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PREFERRED EQUITY AS A GROWING PART OF ACQUISITION FINANCE FOR FINANCIAL SPONSORS

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The past year has seen a significant increase in the use of preferred equity instruments as part of third party acquisition financings, particularly in the context of leveraged buyouts led by financial sponsors. A key driver behind this recent growth is that these instruments are structured to receive equity treatment from the rating agencies and bank regulators while otherwise retaining many debt-like features, such as limited governance rights and limited upside participation. Obtaining equity treatment for these instruments is attractive to financial sponsors because it allows them to increase effective leverage without negatively affecting the pricing of the senior portion of the debt capital stack due to a lower credit rating and without losing the ability to have financial institutions subject to the restrictions contained in the "Interagency Guidance on Leveraged Lending" underwrite all or part of that senior debt. Financial sponsors also like preferred equity because the increased leverage improves their potential internal rate of return and enhances their competitiveness in an auction scenario by allowing them to offer a higher purchase price.

Moreover, the trend toward using preferred equity may accelerate further in 2018 due to the continued growth of private credit providers, who were the primary underwriters of preferred equity instruments in 2017 (although regulated financial institutions did also underwrite some preferred equity in acquisition financing transactions). The higher returns available on preferred equity instruments relative to other types of junior capital can be especially appealing to private credit providers looking for yield—particularly in the recent low-yield environment. Additionally, market developments have

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shown that private credit providers who can offer a combined second lien and preferred equity solution have a competitive edge in many underwritten acquisition financings.

The rapid growth in the use of preferred equity in acquisition financings, and the differences between preferred equity and more traditional junior, subordinated, or mezzanine debt, have created both opportunities and risks that all transaction participants should consider. We have set forth below the key features of the preferred equity instruments used in acquisition financings and the key credit considerations resulting from the differences between these instruments and traditional debt instruments, as well as certain key tax considerations, including in relation to the recent U.S. tax reform legislation, which includes restrictions on interest deductibility that will reduce the cost of capital of preferred equity relative to debt.

Key Features and Credit Considerations

Maturity and Dividend Step-Up

In order to receive equity treatment from rating agencies and regulators, preferred equity instruments are usually structured to have no current cash pay dividends, no stated maturity and no mandatory redemption or investor put rights other than in the context of a change of control or other fundamental transaction, such as an IPO. To compensate the investor for these features, a relatively high fixed dividend rate (typically 10%+) is generally applied, with unpaid dividends compounding on a semi-annual or quarterly basis. In addition, dividend rates are often structured to step up after the passage of time (typically after four to six years) so as to incentivize the issuer and its sponsor to voluntarily redeem the preferred equity and give the investor the possibility of an exit. It is not uncommon for these duration-based dividend step-ups to be structured as an annual increase of 100-200 basis points once they have been triggered.

Governance and Voting

Because they come with a preferred return that must be paid before any dividends can be paid on the common equity, preferred equity instruments are typically non-voting (subject to limited ex-

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ceptions) and carry no or limited governance rights outside of the limited restrictive covenants discussed below. As a result, preferred equity holders have very little control over day-to-day operations or even major decisions. It is only for truly fundamental transactions that preferred equity holders have the protection of a mandatory redemption right. Ensuring that the sponsor's incentives and risk tolerance are aligned with those of the preferred equity investor are thus key factors in ensuring a successful investment. As a result, to ensure a right to participate in important decisions and have access to board materials and discussions, preferred equity investors often negotiate board observer and director rights. Though in certain instances all or some of these rights may "spring" into effect only after a certain period of time has passed (*i.e.*, duration based) or upon certain triggering events (*e.g.*, a failure to exit or a default under junior debt).

