the Fincos), on the other hand, may elect to waive conditions to their respective performance and complete the merger.

Termination of the Merger Agreement (page 59)

The merger agreement may be terminated at any time prior to the effective time of the merger, whether before or after stockholder approval has been obtained, as follows:

- by mutual written consent of the Mergercos and Michaels;
- by either the Mergercos or Michaels, if:
  - our stockholders do not adopt the merger agreement at the special meeting or any postponement or adjournment thereof;

a final, non-appealable governmental order prohibits the merger;

the merger has not been consummated on or before December 19, 2006, provided that if the closing shall not have occurred prior to such date solely as a result of the failure of the marketing period to have been completed prior to such date, then such date is extended to March 31, 2007; or

there is a breach by the non-terminating party of any of its representations or warranties or failure to perform any of its covenants or agreements in the merger agreement such that the closing conditions would not be satisfied and which cannot be cured prior to the termination date set forth above;

by the Mergercos, if our board of directors withdraws or adversely modifies its recommendation or approval of the merger agreement or recommends or approves another takeover proposal; or

by Michaels, if

prior to adoption of the merger agreement by our stockholders, our board of directors determines that the failure to take such action would be inconsistent with its fiduciary duties under applicable law, but only after our board of directors has given proper notice to the Mergercos and taken into account any changes to the financial terms of the merger agreement proposed by the Sponsor Entities to us in response to such notice or otherwise; or

all of the mutual conditions to closing and all of the conditions to the Sponsor Entities obligations to close have been satisfied (other than those conditions that by their terms are to be satisfied at the closing) and, on or after the last day of the marketing period, neither the Fincos nor the surviving corporation has received the proceeds of the debt financing.

Termination Fees and Expenses (page 60)

Under certain circumstances, in connection with the termination of the merger agreement, we will be required to pay to the Mergercos an aggregate termination fee of $120 million.

The Sponsor Entities have agreed to pay us a termination fee of $200 million if we terminate the merger agreement in certain circumstances related to the failure of the Fincos to receive the proceeds of the debt financing. If, in the event that the Sponsor Entities become obligated to pay this termination fee, none of the Sponsor Entities is otherwise in breach of the merger agreement such that the conditions to our obligation to close have been satisfied, then our termination of the merger agreement in these circumstances and receipt of payment of such termination fee shall be our sole and exclusive remedy against the Sponsor Entities for any loss or damage suffered as a result of any breach of the merger agreement by the Sponsor Entities and the failure of the merger to be consummated.

The parties have agreed that the aggregate liability of Michaels and our subsidiaries, as a group, on the one hand, or the Sponsor Entities, Bain Capital Fund IX, LLC and Blackstone Capital Partners V L.P., as a group, on the other hand, arising from any breach of the merger agreement (other than breaches related to fraud) shall be capped at $600 million.

Specific Performance (page 62)

The parties to the merger agreement are entitled to an injunction or injunctions to prevent breaches of merger agreement and to enforce specifically the terms and provisions of the merger agreement in any court of the State of Delaware or any Federal court sitting in the State of Delaware.

Market Price of Our Stock (page 65)

Our common stock is listed on the New York Stock Exchange (the NYSE) under the trading symbol MIK . The closing sale price of our common stock on the NYSE on March 17, 2006, which was the last trading

day before we announced that our board of directors was exploring strategic alternatives, including a potential sale of Michaels, was $33.96. The closing sale price of our common stock on the NYSE on June 30, 2006, which was the last trading day before we announced the merger, was $41.24. On [ ], 2006, the last trading day before the date of this proxy statement, the closing price of our common stock on the NYSE was $[ ].

Appraisal Rights (page 63 and Annex E)

Pursuant to section 262 of the Delaware General Corporation Law, referred to as the DGCL, our stockholders have the right to dissent from the merger and receive a cash payment for the judicially determined fair value of their shares of our common stock. The judicially determined fair value under section 262 could be greater than, equal to or less than the $44.00 per share that our stockholders are entitled to receive in the merger. Stockholders that wish to exercise their appraisal rights must not vote in favor of the adoption of the merger agreement and must strictly comply with all of the procedures required by the DGCL. A copy of section 262 of the DGCL is attached to this proxy statement as Annex E.

Table of Contents

QUESTIONS AND ANSWERS ABOUT THE SPECIAL MEETING AND THE MERGER

The following questions and answers are intended to address some commonly asked questions regarding the special meeting and the merger. These questions and answers may not address all questions that may be important to you as our stockholder. Please refer to the more detailed information contained elsewhere in this proxy statement, the annexes to this proxy statement and the documents referred to or incorporated by reference in this proxy statement.

Q: What is the proposed transaction?

A: The proposed transaction is the merger of Michaels with affiliates of Bain and Blackstone pursuant to the merger agreement. Once the merger agreement has been adopted by the Michaels stockholders and the other closing conditions under the merger agreement have been satisfied or waived, the Mergercos will merge with and into Michaels. Michaels will be the surviving corporation in the merger and will become wholly owned by entities sponsored by or co-investors with Bain and Blackstone.

Q: What will I receive in the merger?

A: Upon completion of the merger, you will receive $44.00 in cash, without interest and less any required withholding taxes, for each share of our common stock that you own. For example, if you own 100 shares of our common stock, you will receive $4,400.00 in cash in exchange for your shares of our common stock, less any required withholding taxes. You will not own shares in the surviving corporation.

Q: Where and when is the special meeting?

A: The special meeting will take place at 8000 Bent Branch Drive, Irving, Texas 75063, on October 5, 2006, at 9:30 a.m., central daylight time.

Q: What vote of our stockholders is required to adopt the merger agreement?

A: For us to complete the merger, holders of a majority of the outstanding shares of our common stock at the close of business on the record date must vote their shares **FOR** the adoption of the merger agreement. Accordingly, failure to vote or an abstention will have the same effect as a vote against adoption of the merger agreement.

Q: How does our board of directors recommend that I vote on the merger agreement?

A: Our board of directors unanimously recommends that our stockholders vote **FOR** the adoption of the merger agreement. You should read *The Merger Reasons for the Merger* beginning on page 20 for a discussion of the factors that our board of directors considered in deciding to recommend the adoption of the merger agreement.

Q: What do I need to do now?

A: We urge you to read this proxy statement carefully, including its annexes, and to consider how the merger affects you. If you are a stockholder of record, then you can ensure that your shares are voted at the special meeting by completing, signing, dating and mailing each proxy card and returning it in the envelope provided. If you hold your shares in street name , you can ensure that your shares are voted at the special meeting by instructing to your broker on how to vote, as discussed below.

Q: If my shares are held in street name by my broker, will my broker vote my shares for me?

A: Yes, but only if you provide instructions to your broker on how to vote. You should follow the directions provided by your broker regarding how to instruct your broker to vote your shares. Without those instructions, your shares will not be voted, which will have the same effect as voting against adoption of the merger agreement.

Table of Contents

Q: Can I change my vote?

A: Yes. You can change your vote at any time before your proxy is voted at the special meeting. If you are a registered stockholder, you may revoke your proxy by notifying Computershare Investor Services, L.L.C., 3020 Legacy Drive, Suite 100-307, Plano, Texas 75023 in writing or by submitting by mail a new proxy dated after the date of the proxy being revoked. In addition, your proxy may be revoked by attending the special meeting and voting in person (you must vote in person, as simply attending the special meeting will not cause your proxy to be revoked).

Please note that if you hold your shares in street name and you have instructed your broker to vote your shares, the above-described options for changing your vote do not apply, and instead you must follow the directions received from your broker to change your vote.

Q: How do I vote my Michaels Stores, Inc. 401(k) shares?

A: If you participate in the Michaels Stores, Inc. Common Stock Fund under the Michaels Stores, Inc. Employees 401(k) Plan, which we refer to as the 401(k) Plan, you may give voting instructions to State Street Bank and Trust Company, as trustee of the 401(k) Plan, by completing and returning the 401(k) Plan proxy card accompanying this proxy statement. Your instructions will tell the trustee how to vote the number of shares of our common stock reflecting your proportionate interest in the Michaels Stores, Inc. Common Stock Fund and any such instruction will be kept confidential. The trustee will vote your shares in accordance with your duly executed 401(k) Plan proxy card received by [ ], 2006. If you do not give the trustee of the 401(k) Plan voting instructions, the number of shares reflecting your proportionate interest will not be voted.

You may also revoke previously given voting instructions by [ ], 2006, by filing with the trustee of the 401(k) Plan either a written notice of revocation or a properly completed and signed 401(k) Plan proxy card bearing a later date. Your voting instructions will be kept confidential by the trustee.

Q: What does it mean if I get more than one proxy card or vote instruction card?

A: If your shares are registered differently or are in more than one account, you will receive more than one proxy card or, if you hold your shares in street name , more than one vote instruction card. Please complete and return all of the proxy cards or vote instruction cards you receive to ensure that all of your shares are voted.

Q: Should I send in my stock certificates now?

A: No. Shortly after the merger is completed, you will receive a letter of transmittal with instructions informing you how to send in your stock certificates to the paying agent in order to receive the merger consideration. You should use the letter of transmittal to exchange stock certificates for the merger consideration to which you are entitled as a result of the merger. DO NOT SEND ANY STOCK CERTIFICATES WITH YOUR PROXY.

Q: What happens if I sell my shares before the special meeting?

A: The record date of the special meeting is earlier than the special meeting and the date that the merger is expected to be completed. If you transfer your shares of our common stock after the record date but before the special meeting, you will retain your right to vote at the special meeting, but will have transferred the right to receive $44.00 per share in cash to be received by our stockholders in the merger. In order to receive the

$44.00 per share, you must hold your shares through completion of the merger.

Q: Am I entitled to exercise appraisal rights instead of receiving the merger consideration for my shares?

A: Yes. As a holder of our common stock, you are entitled to appraisal rights under Delaware law in connection with the merger if you meet certain conditions, which conditions are described in this proxy statement under the caption *Appraisal Rights* beginning on page 63.

Q: Who can help answer my other questions?

A: If you have more questions about the merger, please contact our Investor Relations Department at (972) 409-1300. If you need assistance in submitting your proxy or voting your shares or need additional copies of this proxy statement or the enclosed proxy card, you should contact our proxy solicitation agent, Morrow & Co., Inc., at (631) 918-4031. If your broker holds your shares, you should call your broker for additional information.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This proxy statement, and the documents to which we refer you in this proxy statement, contain forward-looking statements about our plans, objectives, expectations and intentions. Forward-looking statements include information concerning possible or assumed future results of operations of our company, the expected completion and timing of the merger and other information relating to the merger. Generally these forward-looking statements can be identified by the use of forward-looking terminology such as anticipate, believe, estimate, expect, may, should, plan, project and similar expressions. For each of these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You should read statements that contain these words carefully. They discuss our future expectations or state other forward-looking information, and may involve known and unknown risks over which we have no control. Those risks include, without limitation:

- the satisfaction of the conditions to consummation of the merger, including the adoption of the merger agreement by our stockholders;
- the occurrence of any event, change or other circumstance that could give rise to the termination of the merger agreement, including a termination under circumstances that could require us to pay a $120.0 million termination fee to the Mergercos;
- the amount of the costs, fees, expenses and charges related to the merger;
- the effect of the announcement of the merger on our business relationships, operating results and business generally, including our ability to retain key employees;
- the risk that the merger may not be completed in a timely manner or at all, which may adversely affect our business and the price of our common stock;
- the potential adverse effect on our business, properties and operations because of certain covenants we agreed to in the merger agreement;
- the risk that we may be subject to litigation, including the litigation described under *The Merger Litigation Concerning the Merger* beginning on page 44, in connection with the merger;
- risks related to diverting management s attention from our ongoing business operations; and
- other risks detailed in our filings with the Securities and Exchange Commission (the SEC), including Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended January 28, 2006. See *Where You Can Find More Information* on page 69.

We believe that the assumptions on which our forward-looking statements are based are reasonable. However, we cannot assure you that the actual results or developments we anticipate will be realized or, if realized, that they will have the expected effects on our business or operations. All subsequent written and oral forward-looking statements concerning the merger or other matters addressed in this proxy statement and attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. Forward-looking statements speak only as of the date of this proxy statement or the date of any document incorporated by reference in this document. Except as required by applicable law or regulation, we do not undertake to release the results of any revisions of these forward-looking statements to reflect future events or circumstances.

Table of Contents

THE PARTIES TO THE MERGER AGREEMENT

Michaels Stores, Inc.

Michaels is the largest arts and crafts specialty retailer in the United States. As of July 21, 2006, we operate 902 Michaels retail stores in 48 states and Canada, and we also operate 165 Aaron Brothers stores in 11 states, offering framing supplies and services and a wide selection of art supplies. Recollections, our scrapbooking/paper crafting retail concept, operates 11 stores located in Arizona, Maryland, Texas, and Virginia as of July 21, 2006. In addition, we own and operate four Star Decorators Wholesale stores located in Arizona, California, Georgia, and Texas as of July 21, 2006, offering merchandise primarily to interior decorators/designers, wedding/event planners, florists, hotels, restaurants and commercial display companies.

Michaels is incorporated in the state of Delaware with its principal executive offices at 8000 Bent Branch Drive, Irving, Texas 75063, and its telephone number is (972) 409-1300.

Bain Paste Mergerco, Inc.
Bain Paste Finco, LLC

Bain Paste Mergerco, Inc. is a Delaware corporation formed by a private equity fund sponsored by Bain in anticipation of the merger. Subject to the terms and conditions of the merger agreement and in accordance with Delaware law, at the effective time of the merger Bain Paste Mergerco, Inc. will merge with and into Michaels Stores, Inc. Bain Paste Mergerco, Inc. has de minimis assets and no operations. Bain Paste Finco, LLC is a Delaware limited liability company formed by a private equity fund sponsored by Bain in anticipation of the merger. Bain Paste Mergerco, Inc. and Bain Paste Finco, LLC each have their principal executive offices at c/o Bain Capital Partners, LLC, 111 Huntington Avenue, Boston, Massachusetts 02199, and its telephone number is (617) 516-2000. Bain is part of Bain Capital, LLC, a global private investment firm that manages several pools of capital, including private equity, venture capital, public equity, and leveraged debt assets, with more than $38 billion in assets under management. Since its inception in 1984, Bain has made private equity investments and add-on acquisitions in over 230 companies around the world, including such leading retailers and consumer companies as Toys R Us, Burger King, Staples, Burlington Coat Factory, Shopper s Drug Mart, Brookstone, Domino s Pizza, Dollarama, Sealy Corp., Sports Authority and Duane Reade. Headquartered in Boston, Bain has offices in New York, London, Munich, Hong Kong, Shanghai and Tokyo.

Blackstone Paste Mergerco, Inc.
Blackstone Paste Finco, LLC

Blackstone Paste Mergerco, Inc. is a Delaware corporation formed by a private equity fund sponsored by Blackstone in anticipation of the merger. Subject to the terms and conditions of the merger agreement and in accordance with Delaware law, at the effective time of the merger Blackstone Paste Mergerco, Inc. will merge with and into Michaels Stores, Inc. Blackstone Paste Mergerco, Inc. has de minimis assets and no operations. Blackstone Paste Finco, LLC is a Delaware limited liability company formed by a private equity fund sponsored by Blackstone in anticipation of the merger. Blackstone Paste Mergerco, Inc. and Blackstone Paste Finco, LLC each have their principal executive offices at c/o The Blackstone Group, 345 Park Avenue, 31st Floor, New York, New York 10154, and its telephone number is (212) 583-5000. Blackstone, a global private investment and advisory firm, was founded in 1985. The firm has raised a total of more than $63 billion for alternative asset investing since its formation, of which approximately $30 billion has been for private equity investing. Blackstone s private equity group is currently investing its fifth general private equity fund with commitments of $15.6 billion, and has over 60 experienced professionals with broad sector expertise. Blackstone s other core businesses include private real estate investing, corporate debt investing, hedge funds, mutual fund management, private placement, marketable alternative asset management and investment banking advisory services.

Table of Contents

THE SPECIAL MEETING

Time, Place and Purpose of the Special Meeting

This proxy statement is being furnished to our stockholders as part of the solicitation of proxies by our board of directors for use at the special meeting to be held on October 5, 2006, beginning at 9:30 a.m., central daylight time, at 8000 Bent Branch Drive, Irving, Texas 75063, or at any postponement or adjournment thereof. The purpose of the special meeting is for our stockholders to consider and vote upon the adoption of the merger agreement. Our stockholders must adopt the merger agreement for the merger to occur. If the stockholders fail to adopt the merger agreement, the merger will not occur. A copy of the merger agreement is attached to this proxy statement as Annex A. A copy of the first amendment to the merger agreement is attached as Annex B to this proxy statement. This proxy statement and the enclosed form of proxy are first being mailed to our stockholders on or about [ ], 2006.

Record Date and Quorum

The holders of record of our common stock as of the close of business on September 1, 2006, the record date for the special meeting, are entitled to receive notice of, and to vote at, the special meeting. On the record date, there were [ ] shares of our common stock outstanding.

The holders of a majority of the outstanding shares of our common stock at the close of business on the record date represented in person or by proxy will constitute a quorum for purposes of the special meeting. A quorum is necessary to hold the special meeting. Once a share is represented at the special meeting, it will be counted for the purpose of determining a quorum at the special meeting and any postponement or adjournment of the special meeting. However, if a new record date is set for the adjourned special meeting, then a new quorum will have to be established.

Required Vote

Completion of the merger requires the adoption of the merger agreement by the affirmative vote of the holders of a majority of the outstanding shares of our common stock at the close of business on the record date for the special meeting. Each outstanding share of our common stock is entitled to one vote.

As of September 1, 2006, the record date for the special meeting, the directors and executive officers of Michaels beneficially owned, in the aggregate, [ ] shares of Michaels common stock, or approximately [ ]% of the outstanding shares of Michaels common stock. The directors and executive officers have informed us that they intend to vote all of their shares of our common stock **FOR** the adoption of the merger agreement and **FOR** any adjournment or postponement of the special meeting, if necessary or appropriate, to solicit additional proxies.

Proxies; Revocation

If you are a stockholder of record and submit a proxy by returning a signed proxy card by mail, your shares will be voted at the special meeting as you indicate on your proxy card. If no instructions are indicated on your proxy card, your shares of Michaels common stock will be voted **FOR** the adoption of the merger agreement and **FOR** any adjournment or postponement of the special meeting, if necessary or appropriate, to solicit additional proxies.

If your shares are held in street name by your broker, you should instruct your broker how to vote your shares using the instructions provided by your broker. If you have not received such voting instructions or require further information regarding such voting instructions, contact your broker and they can give you directions on how to vote your shares. Under the rules of the NYSE, brokers who hold shares in street name for customers may not exercise their voting discretion with respect to the approval of non-routine matters such as the merger proposal and thus, absent specific instructions from the beneficial owner of such shares, brokers are not empowered to vote such shares with respect to the adoption of the merger agreement (i.e., broker non-votes). Shares of our common stock held by persons attending the special meeting but not voting, or shares for which we have received proxies with respect to which holders have abstained from voting, will be considered abstentions. Abstentions and properly executed broker non-votes, if any, will be treated as shares that are present and entitled to vote at the special meeting

for purposes of determining whether a quorum exists but will have the same effect as a vote **AGAINST** adoption of the merger agreement and any adjournment or postponement of the special meeting.

You may revoke your proxy at any time before the vote is taken at the special meeting. To revoke your proxy, you must either advise Computershare Investor Services, L.L.C., 3020 Legacy Drive, Suite 100-307, Plano, Texas 75023 in writing, submit by mail a new proxy card dated after the date of the proxy you wish to revoke or attend the special meeting and vote your shares in person. Attendance at the special meeting will not by itself constitute revocation of a proxy.

Please note that if you hold your shares in street name and you have instructed your broker to vote your shares, the options for revoking your proxy described in the paragraph above do not apply and instead you must follow the directions provided by your broker to change your vote.

If you participate in the Michaels Stores, Inc. Common Stock Fund under the 401(k) Plan, you will receive a voting instruction card which will provide State Street Bank and Trust Company, as trustee of the 401(k) Plan, with instructions on how to vote the number of shares reflecting your proportionate interest in the Michaels Stores, Inc. Common Stock Fund. You must submit your voting instructions to State Street by the close of business on [ ], 2006, to allow State Street time to receive your voting instructions and vote on behalf of the 401(k) Plan. You may revoke previously given voting instructions by [ ], 2006, by filing with State Street either a written notice of revocation or a properly completed and signed 401(k) Plan proxy card bearing a later date.

Michaels does not expect that any matter other than the adoption of the merger agreement (and the approval of the adjournment or postponement of the special meeting, if necessary or appropriate, to solicit additional proxies) will be brought before the special meeting. If, however, any such other matter is properly presented at the special meeting or any adjournment or postponement of the special meeting, the persons appointed as proxies will have discretionary authority to vote the shares represented by duly executed proxies in accordance with their discretion and judgment.

Adjournments and Postponements

Although it is not currently expected, the special meeting may be adjourned or postponed for the purpose of soliciting additional proxies. Any adjournment may be made without notice (if the adjournment is not for more than thirty days), other than by an announcement made at the special meeting of the time, date and place of the adjourned meeting. Whether or not a quorum exists, holders of a majority of the shares of our common stock present in person or represented by proxy at the special meeting and entitled to vote thereat may adjourn the special meeting. If no instructions are indicated on your proxy card, your shares of our common stock will be voted FOR any adjournment or postponement of the special meeting, if necessary or appropriate, to solicit additional proxies. Any adjournment or postponement of the special meeting for the purpose of soliciting additional proxies will allow our stockholders who have already sent in their proxies to revoke them at any time prior to their use at the special meeting as adjourned or postponed.

Solicitation of Proxies

Michaels will pay the cost of this proxy solicitation. In addition to soliciting proxies by mail, directors, officers and employees of Michaels may solicit proxies personally and by telephone, facsimile or other electronic means of communication. These persons will not receive additional or special compensation for such solicitation services. Michaels will, upon request, reimburse brokers, banks and other nominees for their expenses in sending proxy materials to their customers who are beneficial owners and obtaining their voting instructions. Michaels has retained Morrow & Co., Inc. to assist it in the solicitation of proxies for the special meeting and will pay Morrow & Co. a fee of approximately $12,500, plus reimbursement of out-of-pocket expenses.

Table of Contents

THE MERGER

Background of the Merger

Our board of directors periodically reviews and assesses strategic alternatives available to us. In early 2006, following a period of consistent growth for Michaels, our board of directors considered a review of our strategic plan and potential alternatives to maximize shareholder value. The board consulted with several investment banks regarding their analysis of our strategic alternatives, and, after further discussions between members of the board and our management, determined, at a meeting of the board held on March 15, 2006, that it was advisable and in the best interests of Michaels and our stockholders to explore strategic alternatives to enhance shareholder value, including through a potential sale of Michaels.

We announced the board s determination to explore strategic alternatives to enhance shareholder value, as well as the retirement of R. Michael Rouleau as President and Chief Executive Officer and the appointment of Jeffrey N. Boyer as President and Chief Financial Officer and Gregory A. Sandfort as President and Chief Operating Officer, in a March 20, 2006, press release. We retained JPMorgan as financial advisor, and Cravath, Swaine & Moore LLP (Cravath) as legal counsel, to Michaels and the board.

Thereafter, and continuing into June 2006, JPMorgan refined and updated its analysis of our strategic alternatives. JPMorgan also began to contact potential strategic and financial acquirors of Michaels. Over the course of the following weeks, JPMorgan contacted over 37 potential acquirors, including nine potential strategic acquirors, to assess their interest in acquiring Michaels.

At the meeting of our board of directors on April 7, 2006, in order to prepare for any potential conflict of interest that might arise in connection with the board s review of our strategic alternatives in light of the significant ownership interest in Michaels of Messrs. Charles J. Wyly, Jr. and Sam Wyly, our board of directors established a special advisory committee of the board, composed of Richard E. Hanlon, Richard C. Marcus, Liz Minyard and Cece Smith (who was designated as chair of the committee). From time to time over the course of April, May and June 2006, the special advisory committee met to consider our strategic alternatives. The special advisory committee retained Wachtell, Lipton, Rosen & Katz (Wachtell Lipton) as its legal counsel.

On April 12, 2006, the board of directors met to discuss the exploration of our strategic alternatives. Representatives of JPMorgan reviewed for the board the work that management and its advisors undertook in connection with the exploration of our strategic alternatives. With respect to the sale of the company alternative, representatives of JPMorgan updated the board on the contacts made by JPMorgan to potential financial and strategic acquirors, noting that several of the potential strategic acquirors stated that they were not interested in exploring further an acquisition of Michaels and that only one potential strategic acquiror expressed any meaningful degree of interest in an acquisition of Michaels. Following a discussion between the board and its advisors regarding next steps, the board directed our management and advisors to continue to explore strategic alternatives.

Over the course of April 2006, JPMorgan continued to make contacts with potential acquirors and assisted potential financial acquirors in forming three groups of co-investors for an acquisition of Michaels. During the week of April 18, 2006, JPMorgan distributed introductory information materials and a form confidentiality agreement to prospective acquirors who had expressed interest in Michaels. We subsequently executed confidentiality agreements with 13 potential financial acquirors, including each member of the financial acquiror groups, and one potential strategic acquiror.

On April 26, 2006, our board of directors met to receive an update regarding the on-going exploration of our strategic alternatives. Representatives of Cravath reviewed with the board the fiduciary duties of directors in the context of considering our strategic alternatives. Representatives of JPMorgan reviewed and discussed with the board their current analysis of the value that each strategic alternative could yield to our stockholders. Representatives of JPMorgan also updated the board on the progress of the potential sale of the company process, including on the status of confidentiality agreement negotiations with potential acquirors, formation of three financial acquiror groups and remaining interest by potential strategic acquirors.

At the April 26, 2006, meeting of the board, JPMorgan confirmed that, to facilitate the sale process, it would be willing to offer debt financing to all potential acquirors of Michaels, noting that no financial acquiror would be obligated to use JPMorgan as its debt financing source. Representatives of Cravath discussed with the board the nature of the potential conflict of interest that might arise from JPMorgan acting both as the financial advisor to Michaels and a possible financing source in connection with the sale of Michaels and described to the board certain procedures that JPMorgan undertook to institute to ensure the separation between the financing teams and the team advising Michaels and the safeguards that Michaels may undertake with regard to such conflict, including obtaining a fairness opinion from another investment bank.

Representatives of JPMorgan were then excused from the board meeting, and the board engaged in a discussion of the risks and benefits relating to JPMorgan s offer, including the potential conflict of interest and the related safeguards, with management and representatives of Cravath and Wachtell Lipton. After this discussion, our board of directors determined that, in the interest of facilitating the sale process, JPMorgan should make a debt financing package available to all potential acquirors, subject to the implementation of the appropriate procedural safeguards. The board of directors also determined that, should we enter into a transaction involving a change of control of Michaels, the board would request that JPMorgan be willing to opine on the fairness of the financial consideration to be received by our stockholders and the board would also seek to secure the opinion of another investment bank not providing financing to the acquiror as to the fairness of the financial consideration to be received by our stockholders, which investment bank could also be the financial advisor to the special advisory committee.

At its April 26, 2006, meeting, our board also reviewed and approved the retention and change in control programs for our employees, which programs were previously approved by the compensation committee of the board at the compensation committee s meetings on April 21, 2006, and April 26, 2006. The Hay Group, the compensation committee s outside compensation consultants, presented to the compensation committee its recommendations with respect to various retention and change of control arrangements, and Cravath reviewed with the compensation committee and the board a summary of the proposed retention and change in control arrangements. In discussing these arrangements, the board noted the increased threat posed by competitors offering to hire our employees following our announcement of the review of strategic alternatives. At the same meeting, the board also approved an amendment to Michaels nonqualified deferred compensation plan to provide for the distribution of all account balances upon a change in control. For a discussion of the treatment of Michaels nonqualified deferred compensation plan in connection with the merger and the impact of the merger on Michaels other compensation arrangements, see *The Merger Interests of Our Directors and Executive Officers in the Merger* beginning on page 36.

On May 8, 2006, the special advisory committee retained Goldman Sachs as its financial advisor. Such retention contemplated that at our request Goldman Sachs would undertake a study to enable it to render an opinion as to the fairness from a financial point of view of the financial consideration to be received by our stockholders in connection with a transaction involving a change of control of Michaels.

On May 18, 2006, our board of directors met to receive an update regarding the ongoing exploration of our strategic alternatives. Representatives of JPMorgan reviewed and discussed with the board their refined analysis of our strategic alternatives and updated the board with respect to a potential sale of the company process, noting that while the financial acquirors continued to be highly interested in an acquisition of Michaels, no potential strategic acquiror was actively engaged in the process.

Over the course of May and June 2006, the continuing potential acquirors conducted their due diligence of Michaels with management, Mr. Rouleau and our advisors. In mid-May 2006, we held in-depth management presentations with each of the continuing potential acquirors.

On June 5, 2006, JPMorgan distributed a bid procedures letter and a draft merger agreement, both of which were previously reviewed by members of the board, to the potential financial acquirors that were still actively engaged in the process, who then represented two separate acquiror groups. The bid procedures letter requested that proposals for an acquisition of Michaels, accompanied by equity and debt financing commitments, sponsor guarantees and comments on the draft merger agreement, be submitted by June 21, 2006.

Our board of directors met on June 12, 2006, to receive an update regarding the ongoing exploration of our strategic alternatives. Representatives of JPMorgan reviewed and discussed with the board their further refined analysis of each of our strategic alternatives. Representatives of JPMorgan also reported to the board on the progress of the potential sale of the company process, including the identity of the continuing potential acquirors and their due diligence efforts.

On June 21, 2006, Bain, Blackstone and a co-investor and another continuing potential financial acquiror group, submitted their respective proposals for the acquisition of Michaels, together with debt and equity financing commitments, sponsor guarantees and comments on the draft merger agreement.

Our board of directors met on June 23, 2006, to further analyze our strategic alternatives and to consider the proposals submitted by the two financial acquiror groups. Representatives of JPMorgan reviewed and discussed with the board their further refined analysis of our strategic alternatives. Representatives of JPMorgan also reviewed with the board the financial terms of each of the acquisition proposals, including the amount of the proposed equity and debt financing and the resulting transaction leverage. Bain, Blackstone and their co-investor offered merger consideration of $42.00 per share, while the other group offered merger consideration of $42.50 per share. Representatives of Cravath reviewed with the board the legal terms of each acquiror groups proposal, including terms relating to the conditionality of the acquiror groups obligation to consummate the merger. Representatives of Goldman Sachs and Wachtell Lipton were also present at the meeting. Following discussion, the board directed that our management and the financial advisors continue to conduct their analysis with respect to the other strategic alternatives and that our advisors seek improved terms from each of the potential acquiror groups.

After the June 23, 2006, board meeting, JPMorgan communicated to each of the acquiror groups that our board of directors was seeking improved terms. Prior to the June 26, 2006, meeting of the board described below, Bain and Blackstone orally informed JPMorgan that they were willing to increase their proposal to $43.25 per share and the other potential acquiror group orally informed JPMorgan that it was willing to increase its proposal to $42.75 per share.

On June 26, 2006, our board of directors held a meeting with our management and representatives of JPMorgan and Goldman Sachs to discuss further strategic alternatives available to us. At this meeting, management discussed with the board its views of the risks associated with each strategic alternative. In addition, each of JPMorgan and Goldman Sachs presented to the board its updated preliminary financial analysis with respect to Michaels, including a review of our strategic alternatives. With respect to the potential sale of the company process, representatives of JPMorgan, Goldman Sachs, Cravath and Wachtell Lipton discussed with the board, in light of the improved financial proposals made by each of the acquiror groups, the process to solicit best and final terms from the acquiror groups.

Following the board s meeting on June 26, 2006, representatives of JPMorgan contacted the two acquiror groups with a request to submit their best and final proposal on June 29, 2006. From June 27, 2006, to June 29, 2006, Cravath held discussions and negotiated the terms of the acquisition documents with counsel for each of the acquiror groups.

On June 28, 2006, each of the acquiror groups presented to Messrs. Charles J. Wyly, Jr. and Sam Wyly and representatives of JPMorgan their plans for Michaels and described the general structure of co-investment opportunities they had offered in past acquisitions. No terms for participation were offered, and no understandings or agreements were reached, with respect to any co-investment by Messrs. Wyly.

On the evening of June 29, 2006, each of the acquiror groups submitted its best and final proposal, including the proposed merger agreement and the related acquisition documents. Bain and Blackstone increased their merger consideration offer to $44.00 per share, while the other potential acquiror group increased its merger consideration offer to $43.50 per share.

On the morning of June 30, 2006, our board of directors met to review our strategic alternatives and to discuss the best and final proposals submitted by the potential acquiror groups. Representatives of JPMorgan and Goldman Sachs discussed their respective financial analyses with respect to Michaels, including a review of our strategic alternatives. Representatives of JPMorgan reported to the board regarding the potential sale of the company process, including with respect to the negotiations that took place with the potential acquiror groups since

the board s meeting on June 26, 2006. Each of JPMorgan and Goldman Sachs reviewed the terms of each of the two proposals. Representatives of Cravath then reviewed with the board the legal terms of the two proposals, noting that both groups had improved their proposed merger agreement terms with respect to deal certainty, but that overall Bain and Blackstone had offered slightly superior terms. Representatives of Cravath responded to questions from the board regarding the legal terms of the offers and again discussed with the board the fiduciary duties of directors in connection with evaluating strategic alternatives.

Following this discussion, the meeting of the board of directors was recessed, and notwithstanding that Messrs. Charles J. Wyly, Jr. and Sam Wyly confirmed that they had no agreement or understanding with either potential acquiror group so that no potential conflict of interest existed, the special advisory committee convened separately with Wachtell Lipton and Goldman Sachs to discuss the potential sale of Michaels. Following the meeting of the special advisory committee, the full board of directors reconvened, and the chair of the special advisory committee reported to the board that each member of the special advisory committee supported submitting the proposed sale of Michaels to Bain and Blackstone to the full board of directors.

After further discussions between the board and representatives of JPMorgan, Goldman Sachs, Cravath and Wachtell Lipton, the board requested that each of JPMorgan and Goldman Sachs render an opinion as to whether the financial consideration to be received by our stockholders in the proposed merger with entities sponsored by Bain and Blackstone was fair from a financial point of view to our stockholders. JPMorgan and Goldman Sachs each delivered to the board an oral opinion, which was subsequently confirmed by delivery of a written opinion each dated June 30, 2006, that, as of such date and based upon and subject to the factors and assumptions set forth in its respective written opinion, the consideration to be received by the holders of our common stock in the proposed merger was fair, from a financial point of view, to such holders. The full text of the written opinions of JPMorgan and Goldman Sachs, which set forth the assumptions made, procedures followed, matters considered and limitations on the review undertaken with such opinions, are attached as Annex C and Annex D to this proxy statement, respectively.

Following additional discussion and deliberation, our board of directors unanimously approved the merger agreement with entities sponsored by Bain and Blackstone, the merger and the other transactions contemplated by the merger agreement, authorized Michaels to enter into the merger agreement and resolved to recommend that our stockholders vote to adopt the merger agreement.

The merger agreement was executed by Michaels, Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC and Blackstone Paste Finco, LLC as of June 30, 2006. On June 30, 2006, after the close of trading on the NYSE, Michaels, Bain and Blackstone issued a joint press release announcing the merger.

At its September 1, 2006, meeting, our board of directors approved an amendment to the merger agreement to permit certain of our stockholders and members of our management to retain certain of their shares of our common stock as shares of common stock of the surviving corporation and, in the case of our management, to retain their options as an equity investment in the surviving corporation. This first amendment to the merger agreement was executed by Michaels, Bain Paste Mergerco, Inc., Blackstone Paste Mergerco, Inc., Bain Paste Finco, LLC and Blackstone Paste Finco, LLC as of September 1, 2006. At the September 1, 2006, meeting, our board also approved a rollover agreement among us and Highfields Capital I LP, Highfields Capital II LP and Highfields Capital III LP (collectively, the Highfields Funds), which was executed by the parties thereto as of September 1, 2006.

Reasons for the Merger

In reaching its decision to approve the merger agreement with entities sponsored by Bain and Blackstone, the merger and the other transactions contemplated by the merger agreement, authorize Michaels to enter into the merger agreement and recommend that our stockholders vote to adopt the merger agreement, our board of directors consulted with its financial and legal advisors and our management. The board of directors considered a number of potentially positive factors, including the following material factors:

- the current and historical market prices of our common stock, and the fact that the $44.00 per share to be paid for each share of our common stock in the merger represents a premium of 29.6% to the closing price of our common stock on March 17, 2006, the last trading day before we announced exploration of our strategic alternatives, and a premium of 31.6% to the average closing price for the three months ended March 17, 2006;

the possible alternatives to the sale of Michaels, including continuing to operate Michaels on a stand-alone basis, and the risks and uncertainties associated with such alternatives, including the risks associated with our ability to meet our projections for future results of operations, compared to the certainty of realizing in cash a fair value for their investment provided to our stockholders by the merger;

the extensive sale process conducted by us, with the assistance of our financial and legal advisors, which involved engaging in discussions with approximately 37 parties to determine their interest in acquiring Michaels, entering into confidentiality agreements with 14 parties and the receipt of two definitive proposals to acquire Michaels;

the price proposed by Bain and Blackstone reflected extensive negotiations between the parties and represented the highest price that we had received for the acquisition of Michaels;

the presentation of JPMorgan and its opinion that, as of the date of its opinion and based upon and subject to the factors and assumptions set forth in such opinion, the consideration to be received by the holders of our common stock in the proposed merger is fair, from a financial point of view, to such holders (see *The Merger Opinion of JPMorgan* beginning on page 22 and Annex C to this proxy statement);

the presentation of Goldman Sachs and its opinion that, as of the date of its opinion and based upon and subject to the factors and assumptions set forth in such opinion, the consideration to be received by the holders of our common stock in the proposed merger is fair, from a financial point of view, to such holders (see *The Merger Opinion of Goldman Sach*s beginning on page 28 and Annex D to this proxy statement);

the terms of the merger agreement and the related agreements, including:

the limited number and nature of the conditions to the Sponsor Entities obligation to consummate the merger;

our ability, under certain limited circumstances, to furnish information to and conduct negotiations with third parties regarding other proposals;

our ability to terminate the merger agreement in order to accept a financially superior proposal, subject to paying the Sponsor Entities a $120 million termination fee;

the limited number and nature of the conditions to funding set forth in the debt financing commitment letters and the obligation of the Sponsor Entities to use their reasonable best efforts (1) to obtain the debt financing and (2) if the Sponsor Entities fail to effect the closing because of a failure to obtain the debt financing, to pay us a $200 million termination fee; and

our ability to enforce specifically the terms and provisions of the merger agreement to prevent breaches of the merger agreement

the fact that the non-financial terms of the proposal received from Bain and Blackstone was, in the aggregate, more favorable to us than the proposal from the other potential acquiror group; and

the availability of appraisal rights to our stockholders who properly exercise their statutory rights (see *Appraisal Rights* beginning on page 63 and Annex E to this proxy statement).

Our board of directors also considered and balanced against the potentially positive factors a number of potentially negative factors concerning the merger, including the following material factors:

the risk that the merger might not be completed, including as a result of a failure by the Sponsor Entities to obtain the debt financing;

the fact that our stockholders will not participate in any future earnings or growth of Michaels;

the fact that the merger consideration consists of cash and will therefore be taxable to our stockholders for U.S. federal income tax purposes;

21

the restrictions on our ability to solicit or engage in discussions or negotiations with a third party regarding other proposals and the requirement that we pay the Sponsor Entities a $120 million termination fee if our board of directors accepts a superior proposal; and

the possibility of disruption to our operations associated with the merger, and the resulting effect thereof on us if the merger does not close.

During its consideration of the transaction with the Sponsor Entities, our board of directors was also aware that all of our directors and executive officers have interests in the merger that are, or may be, different from, or in addition to, those of our stockholders generally, as described under *The Merger Interests of Our Directors and Executive Officers in the Merger* beginning on page 36.

After taking into account all of the factors set forth above, as well as others, our board of directors determined that the potentially positive factors outweighed the potentially negative factors. Furthermore, our board of directors determined it to be advisable and in the best interests of our stockholders that we enter into the merger agreement, and that the merger agreement, the merger and the other transactions contemplated by the merger agreement are advisable and in the best interests of our stockholders. **The board of directors has unanimously approved the merger agreement, the merger and the other transactions contemplated by the merger agreement and recommends that our stockholders vote to adopt the merger agreement at the special meeting.**

The board of directors did not assign relative weights to the above factors or the other factors considered by it. In addition, the board of directors did not reach any specific conclusion on each factor considered, but conducted an overall analysis of these factors. Individual members of the board of directors may have given different weights to different factors.

Recommendation of Our Board of Directors

On June 30, 2006, after evaluating a variety of business, financial and market factors and consulting with our legal and financial advisors, and after due discussion and due consideration, our board of directors unanimously approved the merger agreement, the merger and the other transactions contemplated by the merger agreement and unanimously declared that the merger agreement, the merger and the other transactions contemplated by the merger agreement are advisable and in the best interests of our stockholders. In addition, on September 1, 2006, our board of directors unanimously approved the first amendment to the merger agreement and unanimously declared it advisable and in the best interests of our stockholders that we enter into the first amendment. **ACCORDINGLY, OUR BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR THE ADOPTION OF THE MERGER AGREEMENT.**

Opinion of JPMorgan

Pursuant to an engagement letter dated March 15, 2006, we retained JPMorgan as our financial advisor in connection with our analysis and consideration of various strategic alternatives available to us, including the merger, and to render an opinion to our board of directors as to the fairness, from a financial point of view, of the consideration to be received by us or our stockholders in connection therewith. At the meeting of our board of directors on June 30, 2006, JPMorgan rendered its oral opinion to our board of directors that, as of such date and based upon and subject to the factors and assumptions set forth in its opinion, the consideration to be received by our stockholders in the merger was fair, from a financial point of view, to such stockholders. JPMorgan has confirmed its June 30, 2006 oral opinion by delivering its written opinion to our board of directors, dated as of June 30, 2006, that, as of such date, the consideration to be received by our stockholders in the merger was fair, from a financial point of view, to such stockholders. No limitations were imposed by our board of directors upon JPMorgan with respect to the investigations made or procedures followed by it in rendering its opinions.

The full text of the written opinion of JPMorgan, dated June 30, 2006, which sets forth the assumptions made, matters considered and limits on the review undertaken, is attached as Annex C to this proxy statement and is incorporated herein by reference. Our stockholders are urged to read the opinion in its entirety. JPMorgan s written opinion is addressed to our board of directors, and is directed only to the consideration to be received in the merger and does not constitute a recommendation to any of our stockholders as to how such stockholder should vote at the special meeting. The summary of the opinion of

22

JPMorgan set forth in this proxy statement is qualified in its entirety by reference to the full text of such opinion.

In arriving at its opinion, JPMorgan, among other things:

- reviewed the merger agreement;

- reviewed certain publicly available business and financial information concerning Michaels and the industries in which we operate;

- compared the proposed financial terms of the merger with the publicly available financial terms of certain transactions involving companies JPMorgan deemed relevant and the consideration received for such companies;

- compared our financial and operating performance with publicly available information concerning certain other companies JPMorgan deemed relevant and reviewed the current and historical market prices of our common stock and certain publicly traded securities of such other companies;

- reviewed certain internal financial analyses and forecasts prepared by our management relating to our business; and

- performed such other financial studies and analyses and considered such other information as JPMorgan deemed appropriate for the purpose of its opinion.

JPMorgan also held discussions with certain members of our management with respect to certain aspects of the merger, and the past and current business operations of Michaels, our financial condition and future prospects and operations, and certain other matters JPMorgan believed necessary or appropriate to its inquiry.

JPMorgan relied upon and assumed, without assuming responsibility or liability for independent verification, the accuracy and completeness of all information that was publicly available or was furnished to or discussed with JPMorgan by us or otherwise reviewed by or for JPMorgan. JPMorgan did not conduct or was not provided with, any valuation or appraisal of any assets or liabilities, nor did JPMorgan evaluate the solvency of Michaels or the Mergercos under any state or federal laws relating to bankruptcy, insolvency or similar matters. In relying on financial analyses and forecasts provided to it, JPMorgan assumed that they were reasonably prepared based on assumptions reflecting the best currently available estimates and judgments by management as to our expected future results of operations and financial condition to which such analyses or forecasts relate. JPMorgan expressed no view as to such analyses or forecasts or the assumptions on which they were based. JPMorgan also assumed that the merger and the other transactions contemplated by the merger agreement will be consummated as described in the merger agreement. JPMorgan relied as to all legal matters relevant to the rendering of its opinion upon the advice of counsel. JPMorgan further assumed that all material governmental, regulatory or other consents and approvals necessary for the consummation of the merger will be obtained without any adverse effect on us or the contemplated benefits of the merger.

The projections furnished to JPMorgan for us were prepared by our management. We do not publicly disclose internal management projections of the type provided to JPMorgan in connection with JPMorgan s analysis of the merger, and such projections were not prepared with a view toward public disclosure. These projections were based on numerous variables and assumptions that are inherently uncertain and may be beyond the control of management, including, without limitation, factors related to general economic and competitive conditions and prevailing interest rates. Accordingly, actual results could vary significantly from those set forth in such projections.

JPMorgan s opinion is based on economic, market and other conditions as in effect on, and the information made available to JPMorgan as of, the date of such opinion. Subsequent developments may affect JPMorgan s written opinion dated as of June 30, 2006, and JPMorgan does not have any obligation to update, revise, or reaffirm such opinion. JPMorgan s opinion is limited to the fairness, from a financial point of view, of the consideration to be received by our stockholders in the merger, and JPMorgan has expressed no opinion as to the fairness of the merger

Table of Contents

to, or any consideration of, creditors or other constituencies of Michaels or the underlying decision by us to engage in the merger.

