Divide and Conquer:

Why and How to Bifurcate Your LBO's Equity Structure

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In a leveraged buyout ("LBO") of a target company, one of the first decisions a private equity fund sponsor ("PE sponsor") must make is how to structure and capitalize the newly formed acquisition entity ("Newco"). This article examines (1) benefits PE sponsor can obtain by bifurcating Newco's equity structure into common stock, on the one hand, and fixed preferred stock and/or subordinated debt, on the other, and (2) advantages and disadvantages of using preferred stock or subordinated debt for this purpose. The article concludes by reviewing one possible "ideal" outcome that PE sponsor could obtain by capitalizing Newco with a combination of common stock and subordinated debt.

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A. The Hypothetical Acquisition — A Tale of Three Structures

PE sponsor forms Newco as a corporation to acquire a target company ("T") for $3 million, with $2 million of senior debt financing and $1 million of equity capital from PE sponsor (ignoring, for this purpose, additional financing necessary to cover transaction costs).[2] This article discusses three hypothetical structures as a basis of comparison:

1. The "**simple common structure**" uses only common stock. Here, PE sponsor capitalizes Newco with

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[2] For simplicity, this article assumes that Newco is formed as a corporation, rather than a flow-through entity (e.g., a limited partnership or limited liability company). Forming Newco as a flow-through entity may deliver significant tax benefits (such as avoiding double tax on Newco's operating income, allowing Newco to deliver stepped-up tax basis upon sale of Newco's assets without double tax to the sellers, and minimizing taxes when selling only a portion of Newco's assets). However, some of PE sponsor's limited partners may be tax-exempt organizations or foreign persons subject to "unrelated business taxable income" or "effectively connected US income," respectively, which disfavor use of a flow-through entity to operate an active business.

$1 mill3ion in return for 1 mi llion common shares at a price of $1 per share.

2. The "**bifurcated preferred structure**" uses a combination of common stock and fixed preferred stock. Here, PE sponsor capitalizes Newco with $1 million in return for 1 million common shares at a price of 10¢ per share ($100,000 total) and $900,000 face amount of straight preferred stock, i.e., preferred stock with no conversion right or residual equity participation feature which receives an amount at a stated redemption date (or upon Newco's earlier liquidation), senior to Newco's common stock, equal to face value (i.e., $900,000) plus a 10% annual yield on such face value.[3]

3. The "**bifurcated note structure**" uses a combination of common stock and fixed subordinated debt. Here, PE sponsor capitalizes Newco with $1 million in return for 1 million common shares at a price of 10¢ per share ($100,000 total) and a $900,000 face amount junior subordinated note ("JSN"), which, like the preferred stock in the bifurcated preferred structure, has no conversion right or other residual equity participation feature and receives an amount at maturity (or upon Newco's earlier liquidation), senior to Newco's equity, equal to face value (i.e., $900,000) plus a 10% annual yield on such face value.

	SIMPLE COMMON STRUCTURE	BIFURCATED PREFERRED STRUCTURE	BIFURCATED NOTE STRUCTURE
COMMON STOCK	$1,000,000	$100,000	$100,000
PREFERRED STOCK	0	900,000	0
JSN	0	0	900,000
TOTAL	**$1,000,000**	**$1,000,000**	**$1,000,000**

B. So Why Bifurcate?

The two bifurcated structures provide benefits to PE sponsor that cannot be easily achieved in the simple common structure, including:

- Creating better and more efficient management incentives
- Allowing PE sponsor earlier capital recoupment
- Increasing PE sponsor's aggregate return

Creating Better and More Efficient Management Incentives. One of PE sponsor's primary LBO goals is to create efficient incentives for T's management to grow the business. The most common method is to sell or grant management some form of equity stake, normally consisting of: common stock, options on common stock, stock appreciation rights (SARs), and/or other contractual arrangements that mimic the economics of common stock.

The two bifurcated structures lower the cost of Newco's common stock (e.g., common stock is priced at 10¢ per share in the two bifurcated structures as compared to $1 per share in the simple common structure). A lower common share price permits management to purchase the same percentage of Newco's common stock for less than it otherwise could, e.g., purchasing 10% of Newco's common stock costs management only $10,000 in the two bifurcated structures as compared to $100,000 in the simple common structure.

