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FINANCIAL AND BANK HOLDING COMPANY
ISSUANCE OF TRUST PREFERRED SECURITIES

TODD H. EVESON

I. INTRODUCTION

Since the first issuance of a “trust preferred” type security in 1993, the aggregate offering price of all trust preferred securities issued annually in the United States has steadily increased, while the same period has been characterized by a corresponding decrease in the aggregate offering price of all traditional preferred securities issued. This trend exists, in spite

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1. Texaco, Inc. is usually cited as the first issuer of a trust preferred security. See GEORGE BENSTON, PAUL IRVINE, JIM ROSENFIELD & JOSEPH F. SPIKEY, JR., FEDERAL RESERVE BANK OF ATLANTA, BANK CAPITAL STRUCTURE, REGULATORY CAPITAL AND SECURITIES INNOVATIONS, 6 (Oct. 2000) (working paper series). In October 1993, Texaco issued a hybrid security called 6-7/8% Cumulative Guaranteed Monthly Income Preferred Shares (“Mips”). Form 10-K of Texaco, Inc., as filed with the Securities and Exchange Commission on March 2, 1994, at http://www.sec.gov/Archives/edgar/data/973499/97349-94-0001515.txt (last visited Feb. 8, 2002). This security was the prototype for today’s trust preferred shares. Texaco’s hybrid involved the issuance of preferred shares by a limited liability company organized under the laws of the Turks & Caicos Islands, British West Indies. The proceeds from the sale of these securities were then loaned to Texaco, Inc. In this manner, Texaco was able to deduct from income the interest payments made to service the debt owed to the limited liability company. Texaco cited this advantage in its annual report for 1993. Id. Texaco, Inc. also effected a second issuance of its “Cumulative Guaranteed Monthly Income Preferred Shares” in September 1994. See Preliminary Prospectus Summary of Texaco, Inc. and Texaco Capital, LLC, as filed with the Securities and Exchange Commission on June 3, 1994 at http://www.sec.gov/Archives/edgar/data/97349.0000950112-94-0001515.txt (last visited Feb. 22, 2002).

Trust preferred securities are known by various acronyms, including TruPS (“trust preferred securities” or “trust pass-through securities”), Quies (“quarterly income capital securities”), Quips (“quarterly income preferred shares”), Skis (“subordinated capital income shares”), Toprs (“trust originated preferred shares”), and Mips (“monthly income preferred shares”).

2. See generally, Elizabeth Roy, Corts, Cahcos and Other Bond-Like Mutants, (Oct. 1, 1999) (stating that most preferred stock issued is of the trust preferred
of the higher transaction costs associated with an issuance of trust preferred securities as compared to those associated with an issuance of traditional preferred shares, because of the primary advantages of trust preferred securities: (1) they do not involve the direct issuance of equity and do not therefore dilute earnings per share or return on equity of the issuer; and (2) the disbursements paid by the issuer of a trust preferred security, unlike dividends paid on traditional preferred stock, are typically tax deductible.

Trust preferred securities achieve these advantages because they are "hybrid" securities, possessing favorable characteristics of both equity and debt. The "hybrid" nature of trust preferred securities derives from the fact that their issuance actually involves two offerings: first, the issuance of subordinated debt to a specially formed subsidiary of the issuer; and second, the issuance of equity, by that subsidiary, to investors. This subsidiary is typically a trust and the equity it issues is typically preferred stock, thus the name "trust preferred."

Trust preferred securities have become increasingly popular with financial holding companies and bank holding companies precisely because they are hybrid securities, possessing the favorable characteristics of both equity and debt. Until 1996, however, it was not clear whether trust preferred securities had

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3. BENSTON, ET AL., supra note 1, at 6. Higher transaction costs are due, in part, to the complexity of the transaction, but also to the fact that an issuance of trust preferred securities necessarily requires the retention of a trustee, along with the attendant fees of that trustee and its counsel. The problem of high transaction costs has been addressed by two developments: (1) "pooled" issuances of trust preferred securities, in which securities issued by several holding companies are "pooled" together in a second special purpose entity; and (2) the private placement of trust preferred securities.


