

American Preferred Equity Tools in the French Market: Practice and Legal Challenges

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The American private equity market has long been familiar with the preferred equity mechanism, which has now become one of its most distinctive financing instruments, attracting all types of investment funds, whether traditional or longer-term in profile (pension funds or retirement funds). This original investment mechanism, situated at the frontier between debt and equity, is defined as an equity investment instrument supplemented by priority contractual economic rights and structured return mechanisms, facilitating companies' access to substantial financing while limiting dilution through better valuation, while offering investors an attractive combination of downside protection and participation in value creation potential. In this respect, it differs from French hybrid capital structures, whose principal underlying instrument is a bond.

Positioned senior to common equity in the share capital structure but junior to debt, preferred equity does not benefit from the same priority protection mechanisms traditionally granted to lenders, the priority of preferred equity tools applying only over the remaining equity. It is precisely in this intermediate position that its attractiveness lies: it offers investors economic priority and downside protection while providing companies with capital that is often less dilutive than common equity. This financing method has achieved great success across various segments of private equity, whether in buy-out transactions (LBOs), minority investments, or other growth transactions, particularly due to the great flexibility offered by American law in structuring the instruments used to implement these transactions.

The popularity of preferred equity in the United States has inevitably tempted American investors to replicate equivalent protection mechanisms in their investments in France where practice exhibits less variety due to certain legal constraints arising from French corporate law or contract law. Recent experience nonetheless shows a strong trend toward diversification of the instruments offered by investors to provide companies with necessary financing, while ensuring maximum protection of the investment in a context of uncertain valuation or heightened risk. Among these mechanisms, practitioners have notably been able to structure instruments allowing the payment of priority cash dividends and the implementation of a participating liquidation preference.

1. Priority Dividends: Pursuing Guaranteed Return

One of the instruments highly favoured in American preferred equity, but also known in French practice, is the right to a priority cash dividend, paid before any distribution to holders of ordinary and/or preferred shares. The cash dividend constitutes the most direct mechanism by which the preferred equity investor receives a fixed and regular return on their investment. As in France, this preferential dividend (*dividende précipitaire*) may be cumulative or non-cumulative, although the cumulative form is most commonly observed in transactions. Under this structure, dividends not paid for a given fiscal year accumulate and must be paid in full before ordinary shareholders can receive any distribution. In the United States, cumulative dividends on preferred stock may accumulate over time or be triggered by the occurrence of a specific event, such as the achievement of cash flow targets or profitability levels. This mechanism is well known in French LBO transactions in which preferred shares with priority dividend rights (“ADP *taux*” or rate-based preferred shares) allow for replication of a mechanism equivalent to that of convertible bonds, thereby generating a fixed return for financial investors and/or the implementation of a sweet equity component for the benefit of managers.

In contrast, in traditional French LBOs, fixed-rate dividends are accumulated during the investment period and are only paid upon the financial investor's exit. This system differs fundamentally from the annual payment of cash dividends, which represents a mechanism particularly typical of the American market but remains largely unfamiliar in France. In American transactions, preferred shares are frequently structured with an annual dividend generally expressed as a percentage of the subscription value, paid in cash each year. Thus, investors benefit from a regular income stream, comparable to a bond coupon, while maintaining their exposure to value creation. In American LLC structures, the priority return may take the form of a preferred return rather than a dividend in the corporate law sense.

Of course, a dividend payable annually in cash assumes the generation of recurring and sufficient cash flows to service the annual dividend amount. In practice, this structure will only be suitable for companies with a certain level of maturity, regular cash generation, and substantial distribution capacity. In particular, the annual payment of the cash dividend must be coordinated with external financing (bank or unitranche) to allow the mobilization of cash for dividend payment without undermining the target's financial capabilities and its maximum leverage level.

This preference for cash dividends in the United States is explained by several structural factors specific to that market. First, a portion of American institutional investors, particularly pension funds and insurance companies, seek instruments generating a current yield to meet their distribution obligations to their subscribers (quite typical in certain open ended funds profiles). Their risk profile also differs from that of a venture capital fund or an LBO fund primarily betting on value creation at exit. Second, the cash dividend functions as a tool of financial discipline for the target, thereby reinforcing the alignment of interests between investors and management. The obvious consequence is that the company must have an immediate, regular cash generation profile allowing it to cover its other cash needs. Finally, in a context of high interest rates such as that observed since 2022, cash interest payments are a means for investors to de-risk their investment on a faster horizon than exit.

