

**Article:        Hybrid Capital in Volatile Markets: Legal Requirements, Fiduciary Duties, and the Frontier Between Debt and Equity**

**Executive Summary**

Hybrid capital is the "third pillar" between conventional debt and common equity. It is neither merely a loan with decorative equity features nor equity dressed in creditor language. It is a negotiated allocation of priority, control, yield, maturity, tax, loss absorption, and regulatory treatment. Common instruments include convertible notes, preferred shares, perpetual subordinated notes, Additional Tier 1 capital, Tier 2 capital, payment-in-kind instruments, warrants, mezzanine debt, and silent participations.

Its appeal is strongest in volatile markets. When valuations are unstable, senior lenders are cautious, and common equity is dilutive or politically unattractive, hybrid capital can close a liquidity gap while postponing the ultimate allocation of upside and downside. That flexibility is also its legal danger. Debt vs equity classification law, hybrid capital covenants, securities disclosure, bank-capital eligibility, director fiduciary duties, insolvency priorities, and tax deductibility all turn on substance over label.

It is our belief that legal work should begin with a classification memorandum, not a term sheet. If the instrument is intended to be debt for tax, equity for rating-agency credit, regulatory capital for prudential purposes, and non-dilutive for governance purposes, counsel must test whether those objectives can coexist.

**The Frontier in Volatile Markets: Liquidity, Valuation, and Loss Absorption**

Hybrid capital addresses two market failures. First, it supplies capital when senior lenders want more collateral and common-equity investors demand deep discounts. Second, it bridges valuation mismatches by giving investors downside protection through coupons, preferences, conversion prices, redemption rights, or covenants, while preserving issuer flexibility.

Credit Suisse illustrates the hard edge of regulatory hybrid capital. FINMA stated that Credit Suisse received extraordinary liquidity assistance on March 19, 2023, triggering a "Viability Event" under the bank's AT1 instruments, and FINMA ordered a complete write-down of the nominal value of those AT1 instruments based on the prospectuses and the Swiss emergency ordinance. The legal lesson is not that every AT1 behaves identically in every jurisdiction. It is that contractual triggers, resolution law, and regulatory authority can determine value faster than ordinary credit analysis can react. The Single Resolution Board, European Banking Authority, and ECB Banking Supervision later emphasized that, under the EU framework, common equity instruments are first to absorb losses and AT1 is written down only after common equity instruments are fully used.

Lufthansa shows a different use of hybrid capital under stress. Its 2020 stabilization package included silent participations of up to EUR 5.5 billion as part of a EUR 9 billion package; Lufthansa stated that EUR 4.5 billion of Silent Participation I was classified as equity under IFRS and the German Commercial Code, while EUR 1.0 billion of Silent Participation II was recognized as debt. That split is a useful reminder that a single rescue package can contain multiple legal and accounting characters.

This means that in a volatile market, the instrument's label is secondary. The controlling questions are who absorbs losses, when payment can be stopped, who controls enforcement, and what happens on insolvency or regulatory intervention.

### Legal Requirements Across Jurisdictions: EU, U.S., Rwanda, and South Africa

Cross-border hybrid capital regulation is converging around disclosure, loss absorption, investor protection, and supervisory oversight, but it still diverges sharply in legal mechanics.

Jurisdiction	Core Legal Requirement	Practical Structuring Consequence
EU bank capital	CRR Article 52 sets AT1 eligibility criteria, including subordination, permanence, discretionary distributions, and loss absorption by conversion or write-down. Basel III classifies CET1, AT1, and Tier 2 by quality and timing of loss absorption.	Draft the instrument around regulatory eligibility from inception. Redemption, call rights, coupons, step-ups, and triggers must be consistent with capital recognition.
U.S. tax and securities law	IRC Section 385 authorizes the Treasury to determine whether a corporate interest is stock, indebtedness, or partly both. SEC Regulation S-K Item 105 requires material risk-factor disclosure, and Item 202 requires description of securities rights.	Tax, disclosure, and investor-risk analysis must be aligned. Conversion rights, subordination, redemption, and payment deferral are not boilerplate; they affect classification and disclosure.
Rwanda	Rwanda's Regulation 15 of 2013 applies to public offers of debt instruments where the issuer seeks listing on an approved securities exchange; it sets requirements including minimum issue size and open-market holder requirements. The Capital Markets Authority also publishes laws, regulations, guidelines, licensing materials, and market rules.	Hybrid debt securities should be screened for public-offer, listing, approval, and licensing requirements. Imported templates must be localized.
South Africa	The JSE states that it acts as listings authority and is licensed as an exchange under the Financial Markets Act 19 of 2012. South Africa's Prudential Authority has also implemented a Basel III-based capital framework for banks.	Preference shares, bank capital instruments, and listed debt require company-law, exchange, and prudential analysis.

