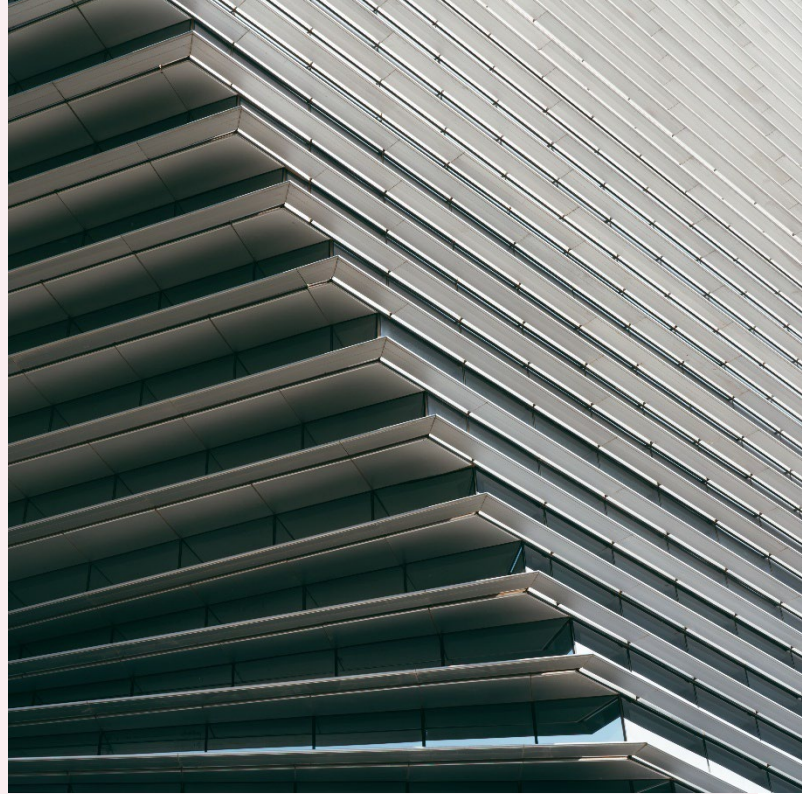


# Control as economics: the new preferred equity playbook

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Market conditions have forced a fundamental shift in how preferred equity is structured and priced. Investors now price governance rights alongside yield, require minimum cash-pay components, and negotiate aggressive anti-priming protections. This article examines how preferred equity has evolved from a convenient financing tool to an instrument designed to perform in difficult conditions, with a focus on enforcement leverage, regulatory developments affecting different investor types, and striking a balance between control rights and economic returns in recent infrastructure and energy transition transactions.

## Key Points

- 1 Preferred equity investors now price control and governance rights as core return components alongside yield, rather than ancillary features. Sponsors seeking to limit investor control face materially higher pricing.
- 2 Market practice emphasises minimum cash-pay requirements and limits payment-in-kind (PIK) accrual in response to recent restructurings where PIK-heavy instruments emerged impaired. Hybrid structures with cash-pay floors have replaced pure PIK dividends.
- 3 Enforcement leverage and credible downside protection have become central to investor confidence and pricing. The ability to credibly threaten enforcement shapes sponsor behaviour well before remedies are exercised.
- 4 Anti-priming and value leakage protections are more aggressively negotiated following recent liability management disputes. Investors now scrutinise, at the outset, how capital holds up under amendment, refinancing and recapitalisation scenarios.

Preferred equity has evolved considerably in recent years. While investors traditionally focused on the same familiar themes – payment mechanics, conversion rights and accounting treatment – market conditions over the past year have forced a meaningful recalibration.

Higher interest rates, slower refinancing cycles and longer exit timelines have changed how risk is underwritten. Investors are also less willing to rely on projected asset growth or future refinancing optionality, particularly after recent restructurings where delayed exits materially impaired junior capital.<sup>1</sup> And, in a distressed scenario, sponsors may be reluctant to throw good money after bad by deploying incremental common equity.

These dynamics catalysed preferred equity's evolution from a structurally convenient solution to an instrument that now must stand on its own economic merits. The most significant change is not in documentation, but in emphasis. Investors no longer underwrite preferred equity as common equity with added protection. Instead, they design instruments that generate returns through a combination of current income, governance rights and credible downside outcomes.

## HOW INVESTORS ARE PRICING PREFERRED EQUITY IN PRACTICE

### Pricing beyond headline yield

Pricing preferred equity in today's market begins with recognising that headline yield tells only part of the story. While nominal return targets have increased with higher base rates, investors are focused on the certainty and timing of those returns.