In accordance with customary investment banking practice, JPMorgan employed generally accepted valuation methods in reaching its opinion. The following is a summary of the material financial analyses utilized by JPMorgan in connection with providing its opinion.

Historical Stock Price Analyses

JPMorgan reviewed the historical trading prices of our common stock for a 52-week period ending June 29, 2006. The high and low trading prices of our common stock for such 52-week period were $41.95 and $30.38, respectively. JPMorgan noted that the $44.00 per share price in the proposed transaction represented a 15.8% premium to our closing stock price on June 29, 2006, the penultimate trading day prior to the announcement of the merger, and a 29.6% premium to our closing stock price on March 17, 2006, the last trading day prior to the date we publicly announced that we were exploring strategic alternatives with respect to the business.

Public Trading Multiples

Using publicly available information, including filings with the SEC, as well as published Wall Street equity research estimates, JPMorgan compared selected financial data of Michaels with similar data for selected publicly traded companies engaged in businesses which JPMorgan judged to be analogous to Michaels. These companies were selected, among other reasons, because of their operational and overall business similarities with our business. The companies reviewed in connection with this analysis were classified into three groups as follows: Direct Peers Jo-Ann Stores, A.C. Moore and Hancock Fabrics; Hardline Retail Home Depot, Lowes, Best Buy, Staples, Office Depot, Bed, Bath & Beyond, Auto Zone and Circuit City; and Best in Class Brands Wal-Mart, Home Depot, Target Corp., Walgreens, Kohl s Corp. and Williams-Sonoma.

For each company, JPMorgan computed the multiple of firm value, which consists of the market value of the company s equity, referred to as equity value, plus the company s net debt, to estimated 2006 EBITDA and estimated 2007 EBITDA (fiscal years ending January 31, 2007 and 2008, respectively). Also, JPMorgan computed each company s price to earnings ratios (based on IBES median EPS estimates for 2006 and 2007 calendarized to a January year-end). JPMorgan then computed median and mean multiples for each group of companies and for all the companies as a single group. The selected financial information compiled by JPMorgan is set forth below:

Comparable Companies Trading Analysis

	FV/2006 EBITDA	FV/2007 EBITDA	P/E 2006	P/E 2007
Direct Peers				
Median	7.8x	6.9x	21.6x	16.5x
Mean	7.8x	6.9x	21.6x	16.5x
Hardline retail				
Median	8.8x	7.6x	17.5x	14.8x
Mean	8.6x	7.6x	17.5x	14.8x
Best in class brands				
Median	8.5x	7.6x	17.0x	14.9x
Mean	9.0x	7.9x	17.7x	15.3x
Overall Median	8.5x	7.6x	18.5x	15.5x
Overall Mean	8.8x	7.8x	18.3x	15.5x

Table of Contents

Based on the multiples of firm value computed as set forth above and taking into account differences between our business and such other companies and such other factors as JPMorgan deemed appropriate, JPMorgan derived a range of multiples of firm value to 2006 EBITDA of 7.5x to 9.0x for Michaels. These multiples were then applied to our management s estimate of 2006 EBITDA, yielding implied trading values for Michaels of approximately $32.25 per share to $38.00 per share. In addition, based on the price to earnings multiples computed as set forth above and taking into account differences between our business and such other companies and such other factors as JPMorgan deemed appropriate, JPMorgan derived a range of price to earnings ratios for 2006 earnings of 15.5x to 19.0x for Michaels. These multiples were then applied to our management s estimate of 2006 EPS, yielding implied trading values for Michaels of approximately $31.50 per share to $38.75 per share.

Selected Transaction Analysis

Using publicly available information, JPMorgan examined multiples of sales, EBITDA and EBIT in recent specialty retail acquisition transactions which JPMorgan judged to be analogous to the merger. Specifically, JPMorgan reviewed the following transactions:

Date Announced	Acquirer	Target	Transaction value ($ in millions)
Jan-06	Leonard Green & Partners LP	The Sports Authority	$ 1,394
Jan-06	Bain Capital	Burlington Coat Factory	1,943
Nov-05	Apollo Management	Linens n Things	1,282
Oct-05	Sun Capital Partners	Shopko Stores	1,143
Sep-05	AAH Holdings Corporation	Party City	356
May-05	Texas Pacific Group/Warburg Pincus	Neiman Marcus	5,195
Apr-05	Gamestop Corp.	Electronics Boutique	1,447
Apr-05	OSIM/JW Child/Temasek	Brookstone	343
Mar-05	Bain Capital/KKR/Vornado	Toys R Us	7,811
Nov-04	Kmart	Sears Roebuck	14,239
Jul-04	Sun Capital	Mervyn s	1,650
Jun-04	May Department Stores	Marshall Field s	3,240
Jul-03	Boise Cascade	OfficeMax Inc.	1,095

JPMorgan computed the mean and median multiples of the latest twelve months (LTM) sales, EBITDA and EBIT for the transaction values for each such transaction as follows:

	Transaction value/LTM		
	SALES	EBITDA	EBIT
Median	0.58x	8.5x	13.1x
Mean	0.66x	9.4x	16.7x

25

Based on this data and taking into account differences between our business and such other companies and such other factors as JPMorgan deemed appropriate, JPMorgan derived a range of multiples for Michaels of LTM EBITDA to transaction value of 9.0x to 11.0x. JPMorgan then applied this range of multiples to our management s estimate of LTM EBITDA as of July 31, 2006 and as of October 31, 2006 and arrived at an estimated range of equity values for our common stock of $34.50 to $42.25 per share.

Discounted Cash Flow Analysis

JPMorgan conducted a discounted cash flow analysis for the purpose of determining the fully diluted equity value per share for our common stock. In conducting its analysis, JPMorgan considered two projected financial cases: a base case and a sensitivity case . Each of these cases was prepared by our management and consisted of a 10-year forecast. In the base case, JPMorgan calculated the unlevered free cash flows that we are expected to generate during fiscal years 2006 through 2015 with estimates through the year ending 2010 based on our management s forecasts and estimates for the years ending 2011 to 2015 based on 2010 margins and moderating growth trends. The sensitivity case is based on the same assumptions as the base case through 2008, and thereafter margins remain at 2008 levels.

For each case, JPMorgan also calculated an implied range of terminal values for Michaels at the end of the 10-year period ending 2015 by applying a perpetual growth rate ranging from 2% to 3% of our unlevered free cash flow during the final year of the 10-year period. The unlevered free cash flows and the range of terminal values were then discounted to present values using a range of discount rates from 9.5% to 10.5%, which were chosen by JPMorgan based upon an analysis of our weighted average cost of capital. The present value of the unlevered free cash flows and the range of terminal values were then adjusted for our cash balances of $442 million as of April 28, 2006. The discounted cash flow analyses indicated a range of equity values of between $39.50 per share and $47.75 per share of our common stock for the base case, and a range of equity values of between $37.00 per share and $44.50 per share for the sensitivity case.

Recapitalization Analysis

JPMorgan performed an analysis of hypothetical recapitalization transactions involving Michaels and the theoretical per share value that our stockholders could receive in such transactions. In the first hypothetical recapitalization transaction, Michaels used $200 million of existing cash and the proceeds of new debt financing to finance a special dividend of $1.2 billion (approximately $8.64 per share) or a repurchase of our common stock of $1.2 billion (approximately 30 million shares at $40 per share). The theoretical post-recapitalization trading value of our common stock was based upon estimated price to earnings ratios of 15.5x to 19.0x applied to our management s projections (adjusted to reflect the use of existing cash and additional leverage). JPMorgan then calculated the implied per share future equity values of our common stock from 2006 to 2008, and then discounted those values to June 30, 2006, using a discount rate of 10%. This analysis resulted in a range of implied present values, inclusive of the proceeds of the dividend or share repurchase, of approximately $34.25 per share to $44.25 per share for our common stock. In the second hypothetical recapitalization transaction, Michaels used $200 million of existing cash and the proceeds of new debt financing to finance a special dividend of $2.2 billion (approximately $15.83 per share) or a repurchase of our common stock of $2.2 billion (approximately 50 million shares at $44 per share). The theoretical post-recapitalization trading value of our common stock was based upon estimated price to earnings ratios of 15.5x to 19.0x applied to our management s projections (adjusted to reflect the use of existing cash and additional leverage). JPMorgan then calculated the implied per share future equity values of our common stock from 2006 to 2008, and then discounted those values to June 30, 2006, using a discount rate of 10%. This analysis resulted in a range of implied present values, inclusive of the proceeds of the dividend or share repurchase, of approximately $36.25 per share to $46.00 per share for our common stock.

Leveraged Buyout Analysis

Using projections prepared by our management, JPMorgan calculated potential returns to equity investors in connection with a hypothetical leveraged acquisition of Michaels. For purposes of this analysis, JPMorgan assumed the transaction would be completed on July 31, 2006 and that a subsequent sale of Michaels would occur in 2011 at a price ranging from 9.0x to 10.0x our management s estimated 2010 EBITDA. JPMorgan also assumed that the required rate of return would range from 17.5% to 25% in a transaction of this type. Based on this analysis, JPMorgan estimated a range of implied equity values of between $41.00 per share and $45.50 per share of our common stock.

The foregoing summary of certain material financial analyses does not purport to be a complete description of the analyses or data presented by JPMorgan. The preparation of a fairness opinion is a complex process and is not necessarily susceptible to partial analysis or summary description. JPMorgan believes that the foregoing summary and its analyses must be considered as a whole and that selecting portions of the foregoing summary and these analyses, without considering all of its analyses as a whole, could create an incomplete view of the processes underlying the analyses and its opinion. In arriving at its opinion, JPMorgan did not attribute any particular weight to any analyses or factors considered by it and did not form an opinion as to whether any individual analysis or factor (positive or negative), considered in isolation, supported or failed to support its opinion. Rather, JPMorgan considered the totality of the factors and analyses performed in determining its opinion. Analyses based upon forecasts of future results are inherently uncertain, as they are subject to numerous factors or events beyond the control of the parties and their advisors. Accordingly, forecasts and analyses used or made by JPMorgan are not necessarily indicative of actual future results, which may be significantly more or less favorable than suggested by those analyses. Moreover, JPMorgan s analyses are not and do not purport to be appraisals or otherwise reflective of the prices at which businesses actually could be bought or sold. None of the selected companies reviewed as described in the above summary is identical to Michaels, and none of the selected transactions reviewed was identical to the merger. However, the companies selected were chosen because they are publicly traded companies with operations and businesses that, for purposes of JPMorgan s analysis, may be considered similar to ours. The transactions selected were similarly chosen because their participants, size and other factors, for purposes of JPMorgan s analysis, may be considered similar to the merger. The analyses necessarily involve complex considerations and judgments concerning differences in financial and operational characteristics of the companies involved and other factors that could affect the companies compared to Michaels and the transactions compared to the merger.

As part of its investment banking business, JPMorgan and its affiliates are continually engaged in the valuation of businesses and their securities in connection with mergers and acquisitions, investments for passive and control purposes, negotiated underwritings, secondary distributions of listed and unlisted securities, private placements, and valuations for estate, corporate and other purposes. JPMorgan was selected to advise us on its analysis and consideration of various strategic alternatives available to us on the basis of such experience and its familiarity with us.

Pursuant to its engagement letter, JPMorgan has acted as financial advisor to Michaels with respect to the merger and will receive a fee equal to 0.40% of the aggregate consideration to be paid in the transaction, or approximately $24 million, all of which is payable upon consummation of the transaction, from us for its services. In addition, we agreed to indemnify JPMorgan for certain liabilities arising out of the engagement of JPMorgan. JPMorgan acted as joint lead arranger and book runner of our revolving credit facility in October 2005 and JPMorgan s commercial bank affiliate is a lender thereunder. In addition, JPMorgan and its affiliates have also provided a variety of services to Bain and Blackstone and their respective affiliates. All such services were performed for customary compensation. In addition, JPMorgan and its affiliates offered financing terms to potential acquirors of Michaels (including Bain and Blackstone and their affiliates) and is arranging and/or providing financing of the merger consideration for the Sponsor Entities, Bain and Blackstone and their respective affiliates. In the ordinary course of its businesses, JPMorgan and its affiliates may actively trade the debt and equity securities of Michaels or affiliates of Bain or Blackstone for its own account or for the accounts of customers and, accordingly, JPMorgan may at any time hold long or short positions in such securities. JPMorgan and certain of its affiliates and certain of their respective employees and certain private investment funds affiliated or associated with JPMorgan have invested in private equity funds managed or advised by Blackstone.

27

Table of Contents

Opinion of Goldman Sachs

Goldman Sachs rendered its oral opinion, which was subsequently confirmed in writing, to the special advisory committee of our board of directors and our board of directors that, as of June 30, 2006, and based upon and subject to the factors and assumptions set forth therein, the $44.00 per share in cash to be received by the holders of the outstanding shares of Michaels common stock pursuant to the merger agreement was fair, from a financial point of view, to such holders.

The full text of the written opinion of Goldman Sachs, dated June 30, 2006, which sets forth the assumptions made, procedures followed, matters considered and limitations on the review undertaken in connection with the opinion, is attached as Annex D to this proxy statement. Goldman Sachs provided its opinion for the information and assistance of the special advisory committee of our board of directors and our board of directors in connection with their consideration of the transaction. Goldman Sachs opinion is not a recommendation as to how any holder of our common stock should vote with respect to the merger.

In connection with rendering the opinion described above and performing its related financial analyses, Goldman Sachs reviewed, among other things:

- the merger agreement;
- annual reports to stockholders and Annual Reports on Form 10-K of Michaels for the five fiscal years ended January 28, 2006;
- certain interim reports to stockholders and Quarterly Reports on Form 10-Q of Michaels;
- certain other communications from Michaels to its stockholders; and
- certain internal financial analyses and forecasts for Michaels prepared by its management.

Goldman Sachs also held discussions with members of our senior management regarding their assessment of our past and current business operations, financial condition, and future prospects. In addition, Goldman Sachs reviewed the reported price and trading activity for our common stock, compared certain financial and stock market information for Michaels with similar information for certain other companies the securities of which are publicly traded, reviewed the financial terms of certain recent business combinations in the retail industry specifically and in other industries generally and performed such other studies and analyses, and considered such other factors, as it considered appropriate.

Goldman Sachs relied upon the accuracy and completeness of all of the financial, accounting, legal, tax and other information discussed with or reviewed by it and assumed such accuracy and completeness for purposes of rendering the opinion described above. In addition, Goldman Sachs did not make an independent evaluation or appraisal of the assets and liabilities (including any contingent, derivative or off-balance-sheet assets and liabilities) of Michaels or any of our subsidiaries, nor was any evaluation or appraisal of the assets or liabilities of Michaels or any of our subsidiaries furnished to Goldman Sachs. Goldman Sachs opinion does not address the underlying business decision of Michaels to engage in the transaction. Goldman Sachs opinion is necessarily based on economic, monetary, market and other conditions as in effect on, and the information made available to it as of, the date of the opinion.

The following is a summary of the material financial analyses delivered by Goldman Sachs to the special advisory committee of our board of directors and our board of directors in connection with rendering the opinion described above. The following summary, however, does not purport to be a complete description of the financial analyses performed by Goldman Sachs, nor does the order of analyses described represent relative importance or weight given to those analyses by Goldman Sachs. Some of the summaries of the financial analyses include information presented in tabular format. The tables must be read together with the full text of each summary and are alone not a complete description of Goldman Sachs financial analyses. Except as otherwise noted, the following quantitative information, to the extent that it is based on market data, is based on market data as it existed on or before June 28, 2006 and is not necessarily indicative of current market conditions.

Table of Contents

Historical Stock Trading Analysis

Goldman Sachs reviewed the historical trading prices for our common stock for the one-year period ended June 28, 2006. Goldman Sachs noted that during the one-year period ended June 28, 2006, our common stock closed at a low of $30.76 on October 13, 2005, and a high of $41.92 on July 5, 2005. Goldman Sachs also noted that on June 28, 2006, our common stock closed at $37.73, and on March 17, 2006, the last public trading date prior to Michaels announcing that it was exploring strategic alternatives including a possible sale of the company, our common stock closed at $33.96. Goldman Sachs also noted that our common stock traded at an all-time high of $43.61.

Selected Companies Analysis

Goldman Sachs calculated and compared the ratio of the price per share to the estimated 2006 earnings per share of Michaels and the following companies that it selected based on financial data as of June 28, 2006, information it obtained from SEC filings, estimates provided by the Institutional Brokerage Estimate System (a data service that compiles estimates issued by securities analysts), or IBES, for the selected companies, and information and forecasts for Michaels provided by our management. The price per share to the estimated 2006 earnings per share ratio of Michaels was calculated using the closing price of our common stock on both March 17, 2006 and June 28, 2006 and the price per share to the estimated 2006 earnings per share ratios of the selected companies were calculated using the selected companies closing prices on June 28, 2006. Although none of the selected companies is directly comparable to Michaels, the companies included were chosen because they are publicly traded companies with operations that for purposes of analysis may be considered similar to certain operations of Michaels. The results of these analyses are summarized as follows:

Selected Company	Estimated 2006 P/E Multiples
AC Moore Arts & Crafts, Inc.	23.3x
American Greetings Corporation	24.2x
Barnes & Noble, Inc.	15.8x
Bed Bath & Beyond Inc.	15.5x
Best Buy Co., Inc.	19.4x
Borders Group, Inc.	13.4x
Circuit City Stores, Inc.	25.1x
GameStop Corp.	18.7x
The Home Depot, Inc.	11.8x
Jo-Ann Stores, Inc.	NM
Lowe s Companies, Inc.	14.8x
Office Depot, Inc.	21.3x
Staples, Inc.	19.4x
Radioshack Corporation	14.3x
Williams-Sonoma, Inc.	17.0x

Selected Company	Estimated 2006 P/E Multiples
Yankee Candle Company, Inc.	12.0x
High	25.1x
Median	18.0x
Low	11.8x
Michaels (based on closing price and estimated 2006 earnings as of March 17, 2006)	17.0x
Michaels (based on closing price and estimated 2006 earnings as of June 28, 2006)	19.3x
Michaels (based on $44.00 per share)	21.6x

Present Value of Future Stock Price Analysis

Goldman Sachs performed an illustrative analysis of the implied present value of the future stock price of Michaels, which is designed to provide an indication of the present value of a theoretical future value of a company s equity as a function of such company s estimated future earnings and its assumed price to future earnings per share multiple. For this analysis, Goldman Sachs used the financial projections for Michaels prepared by our management. Goldman Sachs first calculated implied per share values for our common stock as of June 30 for each of the fiscal years 2007 to 2010 by applying price to forward earnings per share multiples of 16.0x to 20.0x to estimates prepared by our management of fiscal years 2007 to 2010 earnings per share. Goldman Sachs then calculated the implied per share future equity values for our common stock from 2007 to 2010, and then discounted those values to June 30, 2006, using discount rates of 10.0% and 13.0%. This analysis resulted in a range of implied present values of $33.04 to $52.35 per share of our common stock.

Discounted Cash Flow Analysis

Goldman Sachs performed an illustrative discounted cash flow analysis to determine a range of implied present values per share of our common stock. All cash flows were discounted to July 31, 2006, and terminal values were based upon EBITDA multiples of estimated fiscal year 2010 EBITDA. Forecasted financial information used in this analysis was based on projections provided by our management. Goldman Sachs used discount rates ranging from 9.0% to 13.0%, reflecting estimates of the weighted average cost of capital of Michaels and terminal EBITDA multiples ranging from 8.0x to 10.0x based on historical EBITDA multiples for Michaels. This analysis resulted in a range of implied present values of $40.31 to $53.82 per share of our common stock.

Using the same projections provided by our management, Goldman Sachs also performed a sensitivity analysis to analyze the effect of increases or decreases in annual sales growth and EBITDA margin from 2006 to 2010. The analysis utilized (1) a range of EBITDA margin compounded annual growth rates of 0.0% to 5.6% from fiscal years 2006 to 2010, (2) a range of compounded annual sales growth rates of 4.4% to 8.4% from fiscal years 2006 to 2010 and (3) terminal EBITDA multiple of 9.0x and a discount rate of 11.0% discounted to July 31, 2006. The EBITDA margin compounded annual growth rates of 0.0% to 5.6% from the fiscal years 2006 to 2010 implies a range of estimated EBITDA margin in 2010 of 13.6%, which is equal to the estimated EBITDA margins in 2006 assumed to remain constant in the projections provided by our management, up to 17.0% through the projection period, which is 1.3% higher than the estimated EBITDA margin in 2010 assumed in the projections provided by our management. The sales growth rates of 4.4% to 8.4% from fiscal years 2006 to 2010 represent a range of -3.0% to 1.0% change in the annual sales growth assumption of the financial projections provided by our management. This resulted in a range of implied present values of $38.21 to $51.47 per share of our common stock.

Selected Transactions Analysis

Goldman Sachs reviewed publicly available information for the following announced merger or acquisition transactions in the U.S. involving companies in the retail industries. While none of the companies participating in the selected transactions are directly comparable to Michaels, the companies participating in the selected transactions are companies with operations that, for the purposes of analysis, may be considered similar to certain operations of Michaels. Goldman Sachs calculated and compared the enterprise values as a multiple of the target company s publicly reported latest twelve months, or LTM, EBITDA prior to announcement of the applicable transaction. For purposes of this analysis, the enterprise value was calculated by adding the announced transaction price for the equity of the target company to the book value of the target company s net debt based on public information available prior to the announcement of the applicable transaction. The following tables set forth the transactions reviewed (listed by acquiror/target and month and year announced) and the enterprise value multiple of LTM EBITDA for each and the results of the analysis. The $44.00 per share of our common stock to be paid to our stockholders in this transaction implies an enterprise value multiple of LTM EBITDA of 12.1x.

Acquiror/Target	**Enterprise Value Multiple of LTM EBITDA**
Supervalu Inc., CVS Corporation, Cerebus Capital Management, L.P./Albertson s, Inc. (January 2006)	7.3x
Leonard Green & Partners, L.P./The Sports Authority, Inc. (January 2006)	7.9
Bain Capital Partners, LLC/Burlington Coat Factory Warehouse Corporation (January 2006)	6.7
Apollo Management V, L.P./Linens n Things, Inc. (November 2005)	8.7
The Bon-Ton Stores, Inc./Northern Department Store Group of Saks Incorporated (October 2005)	7.3
Prentice Capital Management, LP, GMM Capital LLC/Goody s Family Clothing, Inc. (October 2005)	13.6
Sun Capital Partners, Inc./Shopko Stores Inc. (October 2005)	6.2
Berkshire Partners LLC, Weston Presidio/Party City Corporation (September 2005)	12.3
TPG Advisers III, Inc, TPG Advisers IV, Inc., Warburg Pincus & Co., Warburg Pincus LLC, Warburg Pincus Partners LLC/The Neiman Marcus Group, Inc. (May 2005)	10.3
GameStop Corp./Electronic Boutique Holdings Corp.(April 2005)	13.2
OSIM International Ltd, J.W. Childs Associates, L.P., Temasek Capital (Private) Limited/Brookstone, Inc. (April 2005)	8.3
Kohlberg Kravis Roberts & Co., Bain Capital Partners LLC and Vornado Realty Trust/Toy R Us, Inc. (March 2005)	9.7
Federated Department Stores, Inc./The May Department Stores Company (February 2005)	8.7
Movie Gallery, Inc./Hollywood Entertainment Corporation (November 2004)	N/A
Kmart Holding Corporation/Sears, Roebuck and Co. (November 2004)	7.6

Table of Contents

Acquiror/Target	Enterprise Value Multiple of LTM EBITDA
Jones Apparel Group, Inc./Barneys New York, Inc. (November 2004)	8.1
Cerebus Capital Management, L.P., Sun Capital Partners Group, Inc./Target Corporation, Mervyn s Holdings, LLC (July 2004)	5.9
The May Department Stores Company/Target Corporation, Marshall Field s (June 2004)	14.4
Circuit City Stores, Inc./InterTan, Inc. (May 2004)	N/A
Boise Cascade Corporation/OfficeMax, Inc. (July 2003)	10.4
High	14.4x
Median	8.7x
Mean	9.4x
Low	5.9x

Leveraged Buyout Analysis

Goldman Sachs performed an illustrative analysis of the range of the price per share of our common stock that an acquiror would theoretically pay if Michaels were acquired in a leverage buyout transaction that closed as of October 31, 2006. Assuming, among other things, (i) a sponsor targeted equity return range of 15.0% to 20.0%, (ii) Michaels would be valued at the end of 2010 at 8.0 to 10.0x EBITDA, (iii) a range of EBITDA margin compounded annual growth rates of 0.0% to 5.6% from years 2006 to 2010, and (iv) a range of sales compounded annual growth rates of 4.4% to 8.4% from years 2006 to 2010, the analysis resulted in a range of implied values of $37.79 to $56.67 per share of our common stock.

Recapitalization Analysis

Goldman Sachs analyzed certain illustrative recapitalization transactions involving Michaels and the theoretical value that our stockholders could receive in such transactions. In the first illustrative recapitalization transaction, Michaels used excess cash and the proceeds of new debt financings to finance a special dividend to its stockholders in the range of $1.25 billion to $1.75 billion, or $9.47 to $13.25 per share. The theoretical post-recapitalization trading value of our shares was based upon estimated price to earnings ratios of 14.0x to 20.0x and projections for Michaels provided by our management after giving effect to the use of excess cash and the additional leverage. Goldman Sachs then calculated the implied per share future equity values for our common stock from 2007 to 2010, and then discounted those values to June 30, 2006, using discount rates of 11.0% and 14.0%. This analysis resulted in a range of implied present values, inclusive of the special dividend amount, of $33.56 and $57.53 per share of our common stock. In the second illustrative recapitalization transaction, the analysis assumed that Michaels used excess cash and the proceeds of new debt financings to finance a cash tender offer in the range of $40.00 to $41.00 per share of our common stock for $1.25 billion to $1.75 billion of its outstanding shares. The theoretical post-recapitalization trading value of the shares not purchased in the tender offer was based upon estimated price to earnings ratios of 14.0x to 20.0x and projections for Michaels provided by our management after giving effect to the use of excess cash and the additional leverage. Goldman Sachs then calculated the implied per share future equity values for our common stock from 2007 to 2010, and then discounted those values to June 30, 2006, using discount rates of 11.0% and 14.0%. This analysis resulted in a range of implied present values, inclusive of the cash tender amount, of $31.04 and $62.29 per share of our common stock.

The preparation of a fairness opinion is a complex process and is not necessarily susceptible to partial analysis or summary description. Selecting portions of the analyses or of the summary set forth above, without

considering the analyses as a whole, could create an incomplete view of the processes underlying Goldman Sachs opinion. In arriving at its fairness determination, Goldman Sachs considered the results of all of its analyses and did not attribute any particular weight to any factor or analysis considered by it. Rather, Goldman Sachs made its determination as to fairness on the basis of its experience and professional judgment after considering the results of all of its analyses. No company or transaction used in the above analyses as a comparison is directly comparable to Michaels or the contemplated transaction.

Goldman Sachs prepared these analyses for purposes of Goldman Sachs providing its opinion to the special advisory committee of our board of directors and our board of directors as to the fairness, from a financial point of view, to the holders of the outstanding shares of our common stock of the $44.00 per share in cash to be received by such holders pursuant to the merger agreement. These analyses do not purport to be appraisals nor do they necessarily reflect the prices at which businesses or securities actually may be sold. Analyses based upon forecasts of future results are not necessarily indicative of actual future results, which may be significantly more or less favorable than suggested by these analyses. Because these analyses are inherently subject to uncertainty, being based upon numerous factors or events beyond the control of the parties or their respective advisors, none of Michaels, Goldman Sachs or any other person assumes responsibility if future results are materially different from those forecast.

The merger consideration was determined through arms -length negotiations between Michaels, Bain and Blackstone and was approved by our board of directors. Goldman Sachs provided advice to the special advisory committee of our board of directors during these negotiations. Goldman Sachs did not, however, recommend any specific amount of consideration to the special advisory committee of our board of directors or our board of directors or that any specific amount of consideration constituted the only appropriate consideration for the transaction.

As described above, Goldman Sachs opinion to the special advisory committee of our board of directors and our board of directors was one of many factors taken into consideration by the special advisory committee and the board in making their determination to approve the merger agreement. The foregoing summary does not purport to be a complete description of the analyses performed by Goldman Sachs in connection with the fairness opinion and is qualified in its entirety by reference to the written opinion of Goldman Sachs attached as Annex D to this proxy statement.

Goldman Sachs and its affiliates, as part of their investment banking business, are continually engaged in performing financial analyses with respect to businesses and their securities in connection with mergers and acquisitions, negotiated underwritings, competitive biddings, secondary distributions of listed and unlisted securities, private placements and other transactions as well as for estate, corporate and other purposes. Goldman Sachs has acted as financial advisor to the special advisory committee of our board of directors in connection with the transaction contemplated by the merger agreement.

In addition, Goldman Sachs has provided and is currently providing certain investment banking services to Bain and its affiliates and portfolio companies, including having acted as joint lead manager with respect to the high yield offering by Houghton Mifflin Company, a portfolio company of Bain, of its 8.250% Senior Notes due 2011 (aggregate principal amount $1,000,000,000) in January 2003; having acted as lead manager with respect to the high yield offering by Sealy Corporation, a former portfolio company of Bain, of its 9.875% Senior Sub Notes due 2007 (aggregate principal amount $50,000,000) in April 2003; having acted as co-manager with respect to the high yield offering by Domino s Pizza LLC, a wholly owned subsidiary of Domino s Pizza Inc., an affiliate of Bain, of its 8 1/4% Senior Subordinated Notes due 2011 (aggregate principal amount $403,000,000) in June 2003; having acted as co-manager with respect to the high yield offering by Houghton Mifflin of its 11 1/2% Senior Discount Notes due 2013 (aggregate principal amount $265,000,000) in September 2003; having acted as co-financial advisor to Sealy in connection with its sale in April 2004; having extended a bank loan (aggregate principal amount $70,000,000) to Maxim Crane Works, a portfolio company of Bain, in July 2004; having acted as financial advisor to Modus Media International Holdings, a former portfolio company of Bain, in connection with its sale in August 2004; having acted as financial advisor to Bain Capital (Europe) Limited, an affiliate of Bain, in connection with its acquisition of Framatome Connectors International in November 2005; having extended a bank loan (aggregate principal amount of $100,000,000) to Domino s in March 2006; having extended a bank loan (aggregate principal amount $1,350,000,000) to Sensata Technologies BV, a portfolio company of Bain, in April 2006; having acted as a joint bookrunner with

respect to the high yield offering by Sensata of its 8.00% Senior Notes due 2014 and 9.00% Senior

---

Subordinated Notes due 2016 (aggregate principal amount $752,000,000) in April 2006; having acted as a manager with respect to the high yield offering by Houghton Mifflin of its Floating Rate Senior PIK Notes due 2011 (aggregate principal amount $300,000,000) in May 2006; having extended a bank loan (aggregate principal amount $650,000,000) to Cumulus Media Partners LLC, a portfolio company of Bain, in connection with its acquisition of Susquehanna Broadcasting Company in April 2006; and having acted as a joint book runner with respect to the high yield offering by Cumulus of its 9.875% Senior Subordinated Notes due 2014 (aggregate principal amount $250,000,000) in May 2006.

In addition, Goldman Sachs has provided and is currently providing certain investment banking services to Blackstone and its affiliates and portfolio companies, including having acted as principal agent with respect to the mortgage financing (aggregate principal amount $120,000,000) of a property owned by affiliates of Blackstone in August 2003; having acted as joint-lead managing underwriter with respect to the public offering of 12,102,600 ordinary shares of Aspen Insurance UK Limited, a portfolio company of Blackstone, in December 2003; having acted as lead managing underwriter with respect to the public offering of 24,137,931 shares of common stock of TRW Automotive Inc., a portfolio company of Blackstone, in February 2004; having acted as financial advisor to an affiliate of Blackstone in connection with the acquisition of Celanese AG in April 2004; having acted as co-lead managing underwriter with respect to the high yield offering by Graham Packaging Company, a portfolio company of Blackstone, of its 8.5% Notes due 2012 and 9.875% Notes due 2014 (aggregate principal amount $625,000,000) in September 2004; having acted as co-financial advisor to Graham in connection with its acquisition of a business unit of Owens-Illinois, Inc. in July 2004; having acted as lead managing underwriter with respect to the public offering of 51,111,111 shares of common stock of Nalco Holding Company, a portfolio company of Blackstone, in November 2004; having acted as co-managing underwriter with respect to the public offering of 9,600,000 shares of 4.25% convertible perpetual preferred stock of Celanese Corp., a portfolio company of Blackstone, in January 2005; having acted as co-managing underwriter with respect to the public offering of 50,000,000 shares of Series A common stock of Celanese in January 2005; having acted as joint lead managing underwriter with respect to the public offering of 13,684,100 shares of common stock of New Skies Satellites NV, a portfolio company of Blackstone, in May 2005; having acted as joint lead managing underwriter with respect to the public offering of 33,350,000 shares of common stock of Nalco in August 2005; having acted as financial advisor to New Skies in connection with its sale in December 2005; and having acted as a lead underwriter with respect to the public offering of 35,000,000 shares of Series A common stock of Celanese in May 2006.

Goldman Sachs may also provide investment banking services to Michaels and its affiliates and Bain, Blackstone and their respective affiliates and portfolio companies in the future. In connection with the above-described investment banking services Goldman Sachs has received, and may receive, compensation. Affiliates of Goldman Sachs have co-invested with Bain, Blackstone and their respective affiliates from time to time and may do so in the future.

Goldman Sachs is a full service securities firm engaged, either directly or through its affiliates, in securities trading, investment management, financial planning and benefits counseling, risk management, hedging, financing and brokerage activities for both companies and individuals. In the ordinary course of these activities, Goldman Sachs and its affiliates may provide such services to Michaels and its affiliates and Bain, Blackstone and their respective affiliates and portfolio companies, may actively trade the debt and equity securities (or related derivative securities) of Michaels and affiliates and portfolio companies of Bain and Blackstone for their own account and for the accounts of their customers and may at any time hold long and short positions of such securities.

The special advisory committee of our board of directors selected Goldman Sachs as its financial advisor because it is an internationally recognized investment banking firm that has substantial experience in transactions similar to the transaction. Pursuant to a letter agreement dated May 8, 2006, the special advisory committee of the board engaged Goldman Sachs to act as its financial advisor in connection with the contemplated transaction. Pursuant to the terms of this engagement letter, Michaels has agreed to pay Goldman Sachs a transaction fee of 0.15% of the aggregate consideration paid in such transaction, or approximately $9.0 million, with one-third of the transaction fee payable upon signing of the merger agreement, one-third of the transaction fee payable upon the stockholder vote for the transaction and the remainder of the transaction fee payable upon consummation of the transaction. Michaels has also

agreed to reimburse Goldman Sachs expenses and indemnify it against certain liabilities arising out of its engagement.

Table of Contents

Financing

The Sponsor Entities estimate the total amount of funds necessary to complete the merger and the related transactions to be approximately $6.164 billion, which includes approximately $5.920 billion to be paid out to our stockholders and holders of other equity-based interests in Michaels, with the remainder to be applied to pay related fees and expenses in connection with the merger, the financing arrangements and the related transactions. These payments are expected to be funded by a combination of equity contributions by entities sponsored by or co-investors with Bain and Blackstone and debt financing, as well as our available cash.

The Mergercos have obtained equity financing commitments and the Fincos have obtained debt financing commitments for the transactions contemplated by the merger agreement. After giving effect to contemplated draws under the new debt commitments, we currently expect total new debt outstanding at the close of the merger to be approximately $4.2 billion, which amount may be increased in respect of certain drawings under the asset-based revolving facility described below on the closing date for working capital purposes.

Equity Financing

Bain Capital Fund IX, LLC has delivered an equity commitment letter for $1.092 billion to Bain Mergerco, and Blackstone Capital Partners V L.P. has delivered an equity commitment letter for $1.092 billion to Blackstone Mergerco, which constitute the equity portion of the merger financing.

Each of the equity commitment letters provides that the equity funds will be contributed to finance, in part, the consummation of the merger and the other transactions contemplated by the merger agreement, including the payment of the merger consideration, the payments due to optionholders and the associated costs and expenses, and for no other purpose. Each of the equity commitments is generally subject to the satisfaction or waiver at the closing of the conditions precedent to the obligations of each Mergerco to consummate the merger. We are an express third party beneficiary under the terms of each of the equity commitment letters. The terms of each of the equity commitment letters will expire automatically on the date that is 30 days after the termination of the merger agreement, except that in the event we file any claim or suit to enforce the terms of the equity commitment letter prior to such expiration, the commitments and obligations set forth in the equity commitment letters will remain in full force and effect until the final, nonappealable determination by a court of competent jurisdiction of such claim or suit.

Debt Financing

In connection with the execution and delivery of the merger agreement, Bain Finco, Blackstone Finco, Bain Capital Fund IX, LLC and Blackstone Capital Partners V L.P. have entered into a debt financing commitment letter with Deutsche Bank AG New York Branch and Deutsche Bank AG Cayman Islands Branch to provide up to $4.8 billion in debt financing, consisting of (1) a senior secured asset-based revolving facility with a maximum availability of $1.0 billion, (2) a senior secured term loan facility in an aggregate principal amount of $2.4 billion, (3) a senior unsecured bridge loan facility in an aggregate principal amount of up to $700 million and (4) a senior subordinated unsecured bridge loan facility in an aggregate principal amount of up to $700 million, to finance, in part, the payment of the merger consideration, the repayment or refinancing of certain of our debt outstanding on the closing date of the merger and to pay fees and expenses in connection with the merger, financing and related transactions and, in the case of the asset-based revolving facility, for general corporate purposes after the closing date of the merger. Subsequent to the date of the merger agreement, each of JPMorgan Chase Bank, N.A., J.P. Morgan Securities Inc., Bank of America, N.A., Banc of America Bridge LLC, Banc of America Securities LLC, Credit Suisse Securities (USA) LLC and Credit Suisse have been added as commitment parties under the debt financing commitment letter.

Borrowings under the asset-based revolving facility are limited by our borrowing base , which is calculated periodically based on specified percentages of the value of eligible credit card receivables and eligible inventory, subject to adjustments for reserves and other matters. No more than $250 million may be borrowed under the asset-based revolving facility for purposes of financing the merger and related transactions, except that additional drawings under the asset-based revolving facility may be made to fund working capital needs. If

availability under the borrowing base is less than $500 million on the closing date of the merger, the lenders have agreed to increase their commitments under the term loan facility by the amount of such shortfall.

The debt financing commitments will expire if not drawn on or prior to April 30, 2007. The facilities contemplated by the debt financing commitments are subject to customary closing conditions, including:

- the consummation of the merger;
- the absence of a material adverse change with respect to Michaels, to the extent such change constitutes a material adverse change for purposes of the merger agreement;
- the execution of definitive credit documentation consistent with the term sheets for the debt facilities;
- receipt of equity contributions in an amount equal to at least 20% of the total sources required to consummate the merger from one or more of Bain, Blackstone and co-investors reasonably acceptable to the lead arrangers for the debt financing;
- the absence of any amendments or waivers to the merger agreement to the extent material and adverse to the lenders which have not been approved by the lead arrangers for the debt financing;
- the receipt of specified financial statements of Michaels; and
- receipt of customary closing documents.

Although the debt financing described in this proxy statement is not subject to the lenders satisfaction with their due diligence or to a market out, such financing might not be funded on the closing date because of failure to meet the closing conditions or for other reasons. As of the date of this proxy statement, no alternative financing arrangements or alternative financing plans have been made in the event the debt financing described herein is not available as anticipated. The documentation governing the debt financing facilities have not been finalized, and accordingly, their actual terms may differ from those described in this proxy statement.

Interests of Our Directors and Executive Officers in the Merger

In addition to their interests in the merger as stockholders, certain of our directors and executive officers have interests in the merger that differ from, or are in addition to, your interests as a stockholder. In considering the recommendation of our board of directors to vote **FOR** the adoption of the merger agreement, you should be aware of these interests. Our board of directors was aware of, and considered the interests of, our directors and executive officers in approving the merger agreement, the merger and the transactions contemplated by the merger agreement. Except as described below, such persons have, to our knowledge, no material interest in the merger that differs from your interests generally.

Treatment of Stock Options

As of August 25, 2006, there were approximately 3,173,973 shares of our common stock subject to outstanding stock options granted under our equity incentive plans to our current executive officers and directors. Each outstanding stock option, other than rollover options, that remains unexercised as of the completion of the merger, whether or not the option is vested or exercisable, will be canceled, and the holder of such stock option that has an exercise price of less than $44.00 will be entitled to receive a cash payment, without interest and less applicable withholding taxes, equal to the product of:

- the number of shares of our common stock subject to the option as of the effective time of the merger, multiplied by
- the excess of $44.00 over the exercise price per share of common stock subject to such option.

Table of Contents

The following table summarizes the outstanding vested and unvested options held by our executive officers and directors as of August 25, 2006, and the consideration that each of them will receive pursuant to the merger agreement in connection with the cancellation of their options:

Name	No. of Shares Underlying Vested and Unvested Options	Weighted Average Per Share Exercise Price of Vested and Unvested Options	Resulting Consideration
Directors			
Charles J. Wyly, Jr.*	910,000	$ 24.52	$17,728,325
Sam Wyly*	592,500	$ 23.12	$12,374,325
Richard E. Hanlon	205,000	$ 21.19	$ 4,675,325
Richard C. Marcus	135,000	$ 26.74	$ 2,330,325
Liz Minyard	170,000	$ 25.21	$ 3,194,650
Cece Smith	135,000	$ 27.04	$ 2,289,900
Executive Officers			
R. Michael Rouleau	450,000	$ 30.21	$ 6,207,250
Jeffrey N. Boyer	248,096	$ 22.54	$ 5,323,611
Gregory A. Sandfort	152,264	$ 30.60	$ 2,040,580
Thomas M. Bazzone	168,750	$ 29.44	$ 2,457,500
Thomas C. DeCaro	148,750	$ 25.35	$ 2,773,925
Harvey S. Kanter	131,529	$ 27.22	$ 2,206,839
Edward F. Sadler	177,084	$ 24.80	$ 3,400,351

* Messrs. Charles J. Wyly, Jr. and Sam Wyly also serve as our executive officers.

Mr. R. Michael Rouleau retired as our President and Chief Executive Officer on March 15, 2006.

Change in Control Severance Agreements

We have entered into change in control severance agreements with each of our current executive officers (other than those executive officers who are also members of our board of directors) and certain other key employees.

The change in control severance agreements provide that during the two-year period following the completion of the merger, the covered executive s status, offices, titles and reporting relationships with Michaels or the surviving corporation will be commensurate with those in effect immediately prior to the completion of the merger, and the covered executive will be entitled to an annual base salary, annual bonus, long-term incentive compensation opportunities, savings and retirement benefit opportunities and welfare and fringe benefits in values and amounts at least equal to those provided by us to the executive immediately prior to completion of the merger. The change in

control severance agreements also provide for comprehensive officer liability insurance coverage and continued indemnification rights.

Table of Contents

Under the change in control severance agreements, if the covered executive s employment with Michaels is terminated without cause in anticipation of the completion of the merger or if, during the two-year period after the completion of the merger, the executive is terminated without cause or resigns for good reason (which includes, among other things, (1) the assignment to the executive of duties and responsibilities that are materially inconsistent with the executive s status, offices, titles and reporting relationships prior to the completion of the merger, (2) the failure to provide the executive with the levels of compensation and benefits required pursuant to the change in control severance agreement and (3) a relocation greater than 50 miles from the executive s current principal place of business), the executive would be entitled to the following severance benefits under the change in control severance agreement:

a lump-sum cash severance payment equal to two times (three times, in the case of Messrs. Boyer and Sandfort) the sum of (1) the executive s base salary in effect on the date of termination and (2) the greater of the average annual incentive award for the previous three fiscal years and the target annual bonus for the year of termination;

a prorated target annual bonus, provided that in the event that Michaels or the surviving corporation makes payments under the annual incentive plan in which the executive participates immediately prior to termination to participants who remain actively employed at a level that exceeds the target level, Michaels or the surviving corporation will make an additional payment to the executive equal to the excess of the actual payout level over the executive s target level bonus, prorated to reflect the period of the executive s employment during the year of termination;

the continuation of welfare and fringe benefits for two years (three years, in the case of Messrs. Boyer and Sandfort) after termination of employment or a lump-sum cash payment in lieu thereof;

the accelerated vesting of all outstanding equity-based compensation awards and the termination of any restrictions and forfeiture provisions related to such awards;

two additional years (three additional years, in the case of Messrs. Boyer and Sandfort) of retirement plan age and service credit for purposes of computing the executive s accrued benefits under our retirement plans or a lump-sum cash payment in lieu thereof; and

reimbursement for the cost of executive-level outplacement services (subject to a $50,000 ceiling).

In addition to the foregoing, in accordance with the change in control severance agreements, Michaels or the surviving corporation will make certain tax gross-up payments to address taxes, interest and penalties that may be imposed under applicable tax laws in connection with excess parachute payments (as defined in Section 280G of the Internal Revenue Code of 1986, as amended (the Internal Revenue Code)) and nonqualified deferred compensation (as defined in Section 409A of the Internal Revenue Code) and will reimburse the executive for certain legal fees and related expenses incurred in connection with negotiations with the Sponsor Entities, including the negotiation of equity rollovers and new employment arrangements. The executives will be entitled to the payments and benefits described in this paragraph even if their employment does not terminate under circumstances that entitle them to severance and they remain employed by the surviving corporation during the two-year period following the completion of the merger.

In order to obtain severance benefits under a change in control severance agreement, an executive must first execute a separation agreement with Michaels or the surviving corporation that includes a waiver and release of any and all claims against Michaels and a commitment that, for one year following termination, the executive will not solicit or hire any employee of Michaels or its subsidiaries and will not interfere with any relationship between Michaels and its employees, customers or suppliers.

