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Third-Party Preferred Equity as a Financing Device: Structuring "Debt-Like" Equity

Drafting Protective Covenants and Remedies Provisions; Redemption and Tax Issues

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Third-Party Preferred Equity as a Financing Device

by Robert G. Frucht, Esq. and
Jason D. Navarino, Esq.

Tuesday, November 7, 2017

RIKER DANZIG SCHERER HYLAND PERRETTI LLP

About Riker Danzig

- Founded in 1882 in Newark, New Jersey
- Based in Morristown, NJ, with offices in New York City and Trenton, NJ
- Full-service firm, recognized by *Law360* in 2017 as "New Jersey Powerhouse"
- Corporate and Tax Groups service wide range of middle-market and larger businesses across industries
  - M&A, joint ventures, LLC and private fund formations
  - Corporate finance and securities offerings
  - Commercial contracts and corporate governance
  - Cross-border transactions and local counsel engagements

Today's Presentation

I. Preferred equity as an alternative to debt financing: advantages and disadvantages
II. Structural differences between preferred equity and traditional equity
III. Key provisions and protective covenants
   A. Doing the deal
   B. Rights and remedies of preferred holders
   C. Governance rights and major decisions
   D. Redemption rights
IV. Tax treatment of PEI returns vs. interest on debt
V. Trust preferred securities
   A. Structure and rationale
   B. Tax treatment

I. Preferred Equity as an Alternative to Debt Financing

Advantages from the Issuer's Perspective

- Balance sheet optics (debt/equity ratio, etc.) may better enable facilitation of future leveraged financings, etc.
- Not necessarily repayable
- May allow issuer to redeem, call, exchange, etc., thus allowing balance sheet control on an ongoing basis
- Cash flow optionality remains with issuer (*e.g.*, payment-in-kind dividends)
- Lack of regular cash interest payments allows for cash to be used for business expansion as needs arise
- Potentially more control by issuer over future earnings

Disadvantages from the Issuer's Perspective

- Debt is cheaper than equity since it is less risky from investor perspective
- Ceding of ownership rights to the investor
- Investors often demand negative control rights or governance rights
- Exit control and timing may not be in accordance with owner/management views
- Investors may have put rights/guaranteed return/forced sale rights that may result in loss of control or loss of company by owner/founder/management
- Over time, bank debt may provide more retention of overall future earnings by the issuer

II. Structural Differences Between Preferred Equity and Traditional Equity

Structural Differences

- Preferred equity, in many ways like debt, is a contractual instrument
- Voting rights of corporate shareholders reside in common stockholders (subject to terms of the preferred instrument)
- Fiduciary duties: a matter of interpretation outside the “zone of insolvency”
- Dividends to common holders may be declared out of surplus but dividends to preferred holders are a matter of contract (one reason issuers of preferred use payment-in-kind dividend payments)
- In a liquidation scenario, preferred will get paid after debt but ahead of the common equity holders
- However, common equity holders have unlimited upside whereas preferred holders get contractual return (albeit ahead of the common holders)
- Inspection rights, books and records, etc. as a matter of contract, not law

III. Key Provisions and Protective Covenants

A. Doing the Deal

- Parties: issuer, issuer's counsel, issuer's financial adviser/banker, investor, investor's counsel, investor's financial adviser/banker
- Documents (or…from whence do the investor's contractually preferred rights arise…)
  - Preferred Equity Purchase Agreement: contains representations and warranties from the issuer and (usually minimal ones) from the investor, indemnifications, covenants, etc.
  - Actual instrument creating the investor's rights: operating agreement if LLC, but if corporation, needs to be in charter/bylaws
  - Certificate of designation vs. investor rights agreement

Doing the Deal

- Documents (cont. from prior slide)
  - Delaware: Certificate of Designations (acts as amendment to charter)
  - Certificated Interest (LLC or corporate): legended to reference preferred instrument
  - Registration rights agreement
  - Equity kicker (*e.g.*, warrant agreement)