Pure payment-in-kind (PIK) structures have become harder to justify. Investors are wary of unchecked dividend accrual, particularly when exits are uncertain and refinancing markets are uneven. Recent restructurings have underscored this risk. In the Mallinckrodt and Cineworld restructurings, PIK-heavy junior instruments emerged materially impaired, with equity holders receiving no recovery despite years of accumulated dividends.

Modern preferred structures often mix minimum cash-pay requirements with PIK mechanics or use capped PIK features that limit total dividend accrual relative to the initial principal amount. Call protection has tightened, with investors reluctant to accept early redemptions that cut off expected economics.

These dynamics were visible in several publicly disclosed sponsor recapitalisations, where preferred investors negotiated enhanced make-whole provisions in connection with opportunistic refinancings.<sup>2</sup>

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<sup>1</sup> Recent restructurings where delayed exits and extended holding periods materially impaired junior capital include Mallinckrodt plc (emerged from Chapter 11 in November 2023) and Cineworld Group plc (entered administration in July 2023). See *In re Lyondell Chemical Co.*, 544 B.R. 75 (Bankr. S.D.N.Y. 2016).

<sup>2</sup> For example, Berkadia arranged \$29m in preferred equity for the recapitalisation of a multifamily portfolio in New Jersey in September 2024. See Berkadia, 'Berkadia Sources \$29M in Preferred Equity for 588-Unit, Multifamily Recapitalisation in New Jersey' (19 September 2024).

## Pricing as a function of control

One of the clearest developments in recent transactions is the value investors attribute to control. Governance, consent and enforcement rights are no longer viewed as ancillary terms. They are evaluated alongside yield as core components of the return profile.<sup>3</sup>

Sponsors seeking to limit investor control face higher pricing. Conversely, robust governance rights allow investors to accept lower headline returns in exchange for downside protection and greater certainty. This trade-off is a defining feature of the modern market.

## Market example

A typical scenario: a sponsor seeks preferred equity to fund an acquisition without diluting common equity or implicating restrictive senior debt covenants (by taking on more debt). In earlier cycles, the preferred instrument might have featured a fully PIK dividend with limited governance rights.

Today's structure includes a minimum cash-pay requirement, a PIK component with a cap on total accrual, and dividend rate step-ups that begin after an agreed number of years unless the preferred equity is redeemed sooner. Governance protections extend to consent rights over debt incurrence above specified thresholds, material asset sales, and any amendments to senior debt that could adversely affect the preferred position.

Publicly disclosed transactions reflect this shift. In October 2025, Energy Vault Holdings announced a \$300m preferred equity investment from Orion Infrastructure Capital to support energy storage infrastructure development.<sup>4</sup> Similar transactions in infrastructure and energy transition sectors have featured preferred equity providers securing meaningful governance rights alongside enhanced economics.

## GOVERNANCE AND STRUCTURAL LEVERS

Governance has become the primary means by which preferred equity investors protect and enhance returns. Rather than seeking day-to-day operational control, investors focus on targeted rights that shape sponsor behaviour and preserve value over the life of the investment.<sup>5</sup>

Expanded consent rights now extend well beyond extraordinary corporate actions. Restrictions on additional debt, amendments to senior debt facilities, asset sales and distributions are negotiated with precision. These rights are especially important in structures where senior debt documents permit substantial flexibility, a risk highlighted in several recent liability management transactions that resulted in priming disputes.<sup>6</sup>

Board and observer rights remain part of the conversation, but information rights often prove more important in practice. Timely access to financial

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<sup>3</sup> See *In re SubMicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006).

<sup>4</sup> Energy Vault Holdings, Inc., Energy Vault Closes \$300 Million Preferred Equity Investment with Orion Infrastructure Capital (9 October 2025).

<sup>5</sup> See *In re Radnor Holdings Corp.*, 353 B.R. 820 (Bankr. D. Del. 2006).

<sup>6</sup> The Serta Simmons Bedding transaction and related litigation exemplify heightened sensitivity to priming risk.

reporting, forecasts and operational updates allows investors to identify emerging issues early.

## **DOWNSIDE PROTECTION AND ENFORCEMENT OPTIONALITY**

Formal enforcement remains uncommon in preferred equity investments, but credible enforcement leverage has become central to pricing and investor confidence. The ability to enforce, or to credibly threaten enforcement, shapes sponsor behaviour well before remedies are exercised.<sup>7</sup>

Modern preferred equity structures typically provide multiple enforcement pathways, including redemption rights, change of control triggers and conversion mechanisms. Conversion (into ordinary common stock) is often viewed as an alternative to enforcement, allowing investors to step into an equity position without triggering insolvency-style processes.

In practice, enforcement is often used as leverage rather than as an endpoint. The prospect of a redemption right being exercised may prompt a refinancing or asset sale on terms favourable to the investor.

