



ETRUPS and ECAPS, Egads! The Insolvency Implications of New Hybrid Debt-Equity Securities

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Clever minds on Wall Street are always hard at work in the alchemist's laboratory trying to develop the next big idea to solve the problems of corporate America. One problem faced by corporations is the trade-off between issuing debt and equity when raising capital. Issuing too much stock risks diluting equity, while too much debt risks ruination in the event of financial distress. Tax policy further complicates this dilemma by encouraging companies to over-leverage their capital structures – interest on bonds is tax-deductible by the issuer, but dividends are not. If only some clever alchemist could help corporate America slip through the horns of this dilemma. Alas, while others are still searching for the secret to turn baser metals into gold, some clever investment bankers recently concocted new securities that have the benefits of both bonds and preferred stock – introducing Enhanced Trust Preferred Securities (“ETRUPS”) and Enhanced Capital Advantaged Preferred Securities (“ECAPS”). Generally, like bonds, ETRUPS and ECAPS provide for regular interest payments and have fixed maturities, but these maturities can be 40 to 60 years after issuance. Unlike bonds, ETRUPS and ECAPS provide that interest payments can be deferred when the issuer is experiencing financial distress, and payments of principal and interest can be met by issuing additional securities at maturity. Putting aside whether the Internal Revenue Service will allow issuers to deduct the “interest” paid on these new hybrid securities, one must question how holders will fare in the event of the issuer's insolvency.

Risks to Holders Upon an Issuer's Insolvency

Holders of these new hybrid securities will face two principal risks in the event of an issuer's insolvency: (1) the loss of the contractual right to payment, which undermines the bargaining position of holders just when they will need it the most; and (2) the possibility that the “claims” of holders will be recharacterized as equity. Unlike other “creditors” who can declare defaults, accelerate maturities, sue, foreclose on collateral, and otherwise enforce rights and remedies, not to mention use events of default as leverage

to bargain for additional protections, holders of these new hybrid securities will have little or no contractual basis on which to insist on additional protections or bargain for additional rights.¹

The Bankruptcy Code provides express authority for the claim of a creditor to be equitably subordinated to the claims of other creditors,² but does not expressly provide for recharacterization of debt as equity. Thus, it should come as no surprise that, in the absence of express statutory authority, bankruptcy courts are split on whether they have authority to invoke the even more draconian measure of recharacterizing debt as equity.³ Nevertheless, many courts have held that their general equitable powers under the Bankruptcy Code⁴ authorize recharacterization.⁵ Relying on tax cases,⁶ courts have identified the following factors in determining whether a nominal debt instrument should be recharacterized as equity in bankruptcy: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; (11) the presence or absence of a sinking fund to provide repayments;⁷ (12) the ratio of shareholder loans to capital; and (13) the amount or degree of shareholder control.⁸ Basically, courts look to determine the intent of the parties and the economic reality of the underlying transaction, irrespective of the labels the parties used in the transaction documents.⁹

Applying these factors to the \$450 million ETRUPS recently issued by Stanley Works is instructive. Stanley's First Supplemental Indenture, dated as of November 22, 2005,¹⁰ provides that the ETRUPS: mature December 1, 2045; are not entitled to the benefit of a sinking fund; bear interest, but were issued without interest coupons; until a “Dissolution Event,” principal and interest are payable by issuing more “debt securities,” but Stanley has the option to pay by check; and are expressly subordinated to just about all types of debt, other than trade claims and inter-company debt. Moreover, no payments may be made in respect of the ETRUPS in the event of a default or acceleration of senior indebtedness; interest may be deferred by Stanley even in the absence of a

default; and interest is generally subject to mandatory deferral upon certain triggering events tied to cash flow ratios. In the event of a mandatory deferral of interest, after the passage of one year, Stanley will have the obligation to use commercially reasonable efforts to effect sales of common stock to raise sufficient funds to pay deferred interest.

While some recharacterization factors are satisfied, others are not and some cannot be ascertained from the limited disclosures, it is manifest that Stanley's ETRUPS have characteristics more often associated with equity than debt securities. Most notably, to the extent ETRUPS resemble bonds, this resemblance evaporates in times of financial distress, when the issuer may defer payments or make payments by issuing additional securities. This makes ETRUPS more akin to preferred stock, which cannot be redeemed or be paid dividends upon insolvency.