The following table shows the amount of potential cash severance payable to each of our current executive officers who is a party to a change in control severance agreement (including the amount the executive would receive as a

result of additional age and service credits under our retirement plans and including the amount the officer would be entitled to be reimbursed for outplacement expenses), based on compensation and benefit levels in effect on July 25, 2006, and assuming the merger is completed on September 25, 2006, and the executive s employment terminates under circumstances that entitle him to severance immediately thereafter. The table also

Table of Contents

shows the estimated value of continuing welfare and fringe benefits and the estimated tax gross-up payment to each such executive in respect of the excise tax imposed on excess parachute payments.

Name	Amount of Potential Cash Severance Payment*	Estimated Value of Welfare and Fringe Benefits	Estimated 280G Gross-Up Payment**
Jeffrey N. Boyer	$ 2,539,719	$ 47,815	$ 1,166,973
Gregory A. Sandfort	$ 2,529,213	$ 122,094	$ 1,295,871
Thomas M. Bazzone	$ 1,106,625	$ 82,172	$ 653,038
Thomas C. DeCaro	$ 943,223	$ 86,240	$ 0
Harvey S. Kanter	$ 1,107,225	$ 95,696	$ 0
Edward F. Sadler	$ 1,120,220	$ 98,082	$ 0

* Includes two or three times (as applicable) the sum of base salary and current target bonus, a prorated target annual bonus for 2006, two or three years (as applicable) of service credit under our qualified and nonqualified retirement plans and $50,000 for outplacement services.

** Estimates are subject to change based on the date of completion of the merger, date of termination of the executive officer, interest rates then in effect and certain other assumptions

used in the calculation. Estimates include the estimated tax gross-up as a result of any acceleration of vesting of stock options as well as the potential cash severance payment and estimated value of benefits set forth in the preceding two columns. In addition, estimates include the estimated tax gross-ups required to be paid in connection with the change in control bonuses, which are described below.

Change in Control Retention Bonus Plan

Michaels has adopted a change in control retention bonus plan in which each of our current executive officers (other than those executive officers who are also members of our board of directors) and certain other key employees participate. Under the change in control retention bonus plan, each executive officer will receive a $125,000 bonus on the one-year anniversary of the completion of the merger, provided that he or she remains employed until such date. If an executive s employment is terminated without cause after the completion of the merger but prior to the one-year anniversary, the executive will continue to be eligible to receive the change in control retention bonus.

Fiscal Year 2006 Bonus Enhancement

Participants (including our current executive officers, other than those executive officers who are also members of our board of directors) in our Fiscal Year 2006 Bonus Plan program will be eligible to receive a one-time bonus enhancement. Under the terms of the bonus plan enhancement, we have guaranteed a 2006 cash bonus for each participant at a minimum level of one payment tier below the participant s target annual bonus. Each participant will also be eligible to receive an additional bonus payment of up to 75% of the participant s target annual bonus, based on the participant s individual performance in fiscal year 2006.

The following table shows the maximum amount of the 2006 cash bonus that would have been payable to each of our current executive officers who participates in our Fiscal Year 2006 Bonus Plan program in the absence of the bonus enhancement, the maximum amount of each such individual s 2006 bonus enhancement and the sum of the two.

Table of Contents

Name	Maximum Regular 2006 Bonus (a)	Maximum 2006 Bonus Enhancement (b)	Maximum Total 2006 Bonus (a) + (b)
Jeffrey N. Boyer	$318,750	$ 178,125	$ 496,875
Gregory A. Sandfort	$315,000	$ 176,250	$ 491,250
Thomas M. Bazzone	$171,750	$ 85,875	$ 257,625
Thomas C. DeCaro	$165,000	$ 82,500	$ 247,500
Harvey S. Kanter	$172,038	$ 86,019	$ 258,056
Edward F. Sadler	$198,000	$ 99,000	$ 297,000

Termination of the Deferred Compensation Plan and Distribution of Account Balances

Upon completion of the merger, we will terminate our nonqualified deferred compensation plan and will cause all accounts thereunder to be distributed in cash to participants, less any required withholding taxes. All account balances under our nonqualified deferred compensation plan are currently vested.

The following table shows the account balances of our executive officers as of July 25, 2006, in the nonqualified deferred compensation plan. All account balances will be distributed as soon as practicable following completion of the merger. Members of our board of directors do not participate in the nonqualified deferred compensation plan.

Name	Account Balance
R. Michael Rouleau*	$ 3,164,201
Jeffrey N. Boyer	$ 55,694
Gregory A. Sandfort	$ 0
Thomas M. Bazzone	$ 126,894
Thomas C. DeCaro	$ 110,553
Harvey S. Kanter	$ 204,852
Edward F. Sadler	$ 1,923,121

* Mr. R. Michael Rouleau retired as our President and Chief Executive Officer on March 15, 2006.

Benefit Arrangements with the Surviving Corporation

The surviving corporation has agreed, for a period of two years following the completion of the merger, to either (1) maintain our employee benefit plans and agreements (other than equity-based plans) at the level in effect on the date of the merger agreement, and provide compensation and benefits to our employees (including our executive officers) that have a value sufficient to replace the value of compensation and benefits provided to such employees under our equity-based plans prior to the completion of the merger or (2) provide compensation and benefits that are not less favorable in the aggregate (including any value attributable to equity-based compensation) than the benefits provided to employees on date of the completion of the merger.

In addition, the surviving corporation has agreed to honor and continue, without amendment or modification, for a period of two years following the completion of the merger, or, if sooner, until all obligations

thereunder have been satisfied, each of our employment, severance, retention, termination and cash incentive compensation plans, policies, programs, agreements and arrangements (including (1) any change in control severance agreements, (2) the Change in Control Severance Plans I and II, (3) the Change in Control Bonus Program, (4) the Fiscal Year 2006 Bonus Enhancement Program and (5) the Fiscal Year 2006 MIK Power Bonus Plan).

The surviving corporation will also maintain, for a period of two years following the completion of the merger, or, if sooner, until all obligations thereunder have been satisfied, our various incentive plans in accordance with their terms with respect to all performance periods under such incentive plans commencing prior to completion of the merger and ending thereafter. The merger agreement provides for other benefit arrangements for specified periods.

Directors and Officers Indemnification and Insurance

The merger agreement provides that all rights to indemnification and exculpation from liabilities for acts or omissions occurring at or prior to the effective time of the merger and rights to advancement of expenses relating thereto now existing in favor of any person who is or prior to the effective time of the merger becomes, or has been at any time prior to the date of the merger agreement, a director, officer, employee or agent (including as a fiduciary with respect to an employee benefit plan) of Michaels, any of our subsidiaries or any of our or their respective predecessors (each, an indemnified party) as provided in the organizational documents of Michaels or any of our subsidiaries or any indemnification agreement between such indemnified party and us or any of our subsidiaries (in each case, as in effect on date of the merger agreement or, with respect to any indemnification agreement entered into after the date of the merger agreement, to the extent the terms thereof are no more favorable in any material respect to the indemnified party than those of certain indemnification agreements existing prior to the date of the merger agreement) shall survive the merger and shall not be amended, repealed or otherwise modified in any manner that would adversely affect any right thereunder of any such indemnified party.

The merger agreement also provides that, without limiting any right of any indemnified party pursuant to any indemnification agreement, from and after the effective time of the merger, in the event of any threatened or actual claim, action, suit, proceeding or investigation, whether civil, criminal or administrative in which any person who is now, or has been at any time prior to the date of the merger agreement, or who becomes prior to the effective time, a director or officer of Michaels is or is threatened to be, made a party in his or her capacity as a director or officer of Michaels, the surviving corporation shall, for a period of six years after the effective time, indemnify and hold harmless, to the fullest extent permitted by law, each such indemnified party in his or her capacity as a director or officer of Michaels or any of our subsidiaries, or any of our or their respective predecessors, against any losses, claims, damages, liabilities, costs, expenses (including reasonable attorney s fees and expenses), judgments, fines and amounts paid in settlement of or in connection with any such threatened or actual claim, arising out of, or pertaining to (1) the fact that such an indemnified party was a director (including in a capacity as a member of any board committee) or officer of Michaels, any of our subsidiaries or any of our or their respective predecessors, or a fiduciary with respect to any employee benefit plan maintained by any of the foregoing, prior to the effective time or (2) the merger agreement or any of the transactions contemplated by the merger agreement, whether in any case asserted or arising before or after the effective time. The surviving corporation has agreed not to settle, compromise or consent to the entry of any judgment in any threatened or actual claim for which indemnification could be sought by an indemnified party under the merger agreement, unless such settlement, compromise or consent includes an unconditional release of such indemnified party from all liability arising out of such claim or such indemnified party otherwise consents in writing to such settlement, compromise or consent. The surviving corporation has also agreed to cooperate with an indemnified party in the defense of any matter for which such indemnified party could seek indemnification under the merger agreement.

The merger agreement further provides that the surviving corporation shall obtain, at the effective time, prepaid (or tail) directors and officers liability insurance policies in respect of acts or omissions occurring at or prior to the effective time for six years from the effective time, covering each indemnified party on terms with respect to such coverage and amounts no less favorable than those of such policies in effect on the date of the merger agreement. In the event the surviving corporation is unable to obtain such tail insurance policies, then, for a period of six years from the effective time, the surviving corporation is required to maintain in effect our current directors and officers liability insurance policies in respect of acts or omissions occurring at or prior to the effective time, covering each indemnified

party on terms with respect to such coverage and amounts no less

favorable than those of such policies in effect on the date of the merger agreement; provided that the surviving corporation may substitute policies of a reputable and financially sound insurance company containing terms no less favorable to any indemnified party; provided further that in satisfying these obligations the surviving corporation is not obligated to pay for coverage for any 12-month period aggregate premiums for insurance in excess of 250% of the amount paid by us for coverage for the period of 12 months beginning on June 1 most recently commenced prior to the date of the merger agreement, although the surviving corporation is required to provide such coverage as may be obtained for such amount.

Arrangements with the Sponsor Entities

As of the date of this proxy statement, no member of our management has entered into any agreement, arrangement or understanding with Bain or Blackstone or their affiliates regarding employment with, or the right to purchase or participate in the equity of, the surviving corporation. In addition, as of the date of this proxy statement no member of our board of directors has entered into any agreement, arrangement or understanding with Bain or Blackstone or their affiliates regarding the right to purchase or participate in the equity of the surviving corporation. Bain and Blackstone have informed us that it is their intention to retain members of our existing management team with the surviving corporation after the merger is completed. Members of management currently are engaged in discussions with representatives of Bain and Blackstone regarding revised terms of employment. In addition to revised terms of employment, Bain and Blackstone have informed us that they anticipate offering members of management the opportunity to convert a portion of their current equity interests in Michaels into equity in the surviving corporation, and that they also intend to set up equity-based incentive compensation plans for management of the surviving corporation. Although we believe members of our management team are likely to enter into new arrangements with the surviving corporation or affiliates of the Sponsor Entities regarding employment with, and the right to purchase or participate in the equity of, the surviving corporation, such matters are subject to further negotiations and discussion and no terms or conditions have been finalized. Any such new arrangements are expected to be entered into prior to the completion of the merger.

Non-Competition Arrangements with the Surviving Corporation

It is contemplated that the surviving corporation will enter into a two-year non-compete agreement with each of Messrs. Charles J. Wyly, Jr. and Sam Wyly, and pay an aggregate of $6 million pursuant to the terms of those agreements.

Appraisal Rights

Our stockholders have the right under Delaware law to dissent from the adoption of the merger agreement, to exercise appraisal rights and to receive payment in cash for the fair value of their shares of our common stock determined in accordance with Delaware law. The fair value of shares of our common stock, as determined in accordance with Delaware law, may be more or less than the merger consideration to be paid to non-dissenting stockholders in the merger. To preserve their rights, stockholders who wish to exercise appraisal rights must not vote in favor of the adoption of the merger agreement and must follow specific procedures. Dissenting stockholders must precisely follow these specific procedures to exercise appraisal rights, or their appraisal rights may be lost. These procedures are described in this proxy statement, and the provisions of Delaware law that grant appraisal rights and govern such procedures are attached as Annex E to this proxy statement. See *Appraisal Rights* beginning on page 63.

Delisting and Deregistration of Our Common Stock

If the merger is completed, our common stock will be delisted from the NYSE and deregistered under the Securities Exchange Act of 1934, as amended (the Exchange Act), and we will no longer file periodic reports with the SEC on account of our common stock.

Material United States Federal Income Tax Consequences of the Merger

The following is a discussion of the material United States federal income tax consequences of the merger to U.S. holders whose shares of our common stock are converted into the right to receive cash in the merger. The discussion is based upon the Internal Revenue Code, Treasury regulations, Internal Revenue Service rulings and judicial and administrative decisions in effect as of the date of this proxy statement, all of which are subject to

change (possibly with retroactive effect) or to different interpretations. The following discussion does not purport to consider all aspects of U.S. federal income taxation that might be relevant to our stockholders. This discussion applies only to stockholders who, on the date on which the merger is completed, hold shares of our common stock as a capital asset. The following discussion does not address taxpayers subject to special treatment under U.S. federal income tax laws, such as insurance companies, financial institutions, dealers in securities, tax-exempt organizations, mutual funds, real estate investment trusts, investors in pass-through entities, S corporations and taxpayers subject to the alternative minimum tax. In addition, the following discussion may not apply to stockholders who acquired their shares of our common stock upon the exercise of employee stock options or otherwise as compensation for services or through a tax-qualified retirement plan or who hold their shares as part of a hedge, straddle, conversion transaction or other integrated transaction. If our common stock is held through a partnership, the U.S. federal income tax treatment of a partner in the partnership will generally depend upon the status of the partner and the activities of the partnership. Partnerships that are holders of our common stock and partners in such partnerships are urged to consult their own tax advisors regarding the tax consequences to them of the merger.

The following discussion does not address potential foreign, state, local and other tax consequences of the merger. **All stockholders are urged to consult their own tax advisors regarding the U.S. federal income tax consequences, as well as the foreign, state and local tax consequences, of the disposition of their shares in the merger.**

For purposes of this summary, a U.S. holder is a holder of shares of our common stock, who or that is, for U.S. federal income tax purposes:

- an individual who is a citizen or resident of the United States;
- a corporation (or other entity taxable as a corporation) created or organized in or under the laws of the United States, any state of the United States or the District of Columbia;
- an estate the income of which is subject to U.S. federal income tax regardless of its source; or
- a trust if (1) a U.S. court is able to exercise primary supervision over the trust s administration and one or more U.S. persons are authorized to control all substantial decisions of the trust; or (2) it was in existence on August 20, 1996 and has a valid election in place to be treated as a domestic trust for U.S. federal income tax purposes.

Except with respect to the backup withholding discussion below, this discussion does not discuss the tax consequences to any stockholder who or that, for U.S. federal income tax purposes, is not a U.S. holder.

For U.S. federal income tax purposes, the merger will be treated as a sale of our common stock for cash by each of our stockholders. Accordingly, in general, the U.S. federal income tax consequences to a stockholder receiving cash in the merger will be as follows:

- The stockholder will recognize a capital gain or loss for U.S. federal income tax purposes upon the disposition of the stockholder s shares of our common stock pursuant to the merger.
- The amount of capital gain or loss recognized by each stockholder will be measured by the difference, if any, between the amount of cash received by the stockholder in the merger and the stockholder s adjusted tax basis in the shares of our common stock surrendered in the merger. Gain or loss will be determined separately for each block of shares (*i.e.*, shares acquired at the same cost in a single transaction) surrendered for cash in the merger.
- The capital gain or loss, if any, will be long-term with respect to shares of our common stock that have a holding period for tax purposes in excess of one year at the time of the merger. Long-term capital gains of individuals are eligible for reduced rates of taxation. There are limitations on the deductibility of capital losses.

Cash payments made pursuant to the merger will be reported to our stockholders and the Internal Revenue Service to the extent required by the Internal Revenue Code and applicable Treasury regulations. These amounts

43

ordinarily will not be subject to withholding of U.S. federal income tax. However, backup withholding of the tax at applicable rates will apply to all cash payments to which a U.S. holder is entitled pursuant to the merger agreement if such holder (1) fails to supply the paying agent with the stockholder s taxpayer identification number (Social Security number, in the case of individuals, or employer identification number, in the case of other stockholders), certify that such number is correct, and otherwise comply with the backup withholding rules, (2) has received notice from the Internal Revenue Service of a failure to report all interest and dividends required to be shown on the stockholder s U.S. federal income tax returns, or (3) is subject to backup withholding in certain other cases. Accordingly, each U.S. holder will be asked to complete and sign a Substitute Form W-9, which is to be included in the appropriate letter of transmittal for the shares of our common stock, in order to provide the information and certification necessary to avoid backup withholding or to otherwise establish an exemption from backup withholding tax, unless an exemption applies and is established in a manner satisfactory to the paying agent. Stockholders who are not U.S. holders should complete and sign a Form W-8BEN (or other applicable tax form) and return it to the paying agent in order to provide the information and certification necessary to avoid backup withholding tax or otherwise establish an exemption from backup withholding tax. Certain of our stockholders will be asked to provide additional tax information in the appropriate letter of transmittal for the shares of our common stock.

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules will be allowed as a refund or a credit against your U.S. federal income tax liability provided the required information is timely furnished to the Internal Revenue Service.

The foregoing discussion of certain material U.S. federal income tax consequences is included for general informational purposes only. We urge you to consult your own tax advisor to determine the particular tax consequences to you (including the application and effect of any state, local or foreign income and other tax laws) of the receipt of cash in exchange for shares of our common stock pursuant to the merger.

Regulatory Approvals

Under the merger agreement, we and the other parties to the merger agreement have agreed to use our reasonable best efforts to complete the transactions contemplated by the merger agreement as promptly as practicable, including obtaining all necessary governmental approvals. The Hart-Scott-Rodino Act provides that transactions such as the merger may not be completed until certain information has been submitted to the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice and certain waiting period requirements have been satisfied. Michaels and an entity to be formed to invest in the Mergercos filed notification reports with the Department of Justice and the Federal Trade Commission under the Hart-Scott-Rodino Act on August 28, 2006, and August 24, 2006, respectively.

Except as noted above with respect to the required filings under the Hart-Scott-Rodino Act and the filing of a certificate of merger in Delaware at or before the effective date of the merger, we are unaware of any material federal, state or foreign regulatory requirements or approvals required for the execution of the merger agreement or completion of the merger.

Litigation Concerning the Merger

On March 21, 2003, Julie Fathergill filed a purported stockholder derivative action, which is pending in the 192nd District Court for Dallas County, Texas. The lawsuit names certain former and current officers and directors, including all of our current directors, as individual defendants, and Michaels, as a nominal defendant.

On July 10, 2006, the plaintiff filed a Second Amended Shareholder Derivative and Class Action Petition in which she added new class action allegations regarding the proposed merger. Among other things, the plaintiff seeks (1) a declaration that the merger agreement violates the individual defendants' fiduciary duties and therefore is unlawful and unenforceable, (2) an injunction that prevents the consummation of the proposed transaction unless and until we disclose all material facts regarding the merger and implement procedures to obtain the highest possible price for our company, (3) an indeterminate amount of damages from the individual defendants, (4) certain corporate governance changes, (5) formation of a constructive trust on the proceeds of defendants' alleged trading activities and (6) restitution from, and disgorgement of proceeds derived by, the named officers with respect to the alleged acts.

The lawsuit is in its preliminary stage. We believe that the lawsuit is without merit and intend to defend the lawsuit vigorously.

On June 9, 2006, Feivel Gottlieb and on June 12, 2006, Roberta Schuman each filed purported stockholder derivative actions, which are pending in the 191st and the 14th District Courts for Dallas County, Texas, respectively. The lawsuits name our chairman of the board and vice chairman of the board, both in their capacities as our officers and directors, and all of our other current directors, as individual defendants, and Michaels, as a nominal defendant.

On July 5, 2006, the plaintiffs filed First Amended Shareholder Derivative and Class Action Petitions (amended petitions) against the individual defendants, Michaels, as a nominal defendant, and Bain and Blackstone. The amended petitions add class action allegations against our directors for breach of fiduciary duty related to the proposed merger, and a claim against Bain and Blackstone for aiding and abetting the directors alleged breach of fiduciary duty. As a result of these new claims, the plaintiffs seek (1) to enjoin the transaction with Bain and Blackstone (or declare it void, if it is consummated), (2) require the defendants to disgorge the property they received as a result of their allegedly wrongful conduct and (3) an indeterminate amount of damages from the defendants, jointly and severally.

By court order dated August 18, 2006, the Gottlieb and Schuman actions were consolidated with the Fathergill action, described above.

The lawsuit is in its preliminary stage. We believe that the lawsuit is without merit and intend to defend the lawsuit vigorously.

On June 19, 2006, Albert Hulliung filed a purported stockholder derivative action, which is pending in the United States District Court, Northern District of Texas, Dallas Division. The lawsuit named our chairman of the board and vice chairman of the board, all of our other current directors, one additional current officer and certain of our former officers as individual defendants and Michaels as a nominal defendant.

On July 27, 2006, the plaintiff amended his complaint adding certain of our other former and current officers and one former director as individual defendants and included allegations similar to those set forth in the second amended (July 10, 2006) Fathergill petition, described above. The plaintiff seeks, among other relief, (1) an indeterminate amount of damages from the individual defendants, (2) restitution from, and disgorgement of proceeds derived by, the individual defendants who received stock options, (3) the imposition of a constructive trust against the individuals who were alleged to have engaged in insider sales and (4) other unspecified equitable relief.

The lawsuit is in its preliminary stage. We believe that the lawsuit is without merit and intend to defend the lawsuit vigorously.

Table of Contents

THE MERGER AGREEMENT

The merger agreement is the legal document that governs the merger. This section of the proxy statement describes the material provisions of the merger agreement but may not contain all of the information about the merger agreement that is important to you. The merger agreement is included as Annex A to this proxy statement and is incorporated into this proxy statement by reference. The first amendment to the merger agreement is included as Annex B to this proxy statement and is incorporated into this proxy statement by reference. We encourage you to read the merger agreement, as amended, in its entirety. The merger agreement, as amended, is a commercial document that establishes and governs the legal relations between us and the Sponsor Entities with respect to the transactions described in this proxy statement. The representations, warranties and covenants made by us and the Sponsor Entities are qualified and subject to important limitations agreed to by us and the Sponsor Entities in connection with negotiating the terms of the merger agreement. Furthermore, the representations and warranties may be subject to standards of materiality applicable to us and the Sponsor Entities that may be different from those that are applicable to you.

Effective Time; The Marketing Period

The effective time of the merger will occur at the time that we file a certificate of merger with the Secretary of State of the State of Delaware on the closing date of the merger (or such later time as provided in the certificate of merger). So long as the marketing period has expired, the closing date will occur on the first business day after all of the conditions to the merger set forth in the merger agreement have been satisfied or waived (or such other date as we and the Mergercos may agree). In the event that all conditions have been satisfied but the marketing period has not expired, then the parties are not required to effect the closing until the earlier of:

- a date during the marketing period specified by the Mergercos on no less than three business days notice to us; and

- the final day of the marketing period.

The marketing period is defined in the merger agreement as the first period of 30 consecutive days following the later of (i) the adoption of the merger agreement by our stockholders and (ii) September 4, 2006, throughout which:

- the Fincos shall have financial and other pertinent information regarding Michaels as may be reasonably requested by them to consummate the debt financing, including all financial statements and financial data of the type required by Regulation S-X and Regulation S-K under the Securities Act of 1933, as amended (the Securities Act) (other than Rule 3-10 of Regulation S-X) and of type and form customarily included in private placements pursuant to Rule 144A promulgated under the Securities Act (collectively, the required financial information); and

- nothing has occurred and no condition exists that would cause any of the conditions to the Sponsor Entities obligations to close not to be satisfied assuming the closing were to be scheduled for any time during such consecutive 30-day period; and

at the end of which, we have received stockholder approval of the merger agreement, no judgment or order issued by any Federal or state court is in effect that enjoins or prohibits consummation of the merger and the waiting period under the Hart-Scott-Rodino Act has terminated or has expired.

If the marketing period shall not have commenced prior to November 1, 2006, as a result of the failure of the Fincos to have the required financial information, then, subject to Michaels having complied as of the first day of the marketing period with our obligations under the merger agreement to use our reasonable best efforts to provide

the required financial information to the Fincos, the marketing period shall be the first period of 30 consecutive days after November 1, 2006, throughout which:

- the Fincos shall have all financial statements for a high-yield financing during the marketing period of the type required in a registered offering by Regulation S-X and Regulation S-K under the Securities Act (other than Rule 3-10 of Regulation S-X) that are customarily included in private placements pursuant to Rule 144A promulgated under the Securities Act, and, in the case of the annual financial statements, the auditors report thereon (collectively, the core required financial information); and

- nothing has occurred and no condition exists that would cause any of the conditions to the Sponsor Entities obligations to close not to be satisfied assuming the closing were to be scheduled for any time during such consecutive 30-day period; and

at the end of which, we have received stockholder approval of the merger agreement, no judgment or order issued by any Federal or state court is in effect that enjoins or prohibits consummation of the merger and the waiting period under the Hart-Scott-Rodino Act has terminated or has expired.

If the financial statements included in the required financial information or the core required financial information, as the case may be, that is available to the Fincos on the first day of any such 30-day period would be stale , within the meaning of Rule 3-12 of Regulation S-X, on any day during such 30-day period if a registration statement using such financial statements were to be filed with the SEC on such date, then a new 30-day period commences.

Throughout the marketing period the Sponsor Entities have agreed:

- to use reasonable best efforts to satisfy on a timely basis the conditions to obtaining the financing set forth in the debt financing commitments obtained in connection with the merger and to cause the lenders providing the debt financing to fund such financing; and

- in the event that any portion of the debt financing becomes unavailable on the terms and conditions contemplated in such commitments, to use reasonable best efforts to obtain as promptly as practicable alternative financing.

In addition, in the event that any portion of the debt financing structured as high yield financing has not been consummated, then, subject to certain exceptions, the Sponsor Entities must use the proceeds of the bridge financing to replace the high yield financing no later than the last day of the marketing period. See *Financing Commitments; Cooperation of Michaels* below for a further discussion of the Sponsor Entities covenants relating to the financing commitments.

Structure

Subject to the terms and conditions of the merger agreement and in accordance with Delaware law, at the effective time of the merger, each Mergerco will merge with and into Michaels. The separate corporate existences of each Mergerco will cease, and Michaels will continue as the surviving corporation, wholly owned by entities sponsored by or co-investors with Bain and Blackstone. The surviving corporation will be a privately held corporation and our current stockholders, other than any co-investors and members of our management who may be permitted to invest in the surviving corporation and who choose to so invest, will cease to have any ownership interest in the surviving corporation or rights as our stockholders. Therefore, such current stockholders will not participate in any future earnings or growth of the surviving corporation and will not benefit from any appreciation in value of the surviving corporation.

Treatment of Stock and Options

Common Stock

At the effective time of the merger, each share of our common stock issued and outstanding immediately prior to the effective time of the merger will automatically be canceled and will cease to exist and will be converted into the right to receive $44.00 in cash, without interest and less applicable withholding taxes, other than shares of our common stock:

- held in our treasury immediately prior to the effective time of the merger, which shares will be canceled without conversion or consideration;
- owned by any of the Sponsor Entities immediately prior to the effective time of the merger, which shares will be canceled without conversion or consideration;
- held by stockholders who have properly demanded and perfected their appraisal rights in accordance with Delaware law, which shares shall be entitled to payment of the fair value of such shares in accordance with Delaware law; and
- retained by the Highfields Funds and members of our management as rollover shares.

After the effective time of the merger, each of our outstanding stock certificates representing shares of common stock converted in the merger will represent only the right to receive the merger consideration of $44.00 in cash per share, without any interest and less applicable withholding taxes, and any dividends declared with a record date prior to the effective time that remain unpaid at the effective time and that are due with respect to such shares. The merger consideration (and dividends, if any) paid upon surrender of each certificate will be paid in full satisfaction of all rights pertaining to the shares of our common stock represented by that certificate.

Stock Options and Restricted Stock

At the effective time of the merger, each outstanding option (other than rollover options held by members of our management) to purchase shares of our common stock, whether or not then exercisable, will be canceled and converted into the right to receive an amount in cash equal to the excess (if any) of the $44.00 per share cash merger consideration over the exercise price per share of the option, multiplied by the number of shares subject to the option (such amount, the option amount), without interest and less any applicable withholding taxes, and all outstanding shares of restricted stock will be converted into the right to receive $44.00 per share in cash, without interest and less any applicable withholding taxes.

Exchange and Payment Procedures

At or prior to the effective time of the merger, the Sponsor Entities will deposit, or will cause the surviving corporation to deposit, cash in an amount sufficient to pay the merger consideration and the option amounts due to each holder of shares of our common stock with a bank or trust company (the paying agent) reasonably acceptable to us. Within two business days after the effective time of the merger, the surviving corporation will cause the paying agent to mail a letter of transmittal and instructions to you and the other stockholders. The letter of transmittal and instructions will tell you how to surrender your common stock certificates in exchange for the merger consideration.

You should not return your stock certificates with the enclosed proxy card, and you should not forward your stock certificates to the paying agent without a letter of transmittal.

You will not be entitled to receive the merger consideration until you surrender your stock certificate or certificates to the paying agent, together with a duly completed and executed letter of transmittal and any other documents as may reasonably be required by the paying agent. The merger consideration may be paid to a person other than the person in whose name the corresponding certificate is registered if the certificate is properly endorsed or is otherwise in the proper form for transfer. In addition, the person who surrenders such certificate must either pay any fiduciary or surety bonds or any transfer or other similar taxes or establish to the reasonable satisfaction of the surviving corporation that such taxes have been paid or are not applicable.

No interest will be paid or will accrue on the cash payable upon surrender of the certificates. The surviving corporation or the paying agent will be entitled to deduct and withhold, and pay to the appropriate taxing authorities, any applicable taxes from the merger consideration and the option amounts. Any sum which is withheld and paid to a taxing authority by the surviving corporation or the paying agent will be deemed to have been paid to the person with regard to whom it is withheld.

At the close of business on the day on which the effective time of the merger occurs, our stock transfer books will be closed, and there will be no further registration of transfers of outstanding shares of our common stock. If, after the close of business on the day on which the effective time of the merger occurs, certificates are presented to the surviving corporation for transfer, they will be canceled and exchanged for the merger consideration.

None of Michaels, the surviving corporation, the Sponsor Entities or the paying agent will be liable to any person for any cash delivered to a public official pursuant to any applicable abandoned property, escheat or similar law. Any portion of the merger consideration deposited with the paying agent that remains undistributed to the holders of certificates evidencing shares of our common stock for twelve months after the effective time of the merger, will be delivered, upon demand, to the surviving corporation. Holders of certificates who have not surrendered their certificates prior to the delivery of such funds to the surviving corporation may only look to the surviving corporation for, and the surviving corporation shall remain liable for, the payment of the merger consideration. Any portion of the merger consideration that remains unclaimed as of a date that is immediately prior to such time as such amounts would otherwise escheat to or become property of any governmental authority will, to the extent permitted by applicable law, become the property of the surviving corporation free and clear of any claims or interest of any person previously entitled to the merger consideration.

If you have lost a certificate, or if it has been stolen or destroyed, then before you will be entitled to receive the merger consideration, you will have to make an affidavit of that fact and, if required by the surviving corporation, post a bond or surety in such reasonable amount as the surviving corporation may direct as indemnity against any claim that may be made against it with respect to that certificate.

Representations and Warranties

We make various representations and warranties in the merger agreement, including with respect to, among other things:

- our and our subsidiaries proper organization, good standing and qualification to do business;
- our interests in our subsidiaries;
- our capitalization, including in particular the number of shares of our common stock, stock options and other equity-based interests;
- our outstanding indebtedness for borrowed money;
- our corporate power and authority to enter into the merger agreement and to consummate the transactions contemplated by the merger agreement;
- the approval and recommendation by our board of directors of the merger agreement, the merger and the other transactions contemplated by the merger agreement;
- the absence of violations of or conflicts with our and our subsidiaries governing documents, applicable law or certain agreements as a result of entering into the merger agreement and consummating the merger;
- the required consents and approvals of governmental entities in connection with the transactions contemplated by the merger agreement;
- our SEC filings since January 1, 2004, including the financial statements contained therein;

48

Table of Contents

- the absence of undisclosed liabilities;
- the accuracy of this proxy statement;
- the absence of a material adverse effect and certain other changes or events related to us or our subsidiaries since January 28, 2006;
- legal proceedings and judgments;
- contracts to which we or our subsidiaries are a party;
- compliance with laws;
- possession of permits necessary to conduct our business;
- employment and labor matters affecting us or our subsidiaries, including matters relating to our and our subsidiaries employee benefit plans;
- taxes and environmental matters;
- real property;
- intellectual property;
- our and our subsidiaries insurance policies;
- the required vote of our stockholders in connection with the adoption of the merger agreement;
- the inapplicability of anti-takeover statutes to the merger;
- the absence of undisclosed broker s fees;
- the receipt by us of a fairness opinion from each of JPMorgan and Goldman Sachs; and
- affiliate transactions.

For the purposes of the merger agreement, material adverse effect means any change, effect, event, occurrence or state of facts that (1) is materially adverse to the business, financial condition or results of operations of Michaels and our subsidiaries, taken as a whole, or (2) prevents or materially impedes, interferes with, hinders or delays beyond December 19, 2006 (or such later date as set forth in the merger agreement) the consummation by Michaels of the merger or the other transactions contemplated by the merger agreement.

A material adverse effect will not have occurred, however, as a result of any change, effect, event, occurrence or state of facts:

- relating to economic, financial market or geopolitical conditions in general;
- relating to changes in law or applicable accounting regulations or principles or interpretations thereof;
- relating to the specialty retail industry generally, to the extent such change, effect, event, occurrence or state of fact does not materially, disproportionately impact Michaels and our subsidiaries, taken as a whole;

consisting of any change in our stock price or trading volume, in and of itself, or any failure, in and of itself, by us to meet published revenue or earnings projections (it being understood that the facts or occurrences giving rise or contributing to such change or failure may be deemed to constitute, or be taken into account in determining whether there has been or would reasonably be expected to be, a

material adverse effect, and it being further understood that any such change or failure may be taken into account in determining whether the facts or occurrences giving rise or contributing to such change or failure are materially adverse to the business, financial condition or results of operations of Michaels and our subsidiaries, taken as a whole);

relating to any outbreak or escalation of hostilities or war or any act of terrorism; and

relating to the announcement of the merger agreement and the transactions contemplated thereby and performance of and compliance with the terms of the merger agreement.

The merger agreement also contains various representations and warranties made by the Sponsor Entities, including with respect to, among other things:

their organization, valid existence and good standing;

their corporate or other power and authority to enter into the merger agreement and to consummate the transactions contemplated by the merger agreement;

the absence of any violation of or conflict with their governing documents, applicable law or certain agreements as a result of entering into the merger agreement and consummating the merger;

the required consents and approvals of governmental entities in connection with the transactions contemplated by the merger agreement;

the accuracy of information supplied for inclusion or incorporation by reference in this proxy statement;

debt and equity financing commitments;

their purpose of formation and prior activities;

their lack of ownership of our common stock; and

the absence of undisclosed broker s fees.

The representations and warranties of each of the parties to the merger agreement will expire upon the effective time of the merger. You should be aware that these representations and warranties made by Michaels to the Sponsor Entities or by the Sponsor Entities to Michaels, as the case may be, subject to important limitations and qualifications agreed to by the parties to the merger agreement, may or may not be accurate as of the date they were made and do not purport to be accurate as of the date of this proxy statement.

Conduct of Our Business Pending the Merger

Under the merger agreement, we have agreed that, subject to certain exceptions and unless the Mergercos give their prior written consent, between June 30, 2006 and the effective time of the merger, we will, and will cause each of our subsidiaries to:

carry on business in the ordinary course; and

to the extent consistent therewith, use reasonable best efforts to preserve substantially intact our and its current business organizations, to keep available the services of our and our subsidiaries current officers and employees and to preserve our and our subsidiaries relationships with significant customers, suppliers, licensors, licensees, distributors, wholesalers, lessors and others with which we and our subsidiaries have significant business dealings.

We have also agreed that during the same time period, and again subject to certain exceptions or unless the Mergercos give their prior written consent, we will not, and will not permit any of our subsidiaries to:

50

declare, set aside or pay any dividends on, or make any other distributions (whether in cash, stock or property) in respect of, any of our or its capital stock, other than:

dividends or distributions by a direct or indirect wholly owned subsidiary to its parent; and

regular quarterly cash dividends on our common stock, not to exceed, in the case of any such quarterly dividend, $0.12 per share;

split, combine or reclassify any of our or our subsidiaries capital stock or issue or authorize the issuance of any other securities in lieu of or in substitution for shares of our or our subsidiaries capital stock;

purchase, redeem or otherwise acquire any shares of our or our subsidiaries capital stock or any rights, warrants or options to acquire any such shares, other than:

the acquisition by us of shares of our common stock in connection with the surrender of shares of our common stock by holders of stock options in order to pay the exercise price of the stock options;

the withholding of shares of our common stock to satisfy tax obligations with respect to awards granted pursuant to our stock plans;

the acquisition by us of stock options and shares of our restricted stock in connection with the forfeiture of such awards; and

the acquisition by the trustee of the 401(k) Plan of shares of our common stock in order to satisfy participant investment elections under the 401(k) Plan;

issue, deliver or sell any shares of our or our subsidiaries capital stock, any other voting securities or any securities convertible into, or any rights, warrants or options to acquire, any such shares, voting securities or convertible securities, or any phantom stock, phantom stock rights, stock appreciation rights or stock based performance units, other than:

upon the exercise of stock options and rights under the ESPP outstanding on June 30, 2006, in each case in accordance with their then present terms;

as required to comply with any benefit plan or benefit agreement of Michaels as in effect on June 30, 2006; and

the issuance of shares of our common stock pursuant to our Dividend Reinvestment and Stock Purchase Plan;

amend our or our subsidiaries certificate of incorporation or bylaws or comparable organizational documents;

purchase an equity interest in or a substantial portion of the assets of, any person or any division or business thereof, if the aggregate amount of the consideration paid or transferred by us and our subsidiaries in connection with all such transactions would exceed $20.0 million or merge or consolidate with any person, in each case other than any such action solely between or among us and our subsidiaries;

sell, lease or otherwise dispose of any of our or our subsidiaries properties or assets (including capital stock of any subsidiary) that are material, individually or in the aggregate, to us and our subsidiaries, taken as a whole, other than:

- sales or other dispositions of inventory and other assets in the ordinary course of business, including in connection with store relocations, closings, remodels and resets; and

- leases and subleases of real property, and voluntary terminations or surrenders of real property leases, in each case, in the ordinary course of business;

pledge, encumber or otherwise subject to a lien any of our or our subsidiaries properties or assets (including capital stock of any subsidiary), other than in the ordinary course of business;

incur any indebtedness for borrowed money, issue or sell any debt securities or warrants or other rights to acquire any debt securities of us or our subsidiaries, guarantee any such indebtedness or any debt securities of another person or enter into any keep well or other agreement to maintain any financial statement condition of another person, other than:

- indebtedness incurred in the ordinary course of business (including any borrowings under our existing revolving credit facilities and any trade letters of credit); and

- indebtedness incurred in connection with the refinancing of any indebtedness existing on June 30, 2006, or permitted to be incurred, assumed or otherwise entered into under the merger agreement;

- make any loans or capital contributions to, or investments in, any other person, other than:
  - o to any subsidiary; or
  - o in the ordinary course of business;

make any capital expenditures, other than:

- in accordance with our capital expenditures plan made available to the Sponsor Entities in writing prior to June 30, 2006;

- in connection with the repair or replacement of facilities destroyed or damaged due to casualty or accident (whether or not covered by insurance); and

- otherwise, in an aggregate amount for all such capital expenditures not covered above not to exceed $25 million;

settle any material claim or material litigation, in each case made or pending against us or any of our subsidiaries, or any of our or their officers and directors in their capacities as such, other than the settlement of claims or litigation in the ordinary course of business which, in any event;

- is for an amount not to exceed, for any such settlement individually, $10 million; and

- would not be reasonably expected to prohibit or materially restrict us and our subsidiaries from operating our and their business in substantially the same manner as operated on June 30, 2006;

settle any material claim or material litigation relating to the consummation of the transactions contemplated by the merger agreement;

cancel any material indebtedness or waive any claims or rights of substantial value, in each case other than in the ordinary course of business;

except (1) in the ordinary course of business, (2) as contemplated by the merger agreement or (3) as required pursuant to the terms of any benefit plan or benefit agreement or other written agreement in effect on June 30, 2006:

Table of Contents

- grant to any of our or our subsidiaries officers, directors or employees any increase in compensation;
- grant to any of our or our subsidiaries officers, directors or employees any increase in severance or termination pay;
- enter into any employment, consulting, severance or termination agreement with any of our or our subsidiaries officers, directors or employees, other than any separation agreement pursuant to which the aggregate severance benefits do not exceed $300,000 with respect to any individual or $2 million in the aggregate with respect to all such individuals;
- establish, adopt, enter into or amend in any material respect any collective bargaining agreement or benefit plan; or
- accelerate any rights or benefits, or make any material determinations, under any benefit plan;

make any change in accounting methods, principles or practices materially affecting our consolidated assets, liabilities or results of operations, other than as required by generally accepted accounting principles or regulatory requirements with respect thereto;

make any material tax election, file any amended tax return with respect to any material tax or change any annual tax accounting period, in each case, other than in the ordinary course of business; or

authorize any of, or commit or agree to take any of, the actions described above.

Stockholders Meeting

The merger agreement requires us, as promptly as reasonably practicable after June 30, 2006, to establish a record date for, duly call, give notice of and hold a meeting of our stockholders to adopt the merger agreement. Subject to limited circumstances contemplated by the merger agreement, our board of directors is required to recommend that our stockholders vote in favor of adoption of the merger agreement.

No Solicitation of Transactions

We have agreed that we will not, nor will we authorize or permit any of our subsidiaries or any of our or their respective directors, officers or employees to, and we will not authorize our or our subsidiaries respective representatives to, directly or indirectly:

solicit, initiate or knowingly encourage, or take any other action to knowingly facilitate, the making of any proposal that constitutes or is reasonably likely to lead to a takeover proposal ; or

enter into, continue or otherwise participate in any discussions or negotiations regarding or furnish to any person any confidential information with respect to any takeover proposal .

A takeover proposal means any inquiry, proposal or offer (other than the transactions contemplated by the merger agreement) from any person or group relating to:

any direct or indirect acquisition or purchase, in a single transaction or a series of transactions, of:

- 20% or more (based on the fair market value thereof, as determined by our board of directors) of assets (including capital stock of our subsidiaries) of us and our subsidiaries, taken as a whole; or
- 20% or more of the outstanding shares of our common stock;

any tender offer or exchange offer that, if consummated, would result in any person or group owning, directly or indirectly, 20% or more of the outstanding shares of our common stock; or

Table of Contents

- any merger, consolidation, business combination, recapitalization, liquidation, dissolution, binding share exchange or similar transaction involving us pursuant to which any person or group (or the shareholders of any person) would own, directly or indirectly, 20% or more of any class of equity securities of us or of the surviving entity in a merger or the resulting direct or indirect parent of us or such surviving entity.

Prior to adoption of the merger agreement by our stockholders, however, we may (and may authorize and permit our subsidiaries, directors, officers, employees and representatives to), in response to a bona fide written takeover proposal, (1) furnish information with respect to us and our subsidiaries to the person making such takeover proposal and its representatives pursuant to a customary confidentiality agreement containing confidentiality provisions substantially similar to those set forth in the confidentiality agreements we previously entered into with affiliates of the Sponsor Entities and (2) participate in discussions and negotiations with such person and its representatives, if, prior to taking any such actions, our board of directors determines:

- after consultation with its financial advisor and outside counsel, that such takeover proposal constitutes or is reasonably likely to lead to a superior proposal ; and
- after consultation with its outside counsel, that the failure to take such action would be inconsistent with its fiduciary duties under applicable law.

For purposes of the merger agreement, superior proposal means any bona fide takeover proposal that:

- if consummated, would result in a person or group (or the shareholders of any person) owning, directly or indirectly, (1) 50% or more of any class of equity securities of Michaels or of the surviving entity in a merger or the resulting direct or indirect parent of Michaels or such surviving entity or (2) 50% or more (based on the fair market value thereof, as determined by our board of directors) of the assets of Michaels and our subsidiaries, taken as a whole; and
- our board of directors determines (after consultation with its financial advisor and outside counsel) would result in greater value to our stockholders from a financial point of view than the merger, taking into account all financial, legal, regulatory and other aspects of such proposal and of the merger agreement (including any changes to the financial terms of the merger agreement proposed by the Sponsor Entities to Michaels in response to such proposal or otherwise).

Neither our board of directors nor any committee thereof may make an adverse recommendation change or approve or recommend, or publicly propose to approve or recommend, or cause or permit us or any of our subsidiaries to enter into, any letter of intent, memorandum of understanding, agreement in principle, merger agreement, acquisition agreement or other similar agreement related to any takeover proposal. At any time prior to the adoption of the merger agreement by our stockholders, however, our board of directors may (subject to the payment of a termination fee as described below), if, after consultation with its outside legal counsel, it determines that the failure to take such action would be inconsistent with its fiduciary duties under applicable law, make an adverse recommendation change or cause or permit Michaels to terminate the merger agreement, but only:

- after the second business day following the Mergercos receipt of written notice from us advising them that our board of directors intends to take such action and specifying the reasons therefor, including the material terms and conditions of any superior proposal that is the basis of the proposed action by our board of directors and a statement that our board of directors intends to terminate the merger agreement; and
- if, in determining whether to take such action, our board of directors takes into account any changes to the financial terms of the merger agreement proposed by the Sponsor Entities to us in response to such notice or otherwise.

