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# PE Firms and Distress: The Tricky Business of Risk Mitigation and Value Creation



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## Initial Actions

- Assess the current situation
  - Payroll
  - Assemble deal team
  - Actual rights and obligations under documents
  - Burn rate and sources of cash
  - Determine and protect key assets
  - Stakeholder objectives
  - Avoid time pressures – prepare the record



## Sources of Personal Liability

- Quick review as to personal liability
  - Basic definition of a fiduciary
  - Delaware and New York statutory provisions
  - Corporation v. limited liability company



## Personal Liability (cont.)

- Securities laws
  - Implicated when you sold interests in your fund or in the portfolio company
  - 1933 Securities Act
  - Investment Adviser Act
  - Blue sky laws
- Operative documents
- ERISA and state laws with strict liability
- Proposed financial reforms may increase scope of liability



# Delaware Corporate Statute – Reliance on Others

- § 141: ...be fully protected in relying in good faith ... upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.



## New York Corporate Statute – Reliance on Others

- § 717: “(a) A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances...”
- ...shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by: (1) ... officers or employees ..., (2) counsel, public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or, (3) [another] committee ... which ... director believes to merit confidence...” [subject to certain limitations]



## Delaware LLC Exculpation

- §18-1101(c): “To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”



## Delaware LLC Exculpation (cont.)

- §18-1101(e) “A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”





## New York LLC Exculpation

- § 409. Duties of managers. “(a) A manager shall perform his or her duties as a manager, including his or her duties as a member of any class of managers, in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances.”
- §417(a): “operating agreement may set forth a provision eliminating or limiting the personal liability of managers to the limited liability company or its members for damages for any breach of duty in such capacity, provided that no such provision shall eliminate or limit: ... bad faith or involved intentional misconduct or a knowing violation of law or that he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled ...”



# Court Definition of Fiduciary Duties

- “Clean Hands and Pure Heart”
- 1924 Opinion - Failed Director
- Current line of cases
  - Caremark
  - AIG
  - Citicorp



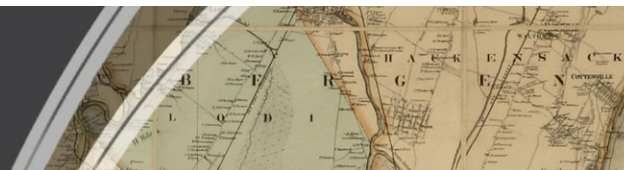
## Standard of Care

- Fiduciary duties - care, loyalty and good faith
- Fiduciary not a guarantor
- Distinguish effort from result
- Duty to monitor
  - Liability for failure to exercise good faith
  - Failure to act in the face of known duty to act, demonstrating conscious disregard for responsibilities
  - Sustained or systematic failure of corporate systems



## Duties Regarding Exit or Financing

- Maintenance of current operations
  - Payroll deductions
- Engage professional deal team
- Reconnoiter the options
- Assess likelihood of success of transaction



# Self – Interested Transactions

- “Entire fairness” standard
- Certain procedures
  - Special committee
  - Committee counsel
  - Open and fair analysis of material facts and company options
  - Fairness opinion



## Self – Interested Transactions (cont.)

- Offer response
  - Generally, either
    - Shop the company
    - Market check
    - Impeccable knowledge of fair value
    - Extent of liquidity crises of the company



## Self – Interested Transactions (cont.)

- **Sale of the company – recent Del. case**
  - Financial adviser with a fairness opinion
  - Revlon duty or specific objective: maximize the sale price – when embark on transaction
  - In absence of duty of care, analysis is the duty of loyalty
    - Gross negligence or
    - Intentional dereliction of duty – conscious disregard
    - Sustained and systemic failure of the board to exercise oversight
  - No single blueprint for the process



## Self – Interested Transactions (cont.)

- **Comparing competing offers**
  - Value of non-cash consideration
  - Earn-outs
  - Other factors differentiating the offers
  - Employment, management and other interested deals
  - Stockholder or member veto right





# Overview for Private Equity

- Opportunities to restructure challenged investments
  - Recapitalizations
  - Chapter 11
- Litigation Risks
  - Perception that deep pockets will always be a target



# Consensual Restructuring

- Additional investment
  - Down round issues
  - Protection for directors
  - Watchmark Corp. v. Argo Global Capital LLC
- Using cash strategically
- Exchange offers
- Debt tenders/buy-backs
- Shutdown costs
- Release considerations



# Conversion of Debt to Equity

- Valuation considerations
- Determining optimal debt levels
- Negotiating with distressed investors



# Pre-packaged or Pre-negotiated Chapter 11

- Often leads to 363 sale
- Venue selection
  - New York or Delaware
  - Cross-border cases and Chapter 15



## Hostile Chapter 11 Cases

- Availability of DIP financing
- Bankruptcy-remote entities
- Creating creditors
- Exclusivity
- Pre-petition lenders may be your allies
- Cramdown and accepting classes
- Treatment of trade creditors



## 363 Sales

- Fair and open auctions
- Stalking horse bids of sponsors
  - Conflict issues
  - Recusal/resignation
  - Separate counsel for sponsor
- Role of creditors committee



# Claims Against Private Equity Firms

- Deepening insolvency
- Recharacterization
- Insider litigation
- Piercing the corporate veil
- Labor claims