B. Rights and Remedies of Preferred Holders

- Dividends
  - Contractually, periodically required dividends
  - Ability of issuer to “defer” - cumulative dividends; may be at Board discretion or per formula (or both)
  - Ability of issuer to pay dividends in kind
  - Instruments often have payment-in-kind and cumulative dividends concepts working simultaneously
- Guaranteed internal rate of return (“IRR”)/forced redemption
  - Investors may require that if they have not received an IRR of *x* by date *y*, issuer must either pay them the cash or redeem their investment, *regardless of market conditions*
  - Note: this may result in loss of control by issuer/management, founder

Rights and Remedies of Preferred Holders

- Investor puts and issuer calls
  - Investor puts may arise on change of control, based upon IRR at a certain period in time (discussed on previous slide), or at any time at investor's option
  - Issuer calls may arise on change of control, any time at issuer's option, or based upon other key metrics
- Investor rights of first refusal on future financings: some investors seek to have a right of first refusal on all financings while they are in the deal
- Protection as to ranking, subordination and *parri passu* issuance
  - Negative leverage covenants - blanket prohibition vs. incurrence ratios
  - Restrictions on layering

Rights and Remedies of Preferred Holders

- Guaranteed maturity dates - looks like debt
- Ability of issuer to extend maturity date
- Conversion rights
  - Convertibility at investor's option, *e.g.*, at time of initial public offering or other exit event
  - May also be convertible at issuer's option
- Registration Rights Agreement - investor will seek to be "ahead" of other selling stockholders and manage underwriter cut-backs, etc.
- Anti-dilution
- Full ratchet anti-dilution vs. weighted average anti-dilution and narrow vs. broad definition of "fully diluted basis" and "common stock outstanding"

C. Governance Rights and Major Decisions

- Board representation vs. observer status: investor will seek to have as much freedom in making appointments as possible but the issuer must be wary of “bad actors” and competitors
- Ability of investor to remove, replace any nominee
- Investors may require nominees to have indemnification agreements from the issuer - D&O insurance, etc.
- Major decisions: investors will seek to have negative control over debt incurrence, exit transactions, sale of key assets, changes in lines of business, etc.
- LLC vs. corporate context and presence or absence of fiduciary duties: investor nominees may or may not have fiduciary duties depending upon corporate form

D. Redemption

- Issuers will seek maximum flexibility in ability to "redeem-out" the investor
- What does the investor get upon redemption? Cash in the amount of:
  - original investment;
  - preferred return; and/or
  - cumulative but unpaid dividends (watch out for payment-in-kind dividends).
- Remember, there are sometimes forced redemptions (recall prior discussion regarding puts)

IV. Tax Treatment of PEI Returns vs. Interest on Debt

Debt v. Equity Treatment

- Internal Revenue Code (“Code”) Section 385(b) lists several factors taken into account in the debt v. equity determination:
  - Whether there is a written unconditional promise to pay, on demand or on a specified date, a fixed amount in money in return for adequate consideration and to pay a fixed rate of interest;
  - Whether there is subordination to, or a preference over, other debt;
  - The ratio of debt to equity;
  - Whether there is convertibility of debt into stock; and
  - The relationship between stockholdings and holdings of the interest in question.

Debt v. Equity Treatment

- These additional factors have been distilled from relevant case law:
  - Intent of the parties
  - Identity between creditors and shareholders
  - Extent of participation in management by the holder of the instrument
  - Ability of the corporation to obtain funds from outside sources
  - “Thinness” of the capital structure in relation to debt
  - Risk involved
  - Formal indicia of the arrangement
  - Relative position of the obligees as to other creditors regarding the payment of interest and principal

Debt v. Equity Treatment

- Additional factors from case law
  - Voting power of the holder of the instrument
  - Provision of a fixed rate of interest
  - A contingency on the obligation to repay
  - Source of the interest payments
  - Presence or absence of a fixed maturity date
  - Provision for redemption by the corporation
  - Provision for redemption at the option of the holder
  - Timing of the advance with reference to the organization of the corporation