For purposes of the merger agreement, adverse recommendation change means any action whereby our board of directors or any committee thereof:

withdraws (or modifies in a manner adverse to the Mergercos), or publicly proposes to withdraw (or modify in a manner adverse to the Mergercos), the approval, recommendation or declaration of advisability by the board or any such committee of the merger agreement or the merger; or

recommends the approval or adoption of, or approves or adopts, or publicly proposes to recommend, approve or adopt, any takeover proposal.

We have also agreed:

to terminate, and to cause our subsidiaries and direct our representatives to terminate all, discussions and negotiations with any person conducted prior to signing the merger agreement with respect to any takeover proposal, and request the prompt return or destruction of all confidential information previously furnished in connection therewith;

to advise the Mergercos as promptly as practicable orally and in writing of the receipt of any takeover proposal after June 30, 2006, the material terms and conditions of any such takeover proposal and the identity of the person making any such takeover proposal;

subject to the fiduciary duties under applicable law of our board of directors, to keep the Mergercos reasonably informed of any material developments with respect to any takeover proposal (including any material changes thereto); and

to provide to the Mergercos all information provided by us to a third party in connection with a takeover proposal.

Employee Benefits

The surviving corporation has agreed, for a period of two years following the completion of the merger, to either (1) maintain our employee benefit plans and agreements (other than equity-based plans) at the level in effect on the date of the merger agreement, and provide compensation and benefits to our employees that have a value sufficient to replace the value of compensation and benefits provided to such employees under our equity-based plans prior to the completion of the merger or (2) provide compensation and benefits that are not less favorable in the aggregate (including any value attributable to equity-based compensation) than the benefits provided to employees on date of the completion of the merger.

In addition, the surviving corporation has agreed to honor and continue, without amendment, or modification, for a period of two years following the completion of the merger, or, if sooner, until all obligations thereunder have been satisfied, each of our employment, severance, retention, termination and cash incentive compensation plans, policies, programs, agreements and arrangements (including (1) any change in control severance agreements, (2) the Change in Control Severance Plans I and II, (3) the Change in Control Bonus Program, (4) the Fiscal Year 2006 Bonus Enhancement Program and (5) the Fiscal Year 2006 MIK Power Bonus Plan).

The surviving corporation will also maintain, for a period of two years following the completion of the merger, or, if sooner, until all obligations thereunder have been satisfied, our various incentive plans in accordance with their terms with respect to all performance periods under such incentive plans commencing prior to completion of the merger and ending thereafter.

The surviving corporation will also, subject to specified limitations, recognize an employee s service with Michaels with respect to determining eligibility to participate, level of benefits, vesting, benefit accruals and early retirement subsidies under the surviving corporation s employee benefit plans to the extent that such recognition would not result in any duplication of benefits.

The surviving corporation will also recognize expenses incurred by employees prior to the completion of the merger during the calendar year in which the merger occurs for purposes of satisfying such year s deductible and co-payment limitations under such plans. In addition, the surviving corporation will also waive pre-existing

condition limitations with respect to the employees under its welfare benefit plans (except to the extent that such pre-existing condition limitations would have been applicable under our employee benefit plans).

Agreement to Use Reasonable Best Efforts

Subject to the terms and conditions of the merger agreement, each party has agreed to use its reasonable best efforts to take, or cause to be taken, all actions, and to do, or cause to be done, and to assist and cooperate with the other parties in doing, all things necessary, proper or advisable to consummate and make effective, in the most expeditious manner practicable, the merger and the other transactions contemplated by the merger agreement, including using reasonable best efforts to accomplish the following:

- the taking of all acts necessary to cause the conditions to closing to be satisfied as promptly as practicable;
- the obtaining of all necessary actions or nonactions, waivers, consents and approvals from governmental entities and the making of all necessary registrations and filings and the taking of all steps as may be necessary to obtain an approval or waiver from, or to avoid an action or proceeding by, any governmental entity;
- the obtaining of consents, approvals and waivers from third parties reasonably requested by the Mergercos to be obtained in connection with the merger under certain contracts and real property leases; and
- the execution and delivery of any additional instruments necessary to consummate the transactions contemplated by, and to fully carry out the purposes of, the merger agreement.

We and our subsidiaries are not required to pay to any person whose consent, approval or waiver under certain contracts and real property leases with respect to the merger is being solicited any fee, penalty or other consideration.

We and our board of directors have also agreed to take all action necessary to ensure that no state takeover statute is or becomes applicable to the merger and if any state takeover statute becomes applicable to the merger, to take all action necessary to ensure that the merger may be consummated as promptly as practicable on the terms contemplated by the merger agreement and otherwise to minimize the effect of such statute or regulation on the merger.

Each Mergerco and Finco has agreed that, in the event of any failure to perform or comply with any covenant or agreement set forth in the merger agreement by one Mergerco (or Finco, as applicable), the other Mergerco (or Finco, as applicable) shall be permitted to cure such failure, including by performing such covenant or agreement on behalf of such first Mergerco (or Finco, as applicable), and, until and unless the other Mergerco (or Finco, as applicable) shall have effected such cure, it shall be deemed to have failed to perform and comply with its covenants and agreements set forth in the merger agreement to the same extent as the first Mergerco (or Finco, as applicable) has so failed with respect to its covenants and agreements.

We have also agreed to retain a nationally recognized investment banking or valuation firm, selected by our board of directors and reasonably acceptable to Mergercos, to render a solvency opinion, customary in scope and substance, as of the closing to our board of directors.

Financing Commitments; Cooperation of Michaels

The Sponsor Entities have agreed to use, and to cause their respective affiliates to use, reasonable best efforts to take, or cause to be taken, all actions and to do, or cause to be done, all things necessary, proper or advisable to arrange the financing on the terms and conditions described in the financing commitments, including, in the case of the debt financing, reasonable best efforts:

to negotiate and enter into the definitive agreements with respect to the debt financing on the terms and conditions contained in the debt financing commitments (or on other terms acceptable to the Fincos, so long as such terms do not contain any conditions to funding on the closing date that are not set forth in the debt financing commitments and would not otherwise reasonably be expected to impair or delay the consummation of the debt financing);

to satisfy or to cause its affiliates to satisfy on a timely basis all conditions applicable to the Sponsor Entities set forth in such definitive agreements that are within the control of any of the Sponsor Entities; and

to consummate the debt financing at the closing, including using reasonable best efforts to cause the lenders and the other persons providing such debt financing to fund the debt financing required to consummate the merger at the closing (including by taking enforcement action to cause such lenders and other persons providing such debt financing to fund such debt financing).

In the event any portion of the debt financing becomes unavailable on the terms and conditions set forth in the debt financing commitments, the Fincos are required to promptly notify Michaels, and the Sponsor Entities are required to use their reasonable best efforts to obtain, as promptly as practicable, any such portion from alternative sources on terms that will still enable the Sponsor Entities to consummate the transactions contemplated by the merger agreement and that are not less favorable in the aggregate (as determined by the Fincos in their reasonable judgment) to the Sponsor Entities and Michaels than those contained in the debt financing commitments. In addition, the Sponsor Entities have agreed that, in the event that

all or any portion of the debt financing structured as high yield financing has not been consummated;

subject to limited exceptions, all closing conditions contained in the merger agreement have been satisfied or waived; and

the bridge facilities contemplated by the debt financing commitments or alternative bridge financing is available on terms and conditions described in the debt financing commitments (or replacements thereof contemplated by the merger agreement);

then the Sponsor Entities will borrow and use, or shall cause the surviving corporation to borrow and use, the proceeds of the bridge financing to replace the high yield financing no later than the last day of the marketing period. See *Effective Time; The Marketing Period* above for a discussion of the marketing period.

The Fincos are required to keep us reasonably informed of the status of their efforts to obtain the debt financing and to provide us with copies of agreements pursuant to which any alternative source shall have committed to provide the Fincos or the surviving corporation with any portion of the debt financing.

We have agreed to, and have agreed to cause our subsidiaries (and to use our reasonable best efforts to cause our and their respective representatives) to, provide such reasonable cooperation as may be reasonably requested by the Fincos in connection with the debt financing, including:

participation in meetings, drafting sessions, presentations, road shows and due diligence;

using reasonable best efforts to furnish the Fincos and the financing sources with financial and other pertinent information regarding Michaels as may be reasonably requested by the Fincos to consummate the debt financing, including all financial statements and financial data of the type required by Regulation S-X and Regulation S-K under the Securities Act (other than Rule 3-10 of Regulation S-X) and of type and form customarily included in private placements pursuant to Rule 144A promulgated under the Securities Act;

assisting the Fincos and the financing sources in the preparation of offering documents and other informational and marketing materials and documents for any portion of the debt financing and materials for rating agency presentations;

reasonably cooperating with the marketing efforts of the Fincos and the financing sources for any portion of the debt financing;

reasonably facilitating the pledging of collateral and execution and delivery of definitive financing documents and customary deliverables; and

using reasonable best efforts to obtain accountants comfort letters, accountants consent letters, legal opinions, surveys and title insurance as reasonably requested by the Fincos.

Conditions to the Merger

The respective obligations of the parties to effect the merger are subject to the satisfaction or (to the extent permitted by law) waiver at or prior to the effective time of the following mutual conditions:

the adoption of the merger agreement by our stockholders;

the expiration or termination of the waiting period (and any extension thereof) applicable to the merger under the Hart-Scott-Rodino Act; and

no temporary restraining order, preliminary or permanent injunction or other judgment or order issued by any Federal or state court being in effect enjoining or otherwise prohibiting the consummation of the merger.

The obligations of the Sponsor Entities to effect the merger are further subject to the satisfaction or (to the extent permitted by law) waiver by the Mergercos (on behalf of themselves and the Fincos) at or prior to the effective time of the merger of the following conditions:

(1) our representations and warranties regarding certain matters relating to our capital structure and authority to consummate the merger must be true and correct in all material respects as of the date of the merger agreement and as of the date the merger is completed, except to the extent that a representation or warranty expressly speaks as of an earlier date, in which case it need be true and correct in all material respects only as of that date, and (2) all other representations and warranties made by us (disregarding all materiality qualifications) must be true and correct as of the date of the merger agreement and as of the date the merger is completed, except to the extent that a representation or warranty expressly speaks as of an earlier date, in which case it need be true and correct only as of that date, and except where the failure of such other representations and warranties to be so true and correct would not, individually or in the aggregate, reasonably be expected to have a material adverse effect;

the performance, in all material respects, by us of all of our material obligations under the merger agreement; and

our delivery to the Sponsor Entities at closing of a certificate with respect to the satisfaction of the conditions relating to our representations and warranties and material obligations.

Our obligation to effect the merger is further subject to the satisfaction or (to the extent permitted by law) waiver by us at or prior to the effective time of the merger of the following conditions:

the representations and warranties made by the Sponsor Entities (disregarding all materiality qualifications) must be true and correct as of the date of the merger agreement and as of the date the merger is completed, except to the extent that a representation or warranty expressly speaks as of an earlier date, in which case it need be true only as of that date, and except where the failure of such representations and warranties to be so true and correct would not, individually or in the aggregate, reasonably be expected to have a sponsor material adverse effect;

the performance, in all material respects, by the Sponsor Entities of all of their material obligations under the merger agreement; and

the delivery to us at closing by each Sponsor Entity of a certificate with respect to the satisfaction of the conditions relating to its representations and warranties and material obligations.

None of Michaels or the Sponsor Entities may rely on the failure of any condition to be satisfied if such failure was caused by such party s (or, in the case of any Sponsor Entity, any other Sponsor Entity s) failure to perform any of its obligations under the merger agreement, to act in good faith or to use its reasonable best efforts to consummate the merger and the other transactions contemplated by the merger agreement.

Termination

The merger agreement may be terminated at any time prior to the effective time of the merger, whether before or after stockholder approval has been obtained, as follows:

by mutual written consent of the Mergercos and Michaels;

by either the Mergercos or Michaels, if:

our stockholders do not adopt the merger agreement at the special meeting or any postponement or adjournment thereof;

any temporary restraining order, preliminary or permanent injunction or other judgment or order issued by any Federal or state court shall have become final and non-appealable, so long as the terminating party shall have used reasonable best efforts to prevent the entry of and to remove such judgment or order;

the merger has not been consummated on or before December 19, 2006; provided that if the closing shall not have occurred prior to such date solely as a result of the failure of the marketing period to have been completed prior to such date, then such date is extended to March 31, 2007; provided further that this right to terminate the merger agreement is not available to any party if the failure of such party (or, in the case of the Mergercos, any other Sponsor Entity) to perform any of its obligations under the merger agreement, to act in good faith or to use its reasonable best efforts to consummate the merger and the other transactions contemplated by the merger agreement has been a principal cause of or resulted in the failure of the merger to be consummated on or before such date; or

if the terminating party (or, in the case of the Mergercos, any other Sponsor Entity) is not then in material breach and there is a breach by the non-terminating party of any of its representations or warranties or failure to perform any of its covenants or agreements in the merger agreement such that the closing conditions would not be satisfied and which cannot be cured prior to the termination date set forth above;

by the Mergercos, if our board of directors withdraws or adversely modifies its recommendation or approval of the merger agreement or recommends or approves another takeover proposal; or

by Michaels, if:

prior to adoption of the merger agreement by our stockholders, our board of directors, after consultation with its outside counsel, determines that the failure to take such action would be inconsistent with its fiduciary duties under applicable law, but only after (1) the second business day following the Mergercos receipt of written notice from us advising them that our board of directors intends to take such action and specifying the reasons therefor, including the material terms and conditions of any superior proposal that is the basis of the proposed action by our board of directors, and (2) our board of directors has taken into account any changes to the financial

Table of Contents

terms of the merger agreement proposed by the Sponsor Entities to us in response to such notice or otherwise (the right to terminate in these circumstances is referred to as the fiduciary out right to terminate); or

all of the mutual conditions to closing and all of the conditions to the Sponsor Entities obligations to close have been satisfied (other than those conditions that by their terms are to be satisfied at the closing) and, on or after the last day of the marketing period, neither the Fincos nor the surviving corporation has received the proceeds of the debt financing.

Fees and Expenses

Payable by Michaels

We have agreed to pay to the Mergercos an aggregate termination fee of $120 million if:

the merger agreement is terminated by the Mergercos upon the occurrence of an adverse recommendation change by our board of directors;

the merger agreement is terminated by Michaels pursuant to the exercise of its fiduciary out right to terminate described above;

the merger agreement is terminated by the Mergercos or Michaels due to the failure to receive the approval of our stockholders at the special meeting or any postponement or adjournment thereof; and

after June 30, 2006, and prior to the termination, a takeover proposal has been publicly made to Michaels generally or has been made directly to our stockholders or has otherwise become publicly known; and

within 12 months after the termination, we consummate or enter into a definitive agreement to consummate the transactions contemplated by any takeover proposal; or

the merger agreement is terminated by the Mergercos or Michaels because the merger is not completed prior to December 19, 2006 (or, if applicable, March 31, 2007); and

the special meeting of our stockholders to approve the merger has not been held;

after June 30, 2006 and prior to the termination, a takeover proposal has been publicly made to Michaels generally or has been made directly to our stockholders or has otherwise become publicly known; and

within 12 months after the termination, we consummate or enter into a definitive agreement to consummate the transactions contemplated by any takeover proposal.

For purposes of determining whether a termination fee is payable by us, a takeover proposal means any inquiry, proposal or offer (other than the transactions contemplated by the merger agreement) from any person or group relating to:

any direct or indirect acquisition or purchase, in a single transaction or a series of transactions, of:

50% or more (based on the fair market value thereof, as determined by our board of directors) of assets (including capital stock of our subsidiaries) of us and our subsidiaries, taken as a whole; or

50% or more of the outstanding shares of our common stock;

any tender offer or exchange offer that, if consummated, would result in any person or group owning, directly or indirectly, 50% or more of the outstanding shares of our common stock; or

any merger, consolidation, business combination, recapitalization, liquidation, dissolution, binding share exchange or similar transaction involving us pursuant to which any person or group (or the shareholders of any person) would own, directly or indirectly, 50% or more of any class of equity securities of us or of the surviving entity in a merger or the resulting direct or indirect parent of us or such surviving entity.

Payable by the Sponsor Entities

The Sponsor Entities have agreed to pay us a termination fee of $200 million if we terminate the merger agreement in the event that all of the mutual conditions to closing and all of the conditions to the Sponsor Entities obligations to close have been satisfied (other than those conditions that by their terms are to be satisfied at the closing) and, on or after the last day of the marketing period, neither the Fincos nor the surviving corporation has received the proceeds of the debt financing.

If, in the circumstances in which the Sponsor Entities become obligated to pay this termination fee, none of the Sponsor Entities is otherwise in breach of the merger agreement such that the conditions to our obligation to close have been satisfied, then our termination of the merger agreement in these circumstances and receipt of payment of such termination fee shall be our sole and exclusive remedy against the Sponsor Entities and any of their respective former, current or future general or limited partners, members or stockholders or against any of their respective former, current or future directors, officers, employees, affiliates, general or limited partners, stockholders, managers, members or agents (collectively, specified persons) for any loss or damage suffered as a result of the breach of any representation, warranty, covenant or agreement contained in the merger agreement by the Sponsor Entities and the failure of the merger to be consummated, and upon payment of such termination fee, none of the Sponsor Entities or any of their respective specified persons shall have any further liability or obligation relating to or arising out of the merger agreement or the transactions contemplated by the merger agreement.

Liability Cap

The parties have agreed that in no event, whether or not the merger agreement shall have been terminated, shall we and our subsidiaries, as a group, on the one hand, or the Sponsor Entities, Bain Capital Fund IX, LLC and Blackstone Capital Partners V L.P., as a group, on the other hand, be subject to monetary damages in excess of $600 million in the aggregate for each such group, respectively, for all losses and damages (including, in our case, lost stockholder premium) arising from or in connection with breaches by the Sponsor Entities, on the one hand, or us, on the other, of their respective representations, warranties, covenants and agreements contained in the merger agreement or arising from any other claim or cause of action, and none of Michaels, the Sponsor Entities, Bain Capital Fund IX, LLC, Blackstone Capital Partners V L.P. or any of their respective specified persons shall have any further liability or obligation to the other parties or otherwise relating to or arising out of the merger agreement or the transactions contemplated by the merger agreement, other than for fraud.

Sponsor Guarantees

Bain Capital Fund IX, LLC has guaranteed the payment by Bain Mergerco and Bain Finco of their obligations to us arising under, or in connection with, the merger agreement, including the payment of the termination fee, up to the maximum aggregate liability of $300 million. Similarly, Blackstone Capital Partners V L.P. has guaranteed the payment by Blackstone Mergerco and Blackstone Finco of their obligations to us arising under, or in connection with, the merger agreement, including the payment of the termination fee, up to the maximum aggregate liability of $300 million. Except in connection with the enforcement of our right to seek specific performance by the Sponsor Entities under the merger agreement, as discussed below, and the exercise of our rights as an express third party beneficiary under the equity commitment letters provided by Bain and Blackstone, as discussed above, our rights under the sponsor guarantees constitute our sole and exclusive remedy against Bain and Blackstone, respectively, and their affiliates.

Amendment and Waiver

The merger agreement may be amended by the written agreement of Michaels and the Mergercos (on behalf of themselves and the Fincos) at any time prior to the closing date of the merger, whether before or after the adoption of the merger agreement by our stockholders, provided that after the merger agreement has been adopted by our stockholders, there shall be no amendment that by law would require the further approval of our stockholders without such approval having been obtained.

The merger agreement also provides that, at any time prior to the effective time of the merger, any party may, by written agreement:

- extend the time for the performance of any of the obligations or other acts of the other parties to the merger agreement;
- to the extent permitted by law, waive any inaccuracies in the representations and warranties contained in the merger agreement or in any document delivered pursuant to the merger agreement; or
- to the extent permitted by law, waive compliance with any of the agreements or conditions contained in the merger agreement, provided that after the merger agreement has been adopted by our stockholders, there shall be no waiver that by law would require the further approval of our stockholders without such approval having been obtained.

Specific Performance

The parties to the merger agreement are entitled to an injunction or injunctions to prevent breaches of merger agreement and to enforce specifically the terms and provisions of the merger agreement in any court of the State of Delaware or any Federal court sitting in the State of Delaware.

First Amendment to Merger Agreement and Rollover Shares and Options

On September 1, 2006, the merger agreement was amended to permit the Highfields Funds to retain 2,500,000 shares of our common stock held by the Highfields Funds as shares of common stock of the surviving corporation. Pursuant to the related rollover agreement dated as of September 1, 2006, among the Highfields Funds and us, the Highfields Funds have agreed to retain such 2,500,000 shares through the closing of the merger. The Highfields Funds are not obligated to retain through the closing date any other shares of our common stock held by them. The Highfields Funds have also agreed to enter, on the closing date of the merger, into a stockholders agreement and a registration rights agreement among the surviving corporation and its other stockholders. We have been informed by Bain and Blackstone that, on the closing date of the merger, Highfields Capital Management LP, an affiliate of the Highfields Funds, and the surviving corporation will enter into a management agreement that will provide for an annual management fee for services that Highfields Capital Management LP renders to the surviving corporation following the completion of the merger. The first amendment to the merger agreement also permits certain of our employees to retain their equity investments in our company, including their options, as an equity investment in the surviving corporation.

Table of Contents

APPRAISAL RIGHTS

The discussion of the provisions set forth below is not a complete summary regarding your appraisal rights under Delaware law and is qualified in its entirety by reference to the text of the relevant provisions of Delaware law, which are attached to this proxy statement as Annex E. Stockholders intending to exercise appraisal rights should carefully review Annex E. Failure to follow precisely any of the statutory procedures set forth in Annex E may result in a termination or waiver of these rights.

If the merger is consummated, dissenting holders of our common stock who follow the procedures specified in Section 262 of the DGCL within the appropriate time periods will be entitled to have their shares of our common stock appraised by a court and to receive the fair value of such shares in cash as determined by the Delaware Court of Chancery in lieu of the consideration that such stockholder would otherwise be entitled to receive pursuant to the merger agreement.

The following is a brief summary of Section 262, which sets forth the procedures for dissenting from the merger and demanding statutory appraisal rights. Failure to follow the procedures set forth in Section 262 precisely could result in the loss of appraisal rights. This proxy statement constitutes notice to holders of our common stock concerning the availability of appraisal rights under Section 262. A stockholder of record wishing to assert appraisal rights must hold the shares of stock on the date of making a demand for appraisal rights with respect to such shares and must continuously hold such shares through the effective time of the merger.

Stockholders who desire to exercise their appraisal rights must satisfy all of the conditions of Section 262. A written demand for appraisal of shares must be filed with us before the special meeting. This written demand for appraisal of shares must be in addition to and separate from a vote against the merger. Stockholders electing to exercise their appraisal rights must not vote **FOR** the merger. Any proxy or vote against the merger will not constitute a demand for appraisal within the meaning of Section 262.

A demand for appraisal must be executed by or for the stockholder of record, fully and correctly, as such stockholder s name appears on the share certificate. If the shares are owned of record in a fiduciary capacity, such as by a trustee, guardian or custodian, this demand must be executed by or for the fiduciary. If the shares are owned by or for more than one person, as in a joint tenancy or tenancy in common, such demand must be executed by or for all joint owners. An authorized agent, including an agent for two or more joint owners, may execute the demand for appraisal for a stockholder of record; however, the agent must identify the record owner and expressly disclose the fact that, in exercising the demand, he is acting as agent for the record owner. A person having a beneficial interest in our common stock held of record in the name of another person, such as a broker or nominee, must act promptly to cause the record holder to follow the steps summarized below and in a timely manner to perfect whatever appraisal rights the beneficial owner may have.

A stockholder who elects to exercise appraisal rights should mail or deliver his, her or its written demand to us at our address at 8000 Bent Branch Drive, Irving, Texas 75063, Attention: General Counsel. The written demand for appraisal should specify the stockholder s name and mailing address, and that the stockholder is thereby demanding appraisal of his, her or its share of our common stock. Within ten days after the effective time of the merger, we must provide notice of the effective time of the merger to all of our stockholders who have complied with Section 262 and have not voted for the merger.

Within 120 days after the effective time of the merger (but not thereafter), any stockholder who has satisfied the requirements of Section 262 may deliver to us a written demand for a statement listing the aggregate number of shares not voted in favor of the merger and with respect to which demands for appraisal have been received and the aggregate number of holders of such shares. We, as the surviving corporation in the merger, must mail such written statement to the stockholder no later than the later of 10 days after the stockholder s request is received by us or 10 days after the latest date for delivery of a demand for appraisal under Section 262.

Within 120 days after the effective time of the merger (but not thereafter), either we or any stockholder who has complied with the required conditions of Section 262 and who is otherwise entitled to appraisal rights may file a petition in the Delaware Court of Chancery demanding a determination of the fair value of the shares of our

common stock owned by stockholders entitled to appraisal rights. We have no present intention to file such a petition if demand for appraisal is made.

Upon the filing of any petition by a stockholder in accordance with Section 262, service of a copy must be made upon us. We must, within 20 days after service, file in the office of the Register in Chancery in which the petition was filed, a duly verified list containing the names and addresses of all stockholders who have demanded payment for their shares and with whom we have not reached agreements as to the value of their shares. If we file a petition, the petition must be accompanied by the verified list. The Register in Chancery, if so ordered by the court, will give notice of the time and place fixed for the hearing of such petition by registered or certified mail to us and to the stockholders shown on the list at the addresses therein stated, and notice will also be given by publishing a notice at least one week before the day of the hearing in a newspaper of general circulation published in the City of Wilmington, Delaware, or such publication as the court deems advisable. The forms of the notices by mail and by publication must be approved by the court, and we will bear the costs thereof. The Delaware Court of Chancery may require the stockholders who have demanded an appraisal for their shares (and who hold stock represented by certificates) to submit their stock certificates to the Register in Chancery for notation of the pendency of the appraisal proceedings and the Delaware Court of Chancery may dismiss the proceedings as to any stockholder that fails to comply with such direction.

If a petition for an appraisal is filed in a timely fashion, after a hearing on the petition, the court will determine which stockholders are entitled to appraisal rights and will appraise the shares owned by these stockholders, determining the fair value of such shares, exclusive of any element of value arising from the accomplishment or expectation of the merger, together with a fair rate of interest to be paid, if any, upon the amount determined to be the fair value.

Stockholders considering seeking appraisal of their shares should note that the fair value of their shares determined under Section 262 could be more, the same or less than the consideration they would receive pursuant to the merger agreement if they did not seek appraisal of their shares. The costs of the appraisal proceeding may be determined by the court and taxed against the parties as the court deems equitable under the circumstances. Upon application of a dissenting stockholder, the court may order that all or a portion of the expenses incurred by any dissenting stockholder in connection with the appraisal proceeding, including reasonable attorneys fees and the fees and expenses of experts, be charged pro rata against the value of all shares entitled to appraisal. In the absence of a determination or assessment, each party bears his, her or its own expenses. The exchange of shares for cash pursuant to the exercise of appraisal rights generally will be a taxable transaction for United States federal income tax purposes and possibly state, local and foreign income tax purposes as well. See *The Merger Material United States Federal Income Tax Consequences of the Merger* on page 42.

Any stockholder who has duly demanded appraisal in compliance with Section 262 will not, after the effective time of the merger, be entitled to vote for any purpose the shares subject to demand or to receive payment of dividends or other distributions on such shares, except for dividends or distributions payable to stockholders of record at a date prior to the effective time of the merger.

At any time within 60 days after the effective time of the merger, any stockholder will have the right to withdraw his, her or its demand for appraisal and to accept the terms offered in the merger agreement. After this period, a stockholder may withdraw his, her or its demand for appraisal and receive payment for his, her or its shares as provided in the merger agreement only with our consent. If no petition for appraisal is filed with the court within 120 days after the effective time of the merger, stockholders rights to appraisal (if available) will cease. Inasmuch as we have no obligation to file such a petition, any stockholder who desires a petition to be filed is advised to file it on a timely basis. No petition timely filed in the court demanding appraisal may be dismissed as to any stockholder without the approval of the court, which approval may be conditioned upon such terms as the court deems just.

Failure by any stockholder to comply fully with the procedures of Section 262 of the DGCL (as reproduced in Annex E to this proxy statement) may result in termination of such stockholder s appraisal rights. In view of the complexity of Section 262, Michaels stockholders who may wish to dissent from the merger and pursue appraisal rights should consult their legal advisors.

Table of Contents

MARKET PRICE OF OUR STOCK

Our common stock is listed on the NYSE under the trading symbol MIK . The following table sets forth the high and low sales prices per share of our common stock on the NYSE for the periods indicated.

	High	Low
Fiscal Year Ended January 29, 2005		
First Quarter	$29.58	$22.16
Second Quarter	28.15	22.29
Third Quarter	30.76	25.23
Fourth Quarter	31.39	26.70
Fiscal Year Ended January 28, 2006		
First Quarter	$36.85	$30.37
Second Quarter	43.61	33.03
Third Quarter	41.95	30.38
Fourth Quarter	38.75	32.10
Fiscal Year Ending February 3, 2007		
First Quarter	$38.35	$31.70
Second Quarter	42.50	35.26
Third Quarter (through [ ], 2006)	[ ]	[ ]

The closing sale price of our common stock on the NYSE on March 17, 2006, which was the last trading day before we announced that our board of directors was exploring strategic alternatives, including a potential sale of Michaels, was $33.96. The closing sale price of our common stock on the NYSE on June 30, 2006, which was the last trading day before we announced the merger, was $41.24. On [ ], 2006, the last trading day before the date of this proxy statement, the closing price of our common stock on the NYSE was $[ ]. You are encouraged to obtain current market quotations for our common stock in connection with voting your shares.

As of [ ], 2006, the last trading day before the date of this proxy statement, there were [ ] registered holders of our common stock.

The following table sets forth dividends announced and paid in respect of Michaels common stock, on a per share basis, for the periods indicated.

	Dividends per Share of Common Stock
Fiscal Year Ended January 29, 2005	
First Quarter	$ 0.06
Second Quarter	0.06
Third Quarter	0.07
Fourth Quarter	0.07
Fiscal Year Ended January 28, 2006	
First Quarter	$ 0.07
Second Quarter	0.10
Third Quarter	0.10
Fourth Quarter	0.10
Fiscal Year Ending February 3, 2007	
First Quarter	$ 0.10
Second Quarter	0.12

Table of Contents

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table presents information regarding the number of shares of our common stock beneficially owned as of August 25, 2006, (unless otherwise indicated) by:

each person who is known to us to be the beneficial owner of more than five percent of our common stock;

each director;

our chief executive officer at the end of our last completed fiscal year and our four most highly compensated executive officers who were serving as executive officers at the end of our last completed fiscal year; and

all current directors and executive officers as a group.

Unless otherwise indicated by footnote, the beneficial owner exercises sole voting and investment power over the shares noted below. The beneficial ownership percentages reflected in the table below are based on 133,251,518 shares of our common stock outstanding as of August 25, 2006.

Name and Address of Beneficial Owners (1)	Amount and Nature of Beneficial Ownership (2)	Percent of Class
Charles J. Wyly, Jr.	5,515,285(3)	4.1%
Sam Wyly	4,610,927(4)	3.4%
Richard E. Hanlon	267,600(5)	*
Richard C. Marcus	149,000(6)	*
Liz Minyard	170,000(7)	*
Cece Smith	135,000(8)	*
R. Michael Rouleau	1,064,138(9)	*
Jeffrey N. Boyer	177,082(10)	*
Edward F. Sadler	131,250(11)	*
Gregory A. Sandfort	66,815(12)	*
Capital Research and Management Company 333 South Hope Street Los Angeles, California 90071	11,520,000(13)	8.6%
Wellington Management Company, LLP 75 State Street Boston, Massachusetts 02109	5,724,535(14)	4.3%
Putnam, LLC d/b/a Putnam Investments One Post Office Square Boston, Massachusetts 02109	10,163,526(15)	7.6%
Highfields Capital Management LP 200 Clarendon Street, 51st Floor Boston, Massachusetts 02116	8,353,200(16)	6.3%
All current directors and executive officers as a group (12 persons)	11,521,755(17)	8.5%

* Less than one percent.

(1) The address of each of our directors and executive officers is c/o Michaels Stores, Inc., 8000 Bent Branch Drive, Irving, TX 75063.

(2) Pursuant to Rule 13d-3 under the Exchange Act, a person has beneficial ownership of any securities as to which such person, directly or indirectly, through any contract, arrangement, undertaking, relationship or otherwise, has or shares voting power and/or investment power or as to which such person has the right to acquire such voting and/or investment power within 60 days. Percentage of beneficial ownership by a person as of a particular date is calculated by dividing the number of shares beneficially owned by such person by the sum of the number of shares outstanding as of such date and the number of unissued shares as to which such person has the right to acquire voting and/or investment power within 60 days. Unless otherwise indicated, the number of shares shown includes outstanding shares of common stock owned as of July 21, 2006 by the person indicated and shares underlying options owned by such person on July 21, 2006 that are exercisable within 60 days of that date. Persons holding shares of common stock pursuant to the Michaels Stores, Inc. Employees 401(k) Plan, as amended and restated, have sole voting power and investment power with respect to such shares.

(3) Includes 726,666 shares under options; 570,039 shares held of record by Stargate, Ltd. (a Texas limited partnership, the general partner of which is a trust of which Mr. Wyly and his spouse are co-trustees); 360,208 shares held of record by Shadywood USA, Ltd. (a Texas limited partnership of which Mr. Wyly is a general partner); and 990,268 shares held of record by family trusts of which Mr. Wyly is the trustee. The number of shares in the table also includes 2,867,204 shares held by subsidiaries of certain non-U.S. trusts of which Mr. Charles J. Wyly, Jr. and/or certain of his family members are direct or contingent beneficiaries. Mr. Wyly filed an amended Schedule 13D with the Securities and Exchange Commission on April 8, 2005 stating that he may be deemed to be the beneficial owner of the shares held in the subsidiaries of those non-U.S. trusts. It is unclear in the Schedule 13D whether or to what extent Mr. Wyly exercises voting and/or investment power with respect to the shares held in the subsidiaries of the non-U.S. trusts.

(4) Includes 500,832 shares under options; 400,000 shares held of record by Tallulah, Ltd. (a Texas limited partnership of which Mr. Wyly is the general partner); and 299,144 shares held of record by family trusts of which Mr. Wyly is the trustee. 27,740 shares of Michaels common stock held by Mr. Wyly s spouse are not included in the total number of shares beneficially owned by Mr. Wyly. The number of shares in the table also includes 2,142,600 shares held by subsidiaries of certain non-U.S. trusts of which Mr. Sam Wyly and/or certain of his family members are direct or contingent beneficiaries. Mr. Wyly filed an amended Schedule 13D with the Securities and Exchange Commission on April 8, 2005 stating that he may be deemed to be the beneficial owner of the shares held in the subsidiaries of those non-U.S. trusts. It is unclear in the Schedule 13D whether or to what extent Mr. Wyly exercises voting and/or investment power with respect to the shares held in the subsidiaries of the non-U.S. trusts.

(5) Includes 205,000 shares under options; 20,334 shares held of record by a family trust of which Mr. Hanlon is a co-trustee; and 30,000 shares held of record by HanFam, LLC (a Virginia limited liability company of which Mr. Hanlon is the sole manager).

(6) Includes 135,000 shares under options.

(7) Includes 170,000 shares under options.

(8) Includes 135,000 shares under options.

(9) Mr. Rouleau s beneficial ownership information is as of March 15, 2006, the date he retired as the President and Chief Executive Officer of Michaels Stores, Inc. Amount includes 925,000 shares under options.

(10) Includes 177,082 shares under options.

(11) Includes 131,250 shares under options.

(12) Includes 64,583 shares under options.

(13) Based on an amendment to a Schedule 13G filed with the Securities and Exchange Commission, dated August 10, 2006, Capital Research and Management Company, an investment advisor, has the sole power to vote or direct the vote and to dispose or direct the disposition of 8,170,000 shares of common stock and has the sole power to dispose or direct the disposition of 3,350,000 shares of common stock.

---

(14) Based on an amendment to a Schedule 13G filed with the Securities and Exchange Commission, dated May 10, 2006, Wellington Management Company, LLP, an investment advisor, shares the power to vote or direct the vote and to dispose or direct the disposition of 4,632,995 shares of common stock and shares the power to dispose or direct the disposition of 1,091,540 shares of common stock.

(15) Based on an amendment to a Schedule 13G filed with the Securities and Exchange Commission, dated February 10, 2006, Putnam, LLC d/b/a Putnam Investments, an investment advisor, along with its parent and certain of its affiliates in their various capacities, shares the power to vote or direct the vote and to dispose or direct the disposition of 826,998 shares of common stock and shares the power to dispose or direct the disposition of 9,336,528 shares of common stock.

(16) Based on an amendment to a Schedule 13G filed with the Securities and Exchange Commission, dated July 11, 2006, Highfields Capital Management LP, an investment advisor, along with its parent and certain of its affiliates in their various capacities, has the sole power to vote or direct the vote and to dispose or direct the disposition of 8,353,200 shares of common stock.

(17) Includes 2,736,939 shares under options. The number of shares also includes (i) 2,867,204 shares held by subsidiaries of certain non-U.S. trusts of which Mr. Charles J. Wyly, Jr. and/or certain of his family members are direct or contingent beneficiaries, and (ii) 2,142,600 shares held by subsidiaries of certain non-U.S. trusts of which Mr. Sam Wyly and/or certain of his family members are direct or contingent beneficiaries.

MULTIPLE STOCKHOLDERS SHARING ONE ADDRESS

In accordance with Rule 14a-3(e)(1) under the Exchange Act, one proxy statement will be delivered to two or more stockholders who share an address, unless we have received contrary instructions from one or more of the stockholders. We will deliver promptly upon written or oral request a separate copy of the proxy statement to a stockholder at a shared address to which a single copy of the proxy statement was delivered. Requests for additional copies of the proxy statement, and requests that in the future separate proxy statements be sent to stockholders who share an address, should be directed to Michaels Stores, Inc., 8000 Bent Branch Drive, Irving, Texas 75063, Attention: Investor Relations Department, telephone: (972) 409-1300. In addition, stockholders who share a single address but receive multiple copies of the proxy statement may request that in the future they receive a single copy by contacting us at the address and phone number set forth in the prior sentence.

SUBMISSION OF STOCKHOLDER PROPOSALS

If the merger is not completed, you will continue to be entitled to attend and participate in our stockholder meetings and we will hold a 2007 annual meeting of stockholders, in which case stockholder proposals will be eligible for consideration for inclusion in the proxy statement and form of proxy for our 2007 annual meeting of stockholders in accordance with Rule 14a-8 under the Exchange Act. To be eligible for inclusion in the proxy statement and form of proxy for the 2007 annual meeting pursuant to Rule 14a-8, proposals of stockholders must have been received by us no later than January 4, 2007, and must comply with Rule 14a-8. If the date of the 2007 annual meeting, if any, is changed by more than 30 days from June 20, 2007, then in order to be considered for inclusion in our proxy materials, proposals of stockholders intended to be presented at the 2007 annual meeting must be received by us a reasonable time before we begin to print and mail our proxy materials for the 2007 annual meeting.

To be presented at the 2007 annual meeting of stockholders without inclusion in our proxy materials for such meeting, proposals of stockholders must be in writing and received by us no later than March 2, 2007 and no earlier than February 5, 2007, in accordance with procedures set forth in our bylaws. If the date of the 2007 annual meeting, if any, is changed by more than 30 days from June 20, 2007, then in order to be presented at the 2007 annual meeting without inclusion in our proxy materials, proposals of stockholders must be in writing and received by us not later than the close of business on the tenth day following the first day on which notice of the date of such meeting is publicly disclosed by us. In order to curtail controversy as to the date on which a proposal was received by us, we suggest that proponents submit their proposals by certified mail, return receipt requested, to Michaels Stores, Inc., P.O. Box 619566, DFW, Texas 75261-9566 and directed to the Secretary of Michaels.

In addition, our bylaws provide that stockholders seeking to nominate candidates for election as directors at an annual meeting of stockholders must provide timely notice thereof in writing. To be timely, a stockholder s notice must be delivered to or mailed and received by the Secretary of Michaels at our principal executive offices not less than 14 days nor more than 50 days prior to the annual meeting. However, if less than 21 days notice of the annual meeting is given to stockholders, such written notice may be delivered or mailed to the Secretary of Michaels at our principal executive offices not later than the close of business on the seventh day following the day on which notice of the meeting was mailed to stockholders. We reserve the right to reject, rule out of order, or take other appropriate action with respect to any proposal that does not comply with these and other applicable requirements.

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any reports, proxy statements or other information that we file with the SEC at its Public Reference Room, 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. You may also obtain copies of this information by mail from the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549, at prescribed rates. Our public filings are also available to the public from document retrieval services and the Internet website maintained by the SEC at www.sec.gov.

Reports, proxy statements or other information concerning us may also be inspected at the offices of the NYSE at 20 Broad Street, New York, NY 10005.

No persons have been authorized to give any information or to make any representations other than those contained in this proxy statement and, if given or made, such information or representations must not be relied upon as having been authorized by us or any other person. This proxy statement is dated [ ]**,** 2006. You should not assume that the information contained in this proxy statement is accurate as of any date other than that date, and the mailing of this proxy statement to stockholders shall not create any implication to the contrary.

Table of Contents

ANNEX A

The merger agreement, as amended, is a commercial document that establishes and governs the legal relations between Michaels and the Sponsor Entities with respect to the transactions described in the proxy statement. The representations, warranties and covenants made by Michaels and the Sponsor Entities in the merger agreement are qualified and subject to important limitations agreed to by Michaels and the Sponsor Entities in connection with negotiating the terms of the merger agreement. Furthermore, the representations and warranties may be subject to standards of materiality applicable to Michaels and the Sponsor Entities that may be different from those that are applicable to stockholders.

Table of Contents

CONFORMED COPY

AGREEMENT AND PLAN OF MERGER
dated as of June 30, 2006,
among
BAIN PASTE MERGERCO, INC.,
BLACKSTONE PASTE MERGERCO, INC.,
BAIN PASTE FINCO, LLC,
BLACKSTONE PASTE FINCO, LLC,
and
MICHAELS STORES, INC.

TABLE OF CONTENTS

	Page
ARTICLE I	
The Merger	
SECTION 1.01. The Merger	2
SECTION 1.02. Closing	2
SECTION 1.03. Effective Time	2
SECTION 1.04. Effects of the Merger	2
SECTION 1.05. Certificate of Incorporation and Bylaws	2
SECTION 1.06. Directors	3
SECTION 1.07. Officers	3
ARTICLE II	
Effect of the Merger on the Capital Stock of the Constituent Corporations; Exchange Fund; Company Equity Awards	
SECTION 2.01. Effect on Capital Stock	3
SECTION 2.02. Exchange Fund	4
SECTION 2.03. Company Equity Awards	7
ARTICLE III	
Representations and Warranties	
SECTION 3.01. Representations and Warranties of the Company	7
SECTION 3.02. Representations and Warranties of the Sponsor Entities	22
ARTICLE IV	
Covenants Relating to Conduct of Business	
SECTION 4.01. Conduct of Business	25
SECTION 4.02. No Solicitation	28
ARTICLE V	
Additional Agreements	
SECTION 5.01. Preparation of the Proxy Statement; Stockholders Meeting	31
SECTION 5.02. Access to Information; Confidentiality	32
SECTION 5.03. Reasonable Best Efforts	32

Table of Contents

	Page
SECTION 5.04. Benefit Plans	33
SECTION 5.05. Indemnification, Exculpation and Insurance	35
SECTION 5.06. Fees and Expenses	37
SECTION 5.07. Public Announcements	38
SECTION 5.08. Stockholder Litigation	39
SECTION 5.09. Financing	39

ARTICLE VI

Conditions Precedent

SECTION 6.01. Conditions to Each Party s Obligation to Effect the Merger	42
SECTION 6.02. Conditions to Obligations of the Sponsor Entities	42
SECTION 6.03. Conditions to Obligation of the Company	43
SECTION 6.04. Frustration of Closing Conditions	43

ARTICLE VII

Termination, Amendment and Waiver

SECTION 7.01. Termination	43
SECTION 7.02. Effect of Termination	45
SECTION 7.03. Amendment	45
SECTION 7.04. Extension; Waiver	45
SECTION 7.05. Procedure for Termination or Amendment	45

ARTICLE VIII

General Provisions

SECTION 8.01. Nonsurvival of Representations and Warranties	46
SECTION 8.02. Notices	46
SECTION 8.03. Definitions	47
SECTION 8.04. Interpretation	48
SECTION 8.05. Consents and Approvals	49
SECTION 8.06. Counterparts	49
SECTION 8.07. Entire Agreement; No Third-Party Beneficiaries	49
SECTION 8.08. GOVERNING LAW	49
SECTION 8.09. Assignment	49
SECTION 8.10. Specific Enforcement; Consent to Jurisdiction	49
SECTION 8.11. Severability	50

Index of Defined Terms

Table of Contents

AGREEMENT AND PLAN OF MERGER (this Agreement) dated as of June 30, 2006, among BAIN PASTE MERGERCO, INC., a Delaware corporation (Bain MergerCo), BLACKSTONE PASTE MERGERCO, INC., a Delaware corporation (Blackstone MergerCo and, together with Bain MergerCo, MergerCos), BAIN PASTE FINCO, LLC, a Delaware limited liability company (Bain FinCo), BLACKSTONE PASTE FINCO, LLC, a Delaware limited liability company (Blackstone FinCo and, together with Bain FinCo, FinCos ; MergerCos and FinCos, collectively, the Sponsor Entities), and MICHAELS STORES, INC., a Delaware corporation (the Company).