5. Traditional preferred stock often is described as a "hybrid" security due to its debt-like traits relative to common stock. See JAMES D. COX, THOMAS L. HAZEN & F. HODGE O'NEAL, CORPORATIONS § 18.1 (1997). For purposes of this article, however, the term "hybrid" will be used to refer only to trust preferred securities.
enough equity characteristics to qualify as Tier 1 capital\textsuperscript{6} of a holding company. As a result, the utility of these securities was limited, at least from the standpoint of a bank holding company. All of this changed on October 21, 1996, when the Board of Governors of the Federal Reserve System ruled that the proceeds of trust preferred securities would, subject to certain limitations, qualify as Tier 1 capital of a holding company.\textsuperscript{7} Since the date of the Federal Reserve's ruling, trust preferred securities have become increasingly popular with holding companies, including many community bank holding companies, as a tool for generating Tier 1 capital.\textsuperscript{8}

Section II provides general background on the Federal Reserve's standards for classification of holding company capital, with special focus on the definition of Tier 1 capital and the treatment of trust preferred securities.\textsuperscript{9} Section III provides a general overview of the structure of a transaction involving the issuance of trust preferred securities by a holding company.\textsuperscript{10} Finally, because banks and bank holding companies have started to show interest in adding trust preferred securities to their investment portfolios, Section IV addresses recent rulings and interpretations of regulatory authorities relating to the purchase of trust preferred securities by financial institutions.\textsuperscript{11}

\textsuperscript{6} See infra notes 14-21 and accompanying text (discussing Tier 1 capital).


\textsuperscript{8} FEDERAL RESERVE BANK OF PHILADELPHIA, TRUST PREFERRED SECURITIES, SRC INSIGHTS 5 (Fourth Quarter, 1997) [hereinafter FED SRC INSIGHTS 97], available at http://www.phil.frb.org/src/srcinsights/srcinsights/fourth97.pdf (last visited Feb. 21, 2002). In fact, by June 30, 1997, approximately 100 bank holding companies had issued trust preferred securities. Id. By the end of 1999, bank holding companies had issued about $31 billion of trust preferred securities. See BENSTON, ET AL., supra note 1. The first bank holding company to issue trust preferred securities was First Bank Systems. Id. at fn 11.

Trust preferred securities have also become a popular choice for community bank holding companies. For instance, from 1997 through 2001, there were over eighty public offerings of trust preferred securities by bank holding companies in which the aggregate offering price of the securities offered was $25 million or less (statistics courtesy of Christopher Gastelu, Ryan, Beck & Co., LLC). Community bank holding companies are also starting to privately place trust preferred securities.

\textsuperscript{9} See infra notes 12-40 and accompanying text.

\textsuperscript{10} See infra notes 41-70 and accompanying text.

\textsuperscript{11} See infra notes 71-95 and accompanying text.
II. CAPITAL REGULATIONS OF THE FEDERAL RESERVE

The Board of Governors of the Federal Reserve System has established certain capital measures to assist in the assessment of the capital adequacy of holding companies. In order to ensure that these measures are meaningful, the Federal Reserve mandates precise methods for calculating an institution's qualifying total capital. Qualifying total capital is the sum of two distinct components: Tier 1 capital and Tier 2 capital.

Tier 1 capital is a crucial measure for two reasons. First, Tier 1 capital is the only form of capital which factors into the calculus of an institution's Tier 1 leverage ratio. Second, Tier 1 capital limits the amount of Tier 2 capital that may be included in qualifying total capital. While Tier 1 capital is a component of qualifying total capital, it is itself composed of four elements.

These elements are common stockholders' equity, qualifying non-cumulative perpetual preferred stock (including related

12. 12 C.F.R. § 225, app. A, B, D, E (2001); see also FED. RESERVE BD., BANK HOLDING COMPANY SUPERVISION MANUAL § 4060.3.1 (1997) [hereinafter FED. MANUAL].

13. 12 C.F.R. § 225, app. A, § II. The Federal Reserve also defines Tier 3 capital, although this is not included in "qualifying total capital." See 12 C.F.R. § 225, app. E, § 2(d) (defining Tier 3 capital as subordinated debt that:

(i) is unsecured; (ii) has an original maturity of at least two years; (iii) is not redeemable prior to maturity without the prior approval of the Federal Reserve; (iv) has a "lock-in" clause precluding payment of interest or principal if such payment would cause the issuer's risk-based capital ratio to fall or remain below the minimum required under 12 C.F.R. § 225, app. A; and (v) does not contain and is not covered by any covenants, terms or restrictions that are inconsistent with safe and sound banking practices).

Id. § 225, app. E, § 2(d).

14. 12 C.F.R. § 225, app. D.