Conclusion

Uncertainty abounds if issuers of these new hybrid securities experience financial distress. As other constituencies scramble to maximize their recoveries, holders of these new hybrid securities will have little or no leverage to insist on protections. A bankruptcy court may recharacterize these hybrid securities and either (1) rank them ahead of equity but behind all other debt (notwithstanding an express provision in an indenture providing that ETRUPS or ECAPS are not subordinate to trade claims and inter-company debt) or (2) simply recharacterize ETRUPS or ECAPS as equity and rank them *pari passu* with other equity interests such as preferred stock.

Obviously, holders should understand insolvency risks before investing in these new hybrid securities, and should consider an in-depth analysis of the likelihood of recharacterization of their securities. Moreover, holders may wish to consider protecting their investments in ETRUPS or ECAPS by also investing in a more traditional debt security (providing the usual covenants, events of default and remedies) issued by the same company. Holders will then have a seat at the bargaining table if the issuer experiences financial distress. Finally, in the event of bankruptcy, holders should be prepared to defend vigorously against any potential attempts to recharacterize their debt instruments as equity. Notwithstanding the fact that these hybrid securities take on characteristics of preferred stock when the issuer is experiencing financial distress, a properly structured transaction should withstand recharacterization.

For more information on how these issues may affect your rights, contact Nicholas F. Kajon at nfk@stevenslee.com or 212-537-0403.

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¹ While holders can litigate over whether the mandatory deferral triggers have been satisfied, the issuer can always rely on the optional deferrals.

² 11 U.S.C. § 510(c). Authority to invoke such a drastic remedy, however, is circumscribed in two important respects: first, there must be inequitable conduct on the part of the creditor; and second, the remedy is limited to subordination of the creditor's claim "to that of another creditor only to the extent necessary to offset injury or damage suffered by the creditor in whose favor the equitable doctrine may be effective." *In re W.T. Grant Co.*, 4 B.R. 53, 74 (Bankr. S.D.N.Y. 1980).

³ Recharacterization is more draconian than equitable subordination because recharacterization does not require inequitable conduct and leads to an all or nothing outcome – if recharacterized as equity, the debt is junior to all classes of claims.

⁴ 11 U.S.C. § 105(a).

⁵ See, e.g., *Bayer Corp. v. Mascotech, Inc.* (*In re Autostyle Plastics, Inc.*), 269 F.2d 726, 750 (6th Cir. 2001); *Moglia v. Quantum Industrial Partners* (*In re Outboard Marine Corp.*), 2003 U.S. Dist. LEXIS 12564 (N.D. Ill., July 21, 2003).

⁶ E.g., *Roth Steel Tube Co. v. Comm'r of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972).

⁷ See, e.g., *Autostyle*, *supra*, 269 F.2d at 750 (deriving 11 factors from *Roth*, *supra*, 800 F.2d at 630).

⁸ *Outboard Marine*, *supra*, 2003 U.S. Dist. LEXIS 12564 at *14-15 (citing *Autostyle* and *Roth* for first 11 factors, and citing *In re Hyperion Enterprises*, 158 B.R. 555 (D.R.I. 1993) for two additional factors). See also *Hillsborough Holdings Corp. v. Celotex Corp.*, 176 B.R. 223, 248 (M.D. Fla. 1994).

⁹ Courts employ a similar analysis in determining whether a transaction is a true sale or a disguised financing, *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.*, 67 F.3d 1063, 1068 (2d Cir. 1995); *In re LTV Steel Company, Inc.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001); or whether a nominal lease should be recharacterized as a disguised financing, *United Airlines, Inc. v. HSBC Bank USA, NA.*, 416 F.3d 609 (7th Cir. 2005).

¹⁰ See <http://www.sec.gov/Archives/edgar/data/93556/000134100405000414/hsi11-22.txt>.

¹¹ Of course, in the Stanley Works example, we do not know enough about certain other factors that might militate against recharacterization. Nevertheless, significant risks are present.