Negative Covenants

Preferred equity instruments generally include some level of negative covenant protection, such as limitations on debt, liens, investments, dispositions and affiliate transactions, with baskets and other thresholds being set with a certain amount of headroom above the levels provided for in the most junior tranche of senior debt. The scope of the covenants included and the amount of any such headroom are often heavily negotiated terms, but the protection provided by these covenants is generally far more limited than that contained in second-lien debt. On the other hand, there are some particular areas where preferred equity may be more restrictive to issuers than senior debt, including the following:

- ***Restricted Payments***. Preferred equity holders expect repayment on their investment prior to any return on the junior capital. As a result, the restricted payments covenant in a preferred equity instrument generally does not include the carve-outs for restricted payments included in senior debt instruments, such as a builder basket or a general basket. Careful consideration should therefore be given by both sponsors and investors to the scope of any distributions that are to be permitted, particularly with respect to tax distributions and other customary payments to sponsors, as these limitations are a key protection for the preferred equity investor.

- ***Anti-Layering and Issuance of Pari Passu Securities***. Holders of preferred equity instruments are typically structurally subordinated to all of the creditors, and even to any equity, at the operating company level, as well at any intermediate holding companies. This structural subordination results from the fact that preferred equity in acquisition financings often sits at least one level (if not multiple levels) above the entity serving as the "holdings" entity for purposes of the senior debt documentation. As such, there is an increased risk of issuers and sponsors layering other capital instruments (whether in the form of debt or equity) between the senior debt and the preferred equity tranche. It is therefore important for preferred equity investors to ensure that they include appropriate anti-layering covenants that restrict not only debt but also equity at entities lower down the structure, and to consider whether a more stringent affiliate transactions covenant is needed to restrict sponsor loans that would otherwise be senior to the preferred equity. Restrictions on the issuance of additional preferred equity or other *pari passu* equity securities are also often included.

Forced Sale and IPO Rights

In addition to mandatory redemption provisions triggered by a voluntary change of control or other fundamental transaction, preferred equity instruments often permit investors to force the issuer to use its reasonable best efforts to sell itself or effectuate an IPO if such a transaction has not occurred within a certain period of time (typically six to seven years after issuance) or upon the occurrence of certain events of defaults. Although these provisions have been prevalent in the market, their practical implementation may ultimately prove more difficult. Implementation concerns include the ability of adversarial sponsors to hinder enforcement of these rights, the prospect of generating relatively low sale or IPO proceeds given the situations in which these rights are likely to be exercised, and the limited enforcement rights available if a sale or IPO process proves to be ineffective

Limited Default Protections and Creditor Rights

Investors in preferred equity instruments are equity holders who do not benefit from any guarantees, security or statutory rights granted to creditors. Moreover, given its nature as equity, the covenant package and enforcement rights in a preferred equity instrument are not as protective as in a debt instrument. As a result, investors in preferred equity instruments lack many of the protections available to debt holders in an enforcement scenario and will rank junior to all creditors of the issuer and its subsidiaries in an insolvency. However, there are a number of negotiated protections for preferred investors that are typically included in these transactions, including the forced sale right noted above. Some of the other common protections include:

- ***Dividend Rate Step-Up***. Typically, the dividend rate steps up by 100-200 basis points upon default, with additional step-ups as the default continues. This step-up is in addition to the more general duration-based step-up discussed above.

- ***Springing Control***. Some preferred equity instruments have provided for additional control rights upon certain events of default, with such rights ranging from additional board seats to full control of the issuer. If such additional control rights are to be included, special attention will need to be paid to the implications such provisions may have on both the "change of control" provisions contained in the senior debt documentation and any duties that preferred holders may owe to the company's junior equity and other stakeholders.

Limited Fiduciary Rights: Delaware

The Delaware Chancery Court recently held that the obligations of a Delaware corporation to its preferred equity holders are only contractual in nature and that a Delaware corporation owes fiduciary duties to its preferred stock holders only to the extent their interests align with those of the corporation's common equity holders. In other words, if the issuer of a preferred equity instrument is a Delaware corporation, the preferred equity holders have neither creditor protections nor fiduciary protections with respect to their preferred equity rights.

Tax Treatment and U.S. Tax Reform

The tax treatment of a preferred equity instrument can differ significantly from that of a debt instrument, with the tax status of each of the issuer, the sponsor and the investors, as well as the particular terms of the preferred equity instrument, playing an important part in any tax analysis. Set forth below are some of the key tax considerations relating to preferred equity instruments used for acquisition financings.