By owning common stock, management receives the beneficial 15% federal long-term capital gain ("CG") tax rate on the stock's appreciation.[4] The lower common share price makes it more likely management will have

[3] For simplicity all calculations of yield on preferred stock or JSNs in this article are done as simple interest, although in practice the preferred stock and JSN terms would call for compound interest.

[4] If there is a substantial risk of forfeiture ("SRF") in respect of a manager's purchased stock (e.g., vesting provisions which would allow Newco to repurchase a manager's stock less than fair value (e.g., cost) if the manager ceases to be a Newco employee before a specified date), in order for the stock's appreciation to qualify for the favorable CG rate, the manager must make an Internal Revenue Code ("Code") § 83(b) election within 30 days after buying or otherwise receiving the stock.

[5] In the past, PE sponsors often caused Newco to make loans to management to purchase common stock. While such loans still occur, they are now less typical because of (i) increased sensitivity among management teams to the personal financial risk of such loans and (ii) § 402 of the Sarbanes Oxley Act of 2002 ("SO") prohibiting a company covered by SO's "issuer" definition (generally a company with publicly-issued or publicly-traded securities or a pending Securities Act of 1933 ("'33 Act") registration statement) from: "directly or indirectly, including through any subsidiary, …extend[ing] or maintain[ing] credit, … arrang[ing] for the extension of credit, or renew[ing] an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof)…." While SO does not typically apply to a private Newco following an LBO, SO would apply if Newco filed a '33 Act registration statement for a high-yield debt offering to finance the LBO. In addition, many PE sponsors and management teams endeavor to comply with some or all aspects of SO even though not required by law to do so.

(and be willing to risk) the financial resources to purchase the full amount of common stock available to it.

In contrast, in the simple common structure, where the common stock price is greater, management may not have (or be willing to risk) the financial resources to purchase all the available common stock.[5] In this case, management may seek to acquire its equity stake in a form which requires a lower (or no) front-end out-of-pocket investment (e.g., stock options or SARs), but which results in taxation of management's appreciation at the higher (35% federal) ordinary income ("OI") tax rate rather than the lower (15% federal) CG rate.

PE sponsor may provide management participation in Newco's growth by granting management options to purchase Newco's common stock at a price equal to the stock's fair value ("FV") at grant. One benefit of options from management's perspective is that management is not out-of-pocket (or at risk) on the front end and has no current taxable income attributable to receipt of the options. By contrast, if Newco simply grants common stock to management without consideration (rather than granting options on common stock without consideration), management would recognize current taxable income equal to the stock's FV taxed at the higher OI rate.[6] The disadvantage of options from management's perspective is that appreciation in Newco's common stock from option grant until option exercise is taxed at the higher OI tax rate (payable when management exercises the option).[7] As a practical matter, options are rarely exercised until a liquidity event (e.g., a sale of Newco) — management generally does not want to put cash at risk (and in the case of ISOs, incur AMT tax) by exercising options prior to a liquidity event — and, therefore, management ultimately receives OI tax treatment on (and Newco receives a corresponding deduction for) the entire amount of appreciation.

Allowing PE Sponsor's Earlier Capital Recoupment. The two bifurcated structures also allow PE sponsor to "take money off the table," i.e., receive a partial return of capital while continuing to hold its full upside potential in Newco's common stock. This is useful, for example, when PE sponsor takes Newco public, when Newco's operations build up a substantial cash balance, or when Newco recapitalizes.

One of the exit scenarios PE sponsor often considers is an initial public offering (an "IPO"). In an IPO there are, for marketing reasons, generally limits on PE sponsor's ability to sell its common stock, either in the IPO or for a significant period thereafter. However, the preferred stock or JSN can be drafted to require Newco to redeem preferred shares or repay the JSN using a portion of its IPO cash proceeds, either mandatorily or in PE sponsor's discretion. This mandatory redemption or put right allows PE sponsor immediately to receive a partial return of capital following an IPO, while at the same time retaining all of its common stock. Underwriters and the public often do not object to this structure, even though they would object to other structures affording a similar economic outcome, such as a partial secondary sale of PE sponsor's common stock in (or shortly after) the IPO.

Similarly, when Newco's operations build up a substantial cash balance or Newco recapitalizes and its senior lenders have been repaid or otherwise consent, PE sponsor's right to require Newco to redeem its preferred stock or JSN can be utilized to allow PE sponsor to extract some of its investmen t capital ahead of Newco's common stockholders, while keeping its upside (common

[6] Where a service provider (e.g., management) receives property (e.g., common stock) "in connection with the performance of services," the service provider has (under Code § 83(a)) OI equal to the spread between the price paid for such property and the FV of such property at time of receipt, except that if the stock is subject to a SRF and the service provider makes no Code § 83(b) election, OI is calculated and taxed at vesting (rather than receipt).