## Deepening Insolvency

- Officers and directors may be liable if they artificially prolong its business beyond the point where failure is likely
- 2007 – Delaware Supreme Court held in Trenwick that Delaware law does not recognize deepening insolvency as an independent claim
- 2008 – The Brown School revived the doctrine





## Deepening Insolvency – *Brown School*

- A PE firm acquired control of Brown School
  - PE firm received \$800,00 in annual management fees
- TBS borrowed \$112.5M from PE firm
- The business failed: TBS and its subsidiaries filed under Chapter 7 bankruptcy petitions



## Deepening Insolvency – *Brown School* (cont.)

- Bankruptcy trustee sued the PE firm
  - Breach of fiduciary duty
  - Deepening insolvency
  - “Interested director” transactions violated duty of loyalty



## Deepening Insolvency – *Brown School* (cont.)

- The PE firm:
  - Argued the Trustee's claims were disguised deepening insolvency claims
- Bankruptcy court dismissed the deepening insolvency claim, but did not dismiss the duty of loyalty claim
- Court rejected PE firm's argument that deepening insolvency was an improper measure of damages for a duty of loyalty claim
- Deepening insolvency lives on in Delaware



## Insider Litigation – *Winstar v. Lucent*

- Court held that Lucent was a non-statutory insider where it did not deal with Winstar on an arm's length basis in various transactions
- Court did not rely on the more typical “actual control” test



## Winstar v. Lucent

- Pre-bankruptcy in 1998, Winstar and Lucent entered into a so-called strategic partnership to build out Winstar's global broadband network
- The parties entered into two main agreements:
  - (1) a \$2 billion secured credit agreement,
  - (2) a supply agreement under which Lucent would build out and deliver the network using mostly Lucent equipment, and



## Winstar v. Lucent

- Lucent argued that Lucent and Winstar did not have any common officers or directors and that it was not a person in control because it did not exercise day-to-day managerial control over Winstar
- The Third Circuit (and courts below) held that: it was not necessary for a creditor to have actual control to be an insider; Creditor could be an insider where there is a close relationship [between debtor and creditor] and ... that transactions between the two were not conducted at arm's length”



## Winstar v. Lucent

- Examples cited by the Bankruptcy Court that transactions between Lucent and Winstar were not conducted at “arm’s length” (cont.):
  - Bankruptcy Court found that what began as a “strategic partnership” to benefit both parties degenerated into a relationship in which Lucent, a much larger company, bullied and threatened Winstar, a much smaller company, into taking actions that were designed to benefit Lucent at the expense of Winstar
  - Lucent propped up its own revenue by causing Winstar to purchase hundreds of millions of dollars of goods well before the goods were needed and, in some instances, where the goods were not needed at all; Lucent treated Winstar as a captive buyer



## Recharacterization – Radnor Holdings

- Recharacterization: case law doctrine that provides that equity can be treated as debt
  - Usually facts and circumstances test
- Tennenbaum Capital Partners LLC (TCP) purchased \$25M of preferred stock and loaned Radnor \$95M on a secured basis
- At all times TCP held less than 20% of the equity of Radnor





## Recharacterization – Radnor Holdings (cont.)

- Radnor's business failed and it filed for Chapter 11
- Radnor and TCP entered into an asset purchase agreement and a DIP credit agreement
  - Provided Radnor with funds to complete 363 sale
  - TCP agreed to purchase Radnor's assets and credit bid its claims



## Recharacterization – Radnor Holdings (cont.)

- The creditors committee sued TCP
  - Attacked “loan to own” strategy
  - Claimed TCP insisted on pre-petition terms that it knew Radnor could not meet
  - Sought recharacterization
- Court focused on intent of parties *at time of transaction* in favor of TCP on all counts
  - Court rejected “facts and circumstances” analysis
  - If the parties intended a loan, the court will not recharacterize the debt as equity
  - Good result for PE firms



## Labor Claims

- PE firms may have liability under state wage/hour laws for unpaid wages and/or state WARN laws when portfolio companies are shut down
- Consult local employment lawyers when closing portfolio companies



## Piercing the Corporate Veil

- Creditors may claim PE firm is liable for debts of portfolio company if it has taken actual control
  - Claim is based on facts and circumstances
  - Claim is hard to prove: often brought in hopes of inducing settlement

Gordian Group LLC



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# Current Market

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- ❖ Large number of distressed companies
- ❖ Constraints faced by existing senior lenders
- ❖ Absence of traditional debtor-in-possession financing shaping the bankruptcy landscape

# How Do You Handle Your Own Conflicts of Interest?

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- ❖ Multiple investments at various levels of the capital structure
- ❖ Social issues

# How Do You Maximize Equity Value in an Existing Distressed Situation?

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- ❖ Buyback portfolio companies' debt at attractive levels
- ❖ Overhang of Chapter 11



# How Do You Maximize Equity Value in an Existing Distressed Situation?

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- ❖ Option value
- ❖ New money
- ❖ Control
- ❖ Internal restructuring

# How Do You Profit in the Distressed Market?

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- ❖ Tallywhacker in the peanut butter
- ❖ Debt purchases to bootstrap into ownership
- ❖ Solution capital
- ❖ Partner with existing equity
- ❖ 363 sales

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