Thus, even though French practice is not familiar with this structure, it has been implemented in certain transactions with particular profiles. For example, a target generating significant cash but operating in a niche market might have more limited expansion capabilities and not benefit from external growth opportunities through build-ups (a classic strategy in LBO structures). In this context, an annual cash dividend, with a declining rate, allows the investor to recover part of their investment in the medium term, while benefiting from upside at exit.

While this mechanism appears very attractive from a theoretical standpoint, it may nonetheless encounter certain legal obstacles under French law. First, and most obviously, the existence of distributable profits allowing the priority dividend shares to capture such profits before other shareholders. This constraint also exists in the United States. Furthermore, French law imposes other public policy limits that do not necessarily exist under American law. The prohibition of “*clauses léonines*” (Article 1844-1 of the Civil Code), which prohibits the allocation of all profits to a single shareholder or completely excluding a shareholder from profits (typically addressed through a first pari passu distribution tranche for all shareholders in the waterfall, generally equal to the nominal value or a certain percentage of exit proceeds), and the prohibition of fixed interest clauses (Article L. 232-15 of the Commercial Code), which notably requires compliance with the public policy provisions applicable to dividend payments. Practitioners must therefore be very vigilant in drafting the terms and conditions of instruments in order to avoid the risk of nullity of the priority cash dividend mechanism.

2. Participating Preferred Equity: Combining Fixed Return with Exposure to Value Creation

French venture/growth capital transactions overwhelmingly use the liquidation preference mechanism by which investors holding preferred shares receive, in priority over other shareholders, an amount of exit proceeds corresponding to the invested capital, sometimes with a multiple (for example, 1.5x or 2x the initial investment amount) and/or a right to receive their pro rata share of sale proceeds (participating vs. non-participating). While liquidation preference multiples greater than 1x reappeared in France from 2022, this practice seems to have clearly declined over the past several months, with investors resorting to other ratchet mechanisms (ratchet warrants ("*bons de souscription d'actions*"), warrants giving rise to other preferred shares, etc.). This liquidation preference is expressed through non-participating preferred shares, which are the norm in the French market.

American preferred equity more often employs the participating preferred mechanism, a structure in which the investor benefits both from the priority return described above and from exposure to capital upside either through the waterfall or through warrants, conversion into equity, or co-investment in common equity. This is the mechanism commonly used in the United States for this type of hybrid transaction.

This mechanism allows the investor to benefit from a double return, referred to as a double dip in American practice. The mechanism operates in two stages. Upon a liquidity event, the investor first receives an amount corresponding to the invested capital, with or without a multiple, as the liquidation preference. Then, and this is the distinguishing feature of the mechanism, the same investor participates in the distribution of the residual balance of sale proceeds, alongside ordinary shareholders, as if their shares had been converted into common stock (and subject to other liquidation preferences applicable to more junior-preferred shares).

While this mechanism is not frequently used in French transactions, it can prove quite useful in transactions where the investor plays more of a role as a financier of a company's growth phase or reorganization. It can be combined with the payment of a priority cash dividend, with the waterfall providing for a variable distribution of exit proceeds depending on project performance. Thus, the higher the financial investor's exit multiple, the more the rebalancing favours management and minority investors, with the financial investor benefiting from a portion of exit proceeds enabling them to improve their performance in addition to dividends received. Generally, however, a cap is provided (usually 3 or 4 times the initial investment) as well as catch-up mechanisms for the benefit of other parties, allowing for distribution of excess sale proceeds in their favour. This double dip mechanism is rarer in French transactions, except in emergency refinancings (rescue financing or pay to play), perhaps because the prohibition of *clauses léonines* (see above) may create a zone of legal uncertainty around certain mechanisms that are too favourable to a single category of investors. However, this uncertainty seems to be surmountable through precise and adequate drafting of clauses containing the waterfall, which would not prevent, at least in theory, its implementation.

Thus, while the convergence between American and French practices is undeniable (French practitioners are progressively importing American preferred equity mechanisms into their LBO structures), structural differences persist, particularly with respect to priority dividends and participating preferred shares. These differences are the result of multiple factors, including different leverage dynamics, more stringent legal constraints, and different investor approaches to value creation. It nonetheless remains highly perceptible that, due to the growing presence of American players in these transactions, the classic mechanisms known across the Atlantic should continue to develop in France and enable divergent positions on valuations or uncertainties regarding project prospects or risks to converge through technical solutions. Certain transactions in the energy or infrastructure sectors, for example, which are characterized by expectations of regular returns, could undoubtedly position themselves as ideal candidates for implementing such mechanisms. This is all the more true as major international investors, heavily influenced by American practices, will certainly be inclined to propose these tools.

- **Pierre-Marie Boya**

Partner

- **Matthieu Grollemund**

Partner