[7] This (OI-at-exercise) rule applies to non-qualified options ("NQOs"). Incentive stock options ("ISOs"), as defined in Code § 422, are subject to more favorable tax rules if the option is exercised more than 12 months before disposition of the stock. However, because spread at ISO exercise is an alternative minimum tax ("AMT") item, a manager holding a substantial number of ISOs seldom exercises substantially before selling the stock, so that the ISO is generally disqualified and taxed as a NQO. Other ISO requirements include (i) an option exercise price at least equal to 100% of the underlying common stock's FV at grant, (ii) a $100,000 ceiling on a manager's options becoming exercisable in any calendar year, (iii) non-transferability of the option (other than by death), (iv) expiration no later than 10 years after grant, and (v) an employment relationship between Newco and grantee.

stock) intact. Even where PE sponsor controls Newco's board, PE sponsor should seek such put rights in lieu of, or in addition to, any Newco right to call the preferred stock or JSN, because PE sponsor has fewer (if any) fiduciary duties to Newco's other stockholders when acting as a stockholder (by putting the preferred stock / JSN) than when acting as a board member (by calling the preferred stock / JSN).[8]

Increasing PE Sponsor's Return. PE sponsor's return is enhanced by a bifurcated structure, since the senior securities — which are 100% held by PE sponsor — typically bear a yield (e.g., the 10% preferential yield on the preferred stock or JSN shown in the examples in this article). When Newco appreciates, the first tranche of value increase is allocable to PE sponsor's accumulated yield, and only the residual value (if any) is allocable to the common stock. PE sponsor's aggregate return as a holder of a combination of preferred stock / JSNs and common stock (commonly referred to as a "strip" of securities) is increased as compared to the amount PE sponsor would receive if it held only common stock. Similarly, the aggregate return to management, which holds only common stock (or common stock options), is decreased.[9]

Looking first at the management incentive equity discussed above, regardless of whether management purchases common stock or is granted options, management generally does not purchase (or acquire options on) the entire strip of securities purchased by PE sponsor. Thus, management typically has a larger share of common stock per dollar invested in Newco than does PE sponsor (whose investment capital is split between common stock, on the one hand, and preferred stock or JSNs, on the other). Because PE sponsor receives 100% of the yield on the preferred stock / JSN layer in each of the two bifurcated structures, the net proceeds received by PE sponsor upon Newco's sale or liquidation is greater than it would have been had management received the same percentage of common stock in the simple common structure.

Another scenario where PE sponsor's return increases by using a bifurcated structure is where warrants or other equity kickers are issued to lenders providing subordinated financing to Newco ("mezz lenders"). Mezz lenders often require warrants to purchase a small percentage of Newco's common stock for a nominal exercise price (e.g., 5% of Newco's common stock at 1¢ per share).[10] Such nominal price warrants cause an immediate transfer of value to the mezz lender from the other common stock investors equal to the excess of the value of the common stock underlying the warrant over the warrant exercise price. For example, if mezz lender is granted warrants representing 5% of Newco's underlying common stock at a nominal exercise price, the value transfer would be approximately $50,000 in the simple common structure but only approximately $5,000 in the two bifurcated structures, due to the common stock's lower value. Moreover, PE sponsor's right to recoup its preferred stock / JSN investment prior to common stock distributions provides PE sponsor with an increased return on Newco's liquidation due to the fact that mezz lender does not share in the preferred stock/JSN yield.[11]

[8] These board member duties include a duty of care (e.g., anti-negligence) and a duty of loyalty (e.g., limitation on self dealing and usurping corporate opportunities). While directors are ordinarily protected by the "business judgment rule," under which courts do not second guess the wisdom of directors' business judgments or impose liability (even for foolish decisions), there are exceptions to this rule. One exception is when directors have a conflict of interest (e.g., the board is not disinterested). This would be the case if the board opted to redeem shares held by directors, in which case the decision to redeem is more carefully scrutinized and the board must take additional precautionary measures to ensure the transaction is fair or remove the taint of interested directors (e.g., approval by disinterested directors).

