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Raising Capital Through Convertible Preferred Stock Offerings

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The Bankers' Statement – Summer 2014

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While the "big" banks and bank holding companies have been issuing preferred stock to raise capital for years, we have recently seen increased interest from community banks and bank holding companies in issuing convertible preferred stock to raise capital. In the past 12 to 18 months, there have been a number of convertible preferred stock offerings, including both registered offerings and private placements, by community bank and thrift holding companies. The capital raised in these offerings has been used to bolster regulatory capital levels, to repay outstanding TARP and debt obligations, or to provide additional capital for growth and expansion (including potential acquisitions).

Convertible preferred stock offerings are often viewed as a more desirable capital-raising option than common stock offerings because of the flexibility they provide in structuring the terms of the capital stock and the ability to limit the dilutive impact to common stockholders. The terms of convertible preferred stock will typically provide for the payment of a fixed quarterly dividend, the right of the holder to convert the preferred stock into common stock at any time at a premium to the market price at the time of issuance, and the right of the company to force the conversion of the preferred stock and/or to redeem the preferred stock after a certain period of time (at least five years after original issuance) and upon the satisfaction of certain market price conditions. Additionally, convertible preferred stock is typically non-voting, except with respect to certain matters that directly impact the rights and preferences of the preferred stock.

Convertible preferred stock can provide significant flexibility to a company because the preferred stock is typically perpetual (i.e., it has no stated maturity) and dividends are often non-cumulative. Thus, dividends on the preferred stock are only payable if and when declared by the company's board of directors. If for any reason the company's board of directors decides not to declare a dividend on the preferred stock for a given dividend period, the holders of the preferred stock

have no right to receive a dividend for that period. Thus, unlike preferred stock with cumulative dividends, where the dividends may be deferred but still accrue and must ultimately be paid, dividends on non-cumulative preferred stock are not required to be made up. The only restriction is that the company is prohibited from paying dividends on junior stock (including common stock) with respect to any dividend period for which the dividend on the preferred stock has not been paid (or provided for) in full.

Legal Considerations

Whether a convertible preferred stock offering makes sense to a particular company depends upon a variety of legal, regulatory, financial, market and other factors. Preliminarily, there are a few legal considerations to be evaluated when determining whether a convertible preferred stock offering is a viable capital raising alternative:

Is the company authorized to issue convertible preferred stock?

Convertible preferred stock can only be issued and sold by a company to the extent authorized by the company's articles of incorporation (or other charter or governing document). If the company does not already have the authority to issue sufficient shares of preferred stock under its existing articles of incorporation, the company must amend its articles of incorporation prior to any offering or sale of preferred stock. Amending a company's articles of incorporation requires stockholder approval which, even if it is obtained, can significantly delay the capital-raising process.

The articles of incorporation of many bank and thrift holding companies, however, already authorize "blank check" preferred stock. This is preferred stock that is authorized by the articles of incorporation but for which the rights and restrictions are unspecified. The board of directors of the company is given the authority and flexibility to designate the terms of the preferred stock (such as convertible, non-cumulative, non-voting preferred stock) at the time the preferred stock is authorized for issuance and sale. The authorization of blank check preferred stock has become relatively common, and a number of bank and thrift holding companies amended their articles of incorporation in late 2008 or early 2009 to authorize blank check preferred stock in connection with the issuance (or consideration of issuance) of TARP securities.

Does the company have sufficient shares of common stock authorized and available?

In order to conduct a convertible preferred stock offering, a company must also have sufficient shares of common stock available for issuance in the event of the conversion of the convertible preferred stock. Thus, the company must check its articles of incorporation (or charter or other governing document) to determine the maximum number of shares of common stock it is authorized to issue and then deduct the number of shares of common stock currently issued and outstanding (or reserved for issuance upon the exercise of outstanding options, warrants or other rights or pursuant to stock-based compensation plans maintained by the company). If the company does not have sufficient shares of common stock authorized and available to satisfy the conversion rights associated with the desired number of shares of preferred stock, the company's articles of incorporation will need to be amended to increase the number of authorized shares of common stock. As noted above, this will require shareholder approval, which will at a minimum delay the capital-raising process.

Do existing stockholders have preemptive rights?

Common stockholders of a company (particularly one formed under Ohio law) may be entitled to preemptive rights with respect to new stock issuances by the company. Preemptive rights grant existing stockholders the right to purchase their proportionate share of any new shares of stock of the same class issued by the corporation under certain situations. A company should evaluate whether its existing stockholders are entitled to preemptive rights and, if so, whether an exemption is available to avoid the application of preemptive rights in a convertible preferred stock offering. In the event that preemptive rights apply, this can significantly complicate and delay any convertible preferred stock offering (or even a common stock offering). As a result, a company might consider amending its articles of incorporation (or charter or other governing document) in advance of a proposed stock offering in order to eliminate the application of preemptive rights.

Regulatory Considerations

A significant feature of convertible preferred stock that makes it attractive to bank and thrift holding companies is the ability to treat any capital raised as Tier 1 capital. If properly structured, convertible preferred stock can qualify as Tier 1 capital under regulatory capital adequacy guidelines. In order to qualify for Tier 1 capital treatment, the terms of the convertible preferred stock must satisfy certain requirements, including:

- The preferred stock may not have a maturity date;
- The preferred stock cannot be redeemed at the option of the holder;
- Dividends on the preferred stock must be non-cumulative;
- The preferred stock may not contain provisions restricting the company's ability or legal right to defer or waive dividends (other than a requirement for prior or concurrent waiver or deferral of dividends on common stock or other junior stock); and
- Redemption of the preferred stock by the company may only be permitted five years after original issuance and then only with the prior approval of the Federal Reserve.

In addition to the foregoing requirements, in July 2013, the Federal Reserve and other federal banking agencies published final rules to implement the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act. These final rules, which are being phased in over the next few years, contain additional guidelines and requirements with regard to the treatment of preferred stock as Tier 1 capital by financial institutions and their holding companies.

Companies that are considering a possible convertible preferred stock offering should carefully evaluate the legal and regulatory considerations discussed above, with the assistance of their legal counsel. Additionally, companies are advised to consult with appropriate regulators and their accountants in advance to confirm that the proposed terms of the convertible preferred stock will result in the desired capital treatment. An experienced financial advisor (who will typically serve as the underwriter or placement agent for the offering) should also be consulted in order to ensure that the terms of the convertible preferred stock offering are structured in a manner that will be attractive to both the company and potential investors.