15. 12 C.F.R. § 225, app. A, § II.A.


17. Technically, the elements of Tier 1 Capital are termed "core capital elements." Id.

18. 12 C.F.R. § 225, app. A, § II.A.1.a; see also FED. MANUAL, supra note 12, at § 4060.3.2.1.1 (explaining policies and procedures of Bank Holding Company supervision).
surplus), qualifying cumulative perpetual stock (including related surplus) and minority interests in the equity accounts of consolidated subsidiaries.

A. Common Stockholders' Equity

Common stockholders' equity is comprised of common stock, related surplus and retained earnings, including associated capital reserves, less certain deductions. A holding company may not, however, take into account treasury shares in its computation of common stockholders' equity.

Common stockholders' equity is the form of Tier 1 capital most favored by regulatory agencies, because it is the source of capital with the purest equity characteristics. The form of Tier 1 capital most favored from a regulatory standpoint is not, however, necessarily the form most favored by holding companies. Hybrid instruments, the proceeds of which meet the qualifications for Tier 1 treatment, may be preferable from the standpoint of an issuing holding company because they allow the issuing holding company to take a deduction for the associated dividend/interest disbursements and because they do not involve the direct issuance of equity by the issuer, and do not, therefore, dilute earnings per share or return on equity.

B. Perpetual Preferred Stock

The second element of Tier 1 capital is "perpetual preferred stock." Perpetual preferred stock, as the term suggests, is simply preferred stock that is not associated with any

23. Id.
24. Fed. Manual, supra note 12, at § 4060.3.2.1.1.1 (stating, "[f]rom a supervisory standpoint, it is desirable that voting common stockholders' equity remain the dominant form of Tier 1 capital"); see also 12 C.F.R. § 225, app. A, § II.A.1.b-c (stating that common stockholders' equity is preferred to other forms of Tier 1 capital).
25. 12 C.F.R. § 225, app. A, § II.A.1.b (stating that a capital instrument's ability to absorb losses while the entity operates as a going concern and the ability to defer or eliminate dividend payments or other distributions are key traits of "pure" equity).
redemption or maturity feature and that is not callable by the holder. The Federal Reserve’s regulations draw a distinction between two sub-types of perpetual preferred stock: non-cumulative perpetual preferred stock and cumulative preferred stock. Each sub-type allows for the deferral of dividends, but in the case of cumulative perpetual preferred stock, dividends that are deferred continue to add up; whereas in the case of non-cumulative perpetual preferred stock, the issuer has the right to eliminate the payment of dividends altogether. Because non-cumulative perpetual preferred stock has characteristics that more closely resemble pure equity, the Federal Reserve places no limit on the amount of non-cumulative perpetual preferred stock that can qualify as Tier 1 capital of a holding company. Cumulative perpetual preferred stock, on the other hand, is not accorded the same regulatory treatment because the issuer of cumulative perpetual preferred stock cannot totally eliminate the payment of dividends. This trait places cumulative perpetual preferred stock farther away from pure equity and closer to the middle of the debt/equity continuum. As a result, the Federal Reserve permits the inclusion of the proceeds of cumulative perpetual preferred stock in Tier 1 capital, but it limits the amount that may qualify as Tier 1 capital to one quarter of total Tier 1 capital.

26. Id. Perpetual preferred stock may, however, include a feature allowing the issue to be callable by the issuer, if such redemption is subject to the prior approval of the Federal Reserve. Id.

27. Id.

28. BRUDNEY & CHIRELSTEIN, supra note 4, at 231; COX, ET AL., supra note 5, §§ 18.8-9. Justice Holmes described non-cumulative stock in the following manner, "[w]e believe that it has been the common understanding of lawyers and business men that in the case of non-cumulative stock entitled only to a dividend if declared out of annual profits, if those profits are justifiably applied by the directors to capital improvements and no dividend is declared within the year, the claim for that year is gone and cannot be asserted at a later date." Wabash Ry. Co. v. Barclay, 280 U.S. 197, 203 (1930).

29. The main differences between common and non-cumulative perpetual preferred stock are preference and voting rights. See 12 C.F.R. § 225, app. A (describing common stockholders’ equity and non-cumulative perpetual preferred stock).