## **LEAKAGE, PRIMING AND STRUCTURAL FRAGILITY**

Value leakage and priming risk have become central concerns in preferred equity negotiations. Investors are keenly aware that incremental debt baskets, most favoured nation (MFN) provisions and sponsor flexibility can erode returns if left unchecked. Recent litigation arising from liability management transactions has heightened sensitivity to these risks across the capital structure.<sup>8</sup>

Provisions that allow junior creditors to block value-destructive amendments (short-circuit provisions) and protections against the incurrence of senior debt (anti-priming provisions) are now more aggressively negotiated. Investors focus not only on the initial structure, but also on how that structure performs under amendment, refinancing and recapitalisation scenarios.

## **REGULATORY AND STRUCTURAL CONSIDERATIONS**

While regulatory and accounting rules matter, commercial terms typically take priority in preferred equity structures. Capital treatment considerations affect different investor types in materially different ways.

For banks, the phased implementation of Basel III Endgame reforms introduces heightened capital requirements that may affect preferred equity holdings, particularly where equity exposures to investment funds trigger punitive risk weightings.<sup>9</sup> Insurance companies under EU Solvency II face evolving capital treatment frameworks, with recent reforms in 2025 introducing more favourable capital charges for certain structured

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<sup>7</sup> See *In re Energy Future Holdings Corp.*, 949 F.3d 806 (3d Cir. 2020).

<sup>8</sup> See *In re TOUSA, Inc.*, 680 F.3d 1298 (11th Cir. 2012).

<sup>9</sup> The proposed Basel III Endgame reforms, expected to take effect in 2025 with phased implementation through 2028, introduce heightened capital requirements for bank equity exposures to investment funds, with punitive risk weightings where transparency to underlying positions is limited. See *Basel III Endgame: Complete Regulatory Capital Overhaul*, PwC (2024).

instruments.<sup>10</sup> These developments are expected to become final in early 2027 and may influence investor appetite for preferred equity structures that optimise capital efficiency.

Investors prioritise enforceability and downside protection over formal classification, but regulatory capital treatment nonetheless shapes the universe of potential preferred equity investors and influences structural preferences. Preferred equity instruments remain subject to standard accounting treatment principles, with classification turning on whether instruments are redeemable at a fixed maturity, redeemable at holder option for cash, or constitute perpetual instruments with mandatory dividends.

## PREFERRED EQUITY VERSUS OTHER HYBRID ALTERNATIVES

Preferred equity continues to compete with other hybrid alternatives, including holdco PIK instruments and structured junior debt. Market practice saw a resurgence in junior financings and hybrid capital from private credit lenders, driven by flexibility in capital structure design and cash flow management benefits.

Preferred equity is favoured where control and downside protection are paramount, while alternative hybrids may be preferred where speed or simplicity is critical. The choice between instruments increasingly depends on transaction dynamics and the relative negotiating positions of the parties.

## WHERE THE MARKET IS HEADING

Preferred equity is likely to remain a key feature of sponsor financings, with continued emphasis on discipline. Documentation is becoming tighter, governance more explicit and enforcement rights clearer. As exit timelines extend and refinancing uncertainty persists, investors engage earlier and more actively.

Recent restructuring outcomes suggest that investors are willing to rely on contractual remedies rather than informal alignment alone. This trend is likely to continue, reinforcing the importance of thoughtful structuring from the outset.

## CONCLUSION

Modern preferred equity is no longer defined by labels or accounting treatment. It is defined by how effectively it performs when conditions are less than ideal. Pricing discipline, governance architecture and credible enforcement leverage now sit at the centre of market practice.

Investors underwrite downside first and upside second, designing instruments that deliver returns even when exits are delayed or refinancing options narrow. Sponsors recognise that flexibility carries a cost.

### Further Reading:

- How do investors make returns on preferred equity? (2024) 11 JIBFL 726.
- The rise of hybrids in the ever-converging PIK and preferred equity landscape (2024) 1 JIBFL 11.
- Lexis+® UK: LexisPSL Banking & Finance Practical Guidance: Practice Note: Flexible financing arrangements in the commercial real estate market.

<sup>10</sup> The European Commission published draft amendments to the Solvency II Delegated Regulation in July 2025, introducing more favourable capital requirements for insurers investing in certain securitised and structured instruments. These reforms are expected to become final in January 2027. See European Commission, Draft Delegated Regulation amending Delegated Regulation (EU) 2015/35 on Solvency II (17 July 2025).

The value of preferred equity no longer lies in its hybrid nature alone, but in the precision with which governance, enforcement and economic terms are structured to perform across market cycles.

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