[9] In addition to receiving incentive equity, management occasionally coinvests with PE sponsor in the entire strip of securities and on the same terms as PE sponsor. The return on this coinvestment is affected by the bifurcated structures in the same manner as PE sponsor's investment.

[10] Mezz lender's purchase of nominal-exercise-price warrants can create original issue discount ("OID") for tax purposes with respect to the other securities (e.g., debt instruments) purchased by mezz lender, since a portion of the price paid for such other securities is allocated to the warrants (based on the relative FV of the warrants and the other securities).

[11] Given this dynamic, a mezz lender may seek a nominal exercise price warrant to purchase the entire strip purchased by PE sponsor (rather than merely the common stock portion of the strip) or a mezz lender may seek a larger percentage of common stock.

> **Benefits of Bifurcated Structures**
>
> - More efficient mechanism for creating management incentives
> - Better returns for PE sponsor
> - PE sponsor may recoup capital earlier

Hence, a bifurcated capital structure should be considered and, in most instances, used.

Notwithstanding the benefits described above, there are several reasons why PE sponsor may choose not to bifurcate Newco's capital structure. First, the issue of complexity; the simple common structure is just that—simple, as compared to a bifurcated structure. Second, with a bifurcated structure, any meaningful reduction in Newco's enterprise value likely renders its common stock worthless, so that management may lose the incentives that PE sponsor hoped to achieve by offering management an equity stake in the first place and PE sponsor may have to devise a new management incentive program, perhaps for the new managers who replaced the failed management.

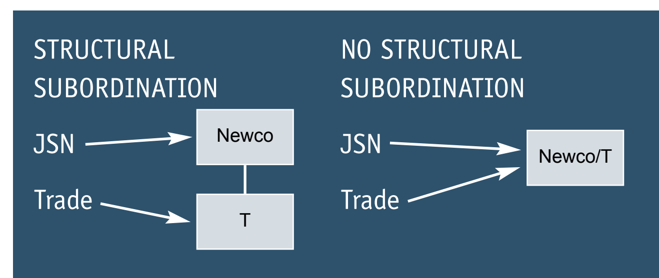
C. Distinctions Between Preferred Stock and JSNs in Bifurcated Structure

Once PE sponsor determines to bifurcate Newco's equity structure, the next decision is whether to use preferred stock, JSNs, or both.

Legal Difference Between Preferred Stock and JSN. The main distinction from a legal (non-tax) perspective between preferred stock and a JSN relates to liquidation seniority. If the securities are respected as drafted, preferred stock is an equity instrument while a JSN is debt. As a matter of state law, debt evidenced by a JSN ranks higher than equity (and pari passu with other unsecured creditors except to the extent the JSN is expressly subordinated to specified creditors). However, as discussed below there is risk that a court may equitably subordinate PE sponsor's JSN to the claims of Newco's other creditors.

If Newco operates T's business itself,[12] rather than through an operating subsidiary, the bifurcated note structure allows PE sponsor to achieve equal priority (i.e., pari passu treatment) with the claims of Newco's trade creditors in case of Newco's bankruptcy (whereas preferred stock is always junior to the claims of Newco's creditors, including trade creditors). However, three factors affect the conclusion that a JSN is pari passu with Newco's creditors.

The first factor is "structural subordination." As mentioned above, a JSN issued by an operating entity is pari passu with such entity's trade creditors (assuming the JSN is not expressly subordinated to trade creditors). However, where Newco is a holding company, with T as an operating company subsidiary, Newco's JSN is structurally subordinated to T's trade creditors, because T's trade creditors have a direct claim on T's assets, while Newco's JSN has a direct claim on only Newco's assets (i.e., T stock) and Newco's claim to T's assets as a T stockholder is junior to the claims of T's creditors.



The second factor is "express subordination." If a JSN expressly states that it is subordinated to Newco's trade creditors (or any other specified creditors), the express subordination language governs.

The third factor is "equitable subordination," i.e., a court determination that PE sponsor acted inequitably or unfairly toward Newco's other creditors and hence that the JSN claim should be equitably subordinated to Newco's other creditors.

[12] This would be the case if Newco acquired T's assets or Newco acquired T's stock and then liquidated or merged T upstream into Newco.

Other things being equal, from a legal standpoint, a correctly structured JSN assists PE sponsor in achieving pari passu status with trade creditors on liquidation and, hence, a bifurcated note structure can be more beneficial to PE sponsor in a downside scenario than a bifurcated preferred structure.