30. 12 C.F.R. § 225, app. A, § II.A.1.b. That is to say, only an amount of cumulative perpetual preferred stock equal to 33 1/3 percent of the sum of common stockholders’ equity, non-cumulative perpetual preferred stock and qualifying minority interests in the equity accounts of consolidated subsidiaries can count as Tier 1 capital.
C. Minority Interests in the Equity Accounts of Consolidated Subsidiaries

The final element of Tier 1 capital is minority interests in the equity accounts of consolidated subsidiaries. This item is accorded Tier 1 treatment because "as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries." The Federal Reserve warns holding companies that they "are expected to avoid using minority interest as an avenue for introducing elements that do not otherwise qualify as Tier 1 capital (such as cumulative or auction-rate perpetual preferred stock) or that would, in effect, result in an excessive reliance on preferred within Tier 1 capital."

Generally speaking, a holding company cannot raise capital in a special purpose finance subsidiary and then qualify it as Tier 1 capital by invoking the rule for minority interests. In fact, the Federal Reserve's Bank Holding Company Supervision Manual explicitly states that a holding company's minority interest in a non-operating, special purpose entity that issued preferred stock to outside investors will not count as Tier 1 capital and likely will not qualify as Tier 2 capital either.

D. Criteria for Tier 1 Treatment of Trust Preferred

Initially, it was not clear which of the core capital elements trust preferred securities would qualify as, or, indeed, whether trust preferred securities would even qualify as Tier 1 capital. The Federal Reserve has removed this uncertainty with the specification of four criteria that a trust preferred security must meet if its proceeds are to qualify as Tier 1 capital. The trust preferred security issued by the special purpose entity (and therefore the underlying debenture issued by the holding company to the special purpose entity) must provide for an

32. Id.
33. Id. For a more detailed discussion of the Federal Reserve's view on qualifying Tier 1 capital, see FED. MANUAL, supra note 12, at § 4060.3.2.1.1.3.
34. FED. MANUAL, supra note 12, at § 4060.3.2.1.1.3.
35. Id.
36. FED SRC INSIGHTS 97, supra note 8, at 2.
interest deferral period of at least twenty consecutive quarters. The underlying debenture must be subordinated to all other debt of the holding company and its terms must provide for the longest feasible maturity, usually thirty years. Finally, the prior approval of the Federal Reserve must be granted prior to an early redemption of the trust preferred securities. 

The proceeds of trust preferred securities, the terms of which meet these criteria, are eligible for inclusion in a holding company's Tier 1 capital. The Federal Reserve limits the portion of total Tier 1 capital that may be derived from trust preferred securities to twenty-five percent. This limitation is imposed because trust preferred securities have cumulative dividends and therefore resemble cumulative perpetual preferred stock. The proceeds of trust preferred stock, which exceed this twenty-five percent cap, will generally qualify for inclusion in a holding company's Tier 2 capital.

III. OVERVIEW OF A TRANSACTION INVOLVING AN ISSUANCE OF TRUST PREFERRED SECURITIES

In addition to the Federal Reserve's capital regulations, a financial holding company or bank holding company issuing trust preferred securities must navigate the confluence of several federal and state statutes, including the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Delaware Business Trust Act (or equivalent state

37. Id.
38. Id.
39. Id. Many trust preferred instruments include a provision allowing the issuing holding company to redeem the security after five years. This right must be subject to the approval of the Federal Reserve if the proceeds of the trust preferred securities are to qualify as Tier 1 capital. Id. Although it is not an explicit requirement, it is probably also good practice to consult the Federal Reserve prior the initial issuance of trust preferred securities. While trust preferred securities often include a "call" feature, any provision granting securityholders a "put" would likely jeopardize the Tier 1 treatment of the proceeds, even if the prior approval of the Federal Reserve was required.
40. Id.
41. 12 C.F.R. § 225, app. A.
A brief overview of a typical issuance of trust preferred securities by a holding company follows.\textsuperscript{46}

A. The Business Trust

An issuance of trust preferred securities by a holding company begins with the organization of a special purpose entity,\textsuperscript{47} formed as a subsidiary of the holding company. This entity should have certain characteristics in order for the transaction to function properly. It should be an association not taxable as a corporation for U.S. federal income tax purposes. It must be authorized to hold debentures of the type employed in the issuance of trust preferred securities. It must be authorized to issue stock, and it should provide limited liability for the holders of that stock.