Onshore Investors

The tax treatment of a preferred equity investment by a U.S. taxable investor will often be more favorable than the tax treatment of an investment in a debt instrument. In particular, U.S. taxable investors in a debt instrument that is treated as having been issued with original issue discount ("OID"), including as a result of any payment-in-kind (or "PIK") features, are generally required to accrue the OID into income over the term of the instrument, resulting in phantom income. Although similar rules apply to preferred equity, it is often possible to structure the terms of preferred equity in a manner such that there is no phantom income. Furthermore, corporate investors in preferred equity instruments may be eligible for the 50% dividends-received deduction, which does not apply to debt instruments. Individual investors are subject to tax on interest income from debt instruments at ordinary income rates (up to 37%), but they may be subject to tax at capital gains rates (up to 20%) on dividends on preferred equity. In addition, individual investors may also be eligible for the new deduction for "pass-through" income for distributions on preferred equity instruments issued by a partnership or limited liability company. On the other hand, U.S. investors that themselves are leveraged may be impacted by the new limitations on deductibility of net interest expense (discussed below), since interest received on investments in debt instruments is included in the calculation of net interest expense, while distributions on preferred equity instruments are not.

Offshore Investors

By contrast, the tax treatment of a preferred equity investment by a non-U.S. investor will often be less favorable than the tax treatment of an investment in a debt instrument. Non-U.S. investors typically are not subject to U.S. income or withholding tax on interest paid or accrued on, or gain realized from the sale of, debt instruments. Distributions on preferred equity investments, however, typically would be subject to U.S. withholding tax and, in the case of an issuer that is a partnership or limited liability company, be treated as "effectively connected income." Furthermore, gain on the sale of a preferred equity investment may be subject to U.S. tax under FIRPTA or, in the case of an investment in a pass-through vehicle, as effectively connected income. As a result, non-U.S. investors may require that preferred equity investments in pass-through vehicles be made through blocker corporations, and private credit providers with both onshore and offshore funds will need to consider how these investments could result in disparate treatment between their onshore and offshore investors. On the other hand, non-U.S. investors often have to carefully arrange their debt investment activities to ensure they are not treated as effectively connected with a U.S. financing business; it should be easier to manage that risk with respect to investments in preferred equity (other than equity in a pass-through vehicle).

Sponsors / Issuers

The lack of deductibility of dividend payments on preferred equity (when compared with interest payments on debt) will be a key consideration of any issuer or financial sponsor when structuring an acquisition financing transaction. This issue has been significantly affected by the recent U.S. tax reform legislation, which includes new limitations on the deductibility of interest payments on debt. In particular, deductions for net interest expense will be capped at 30% of EBITDA from the 2018 tax year (and at 30% of EBIT from the 2021 tax year), although disallowed deductions may be carried forward in certain circumstances. Pass-through issuers may also realize a tax benefit from preferred equity that is effectively equivalent to an interest deduction that is not subject to the new limitations. Accordingly, highly-levered sponsors that would have interest deductions capped by the new rule may consider structuring an issuance as preferred equity of a pass-through issuer instead of debt (although that might not always be practicable). In any event, even corporate issuers that expect to have their interest deductions capped by the new rule may be more likely to consider issuing preferred equity than previously, given that their cost of capital for debt will no longer benefit from as significant a tax subsidy as it previously did.

2018 and Beyond

Preferred equity is emerging as a key financing tool for financial sponsors, and its role can be expected to continue to grow as financial sponsors and private credit providers see the benefits that can result from including a preferred equity tranche in capital structures. Furthermore, the tax treatment of preferred equity relative to debt can be significantly more favorable for certain investors, and recent changes to interest deductibility resulting from U.S. tax reform will likely increase the attractiveness of preferred equity to financial sponsors, particularly in the case of highly levered issuers. The ultimate benefit of preferred equity is that it allows financial sponsors to increase effective leverage in a non-dilutive fashion without impacting the credit profile or regulatory treatment of the senior debt being used to finance an acquisition. However, given that the use of preferred equity in acquisition financing is still a relatively recent development, transaction participants, particularly preferred equity providers, should take care to fully understand the risks associated with any transaction involving preferred equity and make sure to have a clear picture of the ways in which these risks differ from those that would arise from using a debt instrument.