Preferred-Stock Minority Investments in the Private Equity Context

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Introduction

When purchasing a company, private equity sponsors typically use a combination of debt and equity to fund the purchase price. When structuring a transaction, private equity sponsors may invest all or a portion of their equity capital in the form of preferred stock or issue preferred stock to minority investors if sufficient debt is not available. Similarly, a company may, from time to time, issue one or more series of preferred stock to raise necessary operating capital when debt financing is only available on restrictive terms or not available at all.

This article explores such uses of preferred stock in private equity transactions, with a particular focus on its use in minority investments, including as an alternative or supplement to debt financing, and will analyze the relative benefits and drawbacks of utilizing preferred stock in this context from the perspective of both the issuing company (which also may be controlled by a private equity sponsor) and the private equity minority investor. Relatedly, it will address how, in the context of financing an acquisition, a private equity sponsor may allocate financing risk and the risk of an acquisition not being consummated with its minority preferred investors, including in connection with commitment letters, guarantees, and termination fees.

Preferred Stock, Generally

Preferred stock is a class of securities that generally provides for a priority claim over common stock on dividends and the distribution of a company's assets in the event of a liquidation of the business. Depending on when and under what circumstances it is issued, a given class or series of preferred stock can rank equal, senior, or junior to other classes or series of preferred stock. Like all equity, preferred stock is junior to all debt and trade creditors.

In addition to the downside protection afforded by such priority rights in the event of liquidation, preferred stock may also enable the holder to share in the possible upside of the issuing company by offering holders the right to convert their preferred stock into common stock or to participate in dividends on common stock.

Preferred stock can include built-in protections, granting the holder control rights over major business and corporate decisions of the issuing company via class voting or veto rights. The specific parameters of these terms vary from issuance to issuance and will be discussed in more detail below (see Advantages and Disadvantages – Private Equity-Controlled Company's Perspective).

As discussed above (see Introduction), a company raising capital may issue preferred stock as an alternative to issuing more common stock or taking on debt. In the leveraged buyout context, a private equity buyer may issue preferred stock to a minority investor to cover a portion of the purchase price that is not funded by the private equity sponsor's fund or with debt financing. Appendix I includes a comparison between the key features of preferred stock and debt.

The issuer of preferred stock can be a corporation, limited liability company, or limited partnership, with the terms of such equity built into the articles of incorporation and shareholders agreement, limited liability company agreement, or limited partnership agreement, respectively. "Preferred stock" typically refers to preferred equity issued by a corporation, while a "preferred membership interest" or a "preferred partnership interest" refers to preferred equity issued by a limited liability company and limited partnership, respectively. For purposes of this article, all such concepts are referred to as preferred stock for simplicity, but the concepts may apply equally to any variety of organizational forms.

Advantages and Disadvantages – Minority Investor's Perspective

Flexibility for Preferred Stock Investors

Preferred stock is a favored vehicle for private equity sponsors making minority investments because of the ability to adapt the terms of the security to address deal-specific considerations. Because preferential rights of preferred stock are generally regarded as contractual rights that are governed by the express provisions of an issuing company's governing documents, issuing companies and investors have considerable flexibility to craft and tailor the specific terms of any given class or series of preferred stock to meet their respective needs. An investor with significant leverage can craft the terms of its preferred stock to grant it as much control of the issuing company and beneficial economic terms as its bargaining power allows.

Control of the Issuing Company by Preferred-Stock Investors

Minority preferred investors will generally wish to keep some measure of control over the policies and direction of the issuing company to protect the potential return on their investment. Control sponsors normally designate a majority of the board of directors of the issuing company in addition to being its largest stockholder and can, therefore, unilaterally implement their policies and otherwise protect their interests by controlling relevant board or stockholder votes absent special negotiated rights for minority investors. Accordingly, a minority preferred investor will commonly seek to build rights into its securities setting out that certain actions may not be taken without its consent or that such actions require additional or majority voting rights for such decisions (see Advantages and Disadvantages – Private Equity-Controlled Company's Perspective). For example, a minority preferred investor may not have sufficient control to prevent an issuing company from incurring excessive debt if determining whether to borrow would simply be subject to a standard board approval, and may, therefore, negotiate into its securities the right to veto any incurrence of debt beyond certain limits.