WHEREAS, the Board of Directors of the Company and each MergerCo has approved and declared advisable, and the sole member of Bain FinCo and the sole member of Blackstone FinCo has approved, this Agreement and the merger of each MergerCo with and into the Company (the Merger), upon the terms and subject to the conditions set forth in this Agreement, whereby each issued and outstanding share of common stock, par value $0.10 per share, of the Company (Company Common Stock), other than (a) shares of Company Common Stock directly owned by the Company, as treasury stock, or by any Sponsor Entity and (b) the Appraisal Shares, will be converted into the right to receive $44.00 in cash;

WHEREAS, concurrently with the execution of this Agreement, (a) Bain Capital Fund IX, LLC, an affiliate of Bain MergerCo and Bain FinCo (the Bain Fund), has entered into (i) a letter agreement, dated as of the date hereof, with Bain MergerCo pursuant to which the Bain Fund has agreed to provide certain equity financing to Bain MergerCo and (ii) a Limited Guaranty, dated as of the date hereof, in favor of the Company with respect to obligations of Bain MergerCo and Bain FinCo arising under, or in connection with, this Agreement (the Bain Limited Guaranty) and (b) Blackstone Capital Partners V L.P., an affiliate of Blackstone MergerCo and Blackstone FinCo (the Blackstone Fund and, together with the Bain Fund, the Funds), has entered into (i) a letter agreement, dated as of the date hereof, with Blackstone MergerCo pursuant to which the Blackstone Fund has agreed to provide certain equity financing to Blackstone MergerCo and (ii) a Limited Guaranty, dated as of the date hereof, in favor of the Company with respect to the obligations of Blackstone MergerCo and Blackstone FinCo arising under, or in connection with, this Agreement (the Blackstone Limited Guaranty and, together with the Bain Limited Guaranty, the Guarantees); and

WHEREAS, the Company and each of the Sponsor Entities desire to make certain representations, warranties, covenants and agreements in connection with the Merger and also to prescribe various conditions to the Merger.

NOW, THEREFORE, in consideration of the representations, warranties, covenants and agreements contained in this Agreement, and subject to the conditions set forth herein, the parties hereto agree as follows:

(a) The Amended and Restated Bylaws of the Company (the Company Bylaws) shall be amended at the Effective Time to be in the form of Exhibit B, with such changes thereto as may be agreed to by the Company and MergerCos, and, as so amended, shall be the Bylaws of the Surviving Corporation until thereafter changed or amended as provided therein or by applicable Law.

SECTION 1.06. Directors. The directors of MergerCos immediately prior to the Effective Time shall be the directors of the Surviving Corporation until the earlier of their resignation or removal or until their respective successors are duly elected and qualified, as the case may be.

SECTION 1.07. Officers. The officers of the Company immediately prior to the Effective Time shall be the officers of the Surviving Corporation, until the earlier of their resignation or removal or until their respective successors are duly elected and qualified, as the case may be.

ARTICLE II

Effect of the Merger on the Capital Stock of the
Constituent Corporations; Exchange Fund;
Company Equity Awards

SECTION 2.01. Effect on Capital Stock. At the Effective Time, by virtue of the Merger and without any action on the part of the holder of any shares of Company Common Stock or any shares of capital stock or other equity interests of any Sponsor Entity:

(a) Capital Stock of MergerCos. Each share of capital stock of each MergerCo issued and outstanding immediately prior to the Effective Time shall be converted into and become one validly issued, fully paid and nonassessable share of common stock, par value $0.01 per share, of the Surviving Corporation.

(b) Cancelation of Treasury Stock and Certain Other Stock. Each share of Company Common Stock that is directly owned by the Company, as treasury stock, or by any of the Sponsor Entities immediately prior to the Effective Time shall automatically be canceled and shall cease to exist, and no consideration shall be delivered in exchange therefor.

(c) Conversion of Company Common Stock. Each share of Company Common Stock issued and outstanding immediately prior to the Effective Time (including shares of Company Restricted Stock, but excluding shares to be canceled in accordance with Section 2.01(b) and, except as provided in Section 2.01(d), the Appraisal Shares) shall be converted into the right to receive $44.00 in cash, without interest (the Merger Consideration). At the Effective Time, all such shares of Company Common Stock shall no longer be outstanding and shall automatically be canceled and shall cease to exist, and each holder of a certificate that immediately prior to the Effective Time

represented any such shares of Company Common Stock (each, a Certificate) shall cease to have any rights with respect thereto, except the right to receive the Merger Consideration and any dividends declared in accordance with Section 4.01(a) with a record date prior to the Effective Time that remain unpaid at the Effective Time and that are due to such holder.

(d) Appraisal Rights. Notwithstanding anything in this Agreement to the contrary, shares (the Appraisal Shares) of Company Common Stock issued and outstanding immediately prior to the Effective Time that are held by any holder who is entitled to demand and properly demands appraisal of such shares pursuant to, and who complies in all respects with, the provisions of Section 262 of the DGCL (Section 262) shall not be converted into the right to receive the Merger Consideration as provided in Section 2.01(c), but instead such holder shall be entitled to payment of the fair value of such shares in accordance with the provisions of Section 262. At the Effective Time, the Appraisal Shares shall no longer be outstanding and shall automatically be canceled and shall cease to exist, and each holder of Appraisal Shares shall cease to have any rights with respect thereto, except the right to receive the fair value of such shares in accordance with the provisions of Section 262. Notwithstanding the foregoing, if any such holder shall fail to perfect or otherwise shall waive, withdraw or lose the right to appraisal under Section 262 or a court of competent jurisdiction shall determine that such holder is not entitled to the relief provided by Section 262, then the right of such holder to be paid the fair value of such holder s Appraisal Shares under Section 262 shall cease and such Appraisal Shares shall be deemed to have been converted at the Effective Time into, and shall have become, the right to receive the Merger Consideration as provided in Section 2.01(c). The Company shall give prompt notice to MergerCos of any demands for appraisal of any shares of Company Common Stock, withdrawals of such demands and any other instruments served pursuant to the DGCL received by the Company, and MergerCos shall have the right to participate in and direct all negotiations and proceedings with respect to such demands. Prior to the Effective Time, the Company shall not, without the prior written consent of MergerCos (which consent shall not be unreasonably withheld or delayed), voluntarily make any payment with respect to, or settle or offer to settle, any such demands, or agree to do or commit to do any of the foregoing.

SECTION 2.02. Exchange Fund. (a) Paying Agent. Prior to the Closing Date, the Sponsor Entities shall appoint a bank or trust company reasonably acceptable to the Company to act as paying agent (the Paying Agent) for the payment of the Merger Consideration and the Option Amounts in accordance with this Article II and, in connection therewith, shall enter into an agreement with the Paying Agent in a form reasonably acceptable to the Company. At or prior to the Effective Time, the Sponsor Entities shall deposit, or shall cause the Surviving Corporation to deposit, with the Paying Agent, cash in an amount sufficient to pay the aggregate Merger Consideration and the aggregate Option Amount, in each case as required to be paid pursuant to this Agreement (such cash being hereinafter referred to as the Exchange Fund).

(b) Certificate Exchange Procedures. As promptly as practicable after the Effective Time, but in any event within two business days thereafter, the Surviving Corporation shall cause the Paying Agent to mail to each holder of record of a Certificate (i) a letter of transmittal (which shall specify that delivery shall be effected, and risk of loss and title to the Certificates shall pass, only upon proper delivery of the Certificates to the Paying Agent and which shall otherwise be in customary form) and (ii) instructions for use in effecting the surrender of the Certificates in exchange for the Merger Consideration. Each holder of record of a Certificate shall, upon surrender to the Paying Agent of such Certificate, together with such letter of transmittal, duly executed, and such other documents as may reasonably be required by the Paying Agent, be entitled to receive in exchange therefor the amount of cash which the number of shares of Company Common Stock previously represented by such Certificate shall have been converted into the right to receive pursuant to Section 2.01(c), and the Certificate so surrendered shall forthwith be canceled. In the event of a transfer of ownership of Company Common Stock which is not registered in the transfer records of the Company, payment of the Merger Consideration may be made to a person other than the person in whose name the Certificate so surrendered is registered if such Certificate shall be properly endorsed or otherwise be in proper form for transfer and the person requesting such payment shall pay any fiduciary or surety bonds or any transfer or other similar taxes required by reason of the payment of the Merger Consideration to a person other than the registered holder of such Certificate or establish to the reasonable satisfaction of the Surviving Corporation that such tax has been paid or is not applicable. Until surrendered as contemplated by this Section 2.02(b), each Certificate shall be deemed at any time after the Effective Time to represent only the right to receive upon such surrender the Merger Consideration which the holder thereof has the right to receive in respect of such Certificate pursuant to this Article II and any dividends declared in accordance with Section 4.01(a) with a record date prior to the Effective Time that remain unpaid at the Effective Time and that are due to such holder. No interest shall be paid or will accrue on any cash payable to holders of Certificates pursuant to the provisions of this Article II.

(c) No Further Ownership Rights in Company Common Stock. All cash paid upon the surrender of Certificates in accordance with the terms of this Article II shall be deemed to have been paid in full satisfaction of all rights pertaining to the shares of Company Common Stock formerly represented by such Certificates, subject, however, to the Surviving Corporation s obligation to pay all dividends that may have been declared by the Company in accordance with Section 4.01(a) and that remain unpaid at the Effective Time. At the close of business on the day on which the Effective Time occurs, the stock transfer books of the Company shall be closed, and there shall be no further registration of transfers on the stock transfer books of the Surviving Corporation of the shares of Company Common Stock that were outstanding immediately prior to the Effective Time. If, after the close of business on the day on which the Effective Time occurs, any Certificate is presented to the Surviving Corporation for transfer, it shall be canceled against delivery of cash to the holder thereof as provided in this Article II.

(d) Termination of the Exchange Fund. Any portion of the Exchange Fund that remains undistributed to the holders of the Certificates for 12 months after the

Effective Time shall be delivered to the Surviving Corporation, upon demand, and any holders of the Certificates who have not theretofore complied with this Article II shall thereafter look only to the Surviving Corporation for, and the Surviving Corporation shall remain liable for, payment of their claims for the Merger Consideration pursuant to the provisions of this Article II.

(e) No Liability. None of the Company, the Surviving Corporation, the Sponsor Entities or the Paying Agent shall be liable to any person in respect of any cash from the Exchange Fund delivered to a public official in compliance with any applicable state, Federal or other abandoned property, escheat or similar Law. If any Certificate shall not have been surrendered prior to the date on which the related Merger Consideration would escheat to or become the property of any Governmental Entity, any such Merger Consideration shall, to the extent permitted by applicable Law, immediately prior to such time become the property of the Surviving Corporation, free and clear of all claims or interest of any person previously entitled thereto.

(f) Investment of Exchange Fund. The Paying Agent shall invest the cash in the Exchange Fund as directed by the Surviving Corporation; provided, however, that such investments shall be in obligations of or guaranteed by the United States of America or any agency or instrumentality thereof and backed by the full faith and credit of the United States of America, in commercial paper obligations rated A-1 or P-1 or better by Moody s Investors Service, Inc. or Standard & Poor s Corporation, respectively, or in certificates of deposit, bank repurchase agreements or banker s acceptances of commercial banks with capital exceeding $1.0 billion (based on the most recent financial statements of such bank that are then publicly available). Any interest and other income resulting from such investments shall be paid solely to the Surviving Corporation. Nothing contained herein and no investment losses resulting from investment of the Exchange Fund shall diminish the rights of any holder of Certificates to receive the Merger Consideration or any holder of a Company Stock Option to receive the Option Amount, in each case as provided herein.

(g) Lost Certificates. If any Certificate shall have been lost, stolen or destroyed, upon the making of an affidavit of that fact by the person claiming such Certificate to be lost, stolen or destroyed and, if required by the Surviving Corporation, the posting by such person of a bond or surety in such reasonable amount as the Surviving Corporation may direct as indemnity against any claim that may be made against it with respect to such Certificate, the Paying Agent shall deliver in exchange for such lost, stolen or destroyed Certificate the applicable Merger Consideration with respect thereto.

(h) Withholding Rights. The Surviving Corporation or the Paying Agent shall be entitled to deduct and withhold from the consideration otherwise payable pursuant to this Agreement to any holder of shares of Company Common Stock or any holder of a Company Stock Option such amounts as the Surviving Corporation or the Paying Agent are required to deduct and withhold with respect to the making of such payment under the Internal Revenue Code of 1986, as amended (the Code), or any provision of state, local or foreign tax Law. To the extent that amounts are so withheld

and paid over to the appropriate taxing authority by the Surviving Corporation or the Paying Agent, such withheld amounts shall be treated for all purposes of this Agreement as having been paid to the holder of the shares of Company Common Stock or the holder of the Company Stock Option, as the case may be, in respect of which such deduction and withholding was made by the Surviving Corporation or the Paying Agent.

SECTION 2.03. Company Equity Awards. (a) As soon as reasonably practicable following the date of this Agreement, the Board of Directors of the Company (or, if appropriate, any committee administering any Company Stock Plan) shall adopt such resolutions or take such other actions as may be required to provide that, at the Effective Time, each unexercised Company Stock Option that is outstanding immediately prior to the Effective Time shall be canceled, with the holder of each such Company Stock Option becoming entitled to receive an amount in cash equal to (i) the excess, if any, of (A) the Merger Consideration over (B) the exercise price per share of Company Common Stock subject to such Company Stock Option, multiplied by (ii) the number of shares of Company Common Stock subject to such Company Stock Option (such amount, the Option Amount). Subject to Section 2.02(h), all amounts payable pursuant to this Section 2.03(a) shall be paid as promptly as practicable following the Effective Time, without interest. In the event that the exercise price per share of Company Common Stock subject to a Company Stock Option is equal to or greater than the Merger Consideration, such Company Stock Option shall be cancelled without consideration and have no further force or effect.

(b) With respect to the ESPP, each participant s accumulated payroll deductions shall be used to purchase shares of Company Common Stock immediately prior to the Effective Time in accordance with the terms of the ESPP, and the shares of Company Common Stock purchased thereunder shall be canceled at the Effective Time and converted into the right to receive the Merger Consideration pursuant to Section 2.01(c). The Company shall cause the ESPP to terminate at the Effective Time, and no further purchase rights shall be granted or exercised under the ESPP thereafter.

ARTICLE III

Representations and Warranties

SECTION 3.01. Representations and Warranties of the Company. Except as disclosed in any report, schedule, form, statement or other document filed with, or furnished to, the Securities and Exchange Commission (the SEC) by the Company and publicly available prior to the date of this Agreement (collectively, the Filed SEC Documents), and, for the avoidance of doubt, without giving effect to any change of fact or circumstance subsequent to the date such document was filed or furnished, or as set forth in the Company Disclosure Letter (it being understood that any information set forth in one section or subsection of the Company Disclosure Letter shall be deemed to apply to and qualify the Section or subsection of this Agreement to which it corresponds in number and each other Section or subsection of this Agreement to the extent that it is

reasonably apparent on its face that such information is relevant to such other Section or subsection), the Company represents and warrants to the Sponsor Entities as follows:

(a) Organization, Standing and Corporate Power. Each of the Company and its Subsidiaries is duly organized and validly existing under the Laws of its jurisdiction of organization and has all requisite corporate, company or partnership power and authority to carry on its business as presently conducted. Each of the Company and its Subsidiaries is duly qualified or licensed to do business and is in good standing (where such concept is recognized under applicable Law) in each jurisdiction where the nature of its business or the ownership, leasing or operation of its properties makes such qualification or licensing necessary, other than where the failure to be so qualified, licensed or in good standing has not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. The Company has made available to the Sponsor Entities prior to the execution of this Agreement a true and complete copy of the Company Certificate of Incorporation and the Company Bylaws and the comparable organizational documents of each of its Subsidiaries, in each case as in effect on the date of this Agreement.

(b) Subsidiaries. Section 3.01(b) of the Company Disclosure Letter lists each Subsidiary of the Company and the jurisdiction of organization thereof. All the outstanding shares of capital stock of, or other equity interests in, each Subsidiary of the Company have been validly issued and are fully paid and nonassessable and are owned, directly or indirectly, by the Company free and clear of all pledges, liens, charges, mortgages, encumbrances or security interests of any kind or nature whatsoever (collectively, Liens), other than Permitted Liens. Except for its interests in its Subsidiaries, the Company does not own, directly or indirectly, any capital stock of, or other equity interests in, any corporation, partnership, joint venture, association or other entity.

(c) Capital Structure. The authorized capital stock of the Company consists of 350,000,000 shares of Company Common Stock and 2,000,000 shares of preferred stock, par value $0.10 per share (the Company Preferred Stock). At the close of business on June 27, 2006, (i) 134,937,396 shares of Company Common Stock were issued and outstanding (which number includes (A) 2,766,400 shares of Company Common Stock held by the Company in its treasury and (B) 12,955 shares of Company Common Stock subject to vesting or other forfeiture conditions or repurchase by the Company (such shares, together with any similar shares issued after June 27, 2006, the Company Restricted Stock)), (ii) 22,487,703 shares of Company Common Stock were reserved and available for issuance pursuant to the Company s Amended and Restated 1997 Stock Option Plan, Second Amended and Restated 2001 Employee Stock Option Plan, Second Amended and Restated 2001 General Stock Option Plan, 2005 Incentive Compensation Plan and Second Amended and Restated 1997 Employees Stock Purchase Plan (such plan, the ESPP ; the foregoing plans, collectively, the Company Stock Plans), of which (A) 10,847,294 shares of Company Common Stock were subject to outstanding options (other than rights under the ESPP) to acquire shares of Company Common Stock from the Company (such options, together with any similar options

granted after June 27, 2006, the Company Stock Options) and (B) 6,188 shares of Company Common Stock were subject to outstanding rights under the ESPP (assuming that the closing price for the Company Common Stock as reported on the New York Stock Exchange on the last day of the offering period in effect under the ESPP on June 27, 2006 was equal to the Merger Consideration), (iii) 8,087,082 shares of Company Common Stock were reserved and available under the Company s Dividend Reinvestment and Stock Purchase Plan (the Company DRIP) and (iv) no shares of Company Preferred Stock were issued or outstanding or held by the Company in its treasury. Except as set forth above, at the close of business on June 27, 2006, no shares of capital stock or other voting securities of the Company were issued, reserved for issuance or outstanding. Since June 27, 2006 to the date of this Agreement, (x) there have been no issuances by the Company of shares of capital stock or other voting securities of the Company, other than issuances of shares of Company Common Stock pursuant to the exercise of the Company Stock Options or rights under the ESPP, in each case outstanding as of June 27, 2006, and (y) there have been no issuances by the Company of options, warrants, other rights to acquire shares of capital stock of the Company or other rights that give the holder thereof any economic interest of a nature accruing to the holders of Company Common Stock, except for rights under the ESPP. All outstanding shares of Company Common Stock (other than Company Restricted Stock) are, and all such shares that may be issued prior to the Effective Time will be when issued, duly authorized, validly issued, fully paid and nonassessable and not subject to preemptive rights. There are no bonds, debentures, notes or other indebtedness of the Company having the right to vote (or convertible into, or exchangeable for, securities having the right to vote) on any matters on which holders of Company Common Stock may vote (Voting Company Debt). Except for any obligations pursuant to this Agreement, any Company Stock Plan or as otherwise set forth above, as of June 27, 2006, there are no options, warrants, rights, convertible or exchangeable securities, stock-based performance units, Contracts or undertakings of any kind to which the Company or any of its Subsidiaries is a party or by which any of them is bound (1) obligating the Company or any such Subsidiary to issue, deliver or sell, or cause to be issued, delivered or sold, additional shares of capital stock or other equity interests in, or any security convertible or exchangeable for any capital stock of or other equity interest in, the Company or of any of its Subsidiaries or any Voting Company Debt, other than pursuant to (x) the Michaels Stores, Inc. Employees 401(k) Plan (the Company 401(k) Plan) and (y) the Company DRIP, (2) obligating the Company or any such Subsidiary to issue, grant or enter into any such option, warrant, right, security, unit, Contract or undertaking or (3) that give any person the right to receive any economic interest of a nature accruing to the holders of Company Common Stock. As of the date of this Agreement, there are no outstanding contractual obligations of the Company or any of its Subsidiaries to repurchase, redeem or otherwise acquire any shares of capital stock of the Company or any such Subsidiary, other than pursuant to the Company Stock Plans and the Company 401(k) Plan. Section 3.01(c) of the Company Disclosure Letter sets forth a true and complete list of all Indebtedness for borrowed money of the Company and its Subsidiaries (other than any such Indebtedness owed to the Company or any of its Subsidiaries, trade letters of credit and any other such Indebtedness with a principal

amount not in excess of $10.0 million individually) outstanding on the date of this Agreement.

(d) Authority; Noncontravention. The Company has all requisite corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated by this Agreement, subject, in the case of the Merger, to receipt of the Stockholder Approval. The execution and delivery of this Agreement by the Company and the consummation by the Company of the transactions contemplated by this Agreement have been duly authorized by all necessary corporate action on the part of the Company, subject, in the case of the Merger, to receipt of the Stockholder Approval. This Agreement has been duly executed and delivered by the Company and, assuming the due authorization, execution and delivery by each of the other parties hereto, constitutes a legal, valid and binding obligation of the Company, enforceable against the Company in accordance with its terms, subject, as to enforceability, to bankruptcy, insolvency and other Laws of general applicability relating to or affecting creditors rights and to general equity principles. The Board of Directors of the Company, at a meeting duly called and held at which all directors of the Company were present, duly adopted resolutions (i) approving and declaring advisable this Agreement, the Merger and the other transactions contemplated by this Agreement, (ii) declaring that it is in the best interests of the stockholders of the Company that the Company enter into this Agreement and consummate the Merger and the other transactions contemplated by this Agreement on the terms and subject to the conditions set forth herein, (iii) directing that the adoption of this Agreement be submitted to a vote at a meeting of the stockholders of the Company and (iv) recommending that the stockholders of the Company adopt this Agreement, which resolutions, as of the date of this Agreement, have not been rescinded, modified or withdrawn in any way. The execution and delivery by the Company of this Agreement do not, and the consummation of the Merger and the other transactions contemplated by this Agreement and compliance with the provisions of this Agreement will not, conflict with, or result in any violation of, or default (with or without notice or lapse of time, or both) under, or give rise to a right of termination, cancellation or acceleration of any obligation or to the loss of a benefit under, or result in the creation of any Lien upon any of the properties or assets of the Company or any of its Subsidiaries under (other than any such Lien created in connection with the Financing or otherwise from any action taken by any of the Sponsor Entities), any provision of (A) the Company Certificate of Incorporation, the Company Bylaws or the comparable organizational documents of any of its Subsidiaries or (B) subject to the filings and other matters referred to in the immediately following sentence, (1) any contract, lease, indenture, note, bond or other agreement that is in force and effect (a Contract) to which the Company or any of its Subsidiaries is a party or by which any of their respective properties or assets are bound, other than any lease of real property under which the Company or any of its Subsidiaries is a tenant or a subtenant, or (2) any statute, law, ordinance, rule or regulation of any Governmental Entity (Law) or any judgment, order or decree of any Governmental Entity (Judgment), in each case applicable to the Company or any of its Subsidiaries or their respective properties or assets, other than, in the case of clause (B) above, any such conflicts, violations, defaults, rights, losses or Liens that have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse

Effect. No consent, approval, order or authorization of, or registration, declaration or filing with, or notice to, any Federal, state, local or foreign government, any court of competent jurisdiction or any administrative, regulatory (including any stock exchange) or other governmental agency, commission or authority (each, a Governmental Entity) is required to be obtained or made by or with respect to the Company or any of its Subsidiaries in connection with the execution and delivery of this Agreement by the Company or the consummation by the Company of the Merger or the other transactions contemplated by this Agreement, except for (I) the filing of a premerger notification and report form by the Company under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the HSR Act), and the filings and receipt, termination or expiration, as applicable, of such other approvals or waiting periods as may be required under any other applicable competition, merger control, antitrust or similar Law, (II) the filing with the SEC of (x) a proxy statement relating to the adoption by the stockholders of the Company of this Agreement (as amended or supplemented from time to time, the Proxy Statement) and (y) such reports under the Securities Exchange Act of 1934, as amended (the Exchange Act), as may be required in connection with this Agreement and the transactions contemplated by this Agreement, (III) the filing of the Certificate of Merger with the Secretary of State of the State of Delaware and of appropriate documents with the relevant authorities of other jurisdictions in which the Company or any of its Subsidiaries is qualified to do business, (IV) any filings required under the rules and regulations of the New York Stock Exchange and (V) such other consents, approvals, orders, authorizations, registrations, declarations, filings and notices the failure of which to be obtained or made has not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect.

(e) SEC Documents. The Company has filed all reports, schedules, forms, statements and other documents with the SEC required to be filed by the Company since January 1, 2004 (the SEC Documents). As of their respective dates of filing, the SEC Documents complied as to form in all material respects with the requirements of the Securities Act of 1933, as amended (the Securities Act), or the Exchange Act, as the case may be, and the rules and regulations of the SEC promulgated thereunder applicable thereto, and none of the SEC Documents contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading. The Company has made available to the Sponsor Entities copies of all comment letters received by the Company from the SEC since January 1, 2004 and relating to the SEC Documents, together with all written responses of the Company thereto. As of the date of this Agreement, to the Knowledge of the Company there are no outstanding or unresolved comments in such comment letters received by the Company from the SEC. As of the date of this Agreement, to the Knowledge of the Company, none of the SEC Documents is the subject of any ongoing review by the SEC. The audited consolidated financial statements and the unaudited quarterly financial statements (including, in each case, the notes thereto) of the Company included in the SEC Documents when filed complied as to form in all material respects with the published rules and regulations of the SEC with respect thereto, have been prepared in all material respects in accordance with generally accepted accounting

principles (GAAP) (except, in the case of unaudited quarterly statements, as permitted by Form 10-Q of the SEC or other rules and regulations of the SEC) applied on a consistent basis during the periods involved (except as may be indicated in the notes thereto) and fairly present in all material respects the consolidated financial position of the Company and its consolidated Subsidiaries as of the dates thereof and the consolidated results of their operations and cash flows for the periods then ended (subject, in the case of unaudited quarterly statements, to normal year-end adjustments). Except for matters reflected or reserved against in the audited consolidated balance sheet of the Company as of January 28, 2006 (or the notes thereto) included in the Filed SEC Documents, neither the Company nor any of its Subsidiaries has any liabilities or obligations (whether absolute, accrued, contingent, fixed or otherwise) of any nature that would be required under GAAP, as in effect on the date of this Agreement, to be reflected on a consolidated balance sheet of the Company (including the notes thereto), except liabilities and obligations that (i) were incurred since January 28, 2006 in the ordinary course of business consistent with past practice, (ii) are incurred in connection with the transactions contemplated by this Agreement or (iii) have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect.

(f) Information Supplied. The Proxy Statement will not, at the date it is first mailed to the stockholders of the Company and at the time of the Stockholders Meeting, contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they are made, not misleading, except that no representation or warranty is made by the Company with respect to statements made or incorporated by reference therein based on information supplied by any of the Sponsor Entities for inclusion or incorporation by reference in the Proxy Statement.

(g) Absence of Certain Changes or Events. Since January 28, 2006, there has not been any change, effect, event, occurrence or state of facts that has had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. From such date through the date of this Agreement, the Company and its Subsidiaries have conducted their businesses only in the ordinary course of business consistent with past practice, and during such period there has not been:

(i) any declaration, setting aside or payment of any dividend on, or making of any other distribution (whether in cash, stock or property) with respect to, any capital stock of the Company, except for the regular quarterly cash dividends on Company Common Stock;

(ii) any split, combination or reclassification of any capital stock of the Company or any issuance or the authorization of any issuance of any other securities in lieu of or in substitution for shares of capital stock of the Company;

(iii) any purchase, redemption or other acquisition by the Company or any of its Subsidiaries of any shares of capital stock of the Company or any of its Subsidiaries or any rights, warrants or options to acquire any such shares, other

than (A) the acquisition by the Company of shares of Company Common Stock in connection with the surrender of shares of Company Common Stock by holders of options to acquire such stock in order to pay the exercise price thereof, (B) the withholding of shares of Company Common Stock to satisfy tax obligations with respect to awards granted pursuant to the Company Stock Plans, (C) the acquisition by the Company of Company Stock Options and shares of Company Restricted Stock in connection with the forfeiture of such awards and (D) the acquisition by the trustee of the Company 401(k) Plan of shares of Company Common Stock in order to satisfy participant investment elections under the Company 401(k) Plan;

(iv) except (A) in the ordinary course of business consistent with past practice or (B) as required pursuant to the terms of any Company Benefit Plan or Company Benefit Agreement or other written agreement, in each case, in effect as of January 28, 2006, (1) any granting to any director or executive officer of the Company or any of its Subsidiaries of any material increase in compensation, (2) any granting to any director or executive officer of the Company or any of its Subsidiaries of any increase in severance or termination pay or (3) any entry by the Company or any of its Subsidiaries into any employment, consulting, severance or termination agreement with any director, executive officer or employee of the Company or any of its Subsidiaries pursuant to which the total annual compensation or the aggregate severance benefits exceed $500,000 per person;

(v) any change in accounting methods, principles or practices by the Company or any of its Subsidiaries materially affecting the consolidated assets, liabilities or results of operations of the Company, except as required (A) by GAAP (or any interpretation thereof), including as may be required by the Financial Accounting Standards Board or any similar organization, or (B) by Law, including Regulation S-X under the Securities Act; or

(vi) any material tax election by the Company or any of its Subsidiaries, other than in the ordinary course of business.

(h) Litigation. There is no suit, action or proceeding pending or, to the Knowledge of the Company, threatened against the Company or any of its Subsidiaries that has had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. There is no Judgment outstanding against the Company or any of its Subsidiaries that has had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. As of the date of this Agreement, to the Knowledge of the Company, no director or officer of the Company is a defendant in any suit, action or proceeding in connection with his or her status as a director or officer of the Company. This Section 3.01(h) does not relate to environmental matters, which are the subject of Section 3.01(j)(ii).

(i) Contracts. Except for this Agreement, Contracts filed as exhibits to the Filed SEC Documents and purchase orders entered into in the ordinary course of

business, Section 3.01(i) of the Company Disclosure Letter sets forth a true and complete list, as of the date of this Agreement, and the Company has made available to the Sponsor Entities true and complete copies, of:

(i) each Contract that would be required to be filed by the Company as a material contract pursuant to Item 601(b)(10) of Regulation S-K under the Securities Act;

(ii) each Contract to which the Company or any of its Subsidiaries is a party that materially restricts the ability of the Company or any of its Subsidiaries to compete in any business or with any person in any geographical area, except for any such Contract that may be canceled, without any material penalty or other liability to the Company or any of its Subsidiaries, upon notice of 90 days or less;

(iii) each loan and credit agreement, note, debenture, bond, indenture and other similar Contract pursuant to which any Indebtedness of the Company or any of its Subsidiaries, in each case in excess of $10.0 million, is outstanding or may be incurred, other than any such Contract between or among any of the Company and any of its Subsidiaries and any letters of credit;

(iv) each Contract to which the Company or any of its Subsidiaries is a party that by its terms calls for aggregate payments by the Company or any of its Subsidiaries of more than $20.0 million over the remaining term of such Contract, except for any such Contract that may be canceled, without any material penalty or other liability to the Company or any of its Subsidiaries, upon notice of 90 days or less; and

(v) each Contract to which the Company or any of its Subsidiaries is a party for the acquisition or disposition by the Company or any of its Subsidiaries of properties or assets for, in each case, aggregate consideration of more than $20.0 million, except for acquisitions and dispositions of properties and assets in the ordinary course of business (including acquisitions of supplies and acquisitions and dispositions of inventory).

Each such Contract described in clauses (i) through (v) above is referred to herein as a Specified Contract . Each of the Specified Contracts is valid and binding on the Company or the Subsidiary of the Company party thereto and, to the Knowledge of the Company, each other party thereto, and is in full force and effect, except for such failures to be valid and binding or to be in full force and effect that have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. There is no default under any Specified Contract by the Company or any of its Subsidiaries or, to the Knowledge of the Company, by any other party thereto, and no event has occurred that with the lapse of time or the giving of notice or both would constitute a default thereunder by the Company or any of its Subsidiaries or, to the Knowledge of the Company, by any other party thereto, in each case except as have not had and would not reasonably be expected to have, individually or in the aggregate, a

Material Adverse Effect. This Section 3.01(i) does not relate to real property leases, which are the subject of Section 3.01(n).

(j) Compliance with Laws; Environmental Matters. (i) Each of the Company and its Subsidiaries is and since January 1, 2004 has been in compliance with all Laws applicable to its business or operations (including the Sarbanes-Oxley Act of 2002), except for instances of possible noncompliance that have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. Each of the Company and its Subsidiaries has in effect all approvals, authorizations, certificates, franchises, licenses, permits and consents of Governmental Entities (collectively, Permits) necessary for it to conduct its business as presently conducted, and all such Permits are in full force and effect, except for such Permits the absence of which, or the failure of which to be in full force and effect, have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. This Section 3.01(j)(i) does not relate to environmental matters, which are the subject of Section 3.01(j)(ii), employee benefit matters, which are the subject of Section 3.01(l), and taxes, which are the subject of Section 3.01(m).

(ii) Except for those matters that have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect, (A) each of the Company and its Subsidiaries is in compliance with all applicable Environmental Laws, and neither the Company nor any of its Subsidiaries has received any written communication alleging that the Company is in violation of, or has any liability under, any Environmental Law, (B) each of the Company and its Subsidiaries validly possesses and is in compliance with all Permits required under Environmental Laws to conduct its business as presently conducted, and all such Permits are valid and in good standing, (C) there are no Environmental Claims pending or, to the Knowledge of the Company, threatened against the Company or any of its Subsidiaries and (D) none of the Company or any of its Subsidiaries has Released any Hazardous Materials at, on, under or from any of the Owned Real Property, the Leased Real Property or any other property in a manner that would reasonably be expected to result in an Environmental Claim against the Company or any of its Subsidiaries.

The term Environmental Claims means any administrative or judicial actions, suits, orders, claims, proceedings or written notices of noncompliance by or from any person alleging liability arising out of the Release of any Hazardous Material or the failure to comply with any Environmental Law. The term Environmental Law means any Law relating to pollution, the environment or natural resources. The term Hazardous Materials means (1) petroleum and petroleum by-products, asbestos in any form that is or could reasonably become friable, radioactive materials, medical or infectious wastes, or polychlorinated biphenyls, and (2) any other material, substance or waste that is prohibited, limited or regulated because of its hazardous, toxic or deleterious properties or characteristics. The term Release means any release, spill, emission,

leaking, pumping, emitting, discharging, injecting, escaping, leaching, dumping, disposing or migrating into or through the environment.

(k) Labor and Employment Matters. Neither the Company nor any of its Subsidiaries is a party to any collective bargaining agreement, and there are not, to the Knowledge of the Company, any union organizing activities concerning any employees of the Company or any of its Subsidiaries that, in each case, has had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. There are no labor strikes, slowdowns, work stoppages or lockouts pending or, to the Knowledge of the Company, threatened in writing, against the Company or any of its Subsidiaries that have had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect.

(l) Employee Benefit Matters. (i) Section 3.01(l) of the Company Disclosure Letter contains a true and complete list, as of the date of this Agreement, of each material Company Benefit Plan that is an employee pension benefit plan (as defined in Section 3(2) of ERISA) (a Company Pension Plan), each material Company Benefit Plan that is an employee welfare benefit plan (as defined in Section 3(1) of ERISA) and all other material Company Benefit Plans and all material Company Benefit Agreements. Each Company Benefit Plan has been administered in compliance with its terms and with applicable Law (including ERISA and the Code), other than instances of noncompliance that have not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. The Company has made available to the Sponsor Entities true and complete copies of (A) each material Company Benefit Plan and each material Company Benefit Agreement, other than any Company Benefit Plan or Company Benefit Agreement that the Company or any of its Subsidiaries is prohibited from making available to the Sponsor Entities as the result of applicable Law relating to the safeguarding of data privacy, (B) the most recent annual report on Form 5500 filed with the Internal Revenue Service with respect to each Company Benefit Plan (if any such report was required by applicable Law) and (C) the most recent summary plan description for each Company Benefit Plan for which a summary plan description is required by applicable Law.

(ii) All Company Pension Plans that are intended to be qualified for Federal income tax purposes have been the subject of determination letters from the Internal Revenue Service to the effect that such Company Pension Plans are so qualified and exempt from Federal income taxes under Sections 401(a) and 501(a), respectively, of the Code, and no such determination letter has been revoked nor, to the Knowledge of the Company, has revocation been threatened.

(iii) None of the Company Benefit Plans is subject to Section 302 or Title IV of ERISA or Section 412 of the Code. None of the Company, any of its Subsidiaries or any other person or entity under common control with the Company within the meaning of Section 414(b), (c), (m) or (o) of the Code participates in, or is required to contribute to, any Multiemployer Plan.

Table of Contents

(iv) Except as individually or in the aggregate has not had and would not reasonably be expected to have a Material Adverse Effect, none of the Company, any of its Subsidiaries, any officer of the Company or any such Subsidiary or any Company Benefit Plan that is subject to ERISA, including any Company Pension Plan, or, to the Knowledge of the Company, any trust created thereunder or any trustee or administrator thereof, has engaged in a prohibited transaction (as such term is defined in Section 406 of ERISA or Section 4975 of the Code) or any other breach of fiduciary responsibility that could subject the Company, any of its Subsidiaries or any officer of the Company or any such Subsidiary to the tax or penalty on prohibited transactions imposed by such Section 4975 of the Code or to any liability under Section 502(i) or 502(1) of ERISA.

(v) No Company Benefit Plan provides health benefits (whether or not insured) with respect to employees or former employees (or any of their beneficiaries) of the Company or any of its Subsidiaries after retirement or other termination of service (other than coverage or benefits (A) required to be provided under Part 6 of Title I of ERISA or any other similar applicable Law or (B) the full cost of which is borne by the employee or former employee (or any of their beneficiaries)).

(vi) Other than payments that may be made to the persons listed in Section 3.01(l)(vi) of the Company Disclosure Letter, any amount that could be received (whether in cash or property or the vesting of property) as a result of the Merger or any other transaction contemplated by this Agreement by any employee, officer or director of the Company or any of its affiliates who is a disqualified individual (as such term is defined in Treasury Regulation Section 1.280G-1) under any employment, severance or termination agreement, other compensation arrangement or Company Benefit Plan or Company Benefit Agreement currently in effect would not be characterized as an excess parachute payment (as defined in Section 280G(b)(1) of the Code).

(vii) The term Company Benefit Agreement means each employment, consulting, indemnification, severance or termination agreement or arrangement between the Company or any of its Subsidiaries, on the one hand, and any current or former employee, officer or director of the Company or any of its Subsidiaries, on the other hand, other than any agreement or arrangement mandated by applicable Law. The term Company Benefit Plan means each bonus, pension, profit sharing, deferred compensation, incentive compensation, stock ownership, stock purchase, stock option, phantom stock or other equity-based compensation, retirement, vacation, severance, disability, death benefit, hospitalization, medical or other employee benefits plan, policy, program, arrangement or understanding, whether formal or informal, oral or written (but excluding any Company Benefit Agreement), in each case sponsored, maintained or contributed to, or required to be sponsored, maintained or contributed to, by the Company or any of its Subsidiaries for the

benefit of any current or former employee, officer or director of the Company or any of its Subsidiaries, other than (A) any multiemployer plan (within the meaning of Section 3(37) of the Employee Retirement Income Security Act of 1974, as amended (ERISA)) (a Multiemployer Plan) or (B) any plan, policy, program, arrangement or understanding mandated by applicable Law.

(m) Taxes. (i) Each of the Company and its Subsidiaries has filed or has caused to be filed all material tax returns required to be filed by it (or requests for extensions, which requests have been granted and have not expired), and all such returns are complete and accurate in all material respects. Each of the Company and its Subsidiaries has either paid or caused to be paid all material taxes due and owing by the Company and its Subsidiaries to any Governmental Entity, or the most recent financial statements contained in the Filed SEC Documents reflect an adequate reserve (excluding any reserves for deferred taxes), if such a reserve is required by GAAP, for all material taxes payable by the Company and its Subsidiaries, for all taxable periods and portions thereof ending on or before the date of such financial statements.

(ii) No deficiencies, audit examinations, refund litigation, proposed adjustments or matters in controversy for any material taxes (other than taxes that are not yet due and payable or for amounts being contested in good faith) have been proposed, asserted or assessed in writing against the Company or any of its Subsidiaries which have not been settled and paid. All assessments for material taxes due and owing by the Company or any of its Subsidiaries with respect to completed and settled examinations or concluded litigation have been paid. There is no currently effective agreement or other document with respect to the Company or any of its Subsidiaries extending the period of assessment or collection of any material taxes.

(iii) Neither the Company nor any of its Subsidiaries has constituted either a distributing corporation or a controlled corporation in a distribution of stock qualifying for tax-free treatment under Section 355 of the Code (A) in the two years prior to the date of this Agreement or (B) which could otherwise constitute part of a plan or series of related transactions (within the meaning of Section 355(e) of the Code) in conjunction with the Merger.

(iv) None of the Company or any of its Subsidiaries has entered into any transaction defined in Treasury Regulation Sections 1.6011-4(b)(2), -4(b)(3) or -4(b)(4), or has entered into a potentially abusive tax shelter (as defined in Treasury Regulation Section 301.6112-1(b)).

(v) The term taxes means all income, profits, capital gains, goods and services, branch, payroll, unemployment, customs duties, premium, compensation, windfall profits, franchise, gross receipts, capital, net worth, sales, use, withholding, turnover, value added, ad valorem, registration, general business, employment, social security, disability, occupation, real property, personal property (tangible and intangible), stamp, transfer (including real

property transfer or gains), conveyance, severance, production, excise, withholdings, duties, levies, imposts, license, registration and other taxes (including any and all fines, penalties and additions attributable to or otherwise imposed on or with respect to any such taxes and interest thereon) imposed by or on behalf of any Governmental Entity. The term tax return means any return, statement, report, form, filing, customs entry, customs reconciliation and any other entry or reconciliation, including in each case any amendments, schedules or attachments thereto, required to be filed with any Governmental Entity or with respect to taxes of the Company or its Subsidiaries.

(n) Title to Properties. (i) Section 3.01(n)(i) of the Company Disclosure Letter sets forth, as of the date of this Agreement, a true and complete list of all real property owned by the Company and its Subsidiaries (individually, an Owned Real Property).

(ii) Section 3.01(n)(ii) of the Company Disclosure Letter sets forth, as of the date of this Agreement, a true and complete list of all material leases of real property (the Real Property Leases) under which the Company or any of its Subsidiaries is a tenant or a subtenant (individually, a Leased Real Property).

(iii) Except as has not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect, the Company or a Subsidiary of the Company has good and valid fee title to each Owned Real Property, in each case free and clear of all Liens and defects in title, except for (A) mechanics , carriers , workmen s, warehousemen s, repairmen s or other like Liens arising or incurred in the ordinary course of business, (B) Liens for taxes, assessments and other governmental charges and levies that are not due and payable or that may thereafter be paid without interest or penalty, (C) Liens affecting the interest of the grantor of any easements benefiting Owned Real Property, (D) Liens (other than liens securing Indebtedness), defects or irregularities in title, easements, rights-of-way, covenants, restrictions, and other, similar matters that would not, individually or in the aggregate, reasonably be expected to materially impair the continued use and operation of the assets to which they relate in the business of the Company and its Subsidiaries as presently conducted, (E) zoning, building and other similar codes and regulations and (F) any conditions that would be disclosed by a current, accurate survey or physical inspection (collectively, Permitted Liens).

(iv) Except as has not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect, the Company or a Subsidiary of the Company has a good and valid title to a leasehold estate in each Leased Real Property, all Real Property Leases are in full force and effect, and neither the Company nor any of its Subsidiaries that is party to such leases has received or given any written notice of any material default thereunder which default continues on the date of this Agreement.

Table of Contents

(v) Section 3.01(n)(v) of the Company Disclosure Letter sets forth, as of the date of this Agreement, a true and complete list of all material leases, subleases or similar agreements under which the Company or any of its Subsidiaries is the landlord or the sublandlord (such leases, subleases and similar agreements, collectively, the Real Property Subleases).

(vi) The Company has made available to the Sponsor Entities true and complete copies of the Real Property Leases and the Real Property Subleases.

(o) Intellectual Property. Section 3.01(o) of the Company Disclosure Letter sets forth, as of the date of this Agreement, a true and complete list of all patents, patent applications, trademarks, trademark applications, trade names, service marks, service mark applications and registered copyrights and applications therefor (collectively, Intellectual Property Rights) that, in each case, are material to the conduct of the business of the Company and its Subsidiaries, taken as a whole, as presently conducted and, except as has not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect, the Company or a Subsidiary of the Company owns, or is licensed or otherwise has the right to use, each such Intellectual Property Right. No claims are pending or, to the Knowledge of the Company, threatened that the Company or any of its Subsidiaries is infringing the rights of any person with regard to any Intellectual Property Right, which claims have had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect. To the Knowledge of the Company, as of the date of this Agreement, no person is infringing the rights of the Company or any of its Subsidiaries with respect to any Intellectual Property Right, in a manner that has had or would reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect.

(p) Insurance. Except as has not had and would not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect, (i) the Company and its Subsidiaries maintain insurance in such amounts and against such risks as is sufficient to comply with applicable Law, (ii) all material insurance policies of the Company and its Subsidiaries are in full force and effect, except for any expiration thereof in accordance with the terms thereof, (iii) neither the Company nor any of its Subsidiaries is in breach of, or default under, any such material insurance policy and (iv) no written notice of cancellation or termination has been received with respect to any such material insurance policy, other than in connection with ordinary renewals.

(q) Voting Requirements. Assuming the accuracy of the representations and warranties set forth in Section 3.02(f), the affirmative vote of holders of a majority of the outstanding shares of Company Common Stock entitled to vote thereon at the Stockholders Meeting or any adjournment or postponement thereof to adopt this Agreement (the Stockholder Approval) is the only vote of the holders of any class or series of capital stock of the Company necessary for the Company to adopt this Agreement and approve the transactions contemplated hereby.