The entity that is most commonly used in the issuance of trust preferred securities is the business trust.\textsuperscript{48} This is because the business trust possesses each of these characteristics.\textsuperscript{49} The most common form of business trust used in the issuance of trust preferred securities is the Delaware Statutory Business Trust.\textsuperscript{50}

\begin{notes}
\item[46] The overview is not intended to present an unabridged description of a transaction involving the issuance of trust preferred securities, and does not constitute legal advice of the author or Gaeta & Glesener, P.A.
\item[47] Sometimes referred to as a "special purpose vehicle," "SPV," or a "finance subsidiary."
\item[48] "The trust... is a device for making dispositions of property. And no other system of law has for this purpose so flexible a tool. It is this that makes the trust unique.... The purposes for which trusts can be created are as unlimited as the imagination of lawyers." AUSTIN W. SCOTT, TRUSTS 3, 4 (4th ed. 1987).
\item[49] A properly organized business trust will qualify as a grantor trust under the Internal Revenue Code. See generally 26 U.S.C. §§ 671-776 (1994, Supp. IV 1998, Supp. V 1999) (defining the IRS rules for grantor trusts, or trusts in which the income is taxable to the settlor). See also JESSE DUREMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS AND ESTATES 596-99 (5th ed. 1995). As such, the business trust is not an association taxable as a corporation under the Internal Revenue Code. Id. Furthermore, business trusts, such as the Delaware business trust, are authorized to hold debentures of the type employed in an issuance of trust preferred securities and are authorized to issue stock. See Del. Code Ann. tit. 12 §§ 3801(a) & (b) (2001). The Delaware business trust also provides limited liability for the holders of that stock. See Del. Code Ann. tit 12, §§ 3803(a) (2001).
\item[50] See generally Del. Code Ann. tit. 12, §§ 3801-24 (2001) (codifying the "Delaware Business Trust Act"). In 1996 alone, there were 210 issuances of trust preferred securities in which the special purpose entity was organized as a Delaware business trust (statistics courtesy of Donene Keemer Damon, Esq. of Richards, Layton & Finger, P.A., Wilmington, DE). Despite the fact that Delaware business
\end{notes}
although the laws of other states, including Connecticut, also allow for the formation of a business trust that is suitable for the issuance of trust preferred securities. While the General Statutes of North Carolina provide for the creation of trusts, trusts formed under the laws of the State of North Carolina are not suitable for use in the issuance of trust preferred securities.

A fundamental step in the formation of any trust is the selection of a trustee by the party forming the trust. In the case of a business trust, the required qualifications of the trustee are usually statutory. The Delaware Business Trust Act, for example, requires that a business trust have at least one trustee that is a resident of the State of Delaware. The holding company should also select a trustee that satisfies the requirements of the Trust Indenture Act so that a separate indenture trustee will not have to be retained. A second key step in the proper formation of the trust is the preparation of a trust agreement that will (i) govern the trust's issuance of the trust preferred securities, and (ii) define the rights and duties of the holding company, the various trustees, and the eventual holders of the trust preferred.

trusts are the most common, business trusts are sometimes referred to as "Massachusetts Trusts." See Del. Code Ann. tit. 12 § 3801(a) (1974); see also Russell M. Robinson, II, Robinson on North Carolina Corporation Law, § 34-3. (5th ed. 1995).


53. Perhaps the biggest problem with the North Carolina statute in terms of its suitability for trust preferred transactions is that it is the only form of property that North Carolina business trusts are explicitly authorized to hold is real property. Id. There is no mention of authority to hold instruments like the debentures which are employed in transactions involving the issuance of trust preferred securities. Id; see also Robinson, supra note 50, at § 34.3 (stating that North Carolina's business trust statute does not deal expressly with the question of whether shareholders of a business trust formed under the laws of the state of North Carolina are entitled to limited liability). The lack of an established body of case law addressing business trusts in the state of North Carolina is also a hindrance to the use of the North Carolina trust.


56. This document usually takes the form of an Amended and Restated Trust Agreement, which supersedes the "short form" trust agreement used to set up the trust during its initial formation.
Once a suitable special purpose entity has been set up, it is necessary that it hold assets of sufficient value to warrant the purchase by prospective investors of stock issued by that entity. This is accomplished by the issuance of debt, by the holding company, to the trust. The sole assets of the trust are its...
entitlement to interest payments on this debt and the future repayment of the principal amount of the debt.\footnote{One of the tenets of the law of trusts is that a trust must have some property, or corpus, that is being held by the trustee. See \textit{Dukeminier \& Johanson, supra} note 49, at 584. Because it is preferable to organize the trust prior to the actual issuance of trust preferred securities and the corresponding sale of debt by the holding company to the trust, the initial corpus (usually referred to as the “initial trust property”) of the trust is some nominal amount, usually ten dollars. This “initial trust property” will serve as the corpus of the trust until the holding company issues its debentures to the trust. “The trust property may be one dollar or one cent or it may be any interest in property that can be transferred.” \textit{Id.}}

