AMR Corporation (AMR), the parent firm of American Airlines, found that its profitability had improved a few years ago. Several years prior, AMR had issued privately about $1.1 billion of convertible preferred stock. As you know, interest is tax deductible whereas dividends are not. AMR decided to offer the preferred stockholders the chance to exchange their shares for a new issue of convertible Quarterly Income Capital Securities (“QUICS”). AMR offered to exchange $1,000 face amount of 6.125% convertible QUICS for $1,000 face amount of 6% convertible preferred stock. All $1.1 billion of preferred stock could be exchanged at the holder’s option.

The QUICS would carry a slightly higher yield and would rank senior to the preferred stock. But QUICS include an interest-deferral feature: AMR can defer interest payments from time to time for up to 20 consecutive quarters. It was reported that because of this feature, the rating agencies view QUICS as “virtually identical to the preferred.”

AMR’s main purpose in offering to exchange convertible QUICS for convertible preferred was to improve the firm’s after-tax cash flow because of the tax deductibility of interest. The table below compares the QUICS and the preferred stock.

Just prior to the exchange offer, AMR’s capitalization was (dollar amounts in millions):

|  |  |  |  |
| --- | --- | --- | --- |
| Long-term debt: |  |  |  |
|   Current maturities |  |  | 189 |
|   Long-term debt, less current maturities | 7710 |
|  |  QUICS |  |  |  | 0 |
|      Total long-term debt |  | 7899 |
|   Convertible preferred stock |  | 1081 |
|   Common stock |  |  | 3318 |
|      Total stockholders’ equity |  | 4399 |
|         Total capitalization |  | 12,298 |
|  |  |  |  |  |  |  |

|  |  |  |
| --- | --- | --- |
| Interest/Dividend Rate | 6⅛ APR; payable quarterly; interest payments can be deferred for up to 20 calendar quarters; at the end of the deferral period, all accrued and unpaid interest must be repaid, together with interest on the unpaid amount compounded quarterly at the 6⅛ APR. | 6% APR; payable quarterly out of funds legally available therefore. |
| Conversion  | At $79.00 per common share. | At $78.75 per common share. |
| Subordination | Subordinated to all existing and future senior debt of AMR and its subsidiaries but senior to AMR’s preferred stock. | Subordinated to all debt of AMR. |
| Market | Registered for public trading; listed on the New York Stock Exchange | Privately placed; not registered for public trading. |

**QUESTIONS**

1. Describe the QUICS. Are they debt, or are they equity? How do they differ from the convertible preferred stock?

2. Recalculate AMR’s capitalization if holders of (i) 50% and (ii) 100% of the convertible preferred stock exchange them for QUICS.

3. Calculate the increase in net income available for common stock that would result from (i) 50% and (ii) 100% of the convertible preferred stock being exchanged for QUICS.

4. Why does this debt-for-equity exchange increase the risk of the common stock? How does the interest-deferral feature affect your interpretation of the QUICS? The risk of the common stock?

5. What trade-off did AMR have to evaluate as it considered whether to proceed with the exchange offer?