Preferred Stock vs. Debt from the Preferred-Stock Investor's Perspective

One of the primary drawbacks of investing in preferred stock as opposed to providing capital in a traditional debt format is that claims by holders of preferred stock are unsecured and are subordinate to debt providers (and possibly other classes or series of preferred stock ranking senior to the preferred stock in question). Accordingly, amounts due to holders of preferred stock may be uncollectible if the issuing company does not have sufficient assets to pay its creditors in full. Additionally, an issuing company can generally only pay dividends out of a surplus (the issuing company's net assets over its stated capital) or out of its net profits for a given year, which may limit the ability of a minority preferred-stock investor to receive a dividend, an important part of its expected return on investment. Despite this, a private equity investor may still favor investing in preferred stock rather than providing debt because of the potential for upside participation. While anticipated payments to debt providers are perhaps more certain than payments to holders of preferred stock, debt payments are fixed. Regardless of how successful a borrower is between the time it borrowed and the final resolution of its loan, the periodic payments and fees to the lender will remain the same. In contrast, investors in preferred stock that is convertible into common stock have the ability to convert their preferred stock such that if an issuing company's value has risen sufficiently following a preferred investment, preferred stockholders can share in an increase in the value of the issuing company alongside the common stockholders.

Advantages and Disadvantages – Private Equity-Controlled Company's Perspective

Flexibility for the Issuing Company

A company issuing preferred stock also benefits from the flexibility described in Advantages and Disadvantages – Minority Investor's Perspective. Because of the contractual nature of preferred stock, an issuing company is free to decide whether to give limited or broad preferential rights depending on the extent of its need for funds and eagerness to attract investors. In a scenario where an issuing company is in need of additional capital and debt is not available, this flexibility allows the company to provide as generous terms as the market will require to facilitate investment.

Preferred Stock vs. Debt from the Issuing Company's Perspective

In comparison to incurring additional debt, a company may be reluctant to issue preferred stock because it may dilute the current investors' ownership in the issuing company if the preferred stock is convertible into common stock. Additionally, although dividend payments on preferred stock are in many ways analogous to interest payments on debt, preferred stock likely yields a higher return for investors than the company would have paid for debt given the preferred stock's junior position to the debt in the capital structure. Finally, a company whose governing documents do not provide for "blank check preferred stock," which allows the board of directors to determine the terms of and issue a class of preferred stock without stockholder consent, has the additional complication of obtaining the consent of other stockholders of the company in order to complete the issuance of preferred stock. Similarly, some stock exchanges require their listed companies to obtain shareholder consent in order to issue preferred stock if the amount of convertible preferred stock to be sold or voting power to be granted to a minority preferred investor is above certain thresholds.

Liquidation Preference

Liquidation Preference, Generally

A liquidation preference refers to the amount per share a series of preferred stock will receive upon liquidation (or deemed liquidation (see "Deemed Liquidation" below)) of the issuing company before any distributions are made to holders of common stock or other junior preferred stock. The amount of the liquidation preference is often tied to the amount of invested capital, but can be higher (by a multiple or other metric) to incentivize investment. This preference may also include the right to receive back dividends that remain unpaid (see "Single-Dip vs. Double-Dip Liquidation Preference" below). The liquidation preference is the means by which a minority preferred investor obtains its down-side protection, ensuring (subject to availability of company assets) that it will at least get its capital plus unpaid dividends. A typical liquidation preference for a convertible preferred stock is the greater of (1) invested capital plus unpaid dividends and (2) the amount that the preferred holder would have received if it converted its preferred stock into common stock immediately prior to the liquidation event.

Deemed Liquidation

Liquidation preferences are paid to preferred stockholders not only in the case of an actual liquidation or dissolution, but also upon certain events that are deemed to be similar to liquidation (this is analogous to a change of control acceleration under a debt instrument). What constitutes a deemed liquidation can be a heavily negotiated point as this is where holders of preferred stock can, on the one hand, cash in their liquidation preference and, on the other, lose the benefits of their preferred status (e.g., if they're dragged along in a sale and have minimal negotiating power). Some of the negotiation points may include whether to include the following as triggers for a deemed liquidation and how these events are defined:

- Initial public offering (IPO)
- Change of control (whether by sale of stock or reorganization, merger, or consolidation)
- Sale of all or substantially all of the company assets

Single-Dip vs. Double-Dip Liquidation Preference

As discussed above, generally, preferred stock provides for a liquidation preference equal to the greater of (1) an amount equal to the invested capital plus all accrued and unpaid dividends (see "Dividends" below) and (2) the amount the holder would be entitled to receive if the preferred stock had been converted to common stock, before any liquidation proceeds are paid to other stockholders. This means that while the preferred holder has a priority return relative to the holders of common stock, assuming sufficient company assets, in the aggregate they will not get more than a holder of common stock. This structure is commonly known as a "single-dip" liquidation preference.