\section*{B. \textit{The Subordinated Debenture and Indenture}}

The debt issued by the holding company to the trust takes the form of debenture, the terms of which are governed by a document known as an indenture. In most issuances of trust preferred securities, the indenture must be qualified under, and contain certain provisions required by, the Trust Indenture Act of 1939.\footnote{15 U.C.S.A. §§ 77llll(a)-(b), 77mmm(a)(1)-(8) (2000) (codifying the Trust Indenture Act of 1939); \textit{see also Hazen, supra} note 55, at §19.5.} If the debenture or debentures in question are to be registered under the Securities Act of 1933, qualification of the indenture is accomplished by the filing of the indenture as an exhibit to the registration statement, filed pursuant to the Securities Act of 1933. If the sale of the debentures falls under an exception to registration, it may still be necessary to qualify the indenture with the Securities and Exchange Commission by filing a Form T-3.\footnote{17 C.F.R. § 269.3 (2001).}

As discussed in Section II above, the debentures, and the indenture that governs them, must have certain features if the proceeds from the sale of the trust preferred securities are to qualify as Tier 1 capital of the holding company.\footnote{\textit{See supra} notes 39-43 and accompanying text.} The required features of the debentures and the indenture are essentially designed to mimic the characteristics of common equity, which has no stated maturity and which allows an issuer to dispense with payments of dividends indefinitely.\footnote{\textit{See generally Brudney \& Chirelstein, supra} note 4, at 133-34 (discussing the relationship between common stock and senior securities).} Accordingly, the debentures are unsecured and deeply subordinated to the rights of other
creditors. They also have a very long maturity (at least thirty years) and allow for long periods of interest (dividend) deferral, both of which are traits usually associated with common equity.\textsuperscript{62}

Aside from these required provisions, a debenture's terms are primarily market driven. It may carry a fixed or variable rate, convertibility features, or other features designed to enhance the marketability of the trust preferred securities.

\textbf{C. The Trust Securities}

Once the holding company has issued debentures to the trust, the trust must raise capital to pay the holding company for those debentures. The trust accomplishes this through the issuance of preferred stock to investors,\textsuperscript{63} who are theoretically now willing to invest in securities issued by the trust because it is the holder of the holding company's debentures and is therefore entitled to receive interest on those debentures along with the eventual repayment of their principal amount. The trust issues stock having an aggregate offering price exactly equal to the aggregate face value of the holding company debentures it holds. The trust then uses the proceeds generated by the sale of its stock to pay the holding company for the debentures. In this manner, the holding company receives the proceeds from the sale of the trust's preferred stock.

The preferred stock of the trust entitles holders to an undivided beneficial interest in the assets of the trust. The preferred stock has terms that mirror those of the underlying debentures so that interest payments on the debentures received by the trust are immediately declared as a dividend to the holders of the trust preferred securities.\textsuperscript{64} The trust does nothing to the

\textsuperscript{62} The debentures are subordinated to the rights of preferred stocks in much the same manner that funds invested in the common stock of a corporation rank junior to those invested in preferred stock and debt of the corporation.

\textsuperscript{63} The trust also issues a relatively small amount of controlling common securities to the holding company. The common securities must account for at least three percent of the total capitalization of the trust.

\textsuperscript{64} The fact that the proceeds from the sale of the trust preferred securities is immediately passed through the trust in satisfaction of the purchase price of the holding company's debentures and the fact that interest payments on those debentures are immediately passed through the trust to the holders of the trust preferred securities gives the trust its "transparent" characteristic.
funds that flow into it other than pass them through to its securityholders. Accordingly, the frequency and amount of the dividends paid on the trust preferred stock precisely mirror the frequency and amount of the interest the holding company pays on the underlying debentures.

In the end, the holding company has issued debentures on which it makes interest payments, but the investors have purchased preferred stock, on which they receive dividends. This is what gives trust preferred securities their "hybrid" characteristics. There is, however, one more item that is essential for the issuance to function properly, the preferred securities guarantee.