This shows that a cross-border hybrid instrument needs a jurisdiction-by-jurisdiction classification matrix covering issuer authority, securities approval, listing, tax treatment, regulatory-capital eligibility, withholding, insolvency priority, and enforcement.

### Fiduciary Duties and Governance: Board Process at the Capital-Stack Boundary

Fiduciary duties in hybrid capital are most acute when the board is allocating value among constituencies. Directors must consider corporate authority, solvency, fairness, disclosure, conflicts, and the economic effect of the instrument on existing stakeholders.

In Trados, the Delaware Court of Chancery reviewed a sale in which preferred holders received merger consideration while common stockholders received nothing. The court applied entire fairness because of conflicts but found no damages because the common stock had no economic value. The lesson for hybrid capital is direct: where preferred investors control board seats or transaction incentives; process matters even if valuation ultimately supports the transaction.

In ThoughtWorks, preferred investors sought redemption of preferred stock. The Delaware Supreme Court affirmed that redemption was limited by legally available funds and that the company was not required to redeem in a manner that would impair its ability to operate. The holding is critical for preferred-share drafting: a redemption right is not always equivalent to a hard debt maturity.

In Gheewalla, Delaware law rejected direct creditor fiduciary-duty claims against directors of a corporation in the zone of insolvency, while recognizing that creditors of an insolvent corporation may pursue derivative claims. And in Nine Systems, a recapitalization involving convertible preferred stock survived on price but failed on process, confirming that fairness is procedural as well as economic.

This reinforces the school of thought that boards issuing hybrid capital should document why the instrument is necessary, why alternatives were rejected, how conflicts were managed, how valuation was tested, and how disclosure protects investors and existing securityholders.

### **Covenants and Structuring Requirements: Anti-Leakage, Waterfalls, and Enforcement**

Hybrid capital covenants are the legal architecture that balance issuer flexibility against investor security. Weak covenants can convert a protected position into unsecured economic exposure.

<b>Covenant Tool</b>	<b>Function</b>	<b>Litigation and Drafting Lesson</b>
Anti-leakage and restricted-payment covenants	Prevent transfer of value to equity holders, unrestricted subsidiaries, or non-creditor affiliates.	The J. Crew transaction became a market example of a "trapdoor" asset-transfer structure that moved collateral outside lender reach.
Guarantee and collateral-release provisions	Determine when subsidiaries, collateral, or guarantees can be released.	PetSmart/Chewy commentary describes how guarantee-release mechanics and subsidiary status can materially affect lender recoveries.
Waterfall and sacred-right provisions	Protect payment priority, pro rata treatment, lien priority, and principal economics.	Marblegate narrowed Trust Indenture Act Section 316(b) to formal core payment terms, increasing the importance of express covenant protection.
Uptier and exchange restrictions	Limit majority-lender transactions that subordinate non-participating lenders.	Serta litigation illustrates the risk of non-pro rata uptier exchanges and the need for precise amendment and exchange language.

It is our opinion that hybrid capital covenants should be drafted as a value-preservation system. Anti-leakage, leverage limits, information rights, waterfall clauses, transfer restrictions, call protection, conversion mechanics, and amendment thresholds must operate together.

### **Tax and Regulatory Classification Challenges**

Hybrid capital tax treatment turns on debt vs equity classification law. IRC Section 385 lists factors including whether there is a written unconditional promise to pay a sum certain, whether the instrument is subordinated, the issuer's debt-to-equity ratio, whether the instrument is convertible into stock, and the relationship between stock ownership and holdings of the instrument. Treasury Regulation Section 1.385-1 provides general rules under Section 385 for determining whether an interest is stock or indebtedness in particular factual situations.

Fin Hay Realty remains a practical warning. The Third Circuit held that the decisive inquiry is economic reality, not form, and that no single factor is conclusive. If shareholder advances are proportional to stock ownership, deeply subordinated, thinly capitalized, dependent on business success, and unlikely to be made by an outside lender, the tax law may treat the instrument as equity.

Therefore, if the commercial bargain depends on interest deductibility, withholding treatment, regulatory-capital recognition, or rating-agency equity credit, classification risk should be priced, disclosed, and supported by contemporaneous evidence.