(r) State Takeover Statutes. Assuming the accuracy of the representations and warranties set forth in Section 3.02(f), the approval of the Board of Directors of the Company of this Agreement, the Merger and the other transactions contemplated by this Agreement represents all the action necessary to render inapplicable to this Agreement, the Merger and the other transactions contemplated by this Agreement, the provisions of Section 203 of the DGCL to the extent, if any, such Section would otherwise be applicable to this Agreement, the Merger and the other transactions contemplated by this Agreement, and no other state takeover statute applies to this Agreement, the Merger or the other transactions contemplated by this Agreement.

(s) Brokers and Other Advisors. No broker, investment banker, financial advisor or other person, other than J.P. Morgan Securities Inc. and Goldman, Sachs & Co., the fees and expenses of which will be paid by the Company, is entitled to any broker s, finder s or financial advisor s fee or commission in connection with the Merger and the transactions contemplated by this Agreement based upon arrangements made by or on behalf of the Company. The Company has made available to the Sponsor Entities complete and correct copies of the letter agreements between the Company and (i) J.P. Morgan Securities Inc. and (ii) Goldman Sachs & Co. pursuant to which such parties could be entitled to any payment from the Company or any of its Subsidiaries in connection with the Merger.

(t) Opinions of Financial Advisors. The Company has received the opinion of each of J.P. Morgan Securities Inc. and Goldman, Sachs & Co., in each case dated the date of this Agreement, to the effect that, as of such date, the Merger Consideration is fair, from a financial point of view, to the holders of shares of Company Common Stock, a signed copy of each of which opinions has been or will promptly be delivered to the Sponsor Entities.

(u) Affiliate Transactions. To the Knowledge of the Company, no executive officer or director of the Company or any of its Subsidiaries or any person who beneficially owns 5% or more of the Company Common Stock is a party to any contract with or binding upon the Company or any of its Subsidiaries or any of their respective properties or assets or has any material interest in any material property owned by the Company or any of its Subsidiaries or has engaged in any material transaction with any of the foregoing within the period of 12 months preceding the date of this Agreement, in each case, that is of the type that would be required to be disclosed under Item 404 of Regulation S-K under the Securities Act.

(v) No Other Representations or Warranties. Except for the representations and warranties contained in this Section 3.01 or in any certificates delivered by the Companyt to limitations, direct the time, method and place of conducting proceedings for any remedy available to the trustee, or exercising any trust or power conferred on the trustee in respect of the Subordinated Debt Securities of that series. (Section 8.5 of the subordinated indenture.)

The subordinated indenture provides that the trustee, subject to the provisions of the Trust Indenture Act will not be required to expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties under the indentures, or in the exercise of its rights or powers, if it shall have reasonable grounds for believing that repayment of such funds or adequate indemnity against such risk or liability is not reasonably assured to it. (Section 9.1(g) of the subordinated indenture.)

The subordinated indenture includes covenants that Westpac will file annually with the trustee a certificate of compliance with all conditions and covenants under the subordinated indenture. (Section 12.7 of the subordinated indenture.)

Modification of the Subordinated Indenture

The subordinated indenture contains provisions permitting Westpac and the trustee to enter into one or more supplemental indentures without the consent of the holders of any of the Subordinated Debt Securities in order to:

evidence the succession of another individual, corporation or other entity to Westpac and the assumption of Westpac's covenants and obligations by its successor;

add to Westpac's covenants for the benefit of the holders of Subordinated Debt Securities of all or any series or surrender any of Westpac's rights or powers or to comply with certain requirements of the SEC relating to the qualification of the

indenture under the Trust Indenture Act;

add to or change any provisions of the subordinated indenture or any Subordinated Debt Securities to such extent as necessary to facilitate the issuance of Subordinated Debt Securities, to facilitate the issuance of Subordinated Debt Securities in global form, or to alter the terms of the Subordinated Debt Securities to align them with any Relevant Tier 2 securities issued after the date of such Subordinated Debt Securities, provided that such alteration is not materially prejudicial to the interests of the holders of the Subordinated Debt Securities as a whole;

change or eliminate any provision of the subordinated indenture affecting only Subordinated Debt Securities not yet issued or when there is no security outstanding of a series created prior to the execution of any such supplemental indenture;

establish the form or terms of Subordinated Debt Securities;

provide for delivery of such supplemental indentures or the Subordinated Debt Securities of any series in or by means of any computerized, electronic or other medium, including pdf or email;

evidence and provide for successor trustees and/or to add to or change any provisions of the subordinated indenture to such extent as necessary to provide for or facilitate the administration of the trusts under the indentures by more than one trustee;

maintain the qualification of the subordinated indenture under the Trust Indenture Act;

correct or supplement any inconsistent provisions or cure any ambiguity or omission or correct any mistake, provided that any such action does not adversely affect the interests of any holder of Subordinated Debt Securities of any series;

- modify the subordination provisions thereof in a manner not adverse to the holders of Subordinated Debt Securities of any series then outstanding; or

- any other change that does not adversely affect the interests of the holders and is not otherwise prohibited. (Section 11.1 of the subordinated indenture.)

In addition, no amendment to the terms and conditions of the subordinated indenture or a Subordinated Debt Security that at the time of such amendment qualifies as Tier 2 Capital is permitted without the prior written consent of APRA if such amendment may affect the eligibility of the Subordinated Debt Security as Tier 2 Capital as described in the Prudential Standards.

The subordinated indenture also contains provisions permitting Westpac and the trustee, with the consent of the holders of not less than a majority of the Outstanding Principal Amount of the Subordinated Debt Securities of the affected series, to execute supplemental indentures adding any provisions to or changing or eliminating any of the provisions of the subordinated indenture or modifying the rights of the holders of Subordinated Debt Securities of that series. No supplemental indenture may, without the consent of the holders of all of the affected Subordinated Debt Securities, among other things:

- change the maturity of any Subordinated Debt Securities, provided that the maturity date for the Subordinated Debt Securities may not be earlier than the fifth anniversary of the issue date of such series of Subordinated Debt Securities;

- change the currency in which such Subordinated Debt Securities are payable;

- reduce the Outstanding Principal Amount thereof or the rate of interest thereon payable upon the redemption thereof;

- impair the right to institute suit for the enforcement of any payment on such Subordinated Debt Securities at maturity or upon redemption;

- reduce the percentage of the Outstanding Principal Amount of Subordinated Debt Securities of any series the holders of which must consent to any such supplemental indenture;

- change any obligation of Westpac to maintain an office or agency in accordance with the provisions of the subordinated indenture;

- modify the subordinated indenture provisions concerning modification of the subordinated indenture or the waiver of past defaults or specified covenants other than to increase the required percentage to effect a modification or provide that additional provisions may not be waived without the consent of each holder of that series of Subordinated Debt Securities;

- modify any Conversion or Write-off provision; or

- modify the subordination provisions thereof in a manner adverse to the holders of Subordinated Debt Securities then outstanding. (Section 11.2 of the subordinated indenture.)

Any such consent given by the holder of a Subordinated Debt Security of a series shall be conclusive and binding upon such holder and all future holders of the Subordinated Debt Securities of such series and of any Subordinated Debt Securities of such series issued on registration thereof, the transfer thereof or in exchange therefor or in lieu thereof, whether or not notation of such consent is made upon the Subordinated Debt Securities of such series.

In addition, no amendment to the terms and conditions of the subordinated indenture or a Subordinated Debt Security that at the time of such amendment qualifies as Tier 2 Capital is permitted without the prior written consent of APRA if such amendment may affect the eligibility

of the Subordinated Debt Security as Tier 2 Capital as described in the Prudential Standards.

Satisfaction and Discharge of the Subordinated Indenture

The subordinated indenture shall generally cease to be of any further effect with respect to a series of Subordinated Debt Securities when Westpac has delivered to the trustee for cancellation all Subordinated Debt Securities of that series. (Section 7.1 of the subordinated indenture.)

Record Dates

Westpac will generally be entitled to set any date as the record date for the purpose of determining the holders of Subordinated Debt Securities entitled to give or take any action under the subordinated indenture in the manner specified in such indenture. If a record date is set, action may only be taken by persons who are holders of Subordinated Debt Securities on the record date. Also, unless otherwise specified in the applicable prospectus supplement or term sheet applicable to a series of Subordinated Debt Securities, to be effective, any action must be taken within 180 days of the record date. (Section 1.4(g) of the subordinated indenture.)

Notice

Notices to holders of Subordinated Debt Securities will be given by mail to the addresses of holders appearing in the applicable securities register. Westpac and the trustee may treat the person in whose name a Subordinated Debt Security is registered as the owner thereof for all purposes. (Sections 1.6 and 3.8 of the subordinated indenture.)

Governing Law

The subordinated indenture and the Subordinated Debt Securities will be governed by, and construed in accordance with, the laws of the State of New York, except that the Non-Viability Trigger Event, Write-off, Conversion and subordination provisions contained in Articles IV, V and VI of the subordinated indenture will be governed by, and construed in accordance with, the laws of the State of New South Wales, Commonwealth of Australia. (Section 1.11 of the subordinated indenture.)

The subordinated indenture also provides that to the extent Westpac or any of its properties, assets or revenues may have or may become entitled to, or have attributed to it, any right of immunity, on the grounds of sovereignty or otherwise, from any legal action, suit or proceeding, from the giving of any relief in any thereof, from setoff or counterclaim, from the jurisdiction of any court, from service of process, from attachment upon or prior to judgment, from attachment in aid of execution or judgment, or from execution of judgment, or other legal process or proceeding for the giving of any relief or for the enforcement of any judgment, in any jurisdiction in which proceedings may at any time be commenced, with respect to its obligations, liabilities or any other matter under or arising out of or in connection with any Subordinated Debt Security or the subordinated indenture, Westpac, to the extent permitted by law, will irrevocably and unconditionally waive, and agree not to plead or claim, any such immunity and will consent to such relief and enforcement. (Section 8.12 of the subordinated indenture.)

Consolidation, Merger or Sale of Assets

The subordinated indenture provides that Westpac may not merge or consolidate with or into any other corporation or other entity or sell, convey or transfer all or substantially all of Westpac's assets, unless:

- Westpac is the surviving entity formed by such merger or consolidation; or
- the entity formed by such consolidation or into which Westpac is merged or which acquires Westpac's assets expressly assumes by supplemental indenture all of Westpac's obligations under the Subordinated Debt Securities and the subordinated indenture; and

immediately after giving effect to such transactions, no event of default shall have occurred and be continuing; and

Westpac shall have delivered to the trustee an officer's certificate and an opinion of counsel each stating that such transaction complies with the subordinated indenture and that all conditions precedent therein provided for relating to such transaction have been complied with.

Upon any such consolidation, merger or sale where Westpac is not the surviving entity, the successor corporation formed by such consolidation or into which Westpac is merged or to which such sale is made shall succeed to and be substituted for Westpac under the subordinated indenture and the Subordinated Debt Securities and all such obligations of Westpac shall terminate.

Notwithstanding the above, the terms and conditions of the subordinated indenture and Subordinated Debt Securities shall not prevent Westpac from consolidating with or merging into any other person or conveying, transferring or leasing its properties and assets substantially as an entirety to any person, or from permitting any person to consolidate with or merge into Westpac or to convey, transfer or lease its properties and assets substantially as an entirety to Westpac where such consolidation, merger, transfer or lease is:

required by APRA (or any statutory manager or similar official appointed by it) under law and prudential regulation applicable in the Commonwealth of Australia (including, without limitation, the Australian Banking Act or the Financial Sector Transfer (Business Transfer and Group Restructure) Act 1999 of Australia, which terms, as used herein, include any amendments thereto, rules thereunder and any successor laws, amendments and rules)); or

determined by the board of directors of Westpac or by APRA (or any statutory manager or similar official appointed by it) to be necessary in order for Westpac to be managed in a sound and prudent manner or for Westpac or APRA (or any statutory manager or similar official appointed by it) to resolve any financial difficulties affecting Westpac, in each case in accordance with prudential regulation applicable in the Commonwealth of Australia.

(Section 10.1 of the subordinated indenture.)

Concerning the Trustee

Westpac may from time to time maintain credit facilities, and have other customary banking relationships with The Bank of New York Mellon, the trustee.

Consent to Service of Process

In accordance with the provisions of the subordinated indenture, we have designated Westpac Banking Corporation, New York Branch, 575 Fifth Avenue, 39th Floor, New York, New York 10017-2422, Attention: Branch Manager, as our authorized agent for service of process in any legal action or proceeding against us with respect to Westpac's obligations under such indenture or the Subordinated Debt Securities instituted in any federal or state court in the Borough of Manhattan, The City of New York, New York and will irrevocably submit to the non-exclusive jurisdiction of such courts in respect of any such legal action or proceeding. (Section 1.14 of the subordinated indenture.)

Additional Provisions Applicable to Subordinated Debt Securities

1. Status of the Subordinated Debt Securities General

1.1 Acknowledgements

The subordinated indenture provides that each holder of Subordinated Debt Securities by its purchase or holding of a Subordinated Debt Security is deemed to acknowledge that:

(a) Westpac intends that the Subordinated Debt Securities constitute Tier 2 Capital and be able to absorb losses at the point of non-viability as described in the Prudential Standards;

(b) Westpac's obligations in respect of the Subordinated Debt Securities are subordinated as described in Section 1.2 below; and

(c) the Subordinated Debt Securities are subject to Conversion or Write-off as described below in Sections 2 and 3. There are two methods of loss absorption:

(i) Conversion, subject to possible Write-off as described below in Section 2.2; or

(ii) Write-off without Conversion as described below in Section 2.2.

Unless the applicable prospectus supplement or term sheet specifies otherwise, the primary method of loss absorption will be Conversion, subject to possible Write-off as described below in Section 2.2.

(Section 4.1 of the subordinated indenture.)

1.2 Status and Subordination

The subordinated indenture provides that:

(a) holders of Subordinated Debt Securities do not have any right to prove in a Winding-Up in respect of Subordinated Debt Securities, except as described below in Section 1.4.

(b) Subordinated Debt Securities constitute direct and unsecured subordinated obligations of Westpac and will rank for payment in a Winding-Up as described below in Section 1.4.

(c) Subordinated Debt Securities will not constitute protected accounts or deposit liabilities of Westpac in Australia for the purposes of the Australian Banking Act.

(Section 4.2 of the subordinated indenture.)

1.3 Solvency condition

The subordinated indenture provides that, prior to a Winding-Up:

(a) the obligation of Westpac to make any payment of principal or interest in respect of Subordinated Debt Securities shall be conditional upon Westpac being Solvent at the time the payment or other amount owing becomes due; and

(b)

no payment of principal or interest shall be made in respect of Subordinated Debt Securities except to the extent that Westpac may make such payment and still be Solvent immediately thereafter.

A certificate as to whether Westpac is Solvent signed by two authorized signatories of Westpac or, if Westpac is in Winding-Up, the liquidator, shall, in the absence of fraud or manifest or proven error, be conclusive evidence of the information contained in such certificate. In the absence of such a certificate, a holder of Subordinated Debt Securities shall be entitled to assume (unless the contrary is proved) that Westpac is, and will after any payment as aforesaid be, Solvent.

Until Subordinated Debt Securities have been Converted or Written-off:

(i) interest will continue to accrue on any principal not paid as a consequence of the provisions described in this Section 1.3 at the Interest Rate; and

(ii) any interest not paid to a holder of Subordinated Debt Securities as a consequence of the provisions described in this Section 1.3 will remain due and payable and will accumulate with compounding.

Any amount not paid as a consequence of the provisions described in this Section 1.3: (x) will remain a debt owing to the holder of Subordinated Debt Securities by Westpac until it is paid and shall be payable on the first date on which the provisions described in paragraphs (a) and (b) of this Section 1.3 would allow payment of such amount (whether or not such date is otherwise a date on which interest is payable or other date on which such amount becomes due); and (y) shall not constitute an event of default (see " Description of the Subordinated Debt Securities Events of Default" above).

(Section 4.3 of the subordinated indenture.)

1.4 Winding-Up

The subordinated indenture provides that, in a Winding-Up:

(a) neither the trustee nor any holder of Subordinated Debt Securities shall have any right or claim against Westpac in respect of the principal of or interest on Subordinated Debt Securities, to the extent any such Subordinated Debt Securities have been Converted or Written-off; and

(b) the rights and claims of the trustee or any holder of Subordinated Debt Securities against Westpac to recover any principal or interest in respect of Subordinated Debt Securities that have not been Converted or Written-off:

  (i) shall be subordinate to, and rank junior in right of payment to, the obligations of Westpac to Senior Creditors and all such obligations to Senior Creditors shall be entitled to be paid in full before any payment shall be paid on account of any sums payable in respect of such Subordinated Debt Securities;

  (ii) shall rank equally with the obligations of Westpac to the holders of other Subordinated Debt Securities that have not been Converted or Written-off (or that have been partially Converted or Written-off), and the obligations of Westpac to holders of Equal Ranking Instruments; and

  (iii) shall rank prior to, and senior in right of payment to, the obligations of Westpac to holders of Ordinary Shares, and other Junior Ranking Capital Instruments.

Unless and until Senior Creditors have been paid in full, neither the trustee nor any holder of Subordinated Debt Securities will be entitled to claim in the Winding-Up in competition with Senior Creditors so as to diminish any payment which, but for that claim, Senior Creditors would have been entitled to receive.

In a Winding-Up, the trustee and any holder of Subordinated Debt Securities will only be entitled to prove for any sums payable in respect of the Subordinated Debt Securities as a liability which is subject to prior payment in full of Senior Creditors. Holders of Subordinated Debt Securities waive in respect of any Subordinated Debt Security, to the fullest extent permitted by law, any right to prove in a Winding-Up as a creditor ranking for payment in any other manner.

However, it is unlikely a Winding-Up of Westpac will occur without a Non-Viability Trigger Event having occurred first and the Subordinated Debt Securities being Converted or Written-off. In that event:

- if the Subordinated Debt Securities have Converted into Ordinary Shares, holders will rank equally with existing holders of Ordinary Shares; and

- if the Subordinated Debt Securities are Written-off, all rights in relation to the Subordinated Debt Securities will be terminated, and holders will not have their Outstanding Principal Amount repaid or receive any outstanding interest or accrued interest, or have the right to have the Subordinated Debt Securities Converted into Ordinary Shares. In such an event, a holder's investment in the Subordinated Debt Securities will lose all of its value and such holder will not receive any compensation.

(Section 4.4 of the subordinated indenture.)

1.5 No Set-Off

The subordinated indenture provides that neither Westpac nor the trustee or any holder of Subordinated Debt Securities is entitled to set-off any amounts due in respect of Subordinated Debt Securities held by the holder against any amount of any nature owed by Westpac to such holder or by such holder to Westpac.

(Section 4.5 of the subordinated indenture.)

1.6 Clawback

The subordinated indenture provides that each holder of Subordinated Debt Securities by its purchase or holding of a Subordinated Debt Security is deemed to have irrevocably acknowledged and agreed that it or the trustee will pay or deliver to the liquidator any payment or asset, whether voluntary or in any other circumstances, received by such holder or the trustee from or on account of Westpac (including by way of credit, set-off or otherwise) or from any liquidator (or any provisional or other liquidator, receiver, manager or statutory manager of Westpac) in violation of the provisions described in Section 1.2 or in " Events of Default" above.

(Section 4.6 of the subordinated indenture.)

1.7 Other Provisions

The subordinated indenture provides that each holder of Subordinated Debt Securities by its purchase or holding of a Subordinated Debt Security is deemed to have irrevocably acknowledged and agreed:

(a) that the provisions described in Section 1.2 above constitute a debt subordination for the purposes of section 563C of the Australian Corporations Act;

(b) without limiting its rights existing otherwise than as a holder of a Subordinated Debt Security, that it must not exercise its voting rights as an unsecured creditor in the Winding-Up of Westpac to defeat, negate or in any way challenge the enforceability of the subordination provisions described in Section 1.2 above; and

(c) that the debt subordination effected by the provisions described in Section 1.2 above are not affected by any act or omission of Westpac or a Senior Creditor which might otherwise affect it at law or in equity.

No consent of any Senior Creditor shall be required for any amendment of the provisions described in Section 1.2 above in relation to any outstanding Subordinated Debt Securities.

(Section 4.7 of the subordinated indenture.)

2. Non-Viability, Conversion and Write-off

2.1 Non-Viability Trigger Event

The subordinated indenture provides that:

(a) if a Non-Viability Trigger Event occurs, Westpac must:

(i) subject to the limitations described in Section 2.3 below, Convert; or

(ii) if the applicable prospectus supplement or term sheet for the Subordinated Debt Securities of any series specifies that the primary method of loss absorption will be Write-off without Conversion as described in Section 2.3 below, Write-off,

all Subordinated Debt Securities or, if paragraph (a) of the definition of "Non-Viability Trigger Event" applies, subject to the provisions described in Section 2.1(b) below, all or some Subordinated Debt Securities (or a percentage of the Outstanding Principal Amount of each Subordinated Debt Security), such that the aggregate Outstanding Principal Amount of all Subordinated Debt Securities Converted or Written-off is, together with the face value or outstanding principal amount of all other Relevant Securities converted, written-off or written-down as described in Section 2.1(b) below, is equal to the aggregate face value or outstanding principal amount of Relevant Securities which APRA has notified Westpac must be converted, written-off or written-down (or, if APRA has not so notified Westpac, all or some Subordinated Debt Securities (or a percentage of the Outstanding Principal Amount of each Subordinated Debt Security), as is necessary to satisfy APRA that Westpac will no longer be non-viable).

(b) In determining the Subordinated Debt Securities or percentage of the Outstanding Principal Amount of each Subordinated Debt Security which must be Converted or Written-off as described in this Section 2.1, Westpac will:

(i) first, convert, write-off or write-down an amount of the face value or outstanding principal amount of all outstanding Relevant Tier 1 Securities before Conversion or Write-off of the Subordinated Debt Securities; and

(ii) second, if conversion, write-off or write-down of Relevant Tier 1 Securities is not sufficient to satisfy APRA that Westpac would not become non-viable, Convert or Write-off (in the case of the Subordinated Debt Securities) and convert, write-off or write-down (in the case of any other Relevant Tier 2 Securities), on a pro-rata basis or in a manner that is otherwise, in Westpac's opinion, fair and reasonable, the Outstanding Principal Amount of each Subordinated Debt Security and outstanding principal amount of all other Relevant Tier 2 Securities (subject to such adjustments as Westpac may determine to take into account the effect on marketable parcels and the need to round to whole numbers of Ordinary Shares, the authorized denominations of any Relevant Tier 2 Securities remaining on issue, and the need to effect the conversion immediately). If the Specified Currency of the principal amount of such Relevant Tier 2 Securities is not Australian Dollars, Westpac may for purposes of determining the amount of the principal amount to be converted, written-off or written-down, convert the principal amount to Australian Dollars at such rate of exchange as Westpac in good faith considers reasonable,

but such determination will not impede the immediate Conversion or Write-off of the relevant Subordinated Debt Securities or percentage of the Outstanding Principal Amount of each Subordinated Debt Security (as the case may be).

(c) If a Non-Viability Trigger Event occurs:

(i) the Subordinated Debt Securities or the percentage of the Outstanding Principal Amount of each Subordinated Debt Security determined as described in Sections 2.1(a) and (b) above shall be Converted or Written-off immediately upon the occurrence of the Non-Viability Trigger Event as described in Sections 2.2 and 3 below. The Conversion or Write-off will be irrevocable;

(ii) Westpac is required to give notice to the trustee and holders of affected Subordinated Debt Securities as described above under the caption " Notice" and the ASX as soon as practicable that a Non-Viability Trigger Event has occurred and that Conversion or Write-off has occurred on the Non-Viability Trigger Event Date;

(iii) the notice must specify (A) the date on which Conversion or Write-off occurred, which we refer to as the Non-Viability Trigger Event Date, and the Subordinated Debt Securities which were, or percentage of the Outstanding Principal Amount of each Subordinated Debt Security which was, Converted or, if the provisions described in Section 2.3 below are applicable, Written-off, and (B) details of the Relevant Securities converted, written-off or written-down as described in Section 2.1(b); and

(iv) in the case of Conversion, the notice must specify the details of the Conversion process, including any details which were taken into account in relation to the effect on marketable parcels and whole numbers of Ordinary Shares, and the impact on any Subordinated Debt Securities outstanding.

Westpac's failure to undertake any steps described in Sections 2.1(c)(ii) to (iv) above will not prevent, invalidate, delay or otherwise impede Conversion or Write-off.

(Section 5.1 of the subordinated indenture.)

2.2 Automatic Conversion or Write-off upon the occurrence of a Non-Viability Trigger Event

The subordinated indenture provides that if a Non-Viability Trigger Event has occurred and all or some Subordinated Debt Securities are (or a percentage of the Outstanding Principal Amount of each Subordinated Debt Security is) required to be Converted or Written-off in accordance with the provisions described in Section 2.1 above, then:

(a) Conversion or Write-off of such Subordinated Debt Securities or percentage of the Outstanding Principal Amount of each Subordinated Debt Security will occur in accordance with the provisions described in Section 2.1 above and, if applicable, Section 2.3 below immediately upon the Non-Viability Trigger Event Date;

(b) in the case of Conversion and subject to the provisions described in Section 3.10 below, each holder of a Subordinated Debt Security that has been Converted in whole or in part in accordance with the provisions described in Section 2.1 will be entitled to (i) the Conversion Number (as defined below) of Ordinary Shares in respect of such Subordinated Debt Securities or the percentage of the Outstanding Principal Amount of each Subordinated Debt Security held by such holder so Converted determined in accordance with the provisions described in Section 3.1 below, and (ii) unless the Subordinated Debt Securities shall have been Converted or Written-off in full, to Subordinated Debt Securities with an Outstanding Principal Amount equal to the aggregate of the remaining percentage of the Outstanding Principal Amount of each Subordinated Debt Security held by such holder, and Westpac will recognize the holder as having been issued the Conversion Number of Ordinary Shares in respect of such portion of Converted Subordinated Debt Securities for all purposes, in each case without the need for any further act or step by Westpac, the holder or any other person

(and Westpac will, as soon as possible thereafter and without delay on its part, take any appropriate procedural steps to effect such Conversion, including updating the Ordinary Share register); and

(c) a holder of Subordinated Debt Securities has no further right or claim in respect of such Subordinated Debt Securities or percentage of the Outstanding Principal Amount of each Subordinated Debt Security so Converted or Written-off (including to payments of interest or accrued interest, and the repayment of Outstanding Principal Amount), except such holder's entitlement, if any, to Subordinated Debt Securities which have not been required to be Converted or Written-off or Subordinated Debt Securities representing the Outstanding Principal Amount of such Subordinated Debt Securities which have not been required to be Converted or Written-off and, in the case of Conversion, subject to the provisions described in Section 3.10, to the Conversion Number of Ordinary Shares issuable in accordance with the provisions described in Section 3.

(Section 5.2 of the subordinated indenture.)

2.3 No further rights

The subordinated indenture provides that if:

(a) for any reason, Conversion of a Subordinated Debt Security (or a percentage of the Outstanding Principal Amount of each Subordinated Debt Security) required to be Converted under the provisions described in Section 2.1 above does not occur within five ASX Business Days after the Non-Viability Trigger Event Date; or

(b) the applicable prospectus supplement or term sheet for the Subordinated Debt Securities of any series specifies that the primary method of loss absorption will be Write-off without Conversion in accordance with the provisions described in this Section 2.3,

then:

(c) the relevant rights and claims of holders of Subordinated Debt Securities in relation to such Subordinated Debt Securities or the percentage of the Outstanding Principal Amount of such Subordinated Debt Securities to be Converted or Written-off (including to payments of interest or accrued interest, and the repayment of Outstanding Principal Amount and, in the case of Conversion, to be issued with the Conversion Number of Ordinary Shares in respect of such Subordinated Debt Securities or percentage of the Outstanding Principal Amount of each Subordinated Debt Security), are immediately and irrevocably written-off and terminated with effect on and from the Non-Viability Trigger Event Date ("**Write-off**"); and

(d) the Outstanding Principal Amount of such Subordinated Debt Securities shall be reduced on the Non-Viability Trigger Event Date by the Outstanding Principal Amount of the Subordinated Debt Securities to be Converted or Written-off, as determined in accordance with the provisions described in Sections 2.1(a) and (b) and any accrued and unpaid interest shall be correspondingly reduced.

(Section 5.3 of the subordinated indenture.)

2.4 Consent to receive Ordinary Shares and other acknowledgements

The subordinated indenture provides that subject to any Write-off required in accordance with the provisions described in Section 2.3 above, each holder of Subordinated Debt Securities by its purchase or holding thereof will be deemed to have irrevocably agreed that:

(a) upon Conversion in accordance with the provisions described in this Section 2 and Section 3 below, it consents to becoming a holder of Ordinary Shares and agrees to be bound by the constitution of Westpac;

(b) unless (x) it has given notice in accordance with the provisions described in Section 3.10 below that it does not wish to receive Ordinary Shares as a result of Conversion or (y) it is a Foreign Holder and Westpac is not satisfied that the laws of both the Commonwealth of Australia and the Foreign Holder's country of residence permit the unconditional issue of Ordinary Shares to the Foreign Holder (but as to which Westpac is not bound to enquire and any decision is in its sole discretion) or has not otherwise satisified the requirements of Section 3.10 below to receive Ordinary Shares, it is obliged to accept Ordinary Shares upon Conversion notwithstanding anything that might otherwise affect a Conversion of Subordinated Debt Securities, including:

   (i) any change in the financial position of Westpac since the issue of the Subordinated Debt Securities;

   (ii) any disruption to the market or potential market for Ordinary Shares or capital markets generally; or

   (iii) any breach by Westpac of any obligation in connection with the Subordinated Debt Securities;

(c)

   (i) Conversion is not subject to any conditions other than those expressly described in this Section 2 and Section 3 below;

   (ii) Conversion must occur immediately on the Non-Viability Trigger Event Date and Conversion may result in disruption or failures in trading or dealings in the Subordinated Debt Securities;

   (iii) it will not have any rights to vote in respect of any Conversion (whether as a holder of a Subordinated Debt Security or as a prospective holder of an Ordinary Share); and

   (iv) notwithstanding the provisions described in Section 3.9 below, Ordinary Shares issued on Conversion may not be quoted at the time of Conversion or at all;

(d) where the provisions described in Section 2.3 above apply, no other conditions or events will affect the operation of such provisions and it will not have any rights to vote in respect of any Write-off under such provisions; and

(e) it has no remedies on account of the failure of Westpac to issue Ordinary Shares in accordance with the provisions described in Section 3 below other than, subject to the provisions described in Section 2.3 above, to seek specific performance of Westpac's obligation to issue Ordinary Shares.

(Section 5.4 of the subordinated indenture.)

2.5 Issue of ordinary shares of successor company

The subordinated indenture provides that if Westpac shall cease to be the ultimate parent company of the Group and the successor company is an Approved Successor, the provisions described herein under " Additional Provisions Applicable to Subordinated Debt Securities" may be amended in accordance with the provisions described in Section 3.14 below.

(Section 5.5 of the subordinated indenture.)

2.6 No conversion at the option of the holders

Holders of Subordinated Debt Securities do not have a right to request Conversion of their Subordinated Debt Securities at any time.

(Section 5.6 of the subordinated indenture.)

2.7 No rights before Conversion

Before Conversion, a Subordinated Debt Security confers no rights on a holder of Subordinated Debt Securities:

(a) to vote at, or receive notices of, any meeting of shareholders (referred to as "members" under Westpac's constitution) of Westpac;

(b) to subscribe for new securities or to participate in any bonus issues of securities of Westpac; or

(c) to otherwise participate in the profits or property of Westpac,

except as otherwise disclosed herein or in an applicable prospectus supplement or term sheet.

(Section 5.7 of the subordinated indenture.)

2.8 Trustee's Rights upon Conversion or Write-off

(a) By its acquisition of the Subordinated Debt Securities, each holder of the Subordinated Debt Securities, to the extent permitted by law, waives any and all claims against the trustee for, agrees not to initiate a suit against the trustee in respect of, and agrees that the trustee shall not be liable for, any action that the trustee takes, or abstains from taking, in either case in accordance with the Conversion or Write-off of the Subordinated Debt Securities other than for the trustee's gross negligence or willful misconduct.

(b) Holders of the Subordinated Debt Securities that acquire such Subordinated Debt Securities in the secondary market shall be deemed to acknowledge, agree to be bound by and consent to the same provisions specified herein to the same extent as the holders of the Subordinated Debt Securities that acquire the Subordinated Debt Securities upon their initial issuance, including, without limitation, with respect to the acknowledgement and agreement to be bound by and consent to the terms of the Subordinated Debt Securities, including in relation to the Conversion and Write-off of the Subordinated Debt Securities.

(c) Westpac's obligation to indemnify and reimburse the trustee under the subordinated indenture shall survive Conversion and Write-off of the Subordinated Debt Securities.

(d) Unless otherwise required by APRA, the rights, immunities, indemnities and protections of the trustee relating to the Conversion and Write-off of the Subordinated Debt Securities will not be amended, changed or modified without the trustee's written consent and that any such amendment, change or modification will be made in an amendment or supplement to the subordinated indenture.

(e) By its acquisition of the Subordinated Debt Securities, each holder of the Subordinated Debt Securities acknowledges and agrees that, upon Conversion or Write-off of the Subordinated Debt Securities, (a) the trustee shall not be required to take any further directions from such holder of the Subordinated Debt Securities either under the terms of the Subordinated Debt Securities or the subordinated indenture unless secured or indemnified to its satisfaction by such holder of the Subordinated Debt Securities, (b) it may not direct the trustee to take any action whatsoever, including without limitation, any challenge to the Conversion or Write-off of the Subordinated Debt Securities or request to call a meeting or take any other action under the subordinated indenture in connection with the Conversion or Write-off of the Subordinated Debt Securities unless secured or indemnified to its satisfaction by such holder of the Subordinated Debt Securities and (c) neither the subordinated indenture nor the Subordinated Debt Securities shall impose any duties upon the trustee whatsoever with respect to the Conversion or Write-off of the Subordinated Debt Securities. Notwithstanding the foregoing, if, following the Conversion or Write-off of the Subordinated Debt Securities, any Subordinated Debt Securities remain outstanding, then the trustee's duties under the subordinated indenture shall remain applicable with respect to the remaining outstanding Subordinated Debt Securities which have not been so Converted or Written-off.

(Section 5.8 of the subordinated indenture.)

3. Procedures for Conversion

3.1 Conversion

On the Non-Viability Trigger Event Date, subject to the provisions described in Section 2.3 above and Section 3.10 below, the following provisions will apply.

(a) Westpac will allot and issue to each holder of a Subordinated Debt Security the Conversion Number of Ordinary Shares for each Subordinated Debt Security. The Conversion Number is, subject always to the Conversion Number being no greater than the Maximum Conversion Number, either (x) the number specified in, or determined in accordance with the relevant provisions in, the applicable prospectus supplement or term sheet for the Subordinated Debt Securities of any series or, (y) if no Conversion Number and no such provisions are specified in any such prospectus supplement or term sheet, calculated according to the following formula:

$$\text{Conversion Number for each Subordinated Debt Security} = \frac{\text{Outstanding Principal Amount of the Subordinated Debt Security (translated into Australian Dollars in accordance with paragraph (b) of the definition of Outstanding Principal Amount where the calculation date shall be the Non-Viability Trigger Event Date)}}{P \times VWAP}$$

where:

Outstanding Principal Amount has the meaning given to it in Section 4 below, as adjusted in accordance with Section 3.13 below.

P means the number specified in any such prospectus supplement or term sheet.

VWAP means the VWAP during the VWAP Period.

Maximum Conversion Number means a number calculated according to the following formula:

$$\text{Maximum Conversion Number} = \frac{\text{Outstanding Principal Amount of the Subordinated Debt Security (translated into Australian Dollars in accordance with paragraph (b) of the definition of Outstanding Principal Amount where the calculation date shall be the ASX Business Day prior to the issue date of the Subordinated Debt Securities of a series)}}{0.20 \times \text{Issue Date VWAP}}$$

where:

Outstanding Principal Amount has the meaning given to it in Section 4 below, as adjusted in accordance with Section 3.13 below.

If any Subordinated Debt Securities are Converted following a Non-Viability Trigger Event, it is likely that the Maximum Conversion Number will apply and limit the number of Ordinary Shares to be issued. In this case, the value of the Ordinary Shares received is likely to be significantly less than the Outstanding Principal Amount of those Subordinated Debt Securities. The Australian dollar may depreciate in value against the U.S. dollar by the time of Conversion. In that case, the Maximum Conversion Number is more likely to apply.

(b) Subject to the provisions described in Section 3.10 below, the rights of each holder of Subordinated Debt Securities in relation to each Subordinated Debt Security that is being Converted as determined in accordance with Sections 2.1(a) and (b) will be immediately and irrevocably written-off and terminated for an amount equal to the Outstanding Principal Amount of such Subordinated Debt Security to be Converted as determined in accordance with Section 2.1 above and Westpac will apply such Outstanding Principal Amount of each such Subordinated Debt Security to be so Converted to subscribe for the Ordinary Shares to be allotted and issued under Section 3.1(a). Each holder of a Subordinated Debt Security will be deemed to have irrevocably directed that any amount payable under the provisions described in this Section 3.1 is to be applied as described in this Section 3.1 without delay (notwithstanding any other terms and conditions described in this prospectus providing for payments to be delayed) and holders do not have any right to payment in any other way.

(c) Any calculation under Section 3.1(a) shall, unless the context requires otherwise, be rounded to four decimal places provided that if the total number of Ordinary Shares to be allotted and issued to a holder of Subordinated Debt Securities in respect of such holder's aggregate holding of Subordinated Debt Securities includes a fraction of an Ordinary Share, that fraction of an Ordinary Share will not be issued or delivered on Conversion.

(Section 6.1 of the subordinated indenture.)

3.2 Adjustments to VWAP generally

For the purposes of calculating VWAP under the provisions described in Section 3.1 above:

(a) where, on some or all of the ASX Business Days in the relevant VWAP Period, Ordinary Shares have been quoted on ASX as cum dividend or cum any other distribution or entitlement and Subordinated Debt Securities will be Converted into Ordinary Shares after that date and those Ordinary Shares will no longer carry that dividend or that other distribution or entitlement, then the VWAP on the ASX Business Days on which those

Ordinary Shares have been quoted cum dividend or cum any other distribution or entitlement will be reduced by an amount, which we refer to as Cum Value, equal to:

(i) in the case of a dividend or other distribution, the amount of that dividend or other distribution including, if the dividend or distribution is franked, the amount that would be included in the assessable income of a recipient of the dividend or distribution who is a natural person resident in Australia under the Tax Legislation;

(ii) in the case of any entitlement that is not a dividend or other distribution for which adjustment is made under the provisions described in Section 3.2(a)(i) which is traded on the ASX on any of those ASX Business Days, the volume weighted average price of all such entitlements sold on ASX during the VWAP Period on the ASX Business Days on which those entitlements were traded (excluding trades of the kind that would be excluded in determining VWAP under the definition of that term); or

(iii) in the case of other entitlements for which adjustment is not made under the provisions described in Sections 3.2(a)(i) or (ii), the value of the entitlement as reasonably determined by Westpac; and

(b) where, on some or all of the ASX Business Days in the VWAP Period, Ordinary Shares have been quoted as ex dividend or ex any other distribution or entitlement, and Subordinated Debt Securities will be Converted into Ordinary Shares which would be entitled to receive the relevant dividend, distribution or entitlement, the VWAP on the ASX Business Days on which those Ordinary Shares have been quoted ex dividend or ex any other distribution or entitlement will be increased by the Cum Value.

(Section 6.2 of the subordinated indenture.)

3.3 Adjustments to VWAP for capital reconstruction

(a) Where during the relevant VWAP Period there is a change to the number of Ordinary Shares on issue because the Ordinary Shares are reconstructed, consolidated, divided or reclassified (in a manner not involving any cash payment or the giving of another form of consideration to or by holders of Ordinary Shares), which we refer to as Reclassification, into a lesser or greater number, the daily VWAP for each day in the VWAP Period which falls before the date on which trading in Ordinary Shares is conducted on a post Reclassification basis will be adjusted by multiplying such daily VWAP by the following formula:

$$\frac{A}{B}$$

where:

A means the aggregate number of Ordinary Shares immediately before the Reclassification; and

B means the aggregate number of Ordinary Shares immediately after the Reclassification.

(b) Any adjustment made by Westpac in accordance with the provisions described in Section 3.3(a) will be effective and binding on holders of Subordinated Debt Securities.

(Section 6.3 of the subordinated indenture.)

3.4 Adjustments to Issue Date VWAP generally

For the purposes of determining the Issue Date VWAP as described in Section 3.1 above, adjustments will be made as described in Sections 3.2 and 3.3 above during the VWAP Period for the Issue Date VWAP. On and from the issue date, adjustments to the Issue Date VWAP:

(a) may be made by Westpac in accordance with the provisions described in Sections 3.5, 3.6, and 3.7 below; and

(b) if so made, will be effective and binding on holders.

(Section 6.4 of the subordinated indenture.)

3.5 Adjustments to Issue Date VWAP for bonus issues

The subordinated indenture provides that

(a) subject to the provisions described in Sections 3.5(b) and 3.5(c), if Westpac makes a pro-rata bonus issue of Ordinary Shares to holders of Ordinary Shares generally (in a manner not involving any cash payment or the giving of another form of consideration to or by holders of Ordinary Shares), the Issue Date VWAP will be adjusted immediately in accordance with the following formula:

$V = Vo \times RD / (RD + RN)$

where:

V means the Issue Date VWAP applying immediately after the application of this formula;

Vo means the Issue Date VWAP applying immediately prior to the application of this formula;

RD means the number of Ordinary Shares on issue immediately prior to the allotment of new Ordinary Shares pursuant to the bonus issue; and

RN means the number of Ordinary Shares issued pursuant to the bonus issue.

(b) The adjustment described in Section 3.5(a) does not apply to Ordinary Shares issued as part of a bonus share plan, employee or executive share plan, executive option plan, share top up plan, share purchase plan or a dividend reinvestment plan.

(c) For the purposes of this Section 3.5, an issue will be regarded as a bonus issue notwithstanding that Westpac does not make offers to some or all holders of Ordinary Shares with registered addresses outside Australia, provided that in so doing Westpac is not in contravention of the ASX Listing Rules.

(Section 6.5 of the subordinated indenture.)

3.6 Adjustments to Issue Date VWAP for capital reconstruction

The subordinated indenture provides that if at any time after the issue date of the Subordinated Debt Securities of a series there is a change to the number of Ordinary Shares on issue because of a Reclassification (in a manner not involving any cash payment or the giving of another form of consideration to or by holders of Ordinary Shares) into a lesser or greater number, the Issue Date

VWAP will be adjusted by multiplying the Issue Date VWAP applicable on the ASX Business Day immediately before the date of any such Reclassification by the following formula:

$$\frac{A}{B}$$

where:

A means the aggregate number of Ordinary Shares on issue immediately before the Reclassification; and

B means the aggregate number of Ordinary Shares on issue immediately after the Reclassification.

(Section 6.6 of the subordinated indenture.)

3.7 No adjustment to Issue Date VWAP in certain circumstances

Notwithstanding the provisions described in Section 3.5 above, no adjustment will be made to the Issue Date VWAP where any such adjustment (expressed in Australian dollars and cents and rounded to the nearest whole cent with A$0.005 being rounded upwards) would be less than one per cent of the Issue Date VWAP then in effect.

(Section 6.7 of the subordinated indenture.)

3.8 Announcement of adjustment to Issue Date VWAP

Westpac will notify any adjustment to the Issue Date VWAP made as described above to ASX and to the trustee and holders of Subordinated Debt Securities as described above under the caption " Notice" within 10 ASX Business Days of Westpac determining the adjustment and the adjustment will be final and binding.

(Section 6.8 of the subordinated indenture.)

3.9 Status and listing of Ordinary Shares

(a) Ordinary Shares issued or arising from Conversion will rank equally with, and will have the same rights as, all other fully paid Ordinary Shares provided that the rights attaching to the Ordinary Shares issued or arising from Conversion do not take effect until 5.00 pm (Sydney time) on the Non-Viability Trigger Event Date (or such other time required by APRA).

(b) Westpac will use all reasonable endeavors to list the Ordinary Shares issued on Conversion of Subordinated Debt Securities on ASX.

(Section 6.9 of the subordinated indenture.)

3.10 Conversion; receipt of Ordinary Shares; where the holder of Subordinated Debt Securities does not wish to receive Ordinary Shares; Holders' Nominee

(a) Where some or all of the Subordinated Debt Securities of a series (or a percentage of the Outstanding Principal Amount of a Subordinated Debt Security) are required to be Converted pursuant to the terms described in Section 2.1, a holder of Subordinated Debt Securities or portion thereof that are subject to Conversion wishing to receive Ordinary Shares must, no later than the Non-Viability Trigger Event Date (or, in the case where Section 3.10(b)(vii) below applies, within 30 days of the date on which Ordinary Shares are issued upon such

Conversion), have provided to Westpac or (if then appointed) the Holders' Nominee (as defined below) a notice setting out:

(i) its name and address (or the name and address of any person in whose name it directs the Ordinary Shares to be issued) for entry into any register of title and receipt of any certificate or holding statement in respect of any Ordinary Shares;

(ii) the security account details of such holder of Subordinated Debt Securities in the Clearing House Electronic Subregister System of Australia, operated by the ASX or its affiliates or successors ("**CHESS**"), or such other account to which the Ordinary Shares may be credited; and

(iii) such other information as is reasonably requested by Westpac for the purposes of enabling it to issue the Ordinary Shares to the holder of Subordinated Debt Securities.

Westpac shall have no duty to seek or obtain from any such holder of Subordinated Debt Securities any of the information required to be submitted as described in this Section 3.10(a).