D. The Preferred Securities Guarantee

A guarantee agreement must be employed in an issuance of trust preferred securities. This agreement is not, however, a guarantee in the traditional sense. Rather than an absolute guarantee of payment by the holding company, the guarantee is merely a promise that funds paid into the trust as interest on the debenture or debentures held by the trust will be paid out to the holders of the trust preferred securities. Like the debt represented by the debenture, the guarantee is deeply subordinated and ranks junior to all other debt of the issuing holding company. The guarantee may seem somewhat hollow, but it serves two important functions in addition to its obvious function as a guarantee of payment, each of which is also critical to the overall transaction.

First, the guarantee, along with certain provisions of the indenture and the trust agreement, helps to bridge the gap in privity between the holding company and the eventual holders of the trust preferred securities. This is somewhat difficult, however, because in a large public offering, the number and identity of the holders of the trust preferred securities is likely to remain in flux while the trust preferred securities are outstanding. The holding

65. A typical preferred securities guarantee agreement would include the following language, "[t]his Preferred Securities Guarantee will constitute an unsecured obligation of the Guarantor and will rank (i) subordinate and junior in right of payment to all Senior Debt of the Guarantor, (ii) pari passu with the Debentures, and (iii) senior to the Guarantor's stock."

66. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1593-1600 (3rd ed. 1989) (discussing the importance of a trustee in enforcing the rights of
company cannot execute a guarantee agreement with every security holder; and even if it could, those holders are likely to change while the issue is outstanding. In order to work around this problem, the holding company executes a guarantee for the benefit of a “guarantee trustee” and that party acts in the collective interest of the holders of the trust preferred securities.

A second, and perhaps more critical, function served by the guarantee agreement relates to an issue created by the Investment Company Act of 1940. SEC Rule 3a-5 states, among other things, that a finance subsidiary of a corporation will not be considered an investment company under section 3(a) of the Investment Company Act of 1940 if “any non-voting preferred stock of the finance subsidiary issued to or held by the public is unconditionally guaranteed by the parent [holding] company as to the payment of dividends, payment of the liquidation preference in the event of liquidation.” A properly drafted guarantee agreement, therefore, allows the trust to avoid classification as an Investment Company under the 1940 Investment Company Act.

IV. CURRENT STATUS OF TRUST PREFERRED SECURITIES

While financial institutions have been issuing trust preferred securities since the Federal Reserve released its October 21, 1996 ruling, they are also starting to become purchasers of trust preferred securities. There have been several interpretations released by the financial services industry regulatory agencies, many of which address investment in, rather than issuance of, trust preferred securities. This section examines interpretations released by the federal banking agencies regarding investment in trust preferred securities.

67. The guarantee trustee is typically the same party serving as indenture trustee and property trustee.
68. 17 C.F.R. § 270.3a-5 (2001).
69. Id. § 270.3a-5(a)(2).
70. If the special purpose entity could not avail itself of this exemption, it would be required to register under, and would be subject to, the 1940 Act thereby complicating the entire transaction probably to the point that it would become impossible. See 15 U.S.C. §§ 80a-1 – 80a-64 (2000).
A. Office of the Comptroller of the Currency (OCC)

In April 1997, the OCC released Interpretive Letter 777, which provided guidance on the authority of national banks to invest in trust preferred securities. National banks may invest in trust preferred securities if they meet the definition of "investment securities" set forth by the OCC in regulation 12 C.F.R. section 1.2(e). In order to qualify as an investment security, for purposes of this regulation a security must be a "marketable debt obligation that is not predominantly speculative in nature."

The OCC classifies trust preferred securities as Type III securities. The OCC caps investment in Type III Securities of any one issuer at ten percent of capital and surplus for national banks. Therefore, a national bank may invest up to this amount in trust preferred securities which are marketable and not predominantly speculative in nature.

