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An update on trust preferred securities

By Dan Hanger

Trust preferred securities were issued by a large number of bank holding companies, especially during the period from 2000 through 2007. This article summarizes a number of key issues related to these securities. I will briefly discuss their changing capital treatment under the Dodd-Frank Wall Street Reform and Consumer Protection Act. I will then discuss a number of issues, particularly regulatory ones, raised when a holding company tries to retire TRPS.

Dodd-Frank Act Changes

Section 171 of Dodd-Frank changed the landscape for the capital treatment of TRPS. This provision effectively eliminated TRPS as an element of tier 1 capital for BHCs going forward. It did so by providing for the same capital treatment for TRPS at BHCs as is applied to the same instruments at banks (where they do not count to tier 1). Retrospectively, under Dodd-Frank, if TRPS were issued prior to May 19, 2010, by depository institution holding companies with consolidated assets of less than $15 billion (as of December 31, 2009), they will continue to be eligible for treatment as tier 1 capital. TRPS securities continue to qualify as an element of tier 2 capital. The notice of proposed rulemaking implementing Basel III would make additional changes to the treatment of TRPS.

Retiring TRPS

Recently, the Federal Reserve has seen an increase in the number of requests to retire TRPS. These requests stem from a number of factors including the approaching end of the five-year deferral period for some companies and the high cost associated with preventing default. In addition, TRPS often have a contractual provision that requires the issuer to obtain the consent of the TRPS holders in order to sell the subsidiary bank. These considerations, as well as the desire to simply reduce costs, are leading BHCs to seek to redeem TRPS. Some have attempted to negotiate a buyback of TRPS at a discount. This has not generally been successful, particularly if the issue is part of a pool. The Federal Reserve is aware of instances where either the trustee of a pool is not interested in negotiating a one-off settlement with a pool participant or the trustee believes any settlement must receive the approval of all the holders.

Also, any redemption of preferred stock, including TRPS, requires the approval of the Federal Reserve. There will likely be a number of factors affecting whether settlements may occur in the future; among them will be the terms of the agreement itself, the identity of the trustee, the actual holders of the instrument, and the market in general.

Another approach that was pursued in at least one instance, involved a BHC voluntarily filing for bankruptcy under Chapter 11 and requesting the bankruptcy court to approve a competitive bidding process to sell and recapitalize its subsidiary bank under section 363 of the Bankruptcy Code. This instance involved AmericaWest Bancorp and its subsidiary AmericanWest Bank, Spokane, Washington.

The basic mechanics of a section 363 transaction include an initial bidder (or "stalking horse") who reaches an agreement to purchase assets from the Chapter 11 debtor. The asset purchase agreement rewards the stalking horse for investing the effort and expense to sign a transaction that will be exposed to competing bids by offering protections that can include a combination of a breakup fee, expense reimbursement, minimum bid increments, deadlines for competing bids, final court approval, and closing. The sale of AWB was completed within eight weeks from bankruptcy filing to closing. In addition, with the protections and short bidding period, the stalking horse (SKBHC Holding LLC in this case) has a significant advantage over competing bidders.

Months of planning, diligence and negotiations took place prior to the bankruptcy filing and experienced legal counsel and investment bankers advised the process. The parties met with the relevant regulators early and kept lines of communication open throughout the process. Another significant factor in this case was that SKBHC Holding LLC had previously filed an application to become a BHC through the proposed acquisition of a different bank and had been thoroughly vetted by the regulators. It seems clear that potentially unique facts and circumstances contributed to the success of this section 363 transaction.

Finally, a couple of BHCs have arranged for officials of the holding company or an outside party to purchase the senior debt of a BHC that is secured by stock in the subsidiary bank. The purchaser will then foreclose on the subsidiary bank stock. While the TRPS remain outstanding, they are obligations of the initial BHC, which no longer has its principle source of income. These transactions raise a number of regulatory issues. We strongly encourage any firm contemplating such a transaction to retain advisors with the requisite skills. For example, because the purchaser of the loan is acquiring the note with the intention of foreclosing, the exemption to requirements of the Bank Holding Company Act and the Change in Bank Control Act related to acquisition of ownership in satisfaction of debt previously contracted do not apply. As such, the purchaser will be required to file either an application (if the purchaser is a company) with the Federal Reserve or a notice under the Change in Bank Control Act with the appropriate supervisor for the bank. In addition, a BHC considering such an approach should consult counsel about other potential legal issues associated with this type of transaction.

As noted, BHCs seeking to eliminate or reduce their obligations under TRPS, regardless of the reason, need to be alert to the regulatory requirements that may arise from any of the approaches discussed in this article. We encourage BHCs considering options for redeeming or otherwise reducing obligations under TRPS to consult with the Federal Reserve early in the process to assist in identifying any potential issues.

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