Consequences of Equity Treatment

- Issuer treatment
  - If treated as preferred equity, dividends are not deductible by the issuer (whereas interest payments on debt would be)
- Investor treatment
  - If U.S. corporation, investor may be eligible for dividends received deduction of 70% or more (Code Section 243)
  - If U.S. individual, investor may be eligible for reduced rate of tax on dividends (Code Section 1(h)(11))
  - If non-U.S. individual or entity, the investor may be subject to up to 30% withholding tax on dividends (whereas interest on debt is usually withholding free thanks to portfolio interest exception of Code Section 871(h))

Section 1504 Preferred Stock

- Code Section 1504 defines “preferred stock” as stock that:
  - Is non-voting;
  - Is limited and preferred as to dividends and its holders do not significantly participate in corporate growth;
  - Has redemption and liquidation rights that do not exceed the issue price (other than a reasonable premium); and
  - Is not convertible to other classes of stock.

Consequences of 1504 Preferred Stock Treatment

- Under Code Section 1504
  - Preferred stock is excluded from the determination of control for purposes of the Section 1504 consolidated return requirements
- Under Code Sections 332 and 337
  - Preferred stock as defined in Section 1504 is excluded from the control requirement for a tax-free liquidation

Nonqualified Preferred Stock

- Under Code Section 351(g)(2)(A), nonqualified preferred stock ("NQPS") means preferred stock if:
  - The holder of the stock has the right to require the issuer or a related person to redeem or purchase the stock;
  - The issuer or a related person is required to redeem or purchase the stock;
  - The issuer or related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that the right will be exercised; or
  - The dividend rate varies with reference to interest rates, commodity prices, etc.

Nonqualified Preferred Stock

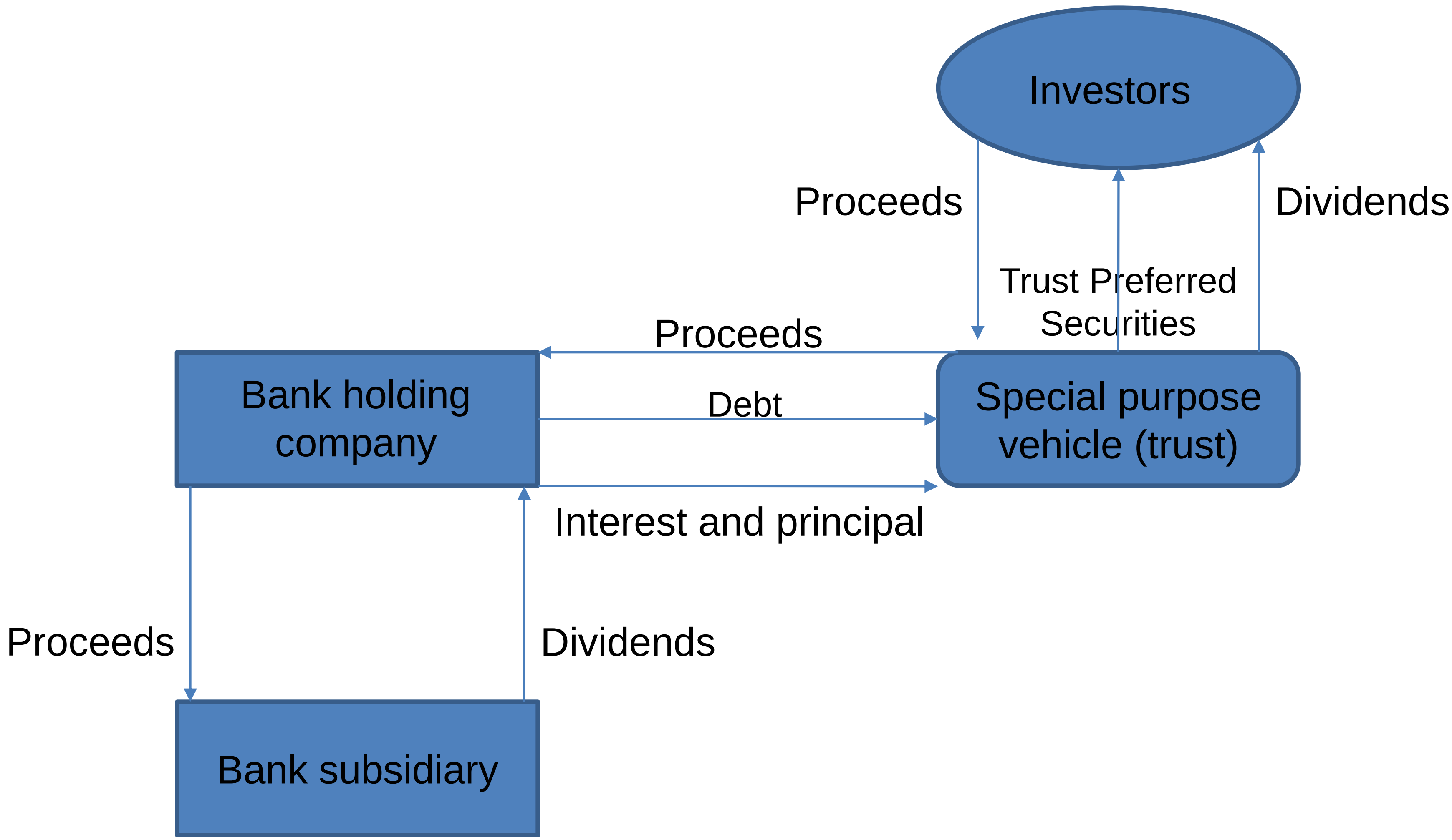
- Limitations and exceptions
  - The redemption rights/obligations listed on the prior slide will cause preferred stock to be NQPS only if they are exercisable within 20 years from the issue date and the likelihood of exercise is not remote
  - Preferred stock is excepted from being NQPS if the redemption rights/obligations are exercisable only upon the death, disability or mental incompetency of the holder, or if the redemption rights/obligations are transferred in connection with performance for services, if they are exercisable only upon the holder's separation from service from the issuer

