Litigation

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Court: Bank's Redemption of Trust Preferred Securities Due to Dodd-Frank Changes Is OK

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Wells Fargo has won a pair of precedent-setting victories connected to the passage of the Dodd-Frank Act, which are important to all financial institutions that issued, and have recently been considering redeeming, trust preferred securities. Many trust indentures contain "Capital Treatment Event" clauses that are very similar to those interpreted in these cases. The orders of a federal judge indicate that President Obama's signing of the Dodd-Frank Act in 2010 constituted a "Capital Treatment Event" that might entitle similarly situated banks to redeem their trust preferred securities, regardless of the timing of any so-called optional redemption date, so long as all other requirements are met.

Wells Fargo & Co. was named in two federal lawsuits following the October 3, 2011 redemption of two separate sets of trust preferred securities that the bank offered to investors beginning in 2007.

Trust preferred securities are a hybrid security issued by many bank holding companies to increase their "Tier I" capital. Tier 1 holdings are what government regulators require when measuring a financial institution's strength and stability. Since 1996, many bank holding companies have created trust preferred securities as a means of partially fulfilling their core capital requirements. Banks offered investors a high rate of interest in return for a favorable regulatory and tax treatment. But the Collins Amendment, a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, 12 U.S.C. § 5301 *et seq.* (July 21, 2010), signed into law by President Obama on July 21, 2010, called for a phasing out of the securities' status as Tier 1 capital. This change in law left many banks on the hook for the high interest payments without the corresponding Tier 1 benefits.

The indentures for both of Wells Fargo's trusts contained "Capital Treatment Event" clauses that allowed Wells Fargo to redeem the securities upon the occurrence of a change or announced prospective change in Tier 1 treatment, subject to the Federal Reserve's consent. Although the securities were then decades away from their scheduled maturity dates, Wells Fargo announced on September 1, 2011 that it would redeem several sets of trust preferred securities pursuant to its "Capital Treatment Event" clauses. It did so on October 3, 2011, repaying to all holders their full principal.

Wells Fargo's redemptions gave rise to several lawsuits, which were eventually consolidated in two actions before the Honorable Claudia Wilken of the Northern District of California. Plaintiffs who had invested in one of these securities argued that the Dodd-Frank Act would not trigger a "Capital Treatment Event" until 2016, when the phase-out period for Tier 1 treatment ends and no trust preferred securities receive Tier 1 treatment. In a separate lawsuit, plaintiffs who had invested in another of these securities took a less draconian approach, arguing that Wells Fargo should have avoided declaring a capital treatment event by redeeming its trust preferred securities on the December 15, 2012 "optional redemption date," which would precede the beginning of the Dodd-Frank Act's phase-out period by 15 days. Together the plaintiffs alleged that Wells Fargo's redemptions of the securities on October 3, 2011 resulted in combined damages of more than $196 million—the amount of interest the outstanding units in the two cases would have earned had Wells Fargo waited until the optional redemption dates specified in the indenture agreements.

Judge Wilken disagreed with both sets of plaintiffs and dismissed both actions, entering judgment in favor of Wells Fargo. "The clear intention of this ["Capital Treatment Event"] clause is to protect defendant from having to continue to pay the high interest rate of the securities if it reasonably believes that it will lose the benefit of being able to treat these securities as Tier I capital," Judge Wilken ruled in the first of the matters to be decided. In the second matter, Judge Wilken specified that Wells Fargo was entitled to redeem the securities pursuant to its "Capital Treatment Event" clause as soon as the Dodd-Frank Act was signed into law by President Obama. Wells Fargo's determination that the "Capital Treatment Event" clause had been triggered was reasonable, Wilken wrote, "because the enactment of the Dodd-Frank Act into law meant that Defendant would not be able to treat an amount of the securities equal to the liquidation amount as Tier I capital."

Judge Wilken dismissed the two complaints without leave to amend, denied the plaintiffs' motions for class certification as moot, awarded Wells Fargo its costs, and entered judgments for Wells Fargo.

While other bank holding companies are undoubtedly affected by the capital treatment change under Dodd-Frank, to date no other opinions have confronted this issue. But given the potential impact on bank finances, other institutions may be very interested in the precedent set by these two cases. The cases are *Call v. Wells Fargo & Company,* No. 11-CV-05215-CW, and *Turkle Trust v. Wells Fargo & Company*, No. 11-CV-06494-CW, both in the U.S. District Court for the Northern District of California.

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