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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Subordinated Debt

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A number of bank holding companies and banks (sometimes referred to as the "issuer") have issued subordinated debt and continue to utilize subordinated debt for a number of reasons. The reasons may include increasing capital, funding investments in technology, acquisitions and other opportunities and replacing higher cost capital. In a low-rate environment, subordinated debt can be relatively inexpensive capital.

Subordinated debt is debt that ranks below other debts in the event the issuer falls into liquidation or bankruptcy. The debt is referred to as subordinated because the debt is paid only after other debt. Subordinated debt is basically an unsecured loan that is paid after other debts and loans are repaid in case of default by the issuer.

Subordinated debt are notes that are issued to investors by the issuer. To qualify as Tier 2 capital, bank regulators require that the notes have a maturity of at least five years, that the holder of the notes have no right to accelerate the debt prior to maturity except in limited circumstances, and the issuer have no right to redeem the notes within the first five years after issuance.
Bank holding companies will generally issue the subordinated debt as Tier 2 capital at the holding company level and downstream the proceeds to a subsidiary bank which then becomes Tier 1 capital. For bank holding companies with less than $3 billion in consolidated assets, the flexibility afforded by the Federal Reserve Board's Small Bank Holding Company Policy Statement ("Policy Statement") can make the subordinated debt a particularly attractive option for financing acquisitions and other growth investments.

The Policy Statement is designed to permit the creation of bank holding companies and also to allow for their expansion by allowing them to have debt levels in excess of what is otherwise allowed for larger bank holding companies. The consolidated asset limit was originally set at $500 million but has been increased three times to its present limit of $3 billion. Under the Policy Statement, if certain requirements are met, a bank holding company may use debt to finance up to 75% of the purchase price of an acquisition thus allowing the bank holding company to have a debt-to-equity ratio of up to 3:1. A qualifying bank holding company is also exempt from the Federal Reserve Board's risk-based capital and leverage rules.

Subordinated debt is advantageous to issuers because it is treated as equity for bank regulatory purposes and as debt for tax purposes. The notes are generally interest only while outstanding with a balloon principal payment due at the maturity of the notes. The interest payments are a tax-deductible expense while dividend payments on preferred stock are not tax-deductible. Subordinated debt does not dilute existing shareholders since it is not an equity instrument. Subordinated debt is useful to bank holding companies that are Subchapter S corporations. Although a Subchapter S corporation cannot have more than one class of stock, subordinated debt is not a separate class of stock and holders of the notes constituting the subordinated debt are not counted as additional shareholders.

Any redemption of the notes prior to maturity is subject to federal and state regulatory approvals. A default by the issuer in the payment of interest or principal may result in a holder of the notes declaring any remaining interest and principal on the notes due and payable. During a period of default by the issuer, the issuer will normally be prohibited from paying any dividends or making any distributions or redeeming or purchasing any of its capital stock.

The notes will generally contain a number of provisions including, but not limited to:

- The holders of the notes will be provided with financial statements on a periodic basis.

- The issuer will not merge or sale a substantial portion of its assets unless the notes are assumed by the acquirer of the assets or the continuing entity in case of a merger.

- The holders of the notes will be provided on an annual basis a certificate of compliance that the issuer has complied with the terms of the notes and is not in default.

The subordinated debt offering of notes to investors will be generally conducted in a private placement that is exempt from registration under state and federal securities laws. Sections 3(b) and 4(2) of the Securities Act of 1933 (the "1933 Act") may be utilized in making a private placement of the notes. Section 4(2), often referred to as the private offering exemption, is one of the more utilized exemptions in making private placements under the provisions of federal securities laws.

Section 4(2) exempts from registration transactions by an issuer not involving a public offering. The exemption has developed to include not only Section 4(2) transactions, but also transactions described in Section 3(b) of the 1933 Act. Sections 3(b) and 4(2) of the 1933 Act are the basis for Regulation D promulgated by the Securities and Exchange Commission.

Regulation D is designed to permit the sale of securities to sophisticated investors, which are also known as accredited investors.

The enactment of Regulation D sets forth the requirements for a substantial portion of private offerings. Although an issuer may fully comply with the requirements of federal law relating to a private placement, it must also comply with any applicable state law regarding the offer and sale of securities.

The notes in the offering to investors are defined as securities under both state and federal securities laws.

Our law firm is available to answer questions regarding the private placement of securities and the offering of subordinated debt.