Proskauer

The Emergence of Third Party Preferred Equity as a Financing Device

July 27, 2017

Increasingly, buyout sponsors are turning to third party preferred equity as a financing tool for their transactions. Structured to be treated as equity for debt rating agencies, bank regulatory regimes and in-place debt facilities, this newly popular financing device straddles the line between debt and equity. Preferred equity financings can be attractive to alternative credit providers because they are priced to provide returns higher than those of traditional junior capital investments but below the returns sought by pure equity investors. Alternative credit providers considering preferred equity financings should be aware of the legal and structural differences, however, between preferred equity and the debt investments with which they are more familiar.

In order to achieve the issuing company's goals of equity treatment not interfering with its lending arrangements, most third party preferred equity financings have the following features which may be unfamiliar to alternative credit providers:

- **"Perpetual" Life.** A key feature of these preferred equity financings is that there is no stated maturity date and often no time-based mandatory redemptions or put rights. Instead, in these types of commercial arrangements, the dividend rates are structured to increase over time to provide economic incentives for the issuer to redeem after a period of time and mandatory redemptions or put rights apply only in connection with change of control or other specified events. The uncertainty over exit timing needs to be considered by prospective investors, especially fund investors with limited lives.

- **Remedies as Equity Holder not Creditor.** While these preferred equity financings have many features of a debt financing (essentially, a negotiated rate of return with little or no equity-like “up-side”), the preferred equity is an equity security. Investors may negotiate certain protections, such as the right to appoint directors or demand a sale of the issuer. Nonetheless, the preferred equity holders will not have the same rights to enforce payment as holders of debt and do not have the benefit of collateral or guarantees or the ability to act as a creditor in a

troubled situation. Therefore, investors will be junior to all creditors of the issuer and its subsidiaries. Prospective investors will have to determine whether this increased risk is adequately addressed by the economics offered in the transaction.

- **Covenant Protection.** Preferred equity terms include protections against issuing equity that is *pari passu* and/or senior to the preferred equity being funded. The level of other covenant protections varies from transaction to transaction, though reference to certain operating covenant protections in the issuer group's debt documentation, with negotiated cushions, is often a feature of these instruments. Prospective investors should be sensitive to how their interests may differ from the lenders and structure the covenant package accordingly. For example, anti-layering provisions and subordinated debt or equity issuances by the issuer's subsidiaries may affect holders of the preferred equity differently than senior lenders at the operating company level.

- **Taxed as Equity.** The issuer and investors often agree to treat the investment as equity for tax purposes. The coupon on preferred equity can have drastically different tax attributes than interest on debt. In addition, the preferred equity is frequently structured to accrue or be pay-in-kind so that, instead of the dividends being payable currently in cash, the liquidation preference will increase over time. Accordingly, investors should consider whether the preferred equity will generate phantom income, recognizing that there would be no cash paying coupon to offset the tax liability. The tax status of the issuer, the specific terms of the preferred equity and the nature of the investor and its owners can determine whether any particular investment can be structured in a manner that is viable from a tax perspective.

The market for third party preferred equity financing is uncharted territory for many alternative credit providers and their counsel. The key to understanding and protecting your interests as a preferred equity investor is making sure that you are working with parties who are experienced at negotiating third party preferred equity financings.

Our market-leading Private Credit Group is among the most sophisticated of its kind. We craft solutions for our clients by taking full advantage of our formidable finance, tax and private equity experience. Structuring third party preferred equity investments is another example of the group harnessing our experience and skill to customize sophisticated financing solutions on behalf of our clients. Please feel free to contact any of the team members listed with any questions.

- **Steven M. Peck**
  Partner
- **Steven M. Ellis**
  Chairman Emeritus of the Firm
- **Stephen A. Boyko**
  Partner
- **Gary J. Creem**
  Partner