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OCTOBER 2008

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 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 five years. The dividends on traditional preferred stock are taxed at the qualified dividend income rate of 15%. The dividends on traditional preferred stock to any incorporated investor are 70% tax-exempt. Therefore, a corporation with a 34% tax rate pays only $10.20 on every $100 in dividends versus $34.00 in tax on every $100 from interest payments.

Another form of preferred stock is known as convertible preferred. 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.

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.

Preferred stock may also 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 recent years, trust preferred stock has been the more prevalent form of preferred securities issued by bank holding companies. Under regulations adopted by the Federal Reserve Board, bank holding companies may include trust preferred securities in tier 1 capital in an amount equal to 25% of all core capital elements (including trust preferred securities).

Amounts of restricted core capital elements in excess of this limit generally will be included in tier 2 capital. Although a Subchapter S corporation cannot 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. A significant advantage to the issuance of trust preferred stock over traditional preferred stock is that the dividends are deductible to the issuer while dividends paid on traditional preferred stock are not. Trust preferred stock is senior to traditional preferred stock, but it is junior to other senior debt.

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.

Bank Failures

During the first eight months of this year there have been 10 bank failures. The FDIC expects that bank failures will increase in the coming months. According to information published by the FDIC, there were 117 institutions with total assets of $78 billion on the FDIC problem bank list at the end of the second quarter 2008 reflecting an increase of $26 billion from the end of the first quarter of 2008. According to the FDIC's *Quarterly Banking Profile*, loans that were noncurrent (90 days or more past due or in a nonaccrual status) increased by twenty percent during the second quarter of this year. The insurance premium rates paid by banks will increase as a result of bank failures with some institutions paying a higher rate based on the risk related to a particular institution.

Identity Theft Red Flags Rules

Final rules regarding the detection, prevention and mitigation of identity theft known as the *Red Flags Rules* implementing sections 114 and 315 of the Fair Accurate Credit Transactions Act (the "FACT Act") require compliance no later than November 1, 2008, by users of consumer credit reports, creditors, financial institutions, and issuers of payment cards.

Users of consumer credit reports must implement reasonable policies and procedures for dealing with discrepancies between the consumer's address on file with the company and the address identified in the consumer's credit report upon receipt of an address discrepancy notice from a consumer reporting agency. The final rules require at a minimum that the user of a consumer credit report form a reasonable belief that a consumer report relates to the same consumer about whom the user requested the report. In certain circumstances, any user of consumer credit reports must furnish to the credit reporting agency an address for the consumer that the consumer reasonably believes is accurate. Under the final rules, financial institutions and other creditors that maintain consumer credit accounts that are designed to allow multiple payments or transactions are now required to develop and implement an identity theft prevention program. The final rules provide illustrated examples of identify theft flags such as a fictitious address on an application.

The final rules require any issuer of debit or credit cards to establish reasonable policies and procedures for assessing the validity of a consumer's request for change of address when the consumer shortly thereafter requests an additional or replacement card. The final rules are available on the website of the FDIC at *www.FDIC.gov*.

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