Legal Benefits of JSN

- If correctly structured, a JSN is better in a downside scenario than preferred stock, because a JSN can be pari passu with trade creditors, while preferred stock is junior to trade creditors

Tax Differences Between Preferred Stock and JSN. There are numerous differences between preferred stock and JSNs from a tax standpoint, significantly with respect to (i) tax treatment of the preferred stock and JSN yield to Newco and the holder, (ii) phantom taxable income, and (iii) tax treatment on redemption.

Because a JSN is debt, Newco is typically entitled to a tax deduction for interest payable on the JSN. In contrast, Newco is never entitled to a tax deduction for dividend payments on preferred stock. However, there are a number of circumstances in which Newco's JSN interest deduction is disallowed.

First, interest on debt may be disallowed if a debt instrument more closely resembles equity than debt. There are a number of factors in this "subjective debt/equity test," including whether Newco has a high debt-equity ratio ("DER"),[13] whether the terms of the JSN are reasonable (e.g., arms-length terms), whether there is substantial overlap between those holding JSNs and those holding common stock (or common stock equivalents such as warrants or convertible securities), and whether PE sponsor — as the JSN holder — acts like a creditor (e.g., whether PE sponsor forces Newco to comply with the JSN's terms and acts vigorously and reasonably to defend its rights upon default). If a debt instrument flunks the subjective debt/equity test, it is treated as equity rather than debt for federal tax purposes.

If a JSN fails any one of several other tax tests, the JSN remains debt for federal tax purposes but Newco's interest deduction is disallowed (in whole or in part) or deferred.[14]

- For example, under Code § 279, if Newco issues debt as consideration for the acquisition of corporate stock or assets, the debt is subordinated to Newco unsecured debt, and the debt is issued with a warrant or conversion privilege, then the interest deduction in excess of a statutorly specified amount is disallowed.[15]
- Under Code § 163(e)(5) (enacted to discourage LBOs financed by high-yield debt with non-cash-pay interest), if Newco issues debt with a term of more than five years, the debt bears an interest rate equal to or greater than the applicable federal rate ("AFR") plus five points, and the debt has substantial OID or payment-in-kind ("PIK") features extending beyond the fifth anniversary of issuance (i.e., the debt requires or permits Newco to accrue interest without current payment or to pay such interest with additional JSNs or stock), then the interest deduction is deferred until paid and generally disallowed in part.
- Under Code § 163(j) (enacted to discourage interest stripping, i.e., payments of deductible interest by a corporation to a related lender which is not taxed on the interest income), if Newco has a greater than 1.5 to 1 DER, Newco issues debt to a tax exempt organization ("TEO") or a foreign person ("FP") or a partnership at least 10% owned by TEOs or FPs, the TEOs, FPs, or the partnership in which the TEOs and FPs are more than 10% owners are more than 50% related to Newco (e.g., own more than 50% of Newco), and

[13] Although there are no clear precedents, it is generally believed that a DER below 5-to-1 is good while a DER between 5-to-1 and 10-to-1 is probably acceptable (but obviously the closer to 5-to-1 the better). A DER above 10-to-1 is questionable (and becomes more questionable as it rises). The DER with respect to the JSN is generally calculated by treating the JSN as debt and all instruments senior to or pari passu with the JSN as debt (e.g., senior debt and mezz debt) but treating any instrument junior to the JSN as equity.

[14] The following is a simplified description of the tax tests, each of which contains additional complexities not described in this article.

[15] Like many of the structural tests, this problem can be avoided, in this case by issuing common stock as the equity kicker to the debt holder rather than a warrant or conversion privilege.

Newco's total interest expense, including interest to unrelated lenders (net of its interest income) for the taxable year exceeds 50% of its earnings before interest, taxes, depreciation and amortization, calculated according to tax principles (its "tax EBITDA"), then Newco's interest deduction is deferred and allowed as a deduction in later years, subject to the 50% of EBITDA test.

- Under Code § 163(l), the interest deduction is disallowed where a substantial portion of a JSN's interest or principal is payable in, or by reference to the FV of, Newco's equity - whether mandatorily, at Newco's option, or at PE sponsor's option (where there is substantial certainty PE sponsor will so opt).[16]

Newco's tax deduction for interest paid on the JSN is a significant benefit of the bifurcated note structure. However, as should be apparent, the JSN and the rest of the capital structure must be carefully crafted to avoid loss (or deferral) of Newco's interest deduction.

