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Structured Preferred Equity – A Versatile Tool in the Debt Restructuring Toolbox

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For many sponsor-backed and other highly leveraged private companies, the business impact of COVID-19 is just beginning to apply pressure to financial covenant compliance. As borrowers and private credit (or other) lenders think through options on how best to address pending or anticipated defaults, structured preferred equity should be considered as a versatile tool in the toolbox.

Structured preferred equity can take different forms but is generally characterized as equity filling gaps between traditional equity and debt positions on a balance sheet. Whether consideration for covenant holidays, right-sizing balance sheets through debt for equity swaps or a method of "handing the keys" to a lender group, structured preferred equity can be tailored to accomplish the parties' goals.

Consideration for Lender Accommodation

At one end of the spectrum, structured preferred equity can provide a non-cash, tax efficient form of consideration to lenders agreeing to a financial covenant holiday, covenant relief to allow access to additional financing or extension of maturity. This often takes the form of warrants or preferred equity (or a combination of the two) intended to allow the lender to share in the "upside" made possible by the lender accommodation. While customary protections to ensure the value of this equity is not impaired or disproportionately modified would be expected, this can take the form of an economic instrument that does not interfere with the existing governance of the issuer.

Debt for Equity Swap to Rightsize the Balance Sheet

Where a long-term impairment of business has resulted in over leverage, structured preferred equity can be used to rightsize the balance sheet and still retain the lender's relative return priority over the sponsor or other equity owners. This often takes the form of "debt-like" preferred stock plus warrants or other equity "kickers." The terms for these instruments are unique to each transaction but often include a preferred equity instrument with economic and covenant protection in line with the debt for which it is exchanged. While structured preferred equity is not debt and does not carry with it lender remedies, care must be taken to ensure the securities provide appropriate economics and protections for the lender-stockholder while at the same time accomplishing the balance sheet de-levering sought by the borrower.

Structured Preferred Equity to Cede Control

In situations where the parties agree that the lender holds the fulcrum security and effectively owns the borrower, structured preferred equity can be used to accomplish the handover, provide economic preference to the lender and allow existing equity holders to maintain a subordinated stake in the borrower. It can be structured to provide complete control in favor the lender, contemplate independent director control or even continued governance for the pre-handover equity. Similarly, economics can be structured as the parties agree, including waterfalls that provide pre-handover a greater share of economics as the lender's returns increase. Lastly, this can be done as part of a balance sheet rightsizing, with economics and governance rights toggling in favor of the lender upon agreed upon defaults or milestone failures.

Structured Preferred Equity as Third-Party Financing

Structured preferred equity is an increasingly common type of financing for buyouts, leveraged dividends, refinancings and, in this environment, rescue financing. Numerous funds formed or designed to invest in structured preferred equity as well as sovereign wealth funds, insurance companies, family offices and private credit funds are eager participants in the market. Third-party financing by third parties may be available as rescue financing to de-lever the balance sheet or provide needed liquidity. These transactions provide additional equity capital for the borrower, benefiting existing lenders, while providing less dilution and governance control than traditional equity investments, benefiting the borrower and its incumbent owners.

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