### **Hybrid Capital in Restructuring**

Restructuring with hybrid capital often takes the form of debt-for-equity swaps, convertible rescue instruments, preferred equity injections, or subordinated notes with payment deferral. In U.S. Chapter 11, a plan may provide for the issuance of securities of the debtor in exchange for claims or interests, and Section 1129(b) permits cramdown if statutory fair-and-equitable requirements are met. Section 1145 also provides a securities-law exemption for certain securities issued under a plan in exchange for claims.

The EU Preventive Restructuring Directive requires member states to provide preventive restructuring frameworks intended to allow viable debtors in financial difficulty to restructure early and avoid insolvency Directive (EU) 2019/1023. The comparative point is important: Chapter 11 is court-centered and plan-driven, while European restructuring tools vary by member state and increasingly use class formation, stay tools, and court confirmation.

This means that hybrid capital can repair a balance sheet only if priority, valuation, voting class, disclosure, and fiduciary process are defensible. A debt-for-equity swap that solves leverage but ignores valuation or class rights simply moves the dispute from the balance sheet to the courtroom.

### **Hybrid Capital and ESG Financing**

ESG hybrid capital financing is also growing because long-dated or subordinated capital can match the economics of infrastructure, energy transition, and sustainability projects. But ESG labels add legal exposure. To use the European Green Bond or EuGB designation, Regulation (EU) 2023/2631 creates a voluntary standard tied to use of proceeds, taxonomy alignment,

factsheets, allocation reporting, impact reporting, and external review. The European Commission's interpretive notice explains that issuers using the EuGB label must complete a factsheet, obtain a positive pre-issuance review, provide allocation reports, and comply with the Regulation's annex templates. ESMA supervises external reviewers of European Green Bonds.

ICMA's Green Bond Principles identify four core components: use of proceeds, process for project evaluation and selection, management of proceeds, and reporting. ICMA's Sustainability-Linked Bond Principles focus on KPI selection, sustainability performance targets, bond characteristics, reporting, and verification.

Therefore, fiduciary responsibility in ESG hybrid capital requires more than good intentions. Boards should ensure that green use of proceeds, KPI ambition, verification, proceeds management, and investor disclosure are legally auditable.

### Synthesis and Call to Action

Hybrid capital is attractive because it is flexible. It is also dangerous for the same reason. The following comparison is the decision framework counsel should apply before launch.

Strategy	Mechanism	Best Use	Principal Legal Risk	Required Legal Response
Bank AT1 or Tier 2 capital	Contractual subordination and regulatory loss absorption	Prudential capital optimization	Regulator-triggered write-down or loss of capital recognition	Align terms with CRR, Basel, local regulator guidance, and disclosure.
Preferred or convertible rescue capital	Preference, conversion, redemption, or participation rights	Liquidity bridge during valuation uncertainty	Fiduciary conflict and misclassification	Use independent processes, valuation support, and conflict management.
Debt-for-equity restructuring	Exchange claims for equity or hybrid securities	Balance-sheet repair	Priority, cramdown, class voting, and disclosure disputes	Build a defensible plan record and valuation case.
ESG hybrid instrument	Subordinated or long-dated capital tied to green projects or sustainability targets	Energy transition and sustainable infrastructure	Greenwashing, KPI weakness, and reporting failure	Apply EU, ICMA, and local disclosure standards with external review.

The frontier between debt and equity is not a drafting inconvenience; it is the legal battlefield on which tax, insolvency, securities regulation, fiduciary duties, and investor remedies meet. In volatile markets, that battlefield moves quickly. It is also worth noting that the strongest transactions are not the most aggressive. They are the ones that can survive a regulator review, a tax audit, a disclosure claim, a fiduciary-duty challenge, and a restructuring dispute.

Our law firm's (Stabit Advocates') hybrid capital expertise is built for that intersection: finance, securities, tax, fiduciary governance, capital markets regulation, ESG disclosure, and restructuring strategy. We navigate hybrid capital transactions with confidence, compliance, and fiduciary integrity.

## Contact Information

Stabit Advocates

Website: [www.stabitadvocates.com](http://www.stabitadvocates.com)

Email: [info@stabitadvocates.com](mailto:info@stabitadvocates.com)

Phone: +250 789 366 274

For more information or to discuss your case, please contact us at [info@stabitadvocates.com](mailto:info@stabitadvocates.com).

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