More investor-friendly preferred stock, available when an investor has significant negotiating leverage, provides for a return of an amount equal to the invested capital plus all accrued and unpaid dividends, as well as participation with common stock holders in the remaining distribution proceeds on an as-converted basis, before any liquidation proceeds are paid to other stockholders. This means that the preferred holder will always receive more than a holder of common stock because it receives its liquidation preference and its pro rata piece of remaining assets. This structure is commonly known as a "double-dip" liquidation preference.

Other Customary Features of Preferred Stock in the Private Equity Minority Investment Context

It is beyond the scope of this article to discuss all features and mechanics of preferred stock in detail; however, this section briefly discusses some key terms that a minority preferred investor will be focused on as they can impact the economics of a preferred investment.

Control Rights Granted to Minority Preferred Investors

A minority preferred investor will generally insist on some level of consent or veto rights on certain key corporate, finance, business, and employee decisions. These rights can take the form of a requirement that a given action must be approved by the class or series of preferred stock that the minority investor holds or the directors appointed by the minority investor. Private equity firms generally prefer a stockholder, rather than a director, consent right because stockholder consent rights are often negotiated into the charter (or certificate of designation) so failure to comply may be considered ultra vires. Additionally, the default rule is that a director (even if appointed by a preferred stockholder) owes fiduciary duties to all stockholders and, therefore, cannot consider only the interests of a minority investor. Note that the issue of fiduciary duties can be mitigated in limited liability companies and limited partnerships if fiduciary duties are permitted to be waived under applicable law.

Minority preferred investor control rights can be limited to fundamental issues (e.g., a sale of the issuing company or changes to its organizational documents) or can extend to broader operational matters (e.g., whether to incur debt or the approval of capital expenditures). Minority preferred investors may favor tighter controls because they tend to be active investors and may have relevant experience that they want to bring to bear on their investment. Conversely, issuing companies and their majority stockholders will seek to limit investor control rights so as not to impede the operation of the business. Relatedly, in order to more closely monitor their investment, minority preferred investors commonly request the right to designate an observer or one or more directors to the issuing company's board, and the right of such representatives to sit on all or key committees.

As mentioned above (see Preferred Stock, Generally), a company can issue multiple series and classes of preferred stock with different ranks within the company's capital structure. If the company has issued (or has the ability to issue in the future) preferred stock that is ranked senior to or pari passu with the preferred stock issued to the minority preferred investor, it is important to negotiate for consent rights over issuances of pari passu and/or senior stock to ensure that the minority preferred investor is not pushed down the capital structure without its consent.

When drafting consent rights, minority preferred investors must be aware of the limitations of such rights. As discussed above (see Advantages and Disadvantages – Minority Investor's Perspective and Advantages and Disadvantages – Private Equity-Controlled Company's Perspective), preferential rights are generally regarded as contractual rights that are governed by the express provisions of an issuing company's governing documents. In addition to allowing parties to tailor terms to specific needs, this also means that preferential rights are limited to what is clearly granted in the underlying documents. For example, to protect the rights of a minority preferred investor, the certificate of incorporation (or certificate of designation) of an issuing company may provide that the organizational documents of the issuing company may not be altered without the consent of the minority preferred investor. However, if the certificate of incorporation (or certificate of designation) of the issuing company does not also specify that, without the consent of the minority preferred investor, the organizational documents of the issuing company cannot be altered through a merger, the issuing company can merge (if the minority preferred investor does not have a veto right over business combinations) into a wholly owned subsidiary with the subsidiary surviving and all preferred stock in the issuing company converted to common stock in the surviving entity, thereby stripping the minority preferred investor of its preferential rights.

The negotiation of control rights is even more crucial in the context of an issuing company that is struggling as investors have heightened concerns about their investment in that context. A broad list of consent rights that minority preferred investors may request is included in Appendix II.

Dividends

A key component of preferred stock for minority preferred investors is the predictable stream of returns provided by dividends. Some preferred stock provides that, instead of a cash dividend, the issuing company will pay PIK (payment-in-kind) dividends that grant the dividend recipient additional shares of the same class or series of preferred stock of the issuing company (this could be considered akin to compound interest).

An issuing company, for a variety of reasons, may not have cash immediately available to declare dividends when they are due. To address this, preferred stock may stipulate that undeclared dividends are cumulative, meaning that that if a given dividend is not declared by the issuing company at the time it is meant to be declared pursuant to the terms of the preferred investment, the dividend is not lost, rather it remains owed to the minority preferred investor. These accumulated amounts may also compound such that the minority preferred investor's investment amount is deemed to be increased by the amount of the accumulated dividend. The issuing company will then pay future dividends to the minority preferred investor on the minority preferred investor's original investment amount and on the amount that has accumulated as well.

