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Hybrid Capital and Private Credit Deep Dive - Alternatives to Enforcement: The Rise of the Equity Option Deed

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Introduction

Private capital markets have transformed substantially over the past decade. Private credit has established itself as a mainstream asset class, sponsor-backed mid-market buyouts have grown increasingly sophisticated and hybrid capital solutions have become a regular and viable option. These developments have fundamentally altered how risk is priced, documented and managed. As transaction structures have grown more intricate, market participants have sought greater certainty regarding downside outcomes.

Lenders have traditionally relied upon security packages and statutory insolvency processes to safeguard their position. Control was typically asserted reactively, following an event of default (in many cases following multiple events of default, time and consensual resolution) and then through acceleration and enforcement. In contemporary private markets, particularly those involving sponsor-backed and layered capital structures, this reactive approach is increasingly regarded as commercially blunt. Whilst formal insolvency may deliver legal finality, it often proves commercially inefficient.

Within this context, the Equity Option Deed has emerged as a significant structural innovation. It does not replace enforcement mechanisms, nor does it represent a radical departure from established creditor protections. Rather, it constitutes an evolution, the deliberate embedding of control optionality at origination or subsequently during the transaction lifecycle following financial underperformance. It reflects a broader transition away from reactive enforcement towards engineered outcomes.

In this Private Credit Deep Dive article, Daniel Hendon (Partner) and Charlotte Boylin (Special Finance Counsel) in Proskauer's Private Credit Group in London, examine the commercial drivers behind the Equity Option Deed, its increasing prevalence in sponsor-backed financings and its significance within the broader transformation of private credit documentation.

Enforcement as the default response

Financial underperformance and events of default have historically followed a well-established trajectory, a borrower group breaches covenants or fails to service debt, the lender accelerates the facility and security is enforced. Control transfers from the sponsor to the lender through administration, receivership or liquidation. This approach offers procedural clarity, statutory authority, defined priority and transparent creditor protections.

In sponsor-backed mid-market transactions (being £10m to £75m EBITDA businesses), enterprise value frequently resides principally in intangible assets, being brand equity, intellectual property, customer relationships, key personnel and ongoing commercial contracts. Formal insolvency can swiftly damage these value drivers. Public filings may cause reputational harm, activate change-of-control provisions, restrict supplier credit, prompt customer migration and accelerate departures of management and employees.

Even where insolvency ultimately proves unavoidable, value leakage can be considerable. Professional fees (encompassing legal, valuation and insolvency practitioner costs) in UK administrations frequently reach seven figures and may increase substantially in larger or more complex cases. Distressed sale valuations are commonly discounted relative to trading multiples, litigation risk may escalate and proceedings often become adversarial.

In essence, whilst the legal framework may be efficient in theory, the economic outcome can be materially compromised in practice.

The development of engineered optionality

The Equity Option Deed represents a recalibration of this standard model. Rather than relying exclusively upon statutory enforcement, lenders negotiate a contractual route to ownership transition in advance ensuring that control is designed rather than improvised.

In its most straightforward form, a private credit provider (frequently providing senior secured, unitranche or hybrid capital) negotiates an option to acquire equity upon the occurrence of specified triggers. These may include covenant breaches, sustained underperformance, payment defaults, insolvency events or refinancing shortfalls. The option is pre-agreed, documented and embedded within the transaction architecture either at origination or during the loan term. It often operates alongside drag-along rights, governance provisions, board observer rights, equity ratchets and transfer mechanics designed to facilitate efficient implementation.

The shift is subtle yet significant. Enforcement becomes one potential outcome within a broader set of control rights and it ceases to be the sole credible path to ownership transition. The lender moves from relying primarily upon security enforcement to structuring a contractual acquisition mechanism that may be exercised without entering administration.

Insights from a decade of restructurings

Over the past ten years, numerous UK businesses have restructured in circumstances where senior secured lenders converted debt into equity. In many instances, formal insolvency was avoided or at least minimised in favour of consensual solutions designed to preserve the operating platform.