A second distinction between the bifurcated structures is taxation of the holder on the yield. Interest income on a JSN is generally taxable at a 35% maximum federal rate, while dividend income is generally taxable at a 15% maximum federal rate (to the extent PE sponsor's taxable income flows through to an individual). In addition, dividend income is taxable to the holder only to the extent of Newco's earnings and profits ("E&P") — with the excess dividend reducing PE sponsor's tax basis in the preferred stock — while interest income is taxable to the holder regardless of Newco's E&P. An individual holder's reduced tax rate on dividends can be a significant benefit of the bifurcated preferred structure.

A third distinction between the bifurcated structures is phantom taxable income to the holder. In the bifurcated note structure, regardless of whether interest on the JSN is actually paid in cash to PE sponsor or simply accrues, the interest is current taxable income to PE sponsor,[17] so that PE sponsor must pay tax on accruing interest income without a related source of cash. In contrast, in the bifurcated preferred structure, accrued but unpaid yield is not included in PE sponsor's income so long as the dividend is not PIK and the terms of the preferred stock are properly drafted. To the extent that accumulated but undeclared preferred stock dividends have not previously been included in PE sponsor's income, any resulting gain on a sale or redemption of the preferred stock is generally taxed at the CG tax rate (to the extent PE sponsor's taxable income flows through to an individual). Therefore, the problem of phantom taxable income is greatly reduced (or even eliminated) through proper use of preferred stock rather than a JSN.

Another structuring consideration is avoidance of tax OID, which creates taxable income to PE sponsor in situations where yield is not explicitly provided. While both bifurcated structures create an OID tax risk, OID can be avoided in the case of preferred stock if the preferred stock terms are properly drafted. Even if PE sponsor is a cash method taxpayer, PE sponsor is nevertheless taxed (and, in the case of JSNs, Newco is generally entitled to a corresponding deduction) on JSN OID.

The simplest example of OID — "explicit OID" — is where the purchase price for the instrument (whether preferred stock or JSN) is less than face value. For example, if PE sponsor purchases for $1 million a JSN or preferred stock which bears no yield but has a principal amount of $1.5 million payable in five years, the JSN or preferred stock would have $500,000 of OID and PE sponsor would be taxed on such instrument as if it provided for $1 million of principal and an annual yield of approximately 10%. PE sponsor would therefore be taxed on an average of $100,000 of income each year. A second form of OID is "allocated OID," created by reallocating a portion of PE sponsor's purchase price for the JSN or preferred stock to the accompanying common stock and/or warrants. For example, if an investor purchases a $1 million JSN or

[16] Other interest deduction disallowance rules are not discussed in this article.

[17] This is true regardless of whether PE sponsor is a cash or accrual method taxpayer.

preferred stock together with a nominal-exercise-price warrant for a total purchase price of $1 million, the IRS would allocate some portion of the purchase price to the warrant (based on the JSN's or the preferred stock's and the warrant's relative FVs), leaving the JSN or preferred stock purchase price less than its $1 million face and creating OID equal to the difference. A third instance of OID creation is where yield is paid in additional securities (e.g., additional JSNs or preferred stock, as the case may be), commonly called "PIK OID." Fourth is "accumulation OID," created by accruing unpaid interest on a JSN where the JSN terms allow Newco to defer interest payments. Accumulation OID generally does not create preferred OID under current IRS regulations.

While OID is a significant risk using the bifurcated note structure, preferred stock OID is avoided under Code § 305 (i) to the extent Newco has inadequate E&P when OID accrues, or (ii) if the preferred stock has a significant participation in Newco's growth (ignoring conversion features), or (iii) if the preferred stock is "evergreen" (i.e., never mandatorily redeemable or puttable). Hence, OID considerations favor the use of the bifurcated preferred structure vis-à-vis the bifurcated note structure.