B. Federal Deposit Insurance Corporation

The FDIC released Financial Institution Letter FIL-16-99 on February 19, 1999. This letter sets forth the FDIC's position concerning investment in trust preferred securities by state non-
member banks. The letter states that section 24 of the Federal Deposit Insurance Act \(^7\) and the implementing regulations that correspond to section 24, \(^7,8 \) "do not restrict an insured state bank’s authority under state law to invest in trust preferred stock." \(^9\)

The letter goes on to clarify, however, that any such investment must come within the same definition of "investment security" used by the OCC. \(^8\) FDIC regulated institutions are, however, not subject to the OCC’s ten percent limit on investment in trust preferred securities. \(^9\) The FDIC’s interpretation also clarifies that state non-member banks are not subject to the fifteen percent of Tier 1 capital limitation imposed on some other types of hybrid securities. \(^8\)

C. **Office of Thrift Supervision (OTS)**

On December 18, 2001, the OTS released Thrift Bulletin 73a. \(^8\) This bulletin, which supercedes Thrift Bulletin 73 and CEO Memorandum 130, \(^8\) provides further guidance on several topics, including underwriting and purchase of trust preferred securities by OTS regulated financial institutions. \(^8\) Thrifts may only invest in trust preferred securities that meet the requirements set forth for thrift investment in corporate debt securities. \(^8\) These requirements are as follows: (1) the security must be able to be sold with reasonable promptness at a price that corresponds reasonably to its fair value; (2) it must be rated in one of the four highest categories by a nationally recognized investment rating service as its most recently published rating before the date of the

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\(^8\) 12 C.F.R. § 362 (2001).
\(^7\) FIL-16-99, *supra* note 76, at 72,669-70.
\(^8\) FIL-16-99, *supra* note 76, at 72,669.
\(^8\) Id. 12 C.F.R. § 362.3(b)(2)(iii) (imposing a fifteen percent of Tier 1 capital limitation on adjustable rate and money market preferred stock).
\(^8\) Id.
\(^8\) Id. at 5-7.
\(^8\) Id. at 6.
purchase of the security; and (3) it must conform to the general lending limits of 12 C.F.R. § 560.93(c). 87

In addition to these baseline requirements for investment in debt securities, Bulletin 73a states that a thrift must limit its investment in trust preferred securities to fifteen percent of total capital. 88 The Bulletin also prohibits entrance into any reciprocal agreement involving the purchase of trust preferred securities of another issuer and purchase of trust preferred securities issued by a thrift’s holding company or affiliates. 89 Finally, the OTS does not allow investment in a security whose maturity may be extended at the sole option of the issuer beyond thirty years. 90

The Bulletin also reaffirms the OTS’ existing requirement that management be able to demonstrate that any trust preferred securities held can be “sold with reasonable promptness at a price that reasonably reflects fair value.” 91 However, the Bulletin reverses the prior OTS position that trust preferred securities sold through a private placement cannot satisfy the “sold with reasonable promptness” requirement. 92

Bulletin 73a also discusses the issuance of trust preferred securities by thrift holding companies. 93 The Bulletin states that trust preferred securities issued by a thrift holding company and invested in the thrift subsidiary will qualify as capital of the thrift subsidiary. 94 The OTS does not allow these proceeds to count toward a thrift’s Tier 1 capital. 95

D. Future Developments

It is likely that the Federal Reserve will issue a Supervision and Regulation Letter addressing the capital treatment of proceeds derived from the issuance of trust preferred. In fact, it

88. Thrift Bulletin 73a, supra note 83, at 6.
89. Id.
90. Id.
91. Id. at 7. This requirement is substantially similar to the OCC’s requirement that securities be “marketable;” see 12 U.S.C. 24(seventh) (1994); 12 C.F.R. pt. 1 (2001).
92. Id.
93. Id.
95. Id.
was believed that an SR Letter was forthcoming at or near the end of 2001. The effects of this letter, if and when it is issued, are obviously unknown at this time, but industry speculation is that it could decrease the percentage of Tier 1 capital that a holding company may derive from trust preferred securities. It remains to be seen whether or not holding companies with trust preferred securities already outstanding will be grandfathered under any new Federal Reserve rules.

V. CONCLUSION

Trust preferred securities offer an almost ideal mix of debt and equity characteristics. They are non-dilutive to shareholders' equity, their interest payments are tax deductible, and yet they qualify as Tier 1 capital for holding companies. Since the Federal Reserve's October 21, 1996 ruling, scores of bank holding companies have issued trust preferred securities, with more and more community bank holding companies joining the group. It remains to be seen whether the Federal Reserve will promulgate any new policies with respect to the issuance of trust preferred securities in 2002, but it is likely that these instruments will remain a part of the capital structure of most holding companies.

96. See supra note 7 and accompanying text.
97. See supra note 8 and accompanying text. See generally Paul Nadler, Good Time to Put Your Trust in Trust-Preferreds, A.M. BANKER, Nov. 27, 2001, at 7 (discussing current economic conditions and issuance of trust preferred securities by community bank holding companies).