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# U P D A T E

## News of Developments in the Financial Sector and Related Areas

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### *Preferred Stock*

In recent years bank holding companies and other financial institutions have become one of the largest issuers of preferred stock. The issuance of traditional preferred stock by a bank holding company will normally qualify as tier 1 capital. There are basically four types of preferred stock: (i) cumulative preferred, (ii) noncumulative preferred, (iii) participating preferred, and (iv) convertible preferred. Preferred stock will generally pay dividends either as a percent of par value or a specific dollar amount and are paid quarterly. In most cases preferred stock does not have voting rights and dividends will be cumulative.

Preferred stock is senior to common stock but is junior to creditors and bondholders. It is not unusual for preferred stock to have a call provision that allows the issuer to call the shares at any time or after a specific period of time such as five years.

Preferred stock may be cumulative or noncumulative. Cumulative preferred stock allows the holder to obtain dividend payments which were not paid in a timely manner by the issuer. If the issuer misses one or more dividend payments, then the holder has the right to receive these missed payments before any dividends can be paid to the holders of the issuer's common stock. However, a holder of noncumulative shares does not have this right. In Interpretive Letter No. 1086, the Office of the Comptroller of the Currency authorizes a national bank to own fixed-rate cumulative preferred stock.

Participating preferred stock allows the holder to receive earnings over and above a specified dividend amount. Participating preferred stock is sometimes utilized as a poison pill in the event of an unwanted takeover by allowing the existing holders to buy more shares at a substantially reduced price.

Convertible preferred allows the holder to convert the shares into the issuer's common stock at a preset conversion price. Since convertible preferred stock allows for the opportunity for capital appreciation through the conversion into the issuer's common stock, the dividend will generally be lower than the dividend on non-convertible preferred stock.

A variation of preferred stock is known as trust preferred. Trust preferred stock has been the more prevalent form of preferred securities issued by bank holding companies. Section 171(b)(5) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 allows a small bank holding company with consolidated assets under $500 million to issue trust preferred securities. The Federal Reserve Board's Small Bank Holding Company Policy generally provides that a small bank holding company is only tested for capital at the subsidiary bank level. As a result, there is no capital requirement at the holding company level of a small bank holding company and the proceeds from the sale of trust preferred securities can be contributed by the holding company to its subsidiary bank as additional tier 1 capital. Approximately 80% of all banking institutions in the United States are less than $500 million in asset size.

A key advantage of trust preferred securities to bank holding companies is that for tax purposes the dividends paid on trust preferred securities, unlike those paid on traditional issued preferred stock, are a tax deductible interest expense. Although a Subchapter S corporation may not have more than one class of stock, trust preferred securities are not considered a separate class of stock and purchasers of trust preferred securities are not counted as additional shareholders in connection with the 100 shareholder limitation on a Subchapter S corporation.

Trust preferred securities are typically issued as non-perpetual cumulative preferred stock by a wholly-owned trust subsidiary of a small bank holding company. The small bank holding company owns all of the common stock of the trust subsidiary. Revenue from the sale of the trust preferred securities by the trust subsidiary is exchanged for junior subordinated debentures issued by the small bank holding company. The debentures feature a coupon payment and term to maturity, which are identical to those of the trust preferred securities. Payments on the subordinated debt and the trust preferred securities are "interest only" until maturity.

In Interpretive Letter No. 908, the Office of the Comptroller of Currency ("OCC") held that trust preferred securities may be purchased and treated as loans by national banks. The OCC noted that trust preferred securities are instruments that possess characteristics particularly associated with debt securities. Before purchasing trust preferred securities as loans, the OCC noted that a national bank should conduct a complete review of relevant credit information and loan administration practices, and determine that the purchase meets the bank's own internal loan underwriting standards. The interpretive ruling by the OCC provides a vehicle for a small bank holding company to convert debt to equity while allowing a bank purchaser of the trust preferred securities to treat the purchases as loans.

Another form of preferred stock is known as noncumulative perpetual preferred stock. Noncumulative perpetual preferred stock is an excellent alternative to all bank holding companies including small bank holding companies. Although common stock should generally be the dominate form of capital for a bank holding company, noncumulative perpetual preferred qualifies as capital for all bank holding companies.

Noncumulative perpetual preferred may be issued at both the bank holding company level and the bank level in order to increase capital. Because noncumulative perpetual preferred is considered a separate class of stock, Subchapter S corporations are not eligible since they can only have one class of stock.

A coupon payment on noncumulative perpetual preferred is similar to trust preferred, and the issuer has the option to call the securities after five (5) years. Any redemption of noncumulative perpetual preferred is subject to regulatory approval. Noncumulative perpetual preferred has no voting rights and is perpetual, meaning that it has no final maturity date. Quarterly dividends are subject to board approval and are noncumulative if not paid. Unlike dividends paid on trust preferred securities, dividends paid on noncumulative perpetual preferred are not a tax deductible interest expense.

Our firm is available to answer questions on the benefits of issuing preferred stock and the placement of it with local investors and third parties.

 **Comments, ideas, opinions and questions - email gbinns@ddh-ar.com - telephone (501) 375-9151 - facsimile (501) 372-7142.**