Types of OID

- Explicit OID: OID created when purchase price of instrument is greater than face value
- Allocated OID: OID created by allocating purchase price from instrument to accompanying common stock or warrants (so that instrument has face amount greater than allocated purchase price)
- PIK OID: OID created when accrued yield is paid with other JSN's or preferred stock
- Accumulation OID: OID created when accrued unpaid yield is permitted to be deferred by a JSN's terms

While the tax aspects of interest (or yield) favor use of preferred stock, the tax treatment of a redemption favors use of a JSN. Repayment of a JSN's principal is treated as a tax free return of basis to PE sponsor and, to the extent PE sponsor has tax basis less than the JSN's face value, the spread is normally taxed at the CG tax rate (to the extent PE sponsor's taxable income flows through to an individual). In contrast, redemption of preferred stock may well be treated as a dividend under Code § 302 when PE sponsor owns a large portion of Newco's common stock and retains such common stock after the preferred stock's redemption, although the 2003 Tax Act reduces to 15% the federal tax rate on dividend income (to the extent PE sponsor's taxable income flows through to an individual). If a preferred redemption is treated as a dividend, the holder's basis in the preferred stock hops over to its Newco common stock. This risk of dividend treatment can be minimized by (i) redeeming the preferred stock at the same time that additional Newco common stock is being issued to third parties (e.g., in connection with an IPO) so that PE sponsor's common stock percentage diminishes at the same time as the preferred stock is being redeemed and/or (ii) redeeming some of PE sponsor's common stock at the same time as the redemption of PE sponsor's preferred stock.

Another factor tending toward use of a JSN is expense amortization. PE sponsor may amortize expenses of issuing a JSN, but generally may not amortize expenses of issuing preferred stock.

In contrast, a factor tending toward use of preferred stock occurs in a downside scenario where extinguishment of a JSN at a discount causes Newco to recognize taxable cancellation of debt income ("CODI") pursuant to Code § 108. While Code § 108 exceptions may allow Newco to avoid CODI, such avoidance subjects Newco to tax attribute reduction (e.g., loss of net operating loss ("NOL") deductions or loss of asset tax basis). However, if preferred stock is cancelled in a restructuring, Newco does not recognize CODI or attribute reduction.

Pro JSN Tax Considerations

- Newco entitled to deduction for interest payments (so long as no disallowance rule applies)
- Principal repayment treated as return of basis
- Amortization of issuance costs

Pro Preferred Stock Tax Considerations

- Generally lower tax rate on preferred stock dividends than JSN interest
- No phantom income if dividend not PIK and property drafted
- Lower OID risk
- No taxable income to Newco if preferred stock cancelled in restructuring

Accounting Differences Between Preferred Stock and JSN. A practical need for net worth often points toward the issuance of preferred stock rather than a JSN. In the bifurcated note structure, the JSN is recorded as a liability and the JSN yield is recorded as interest expense. In contrast, preferred stock is generally recorded as equity and the yield as a dividend, except as described below.

The Financial Accounting Standards Board recently promulgated FASB 150 under which preferred stock which is mandatorily redeemable (i.e., redeemable on a fixed or determinable date or on an event certain to occur) is recorded as a liability on Newco's balance sheet and any accruing yield on such preferred stock is recorded as an expense.[18] The glaring exception, which may be used in drafting preferred stock terms so as to avoid FASB 150 liability classification, is to make the preferred stock redeemable (i.e., puttable) at the holder's option rather than mandatorily redeemable. Since exercise of the put is not an event certain to occur, such preferred stock should not be treated as a liability. However, this is not FASB's last word on the subject and the rules could change in the future to address this exception. In addition, mandatory redemption using proceeds from an IPO also should not cause the preferred stock to be treated as a liability — again, because an IPO is not an event certain to occur.

[18] For a private (rather than a public) company, FASB 150 does not go into effect until approximately January 1, 2005.

Accounting Differences Between JSNs and Preferred Stock

- JSN: Booked as debt and yield booked as interest expense
- Preferred stock: Generally booked as equity and yield as dividends, except where mandatorily redeemable under FASB 150

Although there are significant benefits to a bifurcated structure, there is no simple answer as to whether the bifurcated note structure or the bifurcated preferred structure is superior. However, whenever it is unclear which bifurcated structure should be utilized, the bifurcated note structure should generally be selected because it is easier — and more tax efficient — to later switch from JSN to preferred stock (while the reverse is not true). From a tax standpoint, a JSN can be exchanged for preferred stock without causing tax to PE sponsor. In contrast, exchanging preferred stock for a JSN is often treated as a taxable dividend to PE sponsor under Code § 302 to the extent of Newco's E&P. In addition, from a legal (non-tax) standpoint, exchanging preferred stock for a JSN may be viewed as a fraudulent conveyance or a preference which would, among other things, cause the JSN to lose its status as debt in a bankruptcy vis-à-vis other debt. Finally, many senior credit facilities contain net worth, DER, and other financial covenants that may prohibit an exchange of preferred stock for a JSN (because of the resulting reduction in net worth) without the senior lender's consent.