Even where no Equity Option Deed was expressly in place, the commercial objective often mirrored its underlying logic being to transfer ownership whilst avoiding value-destructive collapse. Lenders recognised that liquidation or forced asset sales could erode enterprise value. Sponsors acknowledged that a public administration could damage reputation and impair future fundraising. The Equity Option Deed formalises these insights by reducing reliance upon post-default negotiation leverage and replacing uncertainty with predefined outcomes.

Economic efficiency: preserving costs to preserve value

A principal rationale for equity option structures is economic efficiency. Formal insolvency processes involve insolvency practitioners together with legal advisers, financial advisers and valuation experts. Fee leakage can be substantial and it arises precisely when liquidity may already be constrained.

The indirect economic consequences can prove even more significant, including tightened supplier terms, customer attrition and contract loss, employee turnover (particularly amongst senior management), cross-defaults across group structures, activation of change-of-control provisions and depressed valuation benchmarks in distressed sales.

By contrast, exercising a pre-agreed equity option can preserve continuity. Trading may continue uninterrupted and the ownership transition may occur without immediate visibility to key stakeholders. The lender can stabilise the business, inject capital where required and implement governance changes without the stigma and disruption associated with formal proceedings.

Confidentiality and reputation in relationship driven markets

Confidentiality represents another compelling driver. In sponsor backed transactions, reputational impact extends beyond the portfolio company to the sponsor itself. A public insolvency can affect fundraising, investor confidence and competitive positioning. A privately executed equity transfer pursuant to contractual option rights avoids the immediate reputational consequences of formal proceedings. Customers and counterparties may experience little or no disruption and the transaction can be characterised as a recapitalisation rather than a collapse.

Reputation matters equally to private credit providers. The market operates on the basis of relationships, and repeat player dynamics are fundamental. Sponsors who lose control in one transaction may return as counterparties in future transactions. A structured, predictable and contractually compliant ownership transition differs materially from an aggressive enforcement strategy.

Control architecture established at origination

A notable development is that equity option structures are increasingly negotiated at origination, particularly in private credit-funded buyouts. Documentation may reflect deliberate design of downside governance, including, equity call options triggered by specified covenant breaches or payment defaults, drag-along rights that streamline transfer mechanics, governance rights enabling rapid board reconstitution, transfer consent frameworks designed to prevent minority blocking positions and ratchets adjusting equity economics upon underperformance.

Significantly, equity options are rarely exercised. Their value frequently lies in their mere existence, a credible and efficient transfer mechanism can incentivise timely refinancing, proactive covenant management and constructive engagement at the earliest indications of distress.

A broader evolution in private credit practice

The increasing adoption of Equity Option Deeds signals a broader maturation of private credit. Early iterations of the asset class often tracked bank lending models, placing substantial emphasis upon security and enforcement. Today, leading private credit providers increasingly design transactions incorporating integrated control pathways, hybrid features and equity-linked downside protection.

This reflects several commercial realities, namely, private credit funds may possess the operational capability to hold and manage equity, sponsors increasingly require flexibility in volatile markets, hybrid instruments blur the traditional boundary between debt and equity and speed and certainty of execution confer competitive advantage.

Conclusion

The Equity Option Deed does not reject insolvency law, nor does it constitute a universal solution to distress. Formal enforcement remains a core creditor protection and in certain circumstances, will continue to be unavoidable. However, the growing prevalence of equity option structures reflects a meaningful shift in approach. Modern private credit focuses not solely upon recovery through security, it increasingly emphasises designing credible, efficient and value-preserving control pathways at origination or during the life of a transaction.

By embedding optionality within documentation, lenders can reduce uncertainty, limit value destruction and align downside governance with commercial reality. Sponsors gain predictability and confidentiality and enterprise value is more likely to be preserved. In complex sponsor-backed private credit and hybrid capital transactions, engineered optionality is becoming as important as traditional security and the Equity Option Deed clearly illustrates this evolution.

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