(b) If a Subordinated Debt Security or a portion thereof is required to be Converted and:

(i) the holder of the Subordinated Debt Security has notified Westpac that it does not wish to receive Ordinary Shares as a result of the Conversion (whether entirely or to the extent specified in the notice), which notice may be given at any time on or after the issue date and no less than 15 business days prior to the Non-Viability Trigger Event Date;

(ii) the Subordinated Debt Security is held by a Foreign Holder;

(iii) the holder of that Subordinated Debt Security is a Clearing System Holder;

(iv) for any reason (whether or not due to the fault of the holder of the Subordinated Debt Security) Westpac has not received the information required by Section 3.10(a) above prior to the Non-Viability Trigger Event Date and the lack of such information would prevent Westpac from issuing the Ordinary Shares to the holder of the Subordinated Debt Security on the Non-Viability Trigger Event Date; or

(v) a FATCA Withholding is required to be made in respect of the Ordinary Shares issued upon Conversion,

then, on the Non-Viability Trigger Event Date:

(vi) where Sections 3.10(b)(i) or 3.10(b)(ii) above apply, Westpac shall issue the Ordinary Shares to the holder of the Subordinated Debt Security only to the extent (if at all) that:

(A) where Section 3.10(b)(i) above applies, the holder of the Subordinated Debt Security has subsequently notified Westpac that it wishes to receive them (provided that Westpac shall have no obligation to comply with any notification received after the Non-Viability Trigger Event Date); and

(B) where Section 3.10(b)(ii) above applies, Westpac is satisfied that the laws of both the Commonwealth of Australia and the Foreign Holder's country of residence permit the unconditional issue of Ordinary Shares to the Foreign Holder (but as to which Westpac is not bound to enquire and any decision is in its sole discretion),

and to the extent Westpac is not required to issue Ordinary Shares directly to the holder of the Subordinated Debt Security, Westpac will issue the balance of the Ordinary Shares to the Holders' Nominee in accordance with Section 3.10(b)(vii)

below;

(vii)
otherwise, subject to applicable law, Westpac will issue the balance of Ordinary Shares in respect of the holder of the Subordinated Debt Security to a competent nominee (which may not be Westpac or any of its Related Entities) (the "**Holders' Nominee**") and will promptly notify such holder of the Subordinated Debt Security of the name of and contact information for the Holders' Nominee and the number of Ordinary Shares issued to the Holders' Nominee on its behalf and, subject to applicable law and:

(A)
subject to Section 3.10(b)(vii)(B) below, the Holders' Nominee will as soon as reasonably possible and no later than 35 days after issue of the Ordinary Shares sell those Ordinary Shares and pay a cash amount equal to the net proceeds received, after deducting any applicable brokerage fees, stamp duty and other taxes (including, without limitation, FATCA Withholding) and charges, to the holder of the Subordinated Debt Security, in each case arising in connection with the issuance or sale of such Ordinary Shares, and each Holders' Nominee shall use the proceeds from such sale to pay any such fees, duties, taxes, charges and any FATCA Withholding arising in connection with such issuance or sale; and

(B)
where Sections 3.10(b)(iii) or 3.10(b)(iv) above apply, the Holders' Nominee will hold such Ordinary Shares and will transfer Ordinary Shares to such holder of the Subordinated Debt Securities (or, where Section 3.10(b)(iii) above applies, the person for whom the Clearing System Holder holds the Subordinated Debt Securities) promptly after such person provides the Holders' Nominee with the information required to be provided by such holder of the Subordinated Debt Securities (as if a reference to Westpac is a reference to the Holders' Nominee and a reference to the issue of Ordinary Shares is a reference to the transfer of Ordinary Shares) but only where such information is provided to the Holders' Nominee within 30 days of the date on which Ordinary Shares are issued to the Holders' Nominee upon Conversion of such Subordinated Debt Securities and, where such holder of the Subordinated Debt Securities fails to provide the Holders' Nominee with the information required to be provided by such holder of the Subordinated Debt Securities, the Holders' Nominee will sell the Ordinary Shares and pay the proceeds to such person in accordance with Section 3.10(b)(vii)(A) above;

(viii)
nothing in this Section 3.10(b) shall affect the Conversion of the Subordinated Debt Securities of a holder of the Subordinated Debt Securities who is not a person to which any of Sections 3.10(b)(i) to 3.10(b)(v) above (inclusive) described in this Section 3.10 applies; and

(ix)
for the purpose of this Section 3.10(b), neither Westpac nor the Holders' Nominee will owe any obligations or duties to the holders of Subordinated Debt Securities in relation to the price at which Ordinary Shares are sold or will have any liability for any loss suffered by a holder of the Subordinated Debt Securities as a result of the sale of Ordinary Shares.

(c)
Subject to Section 2.3, if, in respect of a Conversion of Subordinated Debt Securities where Section 3.10(b)(vii) applies, Westpac fails to issue the Conversion Number of Ordinary Shares in respect of the Subordinated Debt Securities or percentage of the relevant Outstanding Principal Amount of such Subordinated Debt Securities on the Non-Viability Trigger Event Date to any Holders' Nominee, a holder of Subordinated Debt Securities has no further right or claim in respect of such Subordinated Debt Securities or the relevant portion thereof that is subject to Conversion except such holder's entitlement to the Ordinary Shares issued upon Conversion to the Holders' Nominee and to receive the Ordinary Shares or the proceeds from their sale pursuant to Section 3.10(b) above, and such holder has no remedies on account of

Westpac's failure to issue Ordinary Shares other than as is provided in Section 2.4(e) above. For the avoidance of doubt, if in respect of a Conversion of Subordinated Debt Securities where Section 3.10(b)(vii) applies, a Write-off occurs under Section 2.3, a holder of Subordinated Debt Securities has no further right or claim in respect of such Subordinated Debt Securities or the relevant portion thereof that is subject to Conversion (including that such holder has no entitlement to Ordinary Shares nor any right to seek specific performance of Westpac's obligation to issue Ordinary Shares as is provided in Section 2.4(e) above).

(Section 6.10 of the subordinated indenture.)

3.11 Conversion or Write-off if amounts not paid

Conversion or Write-off may occur even if an amount shall not have been paid to a holder of Subordinated Debt Securities due to Westpac's inability to satisfy the solvency condition described in Section 1.3 above.

(Section 6.11 of the subordinated indenture.)

3.12 Conversion or Write-off after Winding-Up commences

If an order is made by a court, or an effective resolution is passed, for a Winding-Up, and a Non-Viability Trigger Event occurs, then Conversion or Write-off shall occur (subject to the provisions described in Section 2.3 above) in accordance with the provisions described in Sections 2.1 and 2.2 above.

(Section 6.12 of the subordinated indenture.)

3.13 Conversion or Write-off of a percentage of Outstanding Principal Amount

If in accordance with the provisions described in Section 2.1 above, a percentage of the Outstanding Principal Amount of each Subordinated Debt Security is required to be Converted or Written-off upon the occurrence of a Non-Viability Trigger Event, then the provisions described in Section 3 will apply to the Conversion or Write-off as if references to the Outstanding Principal Amount of each Subordinated Debt Security were references to the relevant percentage of the Outstanding Principal Amount of each Subordinated Debt Security to be Converted or Written-off.

(Section 6.13 of the subordinated indenture.)

3.14 Amendment of terms and conditions relating to Conversion for Approved Successor

The subordinated indenture provides that

(a) if:

(i) it is proposed that Westpac be replaced as the ultimate parent company of the Group by an Approved Successor, which we refer to as the Replacement; and

(ii) the Approved Successor agrees to expressly assume, by supplemental indenture to the subordinated indenture, Westpac's obligations in respect of the Subordinated Debt Securities for the benefit of holders of Subordinated Debt Securities under which it agrees (among other things):

(A) to deliver fully paid ordinary shares in the capital of the Approved Successor, which we refer to as Approved Successor Shares, under all circumstances when Westpac would have otherwise been obliged to deliver Ordinary Shares on a Conversion, subject to the same terms and conditions described in this prospectus, as amended in accordance with the provisions described in this Section 3.14; and

(B) to use all reasonable endeavors and furnish all such documents, information and undertakings as may be reasonably necessary in order to procure quotation of the Approved Successor Shares issued under the terms and conditions described in this prospectus on the stock exchanges on which the other Approved Successor Shares are quoted at the time of a Conversion,

Westpac may, with APRA's prior written approval, but without the authority, assent or approval of holders of Subordinated Debt Securities, give a notice, which we refer to as an Approved Replacement Notice, to holders of Subordinated Debt Securities as described above under the caption " Notice" (which, if given, must be given as soon as practicable before the Replacement and in any event no later than 10 ASX Business Days before the Replacement occurs).

(b) An Approved Replacement Notice must specify the amendments to the terms and conditions of the Subordinated Debt Securities which will be made in accordance with the provisions described in this Section 3.14, being those amendments which in Westpac's reasonable opinion are necessary, expedient or appropriate to effect the substitution of the Approved Successor as the debtor in respect of Subordinated Debt Securities and the issuer of ordinary shares on Conversion (including such amendments as are necessary, expedient or appropriate for the purposes of complying with the provisions of Chapter 2L of the Australian Corporations Act where the Approved Successor is not an authorized deposit-taking institution under the Australian Banking Act) or which are necessary, expedient or convenient in relation to taxes where the Approved Successor is incorporated outside Australia.

(c) An Approved Replacement Notice, once given, will be irrevocable.

(d) If Westpac gives an Approved Replacement Notice to holders of Subordinated Debt Securities in accordance with the provisions described in Section 3.14(a), then with effect on and from the date specified in the Approved Replacement Notice:

(i) the Approved Successor will assume all of the obligations of, and succeed to, and be substituted for, and may exercise every right and power of, Westpac in respect of the Subordinated Debt Securities with the same effect as if the Approved Successor had been the original issuer of the Subordinated Debt Securities;

(ii) Westpac (or any corporation which has previously assumed the obligations of Westpac) will be released from its liability in respect of the Subordinated Debt Securities; and

(iii) references to Westpac herein will be deemed to be references to the Approved Successor and references to Ordinary Shares herein will be deemed to be references to Approved Successor Shares.

(e) If Westpac gives an Approved Replacement Notice in accordance with the provisions described in Section 3.14(a), then each holder of Subordinated Debt Securities by its purchase and holding of a Subordinated Debt Security will be deemed to have irrevocably consented to becoming a member of the Approved Successor in respect of Approved Successor Shares issued on Conversion and to have agreed to be bound by the constitution or other organizational documents of the Approved Successor.

(f) Westpac will not be permitted to issue an Approved Replacement Notice unless:

(i) APRA is satisfied that the capital position of Westpac on a "Level 1 basis" and "Level 2 basis" in accordance with the Prudential Standards will not be adversely affected by the Replacement; or

(ii) the Approved Successor or another entity which is not a Related Entity of Westpac (other than an entity which is a direct or indirect parent entity of Westpac) and is approved by APRA subscribes for Ordinary Shares or other capital instruments acceptable to APRA in such amount as may be necessary, or take other steps acceptable to APRA to ensure that the capital position of Westpac on a "Level 1 basis" and "Level 2 basis" in accordance with the Prudential Standards will not be adversely affected by the Replacement, including, if required by APRA or the Prudential Standards, undertaking any capital injection in relation to Westpac to replace the Subordinated Debt Securities.

Any capital injection carried out pursuant to the provisions described in Section 3.14(f)(ii) must:

(A) be unconditional;

(B) occur simultaneously with the substitution of the Approved Successor; and

(C) be of equal or better quality capital and at least the same amount as the Subordinated Debt Securities, unless otherwise approved by APRA in writing.

The foregoing provisions described in this Section 3.14 will not prevent Westpac from proposing, or limit, any scheme of arrangement or other similar proposal that may be put to holders of Subordinated Debt Securities or Westpac's members.

(Section 6.14 of the subordinated indenture.)

3.15 Power of attorney

The subordinated indenture provides that by holding a Subordinated Debt Security, each such holder is deemed to irrevocably appoint each of Westpac, its directors or authorized signatories and any of Westpac's liquidators or administrators (each an Attorney) severally to be the attorney of such holder with power in the name and on behalf of such holder to sign all documents and transfers and do any other thing as may in the Attorney's opinion be necessary or desirable to be done in order to give effect to, or for such holder to observe or perform such holder's obligations under, the provisions described in Sections 2 and 3. Such power of attorney is given for valuable consideration and to secure the performance by such holder of such holder's obligations under the provisions described in Sections 2 and 3 and is irrevocable.

(Section 6.15 of the subordinated indenture.)

3.16 Cancellation

The subordinated indenture provides that all Subordinated Debt Securities so Converted will forthwith be canceled and may not be re-issued or resold.

(Section 6.16 of the subordinated indenture.)

3.17 Calculations

For the avoidance of doubt, any and all calculations relating to the Conversion or Write-off of the Subordinated Debt Securities and any adjustments thereto shall be performed by, or on behalf of, Westpac and the holders shall direct any questions or concerns regarding such calculations to Westpac or such other persons performing such calculations or adjustments.

(Section 6.17 of the subordinated indenture.)

4. Definitions

In this section " Additional Provisions Applicable to Subordinated Debt Securities", the following expressions have the following meanings:

"Additional Tier 1 Capital" has the meaning given to it in the Prudential Standards;

"Administrative Action" means any judicial decision, official pronouncement or action, published or private ruling, interpretative decision, regulatory procedure or policy, application of a regulatory procedure or policy and any notice or announcement (including any notice or announcement of intent to adopt or make any of those things);

"Adverse Tax Event" has the meaning set out in " Redemption of Subordinated Securities Redemption for Taxation Reasons";

"Approved Successor" means a company that replaces, or is proposed to replace, Westpac as the ultimate parent company of the Group and that satisfies the following requirements:

(a) the proposed successor company complies with all applicable legal requirements and obtains any necessary regulatory approvals (including, to the extent required, APRA's prior written approval);

(b) the proposed successor company agrees to take any necessary action to give effect to an amendment to the terms of the subordinated indenture as described in Section 3.14;

(c) the ordinary shares of the proposed successor company are to be listed on the ASX or any internationally recognized stock exchange;

(d) the proposed successor company has a place of business in New South Wales, Australia or has appointed a process agent in New South Wales, Australia to receive service of process on its behalf in relation to any legal proceedings arising out of or in connection with the Subordinated Debt Securities;

(e) the proposed successor company has, in the reasonable opinion of an independent expert, the financial capacity to perform Westpac's obligations under the subordinated indenture in respect of the Subordinated Debt Securities; and

(f) the proposed replacement of Westpac and the requirements described in paragraphs (a) to (c) of this definition would not, in the reasonable opinion of an independent expert, otherwise adversely affect the interests of holders of the Subordinated Debt Securities, and for the purposes of this definition, "independent expert" means a reputable investment bank operating in Australia or an investment bank of international repute acting independently of Westpac and appointed by Westpac to provide the opinions referred to in paragraphs (e) and (f) of this definition;

"Assets" means, in respect of Westpac, its total non-consolidated gross assets as shown by the latest published full-year audited or half-year reviewed accounts, as the case may be, of Westpac, but adjusted for events subsequent to the date of such accounts in such manner and to such extent as two authorized signatories of Westpac or, if Westpac is in Winding-Up, the liquidator may determine to be appropriate;

"ASX" means the Australian Securities Exchange operated by ASX Limited (ABN 98 008 624 691);

"ASX Business Day" means a business day as defined in the ASX Listing Rules;

"ASX Listing Rules" means the listing rules of ASX from time to time with any modifications or waivers in their application to Westpac which ASX may grant;

"Australian Dollars" and ***"A$"*** mean the lawful currency of Australia;

"CHESS" has the meaning given to it in Section 3.10(a)(ii);

"Clearing System Holder" means that the Holder is the operator of a clearing system or a depository, or a nominee for a depository, for a clearing system.

"Common Equity Tier 1 Capital" has the meaning given to it in the Prudential Standards;

"Conversion" means, upon the occurrence of a Non-Viability Trigger Event, the conversion of all or some Subordinated Debt Securities (or a percentage of the Outstanding Principal Amount of each Subordinated Debt Security) into Ordinary Shares of Westpac in accordance with the terms of the subordinated indenture. "Convert" and "Converted" shall have corresponding meanings;

"Denomination" has the meaning given in the prospectus supplement;

"Equal Ranking Instruments" means instruments which satisfy the requirements set out in one of the following paragraphs (a), (b) or (c):

(a) any instruments, present and future, issued by Westpac after January 1, 2013 which:

(i) by their terms are, or are expressed to be, subordinated in a Winding-Up to the claims of Senior Creditors;

(ii) qualify as Tier 2 Capital of Westpac; and

(iii) in a Winding-Up rank, or are expressed to rank, prior to, and senior in right of payment to, instruments which constitute Additional Tier 1 Capital or Common Equity Tier 1 Capital of Westpac (or any instruments which were issued prior to January 1, 2013 and were treated as constituting tier one capital in accordance with the Prudential Standards which applied prior to January 1, 2013 irrespective of whether or not such instruments are treated as constituting tier one capital in accordance with any transitional arrangements approved by APRA);

(b) the Perpetual Capital Notes (irrespective of whether or not such instruments are treated as constituting Tier 2 Capital in accordance with any transitional arrangements approved by APRA); or

(c) any other instruments, present and future, issued by Westpac where, the right to repayment ranks, or is expressed to rank, in a Winding-Up, equally with the claims of holders of Subordinated Debt Securities (irrespective of whether or not such instruments qualify as Tier 2 Capital of Westpac);

"FATCA Withholding" means any deduction or withholding made for or on account of FATCA;

"Foreign Holder" means a holder of Subordinated Debt Securities (a) whose place of residence is outside Australia or (b) who Westpac otherwise believes may not be a resident of Australia;

"Holders' Nominee" has the meaning given to it in Section 3.10(b)(vii);

"Interest Rate" means the rate or rates (expressed as a percentage per annum) of interest payable in respect of the Outstanding Principal Amount of the Subordinated Debt Securities specified in a prospectus supplement or a term sheet or calculated or determined in accordance with the provisions specified in a prospectus supplement or a term sheet;

"Issue Date VWAP" means the VWAP during the period of 20 ASX Business Days on which trading in Ordinary Shares took place immediately preceding but not including the issue date, as adjusted in accordance with Section 3;

"Junior Ranking Capital Instruments" means instruments, present and future, issued by Westpac which:

(a) by their terms are, or are expressed to be, subordinated in a Winding-Up to the claims of holders of Subordinated Debt Securities and other Equal Ranking Instruments; and

(b) qualify as Additional Tier 1 Capital or Common Equity Tier 1 Capital of Westpac (or, in the case of any instruments issued prior to January 1, 2013, were treated as constituting tier one capital in accordance with the Prudential Standards which applied prior to January 1, 2013 irrespective of whether or not such instruments are treated as constituting Tier 1 Capital in accordance with any transitional arrangements approved by APRA);

"Liabilities" means, in respect of Westpac, its total non-consolidated gross liabilities as shown by its latest published full-year audited or half-year reviewed accounts, as the case may be, but adjusted for events subsequent to the date of such accounts in such manner and to such extent as two authorized signatories of Westpac or, if Westpac is in Winding-Up, the liquidator may determine to be appropriate;

"Non-Viability Trigger Event" occurs when APRA notifies Westpac in writing that it believes:

(a) Conversion or Write-off of all or some Subordinated Debt Securities, or conversion or write-off of all or some Relevant Securities is necessary because, without it, Westpac would become non-viable; or

(b) a public sector injection of capital, or equivalent support, is necessary because, without it, Westpac would become non-viable;

"Non-Viability Trigger Event Date" has the meaning given to it in Section 2.1(c)(iii);

"Ordinary Share" means a fully paid ordinary share in the capital of Westpac;

"Outstanding Principal Amount" means in respect of any Subordinated Debt Security which is outstanding at any time, the outstanding principal amount of the Subordinated Debt Security, and for such purposes:

(a) the principal amount of a Subordinated Debt Security issued at a discount or at par, but which has not been Converted or Written-off, is at any time to be taken to be equal to its Denomination;

(b) if an amount is required to be determined in Australian Dollars, the Australian Dollar equivalent of the Specified Currency is to be determined on the basis of the spot rate of exchange for the sale of Australian Dollars against the purchase of such relevant Specified Currency in the Sydney foreign exchange market quoted by any leading bank selected by Westpac on the relevant calculation date. The calculation date is, at the discretion of Westpac, either the date specified in the relevant formula or the preceding day on which commercial banks and foreign exchange markets are open for business in Sydney or such other date as may be specified by Westpac in the prospectus supplement; and

(c) if the principal amount of a Subordinated Debt Security has from time to time been Converted or Written-off as described in Sections 2 and 3, the principal amount of the Subordinated Debt Security will be reduced by the principal amount so Converted or Written-off;

"Perpetual Capital Notes" means the Perpetual Capital Floating Rate Notes issued by Westpac on September 30, 1986 (as may be varied or amended from time to time);

"Prudential Standards" means the prudential standards and guidelines published by APRA and as applicable to Westpac from time to time;

"Regulatory Event" has the meaning set out in " Redemption of Subordinated Securities Redemption for Regulatory Reasons";

"Related Entity" means an entity over which Westpac or any parent of Westpac exercises control or significant influence, as determined by APRA from time to time;

"Relevant Securities" means Relevant Tier 1 Securities and Relevant Tier 2 Securities;

"Relevant Tier 1 Security" means a security forming part of the Tier 1 Capital of Westpac on a "Level 1 basis" or "Level 2 basis" in accordance with the Prudential Standards which, upon the occurrence of a Non-Viability Trigger Event, may be either:

(a) converted into Ordinary Shares; or

(b) written-off or written-down (and all rights and claims of the holders in respect of the security shall be written-off or written-down);

"Relevant Tier 2 Security" means a security, including the Subordinated Debt Securities, forming part of the Tier 2 Capital of Westpac on a "Level 1 basis" or "Level 2 basis" in accordance with the Prudential Standards which, upon the occurrence of a Non-Viability Trigger Event, may be either:

(a) converted into Ordinary Shares; or

(b) written-off or written-down (and all rights and claims of the holders in respect of the security shall be written-off or written-down).

"Relevant Transaction" has the meaning set out in " Redemption of Subordinated Securities Redemption for Taxation Reasons";

"Senior Creditors" means all depositors and other creditors (present and future) of Westpac, including all holders of Westpac's debt:

(a) whose claims are admitted in a Winding-Up; and

(b) whose claims are not made as holders of indebtedness arising under:

   (i) an Equal Ranking Instrument; or

   (ii) a Junior Ranking Capital Instrument.

Senior Creditors include holders of any instruments issued by Westpac prior to January 1, 2013 which constituted Lower Tier 2 Capital as described in the Prudential Standards as in effect prior to January 1, 2013, irrespective of whether or not such instruments are treated as constituting Tier 2 Capital in accordance with any transitional arrangements approved by APRA;

"Solvent" with respect to Westpac, shall mean (i) it is able to pay its debts as they fall due; and (ii) its Assets exceed its Liabilities;

"Solvent Reconstruction" means a scheme of amalgamation or reconstruction not involving a bankruptcy or insolvency, where the obligations of Westpac in relation to the outstanding Subordinated Debt Securities are assumed by the successor entity to which all, or substantially all, of the property, assets and undertaking of Westpac are transferred or where an arrangement with similar effect not involving a bankruptcy or insolvency is implemented;

"Specified Currency" has the meaning given in a prospectus supplement or a term sheet;

"Tax Legislation" means (a) the Income Tax Assessment Act 1936 of Australia or the Income Tax Assessment Act 1997 of Australia (both as amended from time to time, as the case may be, and a reference to any section of the Income Tax Assessment Act 1936 includes a reference

to that section as

rewritten in the Income Tax Assessment Act 1997), (b) any other law setting the rate of income tax payable by the Company, and (c) any regulation made under such laws.

"Tier 1 Capital" has the meaning given to it in the Prudential Standards;

"Tier 2 Capital" has the meaning given to it in the Prudential Standards;

"VWAP" means, subject to any adjustments under the provisions described in Sections 3 above, the average of the daily volume weighted average sale prices (such average and each such daily average sale price being expressed in Australian dollars and cents and rounded to the nearest full cent, with A$0.005 being rounded upwards) of Ordinary Shares sold on ASX during the relevant period or on the relevant days but does not include any "crossing" transacted outside the "Open Session State" or any "special crossing" transacted at any time, each as defined in the ASX Market Rules or any overseas trades or trades pursuant to the exercise of options over Ordinary Shares;

"VWAP Period" means the period of 5 ASX Business Days on which trading in Ordinary Shares took place immediately preceding (but not including) the Non-Viability Trigger Event Date;

"Winding-Up" means the legal procedure for the liquidation of Westpac commenced when:

(a) a court order is made for the winding-up of Westpac; or

(b) an effective resolution is passed by members for the winding-up of Westpac,

other than in connection with a Solvent Reconstruction; and

"Write-off" has the meaning given to it in Section 2.3(c). "Written-off" shall have a corresponding meaning.

(Section 1.1 of the subordinated indenture.)

DESCRIPTION OF ORDINARY SHARES

Share Capital

As at September 30, 2016, Westpac had 3,183,907,786 Ordinary Shares on issue.

Description of the type and class of securities admitted

The Ordinary Shares were created under Australian legislation. The Ordinary Shares are currently listed on ASX and the New Zealand Exchange, and American Depository Shares representing Ordinary Shares are currently listed on the New York Stock Exchange. Westpac will use all reasonable endeavors to list the Ordinary Shares issued on Conversion of Subordinated Debt Securities on ASX.

Form and currency of the Ordinary Shares

The Ordinary Shares are denominated in A$. The Ordinary Shares are in uncertificated, registered form.

Rights attaching to the Ordinary Shares

Westpac was registered on August 23, 2002 as a public company limited by shares under the Australian Corporations Act. Westpac's constitution was most recently amended at the general meeting held on December 13, 2012. The rights attaching to Westpac's Ordinary Shares are set out in the Australian Corporations Act and its constitution, and include:

Profits and dividends

Holders of Ordinary Shares are entitled to receive such dividends on those shares as may be determined by Westpac's Directors from time to time. Dividends that are paid but not claimed may be invested by our Directors for the benefit of Westpac until required to be dealt with in accordance with any law relating to unclaimed monies.

Our constitution requires that dividends be paid out of our profits. In addition, under the Australian Corporations Act, Westpac must not pay a dividend unless our assets exceed our liabilities immediately before the dividend is declared and the excess is sufficient for payment of the dividend. In addition, the payment must be fair and reasonable to the Westpac's shareholders and must not materially prejudice Westpac's ability to pay its creditors.

Subject to the Australian Corporations Act, the constitution, the rights of persons (if any) entitled to shares with special rights to dividend and any contrary terms of issue of or applying to any shares, our Directors may determine that a dividend is payable, fix the amount and the time for payment and authorize the payment or crediting by Westpac to, or at the direction of, each shareholder entitled to that dividend.

If any dividends are returned unclaimed, we are generally obliged, under the Australian Banking Act, to hold those amounts as unclaimed monies for a period of three years. If at the end of that period the monies remain unclaimed by the shareholder concerned, we must submit an annual unclaimed money return to the Australian Securities and Investment Commission by March 31 each year containing the unclaimed money as at December 31 of the previous year. Upon such payment being made, we are discharged from further liability in respect of that amount.

Westpac's Directors may, before paying any dividend, set aside out of our profits such sums as they think proper as reserves, to be applied, at the discretion of our Directors, for any purpose for which the profits may be properly applied. Westpac's Directors may carry forward so much of the profits remaining as they consider ought not to be distributed as dividends without transferring those profits to a reserve.

The following restrictions apply to our ability to declare and/or pay dividends:

(i) if the payment of the dividend would breach or cause a breach by Westpac of applicable capital adequacy or other supervisory requirements of APRA. Currently, one such requirement is that a dividend should not be paid without APRA's prior consent if payment of that dividend, after taking into account all other dividends (if any) paid on our shares and payments on more senior capital instruments, in the preceding 12 consecutive months to which they relate, would cause the aggregate of such dividend payments to exceed our after tax earnings for the preceding 12 consecutive months, as reflected in our relevant audited consolidated financial statements. Restrictions on the distribution of earnings, including payment of dividends, discretionary bonuses and Additional Tier 1 capital distributions, also apply when capital ratios fall within APRA's capital conservation buffer range;

(ii) if, under the Australian Banking Act, Westpac is directed by APRA not to pay a dividend;

(iii) if the declaration or payment of the dividend would result in Westpac becoming insolvent; and

(iv) if any interest payment, dividend, redemption payment or other distribution on certain Additional Tier 1 securities issued by the Group is not paid in accordance with the terms of those securities, we may be restricted from declaring and/or paying dividends on Ordinary Shares (and certain Additional Tier 1 securities). This restriction is subject to a number of exceptions.

Voting rights

Holders of our fully paid Ordinary Shares have, at general meetings (including special general meetings), one vote on a show of hands and, upon a poll, one vote for each fully paid share held by them.

Winding-Up

Subject to any preferential entitlement of holders of preference shares on issue at the relevant time, holders of our Ordinary Shares are entitled to share equally in any surplus assets if we are wound up.

TAXATION

United States Taxation

Senior Debt Securities

The following is a general discussion of the material US federal income tax considerations relating to the purchase, ownership and disposition of the Senior Debt Securities by US Holders (as defined below) who purchase the Senior Debt Securities in an offering of Senior Debt Securities at their issue price (determined as set forth below) and hold the Senior Debt Securities as capital assets, within the meaning of section 1221 of the Code. This discussion does not address all of the tax considerations that may be relevant to US Holders in light of their particular circumstances or to US Holders subject to special rules under US federal income tax laws, such as banks, insurance companies, retirement plans, regulated investment companies, real estate investment trusts, dealers in securities, brokers, tax-exempt entities, certain former citizens or residents of the US, US Holders who hold the Senior Debt Securities as part of a "straddle", "hedging", "conversion" or other integrated transaction, US Holders who mark their securities to market for US federal income tax purposes or US Holders whose functional currency is not the US dollar. In addition, this discussion does not address the effect of any state, local or non-US tax laws or any US federal estate, gift or alternative minimum tax considerations.

This discussion is based on the Code, the Treasury Regulations promulgated thereunder and administrative and judicial pronouncements, all as in effect on the date hereof, and all of which are subject to change, possibly with retroactive effect. This discussion does not describe the US federal income tax considerations relating to the purchase, ownership or disposition of a "contingent payment debt instrument" (as defined under applicable Treasury Regulations) (such as a Senior Debt Security where the amount of principal and/or interest payable is determined by reference to one or more commodities, derivatives, securities or indices or any currency or currencies other than the currency in which the Senior Debt Security is denominated), a Senior Debt Security with a maturity later than 30 years from its date of issuance, a Senior Debt Security that does not obligate Westpac to repay an amount equal to at least the issue price of the Senior Debt Security, or certain "variable rate debt instruments" (as defined under applicable Treasury Regulations), and a general discussion of any materially different US federal income tax considerations relating to any such particular Senior Debt Security will be included in the applicable prospectus supplement or term sheet.

For purposes of this discussion, the term "US Holder" means a beneficial owner of a Senior Debt Security that is, for US federal income tax purposes, (i) an individual citizen or resident of the US, (ii) a corporation created or organized in or under the laws of the US or of any state thereof or the District of Columbia, (iii) an estate the income of which is subject to US federal income taxation regardless of its source, or (iv) a trust with respect to which a court within the US is able to exercise primary supervision over its administration and one or more United States persons have the authority to control all of its substantial decisions, or certain electing trusts that were in existence on August 19, 1996 and were treated as domestic trusts on that date.

If an entity treated as a partnership for US federal income tax purposes invests in a Senior Debt Security, the US federal income tax considerations relating to such investment will generally depend in part upon the status and activities of such entity and its partners. Such an entity should consult its own tax advisor regarding the US federal income tax considerations applicable to it and its partners of the purchase, ownership and disposition of such a Senior Debt Security.

Prospective purchasers are advised to consult their own tax advisors as to the US federal income and other tax considerations relating to the purchase, ownership and disposition of the Senior Debt Securities in light of their particular circumstances, as well as the effect of any state, local or non-US tax laws.

Interest and Original Issue Discount on the Senior Debt Securities

Each US Holder of a Senior Debt Security must include in income payments of "qualified stated interest" (as described below) in respect of such Senior Debt Security in accordance with such US Holder's method of accounting for US federal income tax purposes as ordinary interest income. In general, if the issue price of a Senior Debt Security, determined by the first price at which a substantial amount of the Senior Debt Securities of a series are sold (ignoring sales to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers), is less than the "stated redemption price at maturity" (as described below) of such Senior Debt Security by an amount that is equal to or more than a *de minimis* amount, a US Holder will be considered to have purchased such Senior Debt Security with original issue discount ("OID"). In general, the *de minimis* amount is equal to $^1/_4$ of 1 percent of the stated redemption price at maturity of a Senior Debt Security multiplied by the number of complete years to maturity (or, in the case of a Senior Debt Security providing for the payment of any amount other than qualified stated interest (as defined below) prior to maturity, multiplied by the weighted average maturity of the Senior Debt Security). If a US Holder acquires a Senior Debt Security with OID, then regardless of such US Holder's method of accounting for US federal income tax purposes, such US Holder generally will be required to accrue its pro rata share of OID on such Senior Debt Security on a constant-yield basis and include such accruals in gross income, whether or not such US Holder will have received any cash payment on such Senior Debt Security. Any amount not treated as OID because it is *de minimis* generally must be included in income (generally as gain from the sale of Senior Debt Securities) as principal payments are received in the proportion that each such payment bears to the original principal amount of the Senior Debt Security. Special rules apply to Senior Debt Securities with a fixed maturity of one year or less. See below under " Short-Term Senior Debt Securities".

"Stated redemption price at maturity" generally means the sum of all payments to be made on a Senior Debt Security other than payments of "qualified stated interest". "Qualified stated interest" generally means stated interest that is unconditionally payable at least annually at a single fixed rate, or in the case of a variable rate debt instrument (as defined below), at a single qualified floating rate or single objective rate (as such terms are defined below). If a Senior Debt Security is a variable rate debt instrument but interest is payable at a rate other than a single qualified floating rate or a single objective rate, the special rules that apply to such Senior Debt Security will be described in the applicable prospectus supplement or term sheet.

In the case of a Senior Debt Security that is a variable rate debt instrument, the amount of qualified stated interest and the amount of OID, if any, that accrues during an accrual period is generally determined by assuming that the variable rate is a fixed rate equal to (i) in the case of a qualified floating rate or qualified inverse floating rate (each as defined below), the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate or (ii) in the case of an objective rate (as defined below, and other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the debt instrument, and the qualified stated interest (or, if there is no qualified stated interest, OID) allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period pursuant to clause (i) or (ii), as applicable. If applicable to any Senior Debt Security, the special rules that apply to a variable rate debt instrument that provides for stated interest at a fixed rate under certain circumstances will be described in the applicable prospectus supplement or term sheet.

A "variable rate debt instrument" is a debt instrument that (i) has an issue price that does not exceed the total noncontingent principal payments by more than an amount equal to the lesser of (a) 0.015 multiplied by the product of such total noncontingent principal payments and the number of complete years to maturity of the instrument (or, in the case of a Senior Debt Security providing for the payment of any amount other than qualified stated interest prior to maturity, multiplied by the

weighted average maturity of the Senior Debt Security) or (b) 15 percent of the total noncontingent principal payments, (ii) provides for stated interest (compounded or paid at least annually) at the current value of (A) one or more qualified floating rates, (B) a single fixed rate and one or more qualified floating rates, (C) a single objective rate or (D) a single fixed rate and a single objective rate that is a qualified inverse floating rate, and (iii) does not provide for any principal payments that are contingent. The current value of a rate is the value of the rate on any day that is no earlier than three months prior to the first day on which that value is in effect and no later than one year following that first day.

A "qualified floating rate" is generally a floating rate under which variations in the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which a debt instrument is denominated. A multiple of a qualified floating rate is not a qualified floating rate unless the relevant multiplier is (i) fixed at a number that is greater than 0.65 but not more than 1.35 or (ii) fixed at a number that is greater than 0.65 but not more than 1.35, increased or decreased by a fixed rate. A variable rate is not considered a qualified floating rate if the variable rate is subject to a cap, floor, governor (*i.e.*, a restriction on the amount of increase or decrease in the stated interest rate) or similar restriction that is reasonably expected as of the issue date to cause the yield on the Senior Debt Security to be significantly more or less than the expected yield determined without the restriction (other than a cap, floor, governor or similar restriction that is fixed throughout the term of the Senior Debt Security).

An "objective rate" is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. However, an objective rate does not include a rate based on information that is within the control of the issuer (or certain related parties of the issuer) or that is unique to the circumstances of the issuer (or certain related parties of the issuer), such as dividends, profits or the value of the issuer's stock. A "qualified inverse floating rate" is an objective rate (i) that is equal to a fixed rate minus a qualified floating rate and (ii) the variations in which can reasonably be expected to inversely reflect contemporaneous variations in the qualified floating rate (disregarding any caps, floors, governors or similar restrictions that would not, as described above, cause a rate to fail to be a qualified floating rate). Notwithstanding the first sentence of this paragraph, a rate is not an objective rate if it is reasonably expected that the average value of the rate during the first half of the Senior Debt Security's term will be either significantly less than or significantly greater than the average value of the rate during the final half of the Senior Debt Security's term. The US Internal Revenue Service ("IRS") may designate rates other than those specified above that will be treated as objective rates. As of the date of this prospectus, no other rates have been designated.

If interest on a Senior Debt Security is stated at a fixed rate for an initial period of one year or less followed by a variable rate that is either a qualified floating rate or an objective rate for a subsequent period, and the value of the variable rate on the issue date is intended to approximate the fixed rate, the fixed rate and the variable rate together constitute a single qualified floating rate or objective rate, as the case may be. A fixed rate and a variable rate will be conclusively presumed to meet the requirements of the preceding sentence if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than 0.25 percentage points (25 basis points).

If a floating rate Senior Debt Security does not qualify as a variable rate debt instrument or otherwise provides for contingent payments, or if a fixed rate Senior Debt Security provides for contingent payments, such Senior Debt Security may constitute a "contingent payment debt instrument". Interest payable on a contingent payment debt instrument is not treated as qualified stated interest. If applicable to any Senior Debt Security, the special rules applicable to contingent payment debt instruments will be described in the applicable prospectus supplement or term sheet.

In general, the following rules apply if (i) a Senior Debt Security provides for one or more alternative payment schedules applicable upon the occurrence of a contingency or contingencies and the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and (ii) either a single payment schedule is significantly more likely than not to occur or the Senior Debt Security provides us or the holder with an unconditional option or options exercisable on one or more dates during the term of the Senior Debt Security. If based on all the facts and circumstances as of the issue date a single payment schedule for a Senior Debt Security, including the stated payment schedule, is significantly more likely than not to occur, then, in general, the yield and maturity of the Senior Debt Security are computed based on this payment schedule. If we have or the holder has an unconditional option or options that, if exercised, would require payments to be made on the Senior Debt Security under an alternative payment schedule or schedules, then (i) in the case of an option or options exercisable by us, we will be deemed to exercise or not exercise an option or combination of options in the manner that minimizes the yield on the Senior Debt Security and (ii) in the case of an option or options exercisable by a holder, the holder will be deemed to exercise or not exercise an option or combination of options in the manner that maximizes the yield on the Senior Debt Security. Senior Debt Securities subject to the above rules will not be treated as contingent payment debt instruments as a result of the contingencies described above. If a contingency (including the exercise of an option) actually occurs or does not occur contrary to an assumption made according to the above rules (a "Change in Circumstances"), then, except to the extent that a portion of the Senior Debt Security is repaid as a result of a Change in Circumstances and solely for purposes of the accrual of OID, the Senior Debt Security is treated as retired and then reissued on the date of the Change in Circumstances for an amount equal to the Senior Debt Security's adjusted issue price on that date.

A US Holder may elect to treat all interest on any Senior Debt Security as OID and calculate the amount includible in gross income under the constant yield method. For purposes of this election, interest includes stated interest, acquisition discount, OID, *de minimis* OID, market discount, *de minimis* market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium. The election must be made for the taxable year in which a US Holder acquires a Senior Debt Security, and may not be revoked without the consent of the IRS.

Premium on the Senior Debt Securities

If the amount paid by a US Holder for a Senior Debt Security exceeds the stated redemption price at maturity of such Senior Debt Security, such US Holder generally will be considered to have purchased such Senior Debt Security at a premium equal in amount to such excess. In this event, such US Holder may elect to amortize such premium, based generally on a constant-yield basis, as an offset to interest income over the remaining term of such Senior Debt Security. In the case of a Senior Debt Security that may be redeemed prior to maturity, the premium amortization and redemption date are calculated assuming that we and the US Holder will exercise or not exercise redemption rights in a manner that maximizes the US Holder's yield. It is unclear how premium amortization is calculated when the redemption date or the amount of any redemption premium is uncertain. The election to amortize bond premium, once made, will apply to all debt obligations held or subsequently acquired by the electing US Holder on or after the first day of the first taxable year to which the election applies, and may not be revoked without the consent of the IRS.

Short-Term Senior Debt Securities

Senior Debt Securities that have a fixed maturity of one year or less ("Short-Term Senior Debt Securities") will be treated as issued with OID. In general, an individual or other US Holder that uses the cash method of accounting is not required to accrue such OID unless such US Holder elects to do so. If such an election is not made, any gain recognized by such US Holder on the sale, exchange,

redemption or other disposition of a Short-Term Senior Debt Security will be ordinary income to the extent of the OID accrued on a straight-line basis, or upon election under the constant yield method (based on daily compounding), through the date of sale, exchange, redemption or other disposition, and a portion of the deduction otherwise allowable to such US Holder for interest on borrowings allocable to the Short-Term Senior Debt Security will be deferred until a corresponding amount of income on such Short-Term Senior Debt Security is realized. US Holders who report income for US federal income tax purposes under the accrual method of accounting and certain other US Holders are required to accrue OID related to a Short-Term Senior Debt Security as ordinary income on a straight-line basis unless an election is made to accrue the OID under a constant yield method (based on daily compounding).

Sale, Exchange, Redemption or Other Disposition of the Senior Debt Securities

In general, a US Holder of a Senior Debt Security will have a tax basis in such Senior Debt Security equal to the cost of such Senior Debt Security to such US Holder, increased by any amount includible in income by such US Holder as OID and reduced by any amortized premium and any payments received with respect to the Senior Debt Security other than payments of qualified stated interest. Upon a sale, exchange, redemption or other disposition of a Senior Debt Security, a US Holder will generally recognize gain or loss equal to the difference between the amount realized on the sale, exchange, redemption or other disposition (less any amount that is attributable to accrued but unpaid qualified stated interest, which will constitute ordinary interest income if not previously included in income) and such US Holder's adjusted tax basis in such Senior Debt Security. Subject to the rules described below under " Foreign Currency Senior Debt Securities", such gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if such US Holder has held such Senior Debt Security for more than one year at the time of such sale, exchange, redemption or other disposition. Certain non-corporate US Holders are entitled to preferential treatment for net long-term capital gains. The ability of a US Holder to offset capital losses against ordinary income is limited. Such gain or loss generally will be from sources within the United States.

Foreign Currency Senior Debt Securities

The following discussion generally describes special rules that apply, in addition to the rules described above, to Senior Debt Securities that are denominated in, or provide for payments determined by reference to, non-US currency ("Foreign Currency Senior Debt Securities"). The amount of qualified stated interest paid with respect to a Foreign Currency Senior Debt Security that is includible in income by a US Holder that uses the cash method of accounting for US federal income tax purposes is the US dollar value of the amount paid, as determined on the date of actual or constructive receipt by such US Holder, using the spot rate of exchange on such date. In the case of qualified stated interest on a Foreign Currency Senior Debt Security held by a US Holder that uses the accrual method of accounting, and in the case of OID (other than OID on a Short-Term Senior Debt Security that is not required to be accrued) for every US Holder, such US Holder is required to include the US dollar value of the amount of such interest income or OID (which is determined in the non-US currency) that accrued during the accrual period. The US dollar value of such accrued interest income or OID generally is determined by translating such income at the average rate of exchange for the accrual period (or, with respect to an accrual period that spans two taxable years, at the average rate of exchange for the partial period within the taxable year). Alternatively, such US Holder may elect to translate such income at the spot rate of exchange on the last day of the accrual period (or, with respect to an accrual period that spans two taxable years, at the spot rate of exchange in effect on the last day of the taxable year). If the last day of the accrual period is within five business days of the date of receipt of the accrued interest, a US Holder that has made such election may translate accrued interest using the spot rate of exchange in effect on the date of receipt. The above election will apply to all debt obligations held by such US Holder and may not be changed without the consent of

the IRS. A US Holder will recognize, as ordinary income or loss, foreign currency gain or loss with respect to such accrued interest income or OID on the date the interest or OID is actually or constructively received, reflecting fluctuations in currency exchange rates between the spot rate of exchange used to determine the accrued interest income or OID for the relevant accrual period and the spot rate of exchange on the date such interest or OID is actually or constructively received.

A US Holder will calculate the amortization of bond premium for a Foreign Currency Senior Debt Security in the applicable non-US currency. Amortization deductions attributable to a period will reduce interest payments in respect of that period, and therefore are translated into US dollars at the spot rate of exchange used for those interest payments. Foreign currency gain or loss will be realized with respect to amortized premium on a Foreign Currency Senior Debt Security based on the difference between the spot rate of exchange at which the amortization deductions were translated into US dollars and the spot rate of exchange on the date such US Holder acquired the Foreign Currency Senior Debt Security.