D. One Ideal Structure

A possible ideal structure is the bifurcated note structure with one refinement described below. As noted above, JSN interest under the right circumstances creates tax deductions for Newco, albeit with the unfortunate effect of the JSN holder being required to report current taxable income on the same interest, regardless of whether the interest is paid in cash or simply accrued. These Newco tax deductions reduce Newco's income tax bill, resulting in an indirect benefit to Newco's

common stockholders because Newco has a higher equity value due to these tax savings. This benefit should ultimately be realized by Newco's stockholders upon Newco's sale. The goal is to create a structure where PE sponsor (in its capacity as a Newco common stockholder) is better off than it would have been under the simple common structure or bifurcated preferred structure, but where PE sponsor (in its capacity as JSN holder or preferred stockholder) is no worse off than it would have been under the simple common structure or bifurcated preferred structure.

This goal is achievable if the JSN pays in cash on a current basis a percentage of the interest equal to or greater than PE sponsor's marginal tax rate on such interest (e.g., 40%), with the remainder accruing, as long as Newco has sufficient taxable income to be a current taxpayer (i.e., Newco is not in an NOL position). This 40% current-pay feature gives PE sponsor as JSN holder cash necessary to pay the income taxes owing on 100% of the JSN's interest. At the same time, Newco's other creditors are no worse off with this structure than under the simple common structure or the bifurcated preferred structure — because in those latter two structures Newco would simply be paying higher taxes to the IRS in an amount approximately equal to the 40% of the interest Newco is paying in cash to the JSN holder. Some senior lenders may place restrictions on this structure, such as cutting off the 40% cash interest payments if Newco's performance lags or requiring the JSN holder to return interest payments to Newco in circumstances where Newco generates tax losses and would have received a refund from IRS had the JSN not been issued.

E. Conclusion

Below is a chart summarizing the benefits of the various structures depending on PE sponsor's goals.

While a bifurcated structure has numerous benefits, and a few detriments, there is no clear winner between preferred stock and a JSN for all scenarios. In certain operating and exit scenarios preferred stock is better and in others a JSN is superior. PE sponsor should carefully consider this issue for each transaction in light of PE sponsor's best estimates for likely operating and exit scenarios, and then consult with its legal and tax advisors to select the best structure for that particular transaction.⊙

DIVIDE AND CONQUER: WHY AND HOW TO BIFURCATE YOUR LBO'S EQUITY STRUCTURE

By Jack S. Levin, Sanford E. Perl and Shelly M. Hirschtritt

Summary of Structural Considerations

GOAL	SIMPLE COMMON STRUCTURE	BIFURCATED PREFERRED STRUCTURE	BIFURCATED NOTE STRUCTURE
SIMPLICITY	X		
ALLOW PE SPONSOR EARLIER CAPITAL RECOUPMENT		X	X
FACILITATE MANAGEMENT CG RATHER THAN OI		X	X
IMPROVE PE SPONSOR'S INVESTMENT RETURNS VIS-À-VIS MANAGEMENT INCENTIVE EQUITY		X	X
IMPROVE PE SPONSOR'S INVESTMENT RETURNS VIS-À-VIS MEZZ LENDER WARRANT HOLDERS		X	X
MAXIMIZE PRIORITY OF PE SPONSOR'S INVESTMENT IN LIQUIDATION			X
SHOW HIGH NET WORTH FOR FINANCIAL ACCOUNTING PURPOSES	X	X	
TAX EFFICIENT WITHDRAWAL OF ORIGINAL INVESTMENT UPON IPO		X	X
TAX EFFICIENT WITHDRAWAL OF ORIGINAL INVESTMENT IN LEVERAGED RECAPITALIZATION			X
CREATE TAX DEDUCTIONS FOR NEWCO, RESULTING IN INCREASED EQUITY VALUE FOR NEWCO			X
AVOID OR MINIMIZE PHANTOM TAXABLE INCOME TO PE SPONSOR AS HOLDER	X	X	
KEEP MANAGEMENT INCENTIVES IN DOWNSIDE SCENARIOS	X		
FLEXIBILITY TO SWITCH TO ANOTHER STRUCTURE LATER			X