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Hybrid Horizons: Investor Group Issues in Hybrid Capital Transactions: Approvals, Sacred Rights and Disproportionate Treatment

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Other installments in our Hybrid Horizons series address issues faced by holders of Hybrid Capital instruments tied to the nature of the security itself and how Hybrid Capital instruments govern the rights and obligations of the Issuer and the investor group collectively. This article discusses inter-investor group dynamics -- issues to consider regarding the internal workings of a group of unaffiliated investors who participate in a Hybrid Capital issuance.

1. Class Approvals and Voting Dynamics

Every Hybrid Capital instrument sets out the rights of the Hybrid Capital investors as a group, as well as which investors may grant approvals or waivers on behalf of the class. As is the case in private credit loans, investors often negotiate whether control of the class requires a simple majority or a “required holders” concept, which could require a higher percentage for approvals or require that an approving majority must include at least two unaffiliated holders. These terms can vary depending on, among other things, the relative investment size of the investors, potential conflicts of interest within the investor group and the investors’ comfort levels with others in the investor group.

Control of, or influence over, approvals by an equity sponsor or an investor that has a significant interest in the common equity of the issuer, for example, should be considered by the investor group and the minority investors in particular. Additionally, while issuers negotiate for the right to issue additional securities of the same class (typically subject to rights of first refusal), the amount of additional securities is often based in part on the additional securities’ potential impact on these inter-investor voting dynamics.

2. Sacred Rights

Another frequently negotiated point concerns sacred rights, which are rights that cannot be amended or waived without the consent of each (or a supermajority percentage of) the adversely affected members of the investor group. Sacred rights typically cover core economic protections, such as seniority, dividend rates, redemption amounts and redemption triggers. Some non-economic sacred rights are also common, including information rights, board observation rights and certain tax covenants. The practical effect can be significant: broader sacred rights requirements make it harder for the issuer and its larger investors to implement changes efficiently, while narrower definitions can leave minority investors exposed.

3. Disproportionate Treatment

Hybrid Capital instruments typically include protections against amendments that adversely and disproportionately affect an investor or group of investors as compared to other investors. This can be structured as a sacred right that each investor can enforce or a right that a majority of the adversely affected group can waive. While often limited to an amendment protection, minority investors may negotiate for other disproportionate treatment protections. For example, prohibiting the issuer from repurchasing Hybrid Capital through negotiated transactions with investors unless the opportunity is offered to all investors on an equal basis.

4. Transfer Rights and Secondary Sales

Investors often have the right to transfer their Hybrid Capital instruments, though often subject to issuer approval or approval not to be unreasonably withheld. Given an issuer’s comfort with an initial lead investor or group of investors, but wary of others controlling governance rights if the initial investors transfer their holdings, protections or rights of the Hybrid Capital instrument can be drafted as personal rights of the lead (or other original) investor that cannot be transferred. This limitation is common for board designation or observer rights but can also apply to covenants such as limitations on acquisitions and dispositions, capital expenditures, budget approvals or variances, etc. Investors should be cognizant of when rights of the class drop away, or that control over rights may be transferable by selling investors, and be comfortable that the lead investor will act responsibly.

In sum, the governance of preferred stock involves balancing individual investor protection against corporate and Hybrid Capital class flexibility. Clarity in drafting approval mechanisms, defining sacred rights narrowly but fairly, and protecting investors against disproportionate treatment is essential to minimizing disputes and preserving the cooperative relationship between investors and the company.

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