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The Preferred Equity Paradox

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Much ink has been spilled about the continued ascent of the "liability management exercise" (LME). Not to fret, this is *not* another LME article; rather, this article focuses on potential consequences of certain LME strategies.

Each headlining-grabbing LME (e.g., J. Crew, Serta, AMC) results in incrementally sophisticated and tighter credit documents, which usually restrict distressed companies from incurring additional debt when a balance sheet crosses a set leverage threshold. Those companies still need capital, which, together with a more onerous interest rate environment, has resulted in a recent uptick in preferred equity issuances.

But this is not your mother's preferred equity. Though called "equity," it looks more like "debt" than ever before, often including debt-like features such as strict operating covenants, maturities, governance controls, and (of course) economic terms that promise—or so people think—a fixed return ahead of common equity holders.

However, in a U.S. Chapter 11 case much of the preferred equity currently in the market may not actually be "preferred" at all. Imagine a scenario where value clears all of a company's debt, value is available for equity, and a bankruptcy court could find that preferred equity holders are *not* entitled to a bargained-for liquidation preference, redemption price, or even the face value of their investment.

Or taking it a step further, what if that court could treat preferred and common holders equally (pari passu), potentially with each group of equity holders receiving different forms of currency under a Chapter 11 plan. For example, under this hypothetical Chapter 11 plan, common equity holders could receive all of a company's reorganized equity (and, thus, control of the reorganized company), leaving preferred equity holders to receive either cash or take-back debt.

We think this scenario is not only possible but likely for much of the preferred equity currently in the market, assuming a court simply reads the words on the page.

Chapter 11 Primer

Transactions in Chapter 11 typically are implemented through a Chapter 11 plan, which establishes treatment for a debtor's debt claimants and interest holders. Plans divide claims and interests into classes for distribution and voting purposes. The Chapter 11 plan process is democratic, generally requiring solicitation of all holders of impaired claims or equity interests. But the power of the Bankruptcy Code (Title 11 of the United States Code (the "Bankruptcy

Code")) allows a plan to be confirmed (i.e., approved) even over the dissent of creditors and interest holders. This is called "cramdown."

The Bankruptcy Code has different standards for "cramming down" a plan on secured claims, unsecured claims, and equity interests. One requirement for all: if any class of claims is impaired under a plan, at least one such class of impaired creditors must vote to accept the plan. But, if no claims are impaired under a plan—for example, if a debtor's value exceeds the aggregate sum of all its secured and unsecured debt—no such "impaired accepting class" is required to confirm the plan. Rather, under those facts, although interest holders will still vote on a plan, confirmation and cramdown on equity holders, including preferred holders, is possible even if every equity holder votes "no," as long as a plan complies with the requirements of section 1129(b) of the Bankruptcy Code.

Relevant here is subsection 1129(b)(2)(C), which requires a Chapter 11 plan to provide that either (a) impaired, dissenting equity holders will receive the greatest of (i) any fixed liquidation preference *to which such holder is entitled*, (ii) any fixed redemption price *to which such holder is entitled* or (iii) the value of their interests or (b) that no holder of a junior interest will recover any property under the plan. If that requirement is met (along with a few other technical ones), a plan can be confirmed over the dissent of a class of preferred equity holders.

'Potemkin' Preference

Many people, including bankruptcy practitioners, assume this section necessarily protects a preferred equity holder's preferred and priority status in a Chapter 11 plan. Potentially not so! Under this statute, a preferred equity holder will only receive the benefit of a liquidation preference, fixed redemption price, and/or priority "waterfall" included in its preferred equity instrument if the transactions contemplated by a Chapter 11 plan *actually* "*entitle*" such holder to the benefit of those provisions.

For example, many liquidation preference provisions are triggered upon a liquidation, winding-up, or dissolution of an issuer. Similarly, waterfall provisions in preferred equity instruments often provide that the preferred equity is entitled to first/senior priority to distributions from a liquidation, winding up, or dissolution.

If, however, an issuer's enterprise value clears its debt, "liquidation" and "dissolution" are probably not the result of the issuer's Chapter 11 case. The plan is likely a *plan of reorganization*, allowing the company to emerge from Chapter 11 and continue operating as a going concern. Without the preference and priority provisions triggered, a preferred equity holder may be left impaired, on a *pari* basis with common equity.

A "preferred" holder with the typical language in its instrument may not *actually be entitled* to a "preference" or senior treatment ahead of common equity if a Chapter 11 plan does not contemplate a liquidation, winding-up, or dissolution.

Even if the parties originally intended such a transaction to result in a preference, a court may not consider arguments about the parties' original intent but rather simply read the words on the page. In other words, the "preference" is Potemkin—a façade with nothing behind it. And that is the paradox.

Words Matter

For investors looking at preferred equity investments, there are solutions. Carefully drafted provisions in preferred equity documents should ensure that preferred holders recover ahead of common in Chapter 11 cases—assuming that is what was intended.

Alternatively, potential gaps in preferred equity instruments may offer strategic opportunities to issuers and common equity holders looking to cram down on preferred equity or at least threaten to do so as leverage in negotiations. Either way, the issues are nuanced and should be addressed with thoughtful legal advice from experienced counsel.

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