While the tax consequences associated with a preferred investment are generally beyond the scope of this article, it is important to note that the structure of the dividend payments (i.e., accrual of unpaid dividends vs. PIK dividends) can have a meaningful impact on the tax results for a preferred investor. For example, while there is no authority directly on point and the tax consequences will depend on the specific facts, it may be possible for a preferred investor to take a position that accrued but unpaid dividends are not includible currently in income for U.S. federal income tax purposes. With respect to PIK dividends, however, these generally are includible currently in income, and therefore PIK dividends give rise to "phantom income" for a preferred investor from a U.S. federal income tax perspective (i.e., the inclusion of income without a corresponding receipt of cash). Preferred investors should consult a tax advisor in connection with the structuring of any preferred investment to determine the tax consequences applicable to their specific situation.

Additional Features of Preferred Stock Issued to Minority Preferred Investors

Some other common features of preferred stock issued to minority preferred investors include:

- Redemption rights (the right of the issuing company to repurchase shares, or the right of the holder to require the issuing company to repurchase shares, at a stated price and a predetermined time)
    - This may be particularly important for a private equity sponsor that has a limited investment horizon and requires liquidity after a set period to realize on its investment thesis.
- Conversion right (the right of the issuing company or the investor to convert the investor's preferred stock into common stock)
    - Conversion ratios may also be subject to adjustments for certain events, including stock splits or the issuance of stock dividends.
- Information rights (e.g., the right to receive the issuing company's financial information, approve the issuing company's annual budget or business plan, inspect the books and records of the issuing company and be notified of a material adverse change to the issuing company)
- Limitations on the ability to transfer or issue shares (e.g., customary drag and tag-along rights, preemptive rights on new issuances, rights of first refusal and first offer)
- Reimbursement of the investor's expenses
- Limits on use of proceeds of the preferred stock issuance

Deal Certainty and Private Equity Minority Investments

Private Equity Deal Certainty, Generally

In the typical private equity leveraged buyout, the buying entity is often a newly formed acquisition subsidiary with no existing business or capital. Accordingly, a seller will need to ensure that the buyer will have the funds needed to close the transaction and that there is a creditworthy entity against which it will have recourse if the buyer breaches its obligations. To address this, a seller will require commitment letters, signed simultaneously with a definitive transaction agreement, from the buyer's equity sponsor (an equity commitment letter) and lender (a debt commitment letter), wherein each commits to deliver an agreed-upon amount of capital to the buyer at or prior to closing. A seller will also require a guarantee from a creditworthy parent entity of the buyer to support the buyer's obligations under the transaction agreement, including the payment of a reverse termination fee to the seller if the buyer cannot close the transaction when required.

Minority Equity Commitment Negotiation Points

All parties need to be mindful of when the minority investor's commitment becomes effective. A seller will require a commitment in place at the time a definitive agreement between the buyer and seller is signed. However, terms of a potential minority investment are not always finalized at that stage. In that scenario, one possibility is for the lead private equity sponsor to commit (subject to any diversity limits under its fund documents) to the entire equity amount in its equity commitment letter and subsequently syndicate a portion to minority investors. Under this structure, the lead private equity sponsor is taking the risk that it will not be able to syndicate its equity commitment to minority investors and could end up having to fund the entire equity amount at closing.

Where terms of a minority investment are agreed upon when the definitive transaction agreement is signed, minority investors typically execute their own equity commitment letter at that time. Not surprisingly, a seller will prefer to be named as an express third-party beneficiary of that equity commitment letter, so that they can directly enforce the obligations of the minority investor to fund the committed capital. Lead private equity sponsors may be hesitant to structure commitment letters in this way because they do not want their equity investors to be sued, potentially damaging both an important relationship and the lead private equity sponsor's reputation for subsequent equity syndications. One approach is to put back-to-back equity commitment letters in place at signing, whereby the minority investor executes an equity commitment letter to the lead private equity sponsor and the lead private equity sponsor then executes an equity commitment letter for the full amount, inclusive of the minority investor's commitment, to the buyer. Under this structure, the seller would have third-party rights only against the lead private equity sponsor and not against the minority investor, and the lead sponsor takes the risk that the minority investor does not fund under the minority investor commitment letter. This is similar to the structure of a debt commitment letter, whereby a seller has no contractual privity with debt financing sources.