Consequences of NQPS Treatment

- Under Code Section 351 (tax free contributions of property)
  - NQPS is not treated as stock for purposes of Section 351
  - Thus, a transfer of property to a corporation in exchange for NQPS will not qualify as a tax-free contribution
  - NQPS is considered "other property" and thus will constitute boot
- Under Code Section 354 (tax free reorganizations)
  - Similar to 351, NQPS is not treated as stock for purposes of Section 354 (with the exception of E reorganizations)
  - Result of this treatment is that the requirements for an entirely tax-free reorganization cannot be met when NQPS is exchanged
- Note that NQPS *is* counted for purposes of determining whether the control test of Code Section 368(c) is satisfied – relevant for both Sections 351 and 354

V. Trust Preferred Securities ("TruPS")

A. Structure and Rationale



Structure and Rationale

- Issuer creates a trust with the issuer retaining common ownership thereof
- Trust issues preferred stock to investors
- Proceeds of sale go to the issuer in return for junior debt that the issuer issues to the trust (same terms as the TruPS)
- Tend to see long-term maturity, deferral of interest for certain periods, early redemptions and subordination
- Issuers can sometimes toggle between fixed/floating after a period of years
- Issuers likely required to stop paying all common dividends if deferring interest to holders of TruPS

Structure and Rationale

- Some issuers have "special event calls" that let issuer call the TruPS on account of changes in capital treatment (below), changes in tax treatment, regulatory/rating agency issues, etc.
- Matures at par - investor is getting interest payments until redemption or maturity
- Use of ultimate issuer guarantee as to payments due on TruPS
- Ability of bank holding companies to count as "capital"
- Disadvantages
  - Complexity leads to high offering costs - legal, accounting and investment banking
  - Interest rates higher as a function of terms (subordination, interest payment deferral, etc.)

B. Tax Treatment

- Trust is a grantor trust – settlors are beneficiaries – and so the trust is disregarded for income tax purposes
- Thus, investors are deemed to own the debt issued to the trust
- Issuer gets to deduct interest payments
- Investors not entitled to dividends received deduction or reduced tax rate on dividends
  - But repayment of principal is generally tax free
  - Foreign investors may avoid withholding taxes thanks to portfolio interest exception

Thank You

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