The amount realized with respect to a sale, exchange, redemption or other disposition of a Foreign Currency Senior Debt Security generally will be the US dollar value of the payment received, determined on the date of disposition of such Foreign Currency Senior Debt Security (using the spot rate of exchange on such date). However, with respect to Foreign Currency Senior Debt Securities that are treated as traded on an established securities market, such amount realized will be determined using the spot rate of exchange on the settlement date in the case of (i) a US Holder that is a cash method taxpayer or (ii) a US Holder that is an accrual method taxpayer that elects such treatment. This election may not be changed without the consent of the IRS. Gain or loss that is recognized generally will be ordinary income or loss to the extent it is attributable to fluctuations in currency exchange rates between the date of purchase and the date of sale, exchange, redemption or other disposition. Such foreign currency gain or loss, together with any foreign currency gain or loss realized on such disposition in respect of accrued interest or OID, will be recognized only to the extent of the total gain or loss realized by such US Holder on the sale, exchange, redemption or other disposition of the Foreign Currency Senior Debt Security. Any gain or loss realized by a US Holder not treated as foreign currency gain or loss generally will be capital gain or loss (subject to the discussion above regarding Short-Term Senior Debt Securities).

A US Holder that determines its amount realized in connection with the sale, exchange, redemption or other disposition of a Foreign Currency Senior Debt Security by reference to the spot rate of exchange on the date of such sale, exchange, redemption or other disposition (rather than on the settlement date) may recognize additional foreign currency gain or loss upon receipt of non-US currency from such sale, exchange, redemption or other disposition.

A US Holder will recognize an amount of foreign currency gain or loss on a sale or other disposition of any non-US currency equal to the difference between (i) the amount of US dollars, or the fair market value in US dollars of any other property, received in such sale or other disposition and (ii) the tax basis of such non-US currency. A US Holder generally will have a tax basis in non-US currency received from a sale, exchange, redemption or other disposition of a Foreign Currency Senior Debt Security equal to the US dollar value of such non-US currency on the date of receipt.

A Senior Debt Security that provides for payments in more than one currency generally will be treated as a "contingent payment debt instrument", and the special rules applicable to such instruments will be described in the applicable prospectus supplement or term sheet.

Aggregation Rules

The Treasury Regulations relating to OID contain special aggregation rules stating in general that, subject to certain exceptions, debt instruments issued in the same transaction or related transactions to a single purchaser may be treated as a single debt instrument with a single issue price, maturity date,

yield to maturity and stated redemption price at maturity for purposes of the OID rules. Under certain circumstances, these provisions could apply to a US Holder that purchases Senior Debt Securities from more than one series of Senior Debt Securities.

Medicare Tax

In addition to regular US federal income tax, certain US Holders that are individuals, estates or trusts are subject to a 3.8% tax on all or a portion of their "net investment income", which may include all or a portion of their interest income (including accrued OID) and net gain from the sale, exchange, redemption or other disposition of a Senior Debt Security.

Backup Withholding and Information Reporting

Backup withholding and information reporting requirements generally apply to interest (including OID) and principal payments made to, and the proceeds of sales by, certain non-corporate US Holders. A US Holder not otherwise exempt from backup withholding generally can avoid backup withholding by providing a properly executed IRS Form W-9. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules generally will be allowed as a refund or a credit against a US Holder's US federal income tax liability, provided the required information is timely furnished by such US Holder to the IRS.

Disclosure Requirements for Certain Holders Recognizing Significant Losses

A US Holder that participates in any "reportable transaction" (as defined in the Treasury Regulations) must attach to its US federal income tax return a disclosure statement on IRS Form 8886. Each US Holder should consult its own tax advisor regarding the possible obligation to file IRS Form 8886 reporting foreign currency loss arising from the Senior Debt Securities or any amounts received with respect to the Senior Debt Securities.

Disclosure Requirements for Specified Foreign Financial Assets

Individual US Holders (and certain US entities specified in US Treasury Department guidance) who, during any taxable year, hold any interest in any "specified foreign financial asset" generally will be required to file with their US federal income tax returns certain information on IRS Form 8938 if the aggregate value of all such assets exceeds certain specified amounts. "Specified foreign financial asset" generally includes any financial account maintained with a non-US financial institution and may also include the Senior Debt Securities if they are not held in an account maintained with a financial institution. Substantial penalties may be imposed, and the period of limitations on assessment and collection of US federal income taxes may be extended, in the event of a failure to comply. Each US Holder should consult its own tax advisor regarding the possible application of this filing requirement.

Subordinated Debt Securities

The following is a general discussion of the material US federal income tax considerations relating to the purchase, ownership and disposition of the Subordinated Debt Securities by Subordinated US Holders (as defined below) who purchase the Subordinated Debt Securities in an offering of Subordinated Debt Securities at their issue price (generally the first price at which a substantial amount of the Subordinated Debt Securities of a series are sold (ignoring sales to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers)) and hold the Subordinated Debt Securities as capital assets, within the meaning of section 1221 of the Code. This discussion does not address all of the tax considerations that may be relevant to Subordinated US Holders in light of their particular circumstances or to Subordinated US Holders subject to special rules under US federal income tax laws, such as banks, insurance companies,

retirement plans, regulated investment companies, real estate investment trusts, dealers in securities, brokers, tax-exempt entities, Subordinated US Holders that own (or are deemed to own) 10% or more (by voting power) of our stock, certain former citizens or residents of the US, Subordinated US Holders who hold the Subordinated Debt Securities as part of a "straddle", "hedging", "conversion" or other integrated transaction, Subordinated US Holders who mark their securities to market for US federal income tax purposes or Subordinated US Holders whose functional currency is not the US dollar. In addition, this discussion does not address the effect of any state, local or non-US tax laws or any US federal estate, gift or alternative minimum tax considerations.

This discussion is based on the Code, the Treasury Regulations promulgated thereunder and administrative and judicial pronouncements and the tax treaty between the United States and Australia, as amended (the "Tax Treaty"), all as in effect on the date hereof, and all of which are subject to change, possibly with retroactive effect. This discussion does not describe the US federal income tax considerations relating to the purchase, ownership or disposition of a Subordinated Debt Security that is issued with an issue price that exceeds such Subordinated Debt Security's principal amount or a Subordinated Debt Security where the amount of principal and/or interest payable is determined by reference to one or more commodities, derivatives, securities or indices or any currency or currencies other than the currency in which the Subordinated Debt Security is denominated, and a general discussion of any materially different US federal income tax considerations relating to any such particular Subordinated Debt Security will be included in the applicable prospectus supplement or term sheet.

For purposes of this discussion, the term "Subordinated US Holder" means a beneficial owner of a Subordinated Debt Security that is, for US federal income tax purposes, (i) an individual citizen or resident of the US, (ii) a corporation created or organized in or under the laws of the US or of any state thereof or the District of Columbia, (iii) an estate the income of which is subject to US federal income taxation regardless of its source, or (iv) a trust with respect to which a court within the US is able to exercise primary supervision over its administration and one or more United States persons have the authority to control all of its substantial decisions, or certain electing trusts that were in existence on August 19, 1996 and were treated as domestic trusts on that date.

If an entity treated as a partnership for US federal income tax purposes invests in a Subordinated Debt Security, the US federal income tax considerations relating to such investment will generally depend in part upon the status and activities of such entity and its partners. Such an entity should consult its own tax advisor regarding the US federal income tax considerations applicable to it and its partners of the purchase, ownership and disposition of such a Subordinated Debt Security.

Except as described below under " Passive Foreign Investment Company Considerations", this discussion assumes that we are not and will not be a passive foreign investment company for US federal income tax purposes.

Prospective purchasers are advised to consult their own tax advisors as to the US federal income and other tax considerations relating to the purchase, ownership and disposition of the Subordinated Debt Securities in light of their particular circumstances, as well as the effect of any state, local or non-US tax laws.

Classification of the Subordinated Debt Securities

The determination of whether a security should be classified as indebtedness or equity for US federal income tax purposes requires a judgment based on all the relevant facts and circumstance. There is no statutory, judicial or administrative authority that directly addresses the US federal income tax treatment of securities similar to the Subordinated Debt Securities. It is therefore unclear whether the Subordinated Debt Securities should be treated as indebtedness or equity for US federal income tax purposes. Nonetheless, although not free from doubt, based upon an analysis of the relevant facts

and circumstances, under applicable law as of the date hereof, it is more likely than not that the Subordinated Debt Securities will be treated as equity for US federal income tax purposes. This classification will be binding on a Subordinated US Holder, unless the Subordinated US Holder expressly discloses that it is adopting a contrary position on its income tax return. However, this treatment is not binding on the IRS and it is possible that a Subordinated Debt Security could be treated as indebtedness for US federal income tax purposes. Due to the lack of authority regarding the classification of the Subordinated Debt Securities for US federal income tax purposes, each Subordinated US Holder should consult its own tax advisor regarding the appropriate classification of the Subordinated Debt Securities. Except as described below under " Alternative Classification of the Subordinated Debt Securities", the remainder of this discussion assumes the Subordinated Debt Securities will be treated as equity for US federal income tax purposes.

Interest Payments on the Subordinated Debt Securities

Payments of interest on the Subordinated Debt Securities will be treated as distributions paid with respect to our stock. A Subordinated US Holder that receives a distribution of cash with respect to a Subordinated Debt Security generally will be required to include the amount of such distribution in gross income as a dividend (without reduction for any non-US tax withheld from such distribution) to the extent of our current or accumulated earnings and profits (as determined for US federal income tax purposes). To the extent the amount of such distribution exceeds such current and accumulated earnings and profits, it generally will be treated first as a non-taxable return of capital to the extent of such Subordinated US Holder's adjusted tax basis in such Subordinated Debt Security and then as gain (which will be treated in the manner described below under " Sale, Exchange, Redemption, Write-off or Other Disposition of the Subordinated Debt Securities"). We have not maintained and do not plan to maintain calculations of earnings and profits for US federal income tax purposes. As a result, a Subordinated US Holder may need to include the entire amount of any such distribution in income as a dividend.

The amount of any distribution on a Subordinated Debt Security made in non-US currency is the US dollar value of the distribution translated at the spot rate of exchange on the date such distribution is received by or for the account of the Subordinated US Holder. Such Subordinated US Holder generally will have a basis in such non-US currency equal to the US dollar value of such non-US currency on the date of such receipt. Any gain or loss on a conversion or other disposition of such non-US currency by such Subordinated US Holder generally will be treated as ordinary income or loss from sources within the United States.

A distribution on a Subordinated Debt Security that is treated as a dividend generally will constitute income from sources outside the United States and generally will be categorized for US foreign tax credit purposes as "passive category income" or, in the case of some Subordinated US Holders, as "general category income". Such distribution will not be eligible for the "dividends received" deduction generally allowed to corporate shareholders with respect to dividends received from US corporations. A Subordinated US Holder may be eligible to elect to claim a US foreign tax credit against its US federal income tax liability, subject to applicable limitations and holding period requirements, for any non-US tax withheld from any such distribution. A Subordinated US Holder that does not elect to claim a US foreign tax credit for non-US income tax withheld may instead claim a deduction for such withheld tax, but only for a taxable year in which the Subordinated US Holder elects to do so with respect to all non-US income taxes paid or accrued by such Subordinated US Holder in such taxable year. The rules relating to US foreign tax credits are very complex, and each Subordinated US Holder should consult its own tax advisor regarding the application of such rules.

Dividends received by an individual (or certain other non-corporate US holders) from a "qualified foreign corporation" generally qualify for preferential rates of tax so long as (i) the distributing corporation is not a passive foreign investment company during the taxable year in which the dividend is paid or the preceding taxable year and (ii) certain holding period and other requirements are met. A non-US corporation generally will be considered to be a qualified foreign corporation if it is eligible for the benefits of a comprehensive income tax treaty with the United States that the US Treasury Department determines is satisfactory for purposes of this provision and that includes an exchange of information program. The Tax Treaty, as currently in effect, meets these requirements. We believe that we are currently eligible for the benefits of the Tax Treaty, but no assurance can be given that we will be so eligible at all times. In addition, as described below under " Passive Foreign Investment Company Considerations", we believe that we were not in our taxable year ending in 2015, and we do not currently expect to become, a passive foreign investment company, but no assurance can be given that we will not be a passive foreign investment company in any year. The IRS may disagree with our conclusions regarding any of the foregoing. Moreover, it is not clear whether the existence of certain creditor remedies provided for under the terms of the Subordinated Debt Securities may adversely affect the holding period requirement for claiming the preferential rates of tax noted above. Therefore, no assurance can be given that a distribution on a Subordinated Debt Security held by a Subordinated US Holder will qualify for such preferential rates. If such preferential rates are applicable, special rules apply for purposes of determining the recipient's investment income (which may limit deductions for investment interest) and foreign income (which may affect the amount of US foreign tax credit). In addition, if a distribution received by an individual to which the preferential rates of tax noted above apply is an "extraordinary dividend" within the meaning of section 1059 of the Code, any loss recognized by such individual on a subsequent disposition of a Subordinated Debt Security will be treated as long-term capital loss to the extent of such "extraordinary dividend", irrespective of such Subordinated US Holder's holding period for such Subordinated Debt Security. Each Subordinated US Holder that is a non-corporate taxpayer should consult its own tax advisor regarding the possible applicability of these preferential rates of tax and the related restrictions and special rules.

Redemption Premium on the Subordinated Debt Securities

A Subordinated Debt Security will be considered to be issued with a "redemption premium" if the excess of the principal amount of the Subordinated Debt Security over its issue price is equal to or more than a *de minimis* amount ($^{1}/_{4}$ of 1 percent of the Subordinated Debt Security's principal amount multiplied by the number of complete years to its maturity). Any such redemption premium will be included in income as a dividend, to the extent of our current or accumulated earnings and profits, under principles similar to the principles applicable to original issue discount described above under " Senior Debt Securities Interest and Original Issue Discount". Under certain circumstances, our right to redeem a Subordinated Debt Security could give rise to redemption premium for this purpose. If we believe that such a right exists, we will so advise in the applicable prospectus supplement or term sheet.

Sale, Exchange, Redemption, Write-off or Other Disposition of the Subordinated Debt Securities

A Subordinated US Holder generally will recognize gain or loss for US federal income tax purposes upon the sale, exchange or other disposition of a Subordinated Debt Security (other than conversion into Ordinary Shares as described below under " Conversion of the Subordinated Debt Securities into Ordinary Shares") in an amount equal to the difference, if any, between the amount realized on the sale, exchange or other disposition and such Subordinated US Holder's adjusted tax basis in such Subordinated Debt Security, except to the extent that any cash received in a redemption that is treated as a sale or exchange is attributable to any accrued but unpaid interest on the Subordinated Debt Security, which might be treated as a distribution paid with respect to our stock, with the consequences described above under " Interest Payments on the Subordinated Debt

Securities". Any gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if such Subordinated US Holder has held such Subordinated Debt Security for more than one year at the time of such sale, exchange or other disposition. Net long-term capital gain of certain non-corporate Subordinated US Holders generally is subject to preferential rates of tax. The deductibility of capital losses is subject to limitations. Such gain or loss generally will be from sources within the United States.

A Write-off in full of a Subordinated Debt Security generally will be treated as a sale, exchange or other disposition of such Subordinated Debt Security. It is unclear how a partial Write-off of a Subordinated Debt Security should be treated for US federal income tax purposes, and each Subordinated US Holder should consult its own tax advisor regarding the US federal income tax consequences of a partial Write-off.

Depending on the circumstances, a redemption of a Subordinated Debt Security may either be (i) a sale or exchange or (ii) a distribution paid with respect to our stock. In general, a redemption of a Subordinated Debt Security will be treated as a sale or exchange if it:

- is "not essentially equivalent to a dividend" with respect to a Subordinated US Holder under section 302(b)(1) of the Code;

- is a "substantially disproportionate" redemption with respect to a Subordinated US Holder under section 302(b)(2) of the Code;

- results in a "complete redemption" of a Subordinated US Holder's interest in our stock under section 302(b)(3) of the Code; or

- is a redemption of stock held by a non-corporate Subordinated US Holder, which results in our partial liquidation under section 302(b)(4) of the Code.

In determining whether any of these tests has been met, a Subordinated US Holder must take into account not only Subordinated Debt Securities and other of our equity interests that the Subordinated US Holder actually owns, but also Subordinated Debt Securities and other of our equity interests that the Subordinated US Holder constructively owns within the meaning of section 318 of the Code. If a redemption does not meet at least one of these tests, it generally will be treated as a distribution paid with respect to our stock, with the consequences described above under " Interest Payments on the Subordinated Debt Securities". Each Subordinated US Holder should consult its own tax advisor regarding the US federal income tax consequences of a redemption of a Subordinated Debt Security, including the treatment of adjusted tax basis where the redemption is treated as a distribution.

A Subordinated US Holder that receives non-US currency from the sale, exchange or other disposition of a Subordinated Debt Security generally will realize an amount equal to the US dollar value of such non-US currency translated at the spot rate of exchange on the settlement date of such sale, exchange or other disposition if (i) such Subordinated US Holder is a cash basis or electing accrual basis taxpayer and the Subordinated Debt Security is treated as being "traded on an established securities market" or (ii) such settlement date is also the date of such sale, exchange or other disposition. Such Subordinated US Holder generally will have a basis in such non-US currency equal to the US dollar value of such non-US currency on the settlement date. Any gain or loss on a conversion or other disposition of such non-US currency by such Subordinated US Holder generally will be treated as ordinary income or loss from sources within the United States. Each Subordinated US Holder should consult its own tax advisor regarding the US federal income tax consequences of receiving non-US currency from the sale, exchange or other disposition of a Subordinated Debt Security in cases not described in the first sentence of this paragraph.

Passive Foreign Investment Company Considerations

In general, a corporation organized outside the United States will be treated as a passive foreign investment company ("PFIC") in any taxable year in which either (i) at least 75% of its gross income is "passive income" or (ii) on average at least 50% of the value of its assets is attributable to assets that produce passive income or are held for the production of passive income. We believe that we were not in our taxable year ending in 2015, and we do not currently expect to become, a PFIC for US federal income tax purposes. However, because this determination is made annually at the end of each taxable year and is dependent upon a number of factors, some of which are beyond our control, such as the value of our assets (including goodwill) and the amount and type of our income, there can be no assurance that we will not be a PFIC in any taxable year or that the IRS will agree with our conclusion regarding its PFIC status in any taxable year.

If we are a PFIC in any taxable year, Subordinated US Holders could suffer adverse consequences, including the possible characterization of any gain from the sale, exchange or other disposition of a Subordinated Debt Security as ordinary income (rather than capital gain) and an interest charge on a portion of the resulting tax liability. Each Subordinated US Holder should consult its own tax advisor regarding the US federal income tax consequences if we are a PFIC during its holding period for the Subordinated Debt Securities.

Conversion of the Subordinated Debt Securities into Ordinary Shares

If a Subordinated Debt Security is Converted and a Subordinated US Holder receives solely Ordinary Shares, such Subordinated US Holder generally will not recognize any income, gain or loss upon such Conversion. A Subordinated US Holder's tax basis in Ordinary Shares received upon Conversion of a Subordinated Debt Security generally will be the same as such Subordinated US Holder's adjusted tax basis in such Subordinated Debt Security at the time of Conversion, and the holding period for Ordinary Shares so received generally will include the holding period of the Subordinated Debt Security Converted.

Under certain circumstances, in connection with a Conversion, we may issue Ordinary Shares to the Holders' Nominee and those Ordinary Shares would be sold by the Holders' Nominee for the benefit of the applicable Subordinated US Holder. Such a sale should be treated for US federal income tax purposes as a sale of such Ordinary Shares by such Subordinated US Holder. See " Sale, Exchange, Redemption, Write-off or Other Disposition of the Subordinated Debt Securities."

Ordinary Shares

The material US federal income tax considerations relating to the ownership and disposition of Ordinary Shares received in a Conversion would generally be the same as the material US federal income tax considerations relating to the ownership and disposition of Subordinated Debt Securities described herein.

Alternative Classification of the Subordinated Debt Securities

As noted above, it is possible that the Subordinated Debt Securities could be treated as indebtedness for US federal income tax purposes. If the Subordinated Debt Securities were so treated, the material US federal income tax considerations for Subordinated US Holders would generally be those described above under " Senior Debt Securities", rather than those described under " Subordinated Debt Securities". Furthermore, in some circumstances, the Subordinated Debt Securities may be treated as "contingent payment debt instruments", in which case a Subordinated US Holder might be required to accrue income on a Subordinated Debt Security in excess of stated interest and original issue discount, if any, and to treat as ordinary income, rather than capital gain, gain recognized on the disposition of such Subordinated Debt Security. Moreover, it is unclear how a

Conversion of a Subordinated Debt Security should be treated for US federal income tax purposes, and each Subordinated US Holder should consult its own tax advisor regarding the US federal income tax consequences of a Conversion.

Medicare Tax

In addition to regular US federal income tax, certain Subordinated US Holders that are individuals, estates or trusts are subject to a 3.8% tax on all or a portion of their "net investment income", which may include all or a portion of their income arising from a distribution with respect to a Subordinated Debt Security and net gain from the sale, exchange, redemption or other disposition of a Subordinated Debt Security.

Backup Withholding and Information Reporting

Backup withholding and information reporting requirements generally apply to interest and principal payments made to, and the proceeds of sales by, certain non-corporate Subordinated US Holders. A Subordinated US Holder not otherwise exempt from backup withholding generally can avoid backup withholding by providing a properly executed IRS Form W-9. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules generally will be allowed as a refund or a credit against a Subordinated US Holder's US federal income tax liability, provided the required information is timely furnished by such Subordinated US Holder to the IRS.

Disclosure Requirements for Certain Holders Recognizing Significant Losses

A Subordinated US Holder that participates in any "reportable transaction" (as defined in the Treasury Regulations) must attach to its US federal income tax return a disclosure statement on IRS Form 8886. Each Subordinated US Holder should consult its own tax advisor regarding the possible obligation to file IRS Form 8886 reporting foreign currency loss arising from the Subordinated Debt Securities or any amounts received with respect to the Subordinated Debt Securities.

Disclosure Requirements for Specified Foreign Financial Assets

Individual Subordinated US Holders (and certain US entities specified in US Treasury Department guidance) who, during any taxable year, hold any interest in any "specified foreign financial asset" generally will be required to file with their US federal income tax returns certain information on IRS Form 8938 if the aggregate value of all such assets exceeds certain specified amounts. "Specified foreign financial asset" generally includes any financial account maintained with a non-US financial institution and may also include the Subordinated Debt Securities if they are not held in an account maintained with a financial institution. Substantial penalties may be imposed, and the period of limitations on assessment and collection of US federal income taxes may be extended, in the event of a failure to comply. Each Subordinated US Holder should consult its own tax advisor regarding the possible application of this filing requirement.

FATCA Withholding

It is possible that, in order to comply with FATCA, we (or, if the Debt Securities or the Ordinary Shares are held through another financial institution, such other financial institution) may be required (pursuant to an agreement entered into with the United States or under applicable law (including pursuant to the terms of any applicable intergovernmental agreement entered into between the United States and any other jurisdiction)) (i) to request certain information from holders or beneficial owners of the Debt Securities or the Ordinary Shares, which information may be provided to the IRS, and (ii) to withhold US tax on some portion of payments made after December 31, 2018 with respect to the Debt Securities, with respect to the issuance of any Ordinary Shares upon any Conversion or with

respect to the Ordinary Shares if such information is not provided or if payments are made to certain foreign financial institutions that have not entered into a similar agreement with the United States (and are not otherwise required to comply with the FATCA regime under applicable law (including pursuant to the terms of any applicable intergovernmental agreement entered into between the United States and any other jurisdiction)).

If we or any other person are required to withhold or deduct amounts arising under or in connection with FATCA from any payments made with respect to the Debt Securities, with respect to the issuance of any Ordinary Shares upon any Conversion or with respect to the Ordinary Shares, holders and beneficial owners of the Debt Securities, and the holders and beneficial owners of the Ordinary Shares issued upon any Conversion, will not be entitled to receive any gross up or other additional amounts on account of any such withholding or deduction. FATCA is complex and its application to the Debt Securities, any Conversion and the Ordinary Shares remains uncertain. Each holder and beneficial owner should consult its own tax advisor regarding the application of FATCA to the Debt Securities, any Conversion and the Ordinary Shares.

Australian Taxation

THE FOLLOWING IS A SUMMARY OF THE AUSTRALIAN WITHHOLDING TAX TREATMENT UNDER THE INCOME TAX ASSESSMENT ACTS OF 1936 AND 1997 OF AUSTRALIA (TOGETHER, "THE AUSTRALIAN TAX ACT") AND THE TAXATION ADMINISTRATION ACT 1953 OF AUSTRALIA AT THE DATE OF THIS PROSPECTUS OF PAYMENTS OF INTEREST BY WESTPAC ON THE DEBT SECURITIES AND CERTAIN OTHER MATTERS RELEVANT TO HOLDERS OF DEBT SECURITIES ("HOLDERS").

THE FOLLOWING SUMMARY IS NOT EXHAUSTIVE AND, IN PARTICULAR, DOES NOT DEAL WITH THE POSITION OF CERTAIN CLASSES OF HOLDERS (INCLUDING, WITHOUT LIMITATION, AUSTRALIAN RESIDENTS, NON-RESIDENTS THAT HOLD THE DEBT SECURITIES THROUGH A PERMANENT ESTABLISHMENT IN AUSTRALIA, DEALERS IN SECURITIES, OR CUSTODIANS OR THIRD PARTIES THAT HOLD THE DEBT SECURITIES ON BEHALF OF ANY PERSON). NOR DOES IT DEAL WITH DEBT SECURITIES ISSUED BY WESTPAC FROM A BRANCH OUTSIDE AUSTRALIA, OR WITH DUAL CURRENCY/PARTLY PAID OR INDEXED DEBT SECURITIES. IF SUCH DEBT SECURITIES ARE ISSUED, THEIR AUSTRALIAN TAXATION TREATMENT WILL BE SUMMARISED IN THE RELEVANT FINAL TERMS, APPLICABLE PROSPECTUS SUPPLEMENT OR TERM SHEET.

THE FOLLOWING SUMMARY IS A GENERAL GUIDE AND SHOULD BE TREATED WITH APPROPRIATE CAUTION. IT IS NOT INTENDED TO BE, NOR SHOULD IT BE CONSTRUED AS, LEGAL OR TAX ADVICE TO ANY PARTICULAR HOLDER. PROSPECTIVE HOLDERS SHOULD BE AWARE THAT THE PARTICULAR TERMS OF ISSUE OF ANY SERIES OF DEBT SECURITIES MAY AFFECT THE TAX TREATMENT OF THAT AND OTHER SERIES OF DEBT SECURITIES. HOLDERS SHOULD CONSULT THEIR PROFESSIONAL ADVISERS.

Australian interest withholding tax ("IWT")

Generally, payments of principal and interest on the Debt Securities made by Westpac to a Holder that is not a resident of Australia for Australian tax purposes (a "Non-Resident") (other than one deriving the interest in carrying on business in Australia at or through a permanent establishment in Australia) will not be subject to Australian taxes or duties other than IWT at a rate of 10% of the amount of an interest payment. However, IWT will not be payable if an exemption applies.

For IWT purposes, "interest" is defined to include amounts in the nature of, or paid in substitution for, interest and certain other amounts. Any premium or issue discount would be interest for these purposes.

There are also specific rules that can apply to treat a portion of the purchase price of the Debt Securities as interest for IWT purposes when Debt Securities that are originally issued at a discount, or with a maturity premium, or which do not pay interest at least annually, are sold by a Non-Resident (other than one holding the Debt Securities as part of a business carried on by it at or through a permanent establishment in Australia) to:

- a resident of Australia for Australian tax purposes (a "Resident") that does not acquire them in carrying on business at or through a permanent establishment in a country outside Australia; or

- a Non-Resident that acquires them in carrying on business in Australia at or through a permanent establishment in Australia.

Exemption from IWT under section 128F of the Australian Tax Act ("section 128F")

Interest on the Debt Securities will be exempt from IWT if the requirements of section 128F are satisfied in relation to the Debt Securities.

Westpac proposes to issue the Debt Securities in a manner which will satisfy the requirements of section 128F.

The exemption from IWT available under section 128F is not intended to apply to related party loans. In particular, in order for that exemption to apply, Westpac must not have known or had reasonable grounds to suspect, at the time of their issue, that any of the Debt Securities, or an interest in the Debt Securities, were being or would later be acquired either directly or indirectly by an Offshore Associate of Westpac (other than one acting in the capacity of a dealer, manager or underwriter in relation to the placement of the Debt Securities or in the capacity of a clearing house, custodian, funds manager or responsible entity of a registered scheme (as defined in the Corporations Act 2001 of Australia)).

In addition, the exemption from IWT available under section 128F will not apply if, at the time of an interest payment in respect of the Debt Securities, Westpac knew or had reasonable grounds to suspect that the recipient of the payment was an Offshore Associate of Westpac (other than one receiving the payment in the capacity of a clearing house, paying agent, custodian, funds manager or responsible entity of a registered scheme (as defined in the Corporations Act 2001 of Australia)).

For these purposes, an Offshore Associate means an associate (as defined in section 128F) of Westpac that is either:

- a Non-Resident that does not acquire the Debt Securities or an interest in the Debt Securities and does not receive all payments under them in carrying on business in Australia at or through a permanent establishment in Australia; or

- a Resident that acquires the Debt Securities or an interest in the Debt Securities and receives payments under them in carrying on business at or through a permanent establishment in a country outside Australia.

Accordingly, if you are an Offshore Associate of Westpac, you should not acquire any of the Debt Securities.

Payment of additional amounts because of a deduction or withholding in respect of IWT

If Westpac is, at any time, compelled by law to deduct or withhold an amount in respect of IWT, then it must, subject to certain exceptions, pay such additional amounts as may be necessary in order to ensure that the aggregate amounts received by the Holders after such deduction or withholding equal the amounts that would have been received by them had no such deduction or withholding been required.

It is noted that Westpac will not be obliged to pay such additional amounts on account of IWT which is payable by reason of the Holder being an associate (as defined in section 128F) of Westpac.

Withholding for failure to provide Tax File Number ("TFN") / Australian Business Number ("ABN")

Westpac is required to deduct and withhold tax from payments of interest at a rate that is currently 49% for the 2016-17 income year (and, under current law, will be reduced to 47% following the 2016-17 income year) on the Debt Securities unless a TFN or, in certain circumstances, an ABN has been provided to Westpac by the Holder, or the Holder has supplied Westpac with proof of some other relevant exemption.

Provided that the requirements of section 128F have been satisfied with respect to the Debt Securities, the TFN / ABN withholding rules will not apply to payments to Holders that are Non Residents and do not hold the Debt Securities in carrying on business in Australia at or through a permanent establishment in Australia.

Westpac will not be obliged to pay additional amounts on account of taxes deducted or withheld on payments made in respect of Debt Securities presented for payment by a Holder that could lawfully avoid (but has not so avoided) such deduction or withholding by complying with any statutory requirements or making a declaration of non-residence or other claim or filing for exemption.

Other Australian withholding taxes

Non-resident withholding tax

Under section 12-315 of Schedule 1 to the Taxation Administration Act 1953 of Australia ("TAA"), regulations may be made that require amounts to be withheld on account of tax liabilities of Non-Residents from certain payments that are made by an Australian entity to such Non-Residents.

These rules do not currently apply to payments in relation to the Debt Securities. However, the possible application of any future regulations to payments received by Non-Residents in respect of the Debt Securities will need to be monitored.

Supply withholding tax

Payments in respect of the Debt Securities will be able to be made free and clear of the "supply withholding tax" imposed under section 12-190 of Schedule 1 to the TAA.

Other Australian tax matters

Gains on disposal of Debt Securities by Non-Residents

Non-Residents that have never held their Debt Securities in the course of carrying on business at or through a permanent establishment within Australia will not be subject to Australian income tax on gains realized by them on the sale or redemption of the Debt Securities provided that such gains do not have an Australian source. A gain arising on the sale of Debt Securities by a Non Resident Holder to another Non Resident where the Debt Securities are sold outside Australia and all negotiations are conducted, and documentation executed, outside Australia would not generally be regarded as having an Australian source.

Conversion of Debt Securities

If a Conversion (including a partial Conversion) of the Subordinated Debt Securities occurs, the Australian tax consequences that may arise for holders are complex. Broadly, in certain circumstances, any gain or loss that may otherwise arise upon a Conversion of the Subordinated Debt Securities may be disregarded under the Australian Tax Act. There are also a range of tax consequences that may

apply to holders of Ordinary Shares in acquiring, holding and disposing of Ordinary Shares. Holders should seek their own taxation advice in relation to the tax consequences if the Subordinated Debt Securities are converted into Ordinary Shares.

Garnishee directions

The Commissioner of Taxation for Australia may give a direction under section 255 of the Australian Tax Act or section 260-5 of Schedule 1 to the TAA or any similar provision requiring Westpac to deduct or withhold from any payment to any other party (including any Holder) any amount in respect of tax payable by that other party. If Westpac is served with such a direction, Westpac intends to comply with that direction and make any deduction or withholding required by that direction.

Goods and services tax ("GST")

Neither the issue, nor the receipt, of the Debt Securities will give rise to a liability for GST in Australia on the basis that the supply of the Debt Securities will comprise either an "input taxed financial supply" or (in the case of a supply to a Non-Resident Holder outside Australia) a "GST-free supply". Furthermore, neither the payment of principal or interest by Westpac, nor the disposal or redemption of the Debt Securities, would give rise to any GST liability in Australia.

Estate duties

No Debt Securities will be subject to death, estate or succession duties imposed by Australia, or by any political subdivision or authority therein having power to tax, if held at the time of death.

Stamp duties

No ad valorem stamp, issue, registration or similar taxes are payable in Australia on the issue or transfer of any Debt Securities.

PLAN OF DISTRIBUTION

We may sell the Debt Securities and Ordinary Shares from time to time in one or more transactions. We may sell securities pursuant to the registration statement to or through agents, underwriters, dealers or other third parties or directly to one or more purchasers or through a combination of any of these methods. In some cases, we or the dealers acting with us or on behalf of us may also purchase securities and reoffer them to the public. We may also offer and sell, or agree to deliver, securities pursuant to, or in connection with, any option agreement or other contractual arrangement.

Agents whom we designate may solicit offers to purchase the securities.

We will name any agent involved in offering or selling securities, and disclose any commissions that we will pay to the agent, in the applicable prospectus supplement or term sheet.

Unless we indicate otherwise in the applicable prospectus supplement or term sheet, agents will act on a best efforts basis for the period of their appointment.

Agents may be deemed to be underwriters under the Securities Act of any of the securities that they offer or sell.

We may use an underwriter or underwriters in the offer or sale of the securities.

We will execute an underwriting agreement with any underwriter or underwriters at the time that we reach an agreement for the sale of the securities.

We will include the names of the specific managing underwriter or underwriters, as well as the names of any other underwriters, and the terms of the transactions, including the compensation the underwriters and dealers will receive, in the applicable prospectus supplement or term sheet.

The underwriters will use the applicable prospectus supplement or term sheet to sell the securities.

We may use a dealer to sell the securities.

If we use a dealer, we, as principal, will sell the securities to the dealer.

The dealer will then sell the securities to the public at varying prices that the dealer will determine at the time it sells the securities.

We will include the name of the dealer and the terms of the transactions with the dealer in the applicable prospectus supplement or term sheet.

We may solicit directly offers to purchase the securities, and we may directly sell the securities to institutional or other investors. We will describe the terms of direct sales in the applicable prospectus supplement or term sheet.

We may engage in at the market offerings into an existing trading market in accordance with Rule 415(a)(4) of the Securities Act.

We may indemnify agents, underwriters and dealers against certain liabilities, including liabilities under the Securities Act. Agents, underwriters and dealers, or their affiliates, may be customers of, engage in transactions with or perform services for us, in the ordinary course of business.

We may authorize agents and underwriters to solicit offers by certain institutions to purchase the securities at the public offering price under delayed delivery contracts.

If we use delayed delivery contracts, we will disclose that we are using them in the prospectus supplement or term sheet and will tell you when we will demand payment and delivery of the securities under the delayed delivery contracts.

These delayed delivery contracts will be subject only to the conditions that we describe in the prospectus supplement or term sheet.

We will describe in the applicable prospectus supplement or term sheet the commission that underwriters and agents soliciting purchases of the securities under delayed contracts will be entitled to receive.

Until the distribution of the securities is completed, rules of the SEC may limit the ability of underwriters and other participants in the offering to bid for and purchase the securities. As an exception to these rules, the underwriters in certain circumstances are permitted to engage in certain transactions that stabilize the price of the securities. Such transactions consist of bids or purchases for the purpose of pegging, fixing or maintaining the price of the securities. If the underwriters create a short position in the securities in connection with the offering by selling more securities than are set forth on the cover page of the applicable prospectus supplement or in the term sheet, the underwriters may reduce that short position by purchasing securities in the open market. The underwriters also may impose a penalty bid on certain underwriters. This means that if the underwriters purchase the securities in the open market to reduce the underwriters' short position or to stabilize the price of the securities, they may reclaim the amount of the selling concession from the underwriters who sold those securities as part of the offering. In general, purchases of a security for the purpose of stabilization or to reduce a short position could cause the price of the security to be higher than it might be in the absence of such purchases. The imposition of a penalty bid might also have an effect on the price of a security to the extent that it were to discourage resales of the security.

WHERE YOU CAN FIND MORE INFORMATION

We file annual and other reports and other information with the SEC under the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. This information may be read and copied at the Public Reference Room of the SEC at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of these public reference facilities. The SEC maintains an Internet site, *http://www.sec.gov*, which contains reports, proxy and information statements and other information regarding issuers that are subject to the SEC's reporting requirements.

You may request a copy of any filings (excluding exhibits) referred to above and in "Incorporation of Information We File with the SEC" at no cost by contacting us at the following address: Westpac Banking Corporation, New York Branch, 575 Fifth Avenue, 39th Floor, New York, New York 10017-2422, Attention: Branch Manager. Telephone requests may be directed to such person at (212) 551-1800.

This prospectus is part of a registration statement that we have filed with the SEC relating to the Debt Securities to be offered. This prospectus does not contain all of the information we have included in the registration statement and the accompanying exhibits and schedules in accordance with the rules and regulations of the SEC, and we refer you to the omitted information. The statements this prospectus makes pertaining to the content of any contract, agreement or other document that is an exhibit to the registration statement necessarily are summaries of their material provisions and do not describe all exceptions and qualifications contained in those contracts, agreements or documents. You should read those contracts, agreements or documents for information that may be important to you. The registration statement, exhibits and schedules are available at the SEC's Public Reference Room or through its Internet site.

INCORPORATION OF INFORMATION WE FILE WITH THE SEC

The SEC allows us to incorporate by reference the information we file with them, which means:

- incorporated documents are considered part of this prospectus;
- we can disclose important information to you by referring you to those documents; and
- information that we file with the SEC will automatically update and supersede this prospectus and previously incorporated information.

We incorporate by reference the documents listed below which were filed with the SEC under the Exchange Act:

- our annual report on Form 20-F for the financial year ended September 30, 2016; and
- the information contained in Exhibit 1 to our report on Form 6-K dated November 8, 2016.

We also incorporate by reference each of the following documents that we file with the SEC after the date of this prospectus until this offering is completed:

- reports filed under Sections 13(a) and (c) of the Exchange Act, including reports on Form 6-K if and to the extent specified in such report as being incorporated by reference in this prospectus; and
- any reports filed under Section 15(d) of the Exchange Act.

You should assume that the information appearing in this prospectus is accurate as of the date of this prospectus only. Our business, financial condition and results of operations may have changed since that date.

ENFORCEABILITY OF FOREIGN JUDGMENTS IN AUSTRALIA

Westpac is a company incorporated in Australia under the Australian Corporations Act and registered in New South Wales, having its registered office at Level 20, Westpac Place, 275 Kent Street, Sydney, New South Wales 2000, Australia. In order to enforce a final, unsatisfied and conclusive judgment for the payment of a fixed or readily calculable sum of money rendered by any New York State or United States federal court having jurisdiction under its own domestic laws, and within whose jurisdiction Westpac was carrying on business at the time of commencement of the proceedings in which such judgment was rendered, with respect to any liability of Westpac with respect to any securities, it is necessary for the judgment creditor to bring separate proceedings as a new cause of action based on such judgment in the courts of competent jurisdiction of New South Wales or Australia against Westpac. Subject to the matters set forth under the heading "Description of the Debt Securities Description of the Senior Debt Securities Events of Default" and "Description of the Debt Securities Description of the Subordinated Debt Securities Events of Default", those courts could reasonably be expected in the circumstances to give conclusive effect to such judgment for the purpose of the proceedings. Westpac has expressly submitted to the jurisdiction of New York State and United States federal courts sitting in The City of New York for the purpose of any suit, action or proceedings arising out of the offering and sale of any securities. Westpac has appointed its New York branch, 575 Fifth Avenue, 39th Floor, New York, New York 10017-2422, Attention: Branch Manager, as its agent upon whom process may be served in any such action.

All of the directors and executive officers of Westpac, and the independent accountants named herein, reside outside the United States. Substantially all or a substantial portion of the assets of all or many of such persons are located outside the United States. As a result, it may not be possible for holders of securities to effect service of process within the United States upon such persons. In addition, it may not be possible for holders of securities to enforce against such persons judgments obtained in United States courts predicated upon the civil liability provisions of federal securities laws of the United States. Westpac has been advised by its Australian counsel, King & Wood Mallesons, that there is doubt as to the enforceability in Australia, in original actions or in actions for enforcement of judgments of United States courts, of civil liabilities predicated upon the federal securities laws of the United States.

CURRENCY OF PRESENTATION AND EXCHANGE RATES

We publish our consolidated financial statements in Australian dollars.

The following table sets forth, for Westpac's financial years indicated, the high, low, average and period-end noon buying rates in New York City for cable transfers of Australian dollars as certified for customs purposes by the Federal Reserve Bank of New York, expressed in US dollars per A$1.00. Westpac's fiscal year ends on September 30 of each year.

Financial Year	At Period End	Average Rate(1)	High	Low
2012	1.0388	1.0371	1.0806	0.9453
2013	0.9342	0.9885	1.0579	0.8901
2014	0.8737	0.9155	0.9705	0.8715
2015	0.7020	0.7781	0.8904	0.6917
2016	0.7667	0.7385	0.7817	0.6855
2017(2)	0.7669	0.7640	0.7715	0.7545

(1) The average of the noon buying rates on the last day of each month or portion thereof during the period.

(2) Through November 4, 2016.

80

Regulations in Australia restrict or prohibit payments, transactions and dealings with assets having a proscribed connection with certain countries or named individuals or entities subject to international sanctions or associated with terrorism.

VALIDITY OF SECURITIES

Debevoise & Plimpton LLP, our New York counsel, will pass, on our behalf, on the validity of the Debt Securities described in this prospectus with respect to New York law. King & Wood Mallesons, our Australian counsel, will pass, on our behalf, on the validity of the Debt Securities and Ordinary Shares with respect to Australian law. Debevoise & Plimpton LLP may rely on the opinion of King & Wood Mallesons on matters of Australian law.

EXPERTS

The financial statements and management's assessment of the effectiveness of internal control over financial reporting (which is included in Management's Report on Internal Control Over Financial Reporting), incorporated in this prospectus by reference to the Annual Report on Form 20-F of Westpac Banking Corporation for the year ended September 30, 2016, have been so incorporated in reliance on the report of PricewaterhouseCoopers, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting. PricewaterhouseCoopers is a member of Chartered Accountants Australia and New Zealand.

LIMITATION ON INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM'S LIABILITY

The liability of PricewaterhouseCoopers (an Australian partnership which we refer to as PwC Australia) with respect to claims arising out of its audit report described under "Experts" above, is subject to the limitations set forth in the Professional Standards Act 1994 of New South Wales, Australia, which we refer to as the Professional Standards Act, and Chartered Accountants Australia and New Zealand (NSW) Scheme adopted by Chartered Accountants Australia and New Zealand on October 8, 2014 and approved by the New South Wales Professional Standards Council pursuant to the Professional Standards Act, which we refer to as the NSW Accountants Scheme. For matters occurring on or prior to October 7, 2014, the liability of PwC Australia may be subject to the limitations set forth in predecessor schemes. The current NSW Accountants Scheme expires on October 7, 2019 unless further extended or replaced.

The Professional Standards Act and the NSW Accountants Scheme may limit the liability of PwC Australia for damages with respect to certain civil claims arising in, or governed by the laws of, New South Wales directly or vicariously from anything done or omitted to be done in the performance of its professional services for us, including, without limitation, its audits of our financial statements. The extent of the limitation depends on the timing of the relevant matter and is:

- in relation to matters occurring on or after October 8, 2013, a maximum liability for audit work of A$75 million; or

- in relation to matters occurring on or prior to October 7, 2013, to the lesser of (in the case of audit services) ten times the reasonable charge for the service provided and a maximum liability for audit work of A$75 million.

The limitations do not apply to claims for breach of trust, fraud or dishonesty.

In addition, there is equivalent professional standards legislation in place in other states and territories in Australia and amendments have been made to a number of Australian federal statutes to limit liability under those statutes to the same extent as liability is limited under state and territory laws by professional standards legislation. Accordingly, liability for acts or omissions by PwC Australia in Australian states or territories other than New South Wales may be limited in a manner similar to that

in New South Wales. These limitations of liability may limit recovery upon the enforcement in Australian courts of any judgment under US or other foreign laws rendered against PwC Australia based on or related to its audit report on our financial statements. Substantially all of PwC Australia's assets are located in Australia. However, the Professional Standards Act and the NSW Accountants Scheme have not been subject to judicial consideration and therefore how the limitation might be applied by the courts and the effect of the limitation on the enforcement of foreign judgments are untested.

US$

Westpac Banking Corporation

(ABN 33 007 457 141)

% Subordinated Notes due 2031

Subject, upon the occurrence of a Non-Viability Trigger Event, to Conversion or possible Write-off, as more fully described in the accompanying prospectus

PROSPECTUS SUPPLEMENT

November , 2016

Joint Book-Running Managers

BofA Merrill Lynch **Citigroup** **J.P. Morgan** **Morgan Stanley**