Similar to debt commitment letters, a lead private equity sponsor will need to insure that there is no gap (commonly referred to as "daylight") between the conditions under which the minority investor (or the lender in the case of a debt commitment letter) is required to deliver its portion of the purchase price and the conditions under which the lead private equity sponsor is required to fund under its equity commitment letter. In a scenario where there is asymmetry between the conditions, it is possible that a lead private equity sponsor could find itself being required to fund its equity commitment when its minority investor is not. A buyer-friendly solution is to treat a minority investment in a similar manner as debt financing is treated for purposes of the remedies under a purchase agreement. Specifically, the lead private equity sponsor would expressly condition the obligation of the lead private equity sponsor to fund under its equity commitment letter on the minority investor's delivery of its portion of the funds, and to thereby limit recourse against the lead private equity sponsor to the reverse termination fee if the minority investor does not fund and the transaction does not close.

Minority Guarantee and Termination Fee Negotiation Points

Related to equity commitments, another common negotiating point is whether a minority investor will be liable for a portion of the reverse termination fee payable pursuant to the lead private equity sponsor's guarantee to the seller. A lead private equity sponsor may negotiate for a minority investor to expressly accept responsibility for a percentage of the reverse termination fee if it is payable under the purchase agreement; however, many minority investors will take the position that the reverse termination fee should be paid only by the lead private equity sponsor and recourse against the minority investor must be limited to contractual remedies under the equity commitment letter such that their liability would be limited to situations where the failure to close was due to their breach.

Conclusion

By virtue of its inherent malleability, preferred stock is a flexible instrument that allows parties to an investment to tailor the terms of their deal in the manner they see fit, enabling an investor to obtain as much control of an issuing company as its bargaining power will allow, and enabling an issuing company to raise capital by crafting terms attractive to investors. It is, however, important to understand the limitations of preferred stock so that a potential minority preferred investor can accurately assess the risks and benefits of such an investment.

Mordechai Biegeleisen of Paul, Weiss, Rifkind, Wharton & Garrison LLP assisted in the preparation of this practice note.

Appendix I – Chart: Preferred Stock vs. Debt

	Preferred Stock	**Debt**
Rank:	Junior to all debt, senior to other equity claims (other than senior classes of preferred)	Senior to all equity claims, including preferred stock
Risk:	Claims are unsecured	Claims may be secured or unsecured
Return:	Dividends and liquidation preference likely results in higher return to the holder than if they had provided debt given its junior status to debt	Fixed, and return is likely lower than if invested in preferred equity given availability of collateral and senior priority of claim
Ability to share in upside if company appreciates:	Yes, through conversion to common stock and participating dividends	No, payments are limited to repayment of face amount and interest
Dilution of ownership:	Yes, if convertible into common stock	No
Control:	Contractual and potentially more fulsome than debt	Contractual, through negative covenants, the scope of which depends on the state of the credit markets generally and whether the debt is secured or unsecured

Appendix II – Consent Rights

Items marked with an asterisk are fundamental rights that most investors would consider paramount to provide sufficient protection for their investment.

Corporate

- Merger, consolidation, business combination*
- Sale of all or substantially all of the company's assets*
- Reorganization, bankruptcy petition*
- Dissolution*
- IPO
- Modification of governance documents*
- Creation of subsidiaries
- Reincorporation and reconstitution (e.g., from an LLC to a corporation)*
- Name change

Finance

- Issuances of equity
- Redemption of equity
- Distribution of cash or securities to stockholders
- Incurrence of debt
- Repayment of debt
- Selection or removal of independent auditor
- Significant tax elections

Business

- Business plan (and changes)
- Annual budget (and changes)
- New lines of business
- Significant new projects
- Major investments and unbudgeted capital expenditures
- Sales of significant assets
- Significant investment loans
- Material leasing and licensing agreements
- Capital-expenditure (capex) projects
- Termination of major business projects

- Major distribution or production agreements
- Changes in distribution or production strategy
- Initiation and settlement of legal proceedings
- Transactions with affiliates and related parties

Employees

- Entry into, amendments to, and waivers of employment or consulting agreements
- Hiring, firing, and compensation of certain executive officers
- Adoption of and amendments to incentive compensation and employee benefit plans

Related Content

For additional information on private equity fund investments and financing, see the following practice notes and forms:

- Chart: Preferred Stock in Private Equity Transactions – Key Characteristics
- Chart: Acquisition Agreement Financing Concerns for Private Equity
- Structuring Private Equity Investments
- Using Capital Structure Mechanisms to Maximize Returns in Private Equity Investments