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Distressed Portfolio Companies: Potential Litigation Aftermath for Sponsors

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Introduction

One distinguishing characteristic of the current recession is the number of private equity firms forced to address financially troubled portfolio companies. Sponsors bought companies through leveraged buy-outs that left substantial acquisition debt on the companies' books. Some of the same companies later took on more debt to pay early returns to their sponsors through dividend recapitalizations. As the economy worsened, many of these companies found themselves carrying more debt than they could support at lower revenues, which led to a rash of bankruptcies and out-of-court restructurings. When portfolio companies fail, there is a growing sentiment among some creditors that the sponsors should be held responsible. A prime example is the Chapter 11 recently filed by Simmons Bedding Co. Ownership of the company has changed hands six times in 20 years and in each instance, as the price of the company rose, successive buy-out firms placed an increasing amount of acquisition debt on the company to finance their purchase. Reports are that the company's debt rose from \$160 million less than 20 years ago to its current \$1.3 billion, and that along the way, private equity firms extracted \$750 million in profits, in several instances through dividend recaps. Now that Simmons has fallen on hard times, hungry creditors are circling and some pundits are suggesting that the latest private equity owner, which bought the business in 2003, may be legally accountable for leaving the company in such a vulnerable condition.

Experts predict that half of all portfolio companies will default on their debt obligations in the next three years. In fact, the data reflects that over the next few years, the volume of leveraged loans maturing doubles or triples each year, with \$430 billion in leveraged loans maturing from 2012 to 2014. Few companies will be in a position to repay these loans on time; nor does it seem likely that the capital markets will recover far enough and fast enough to refinance the bulk of these loans. As a result, it appears that the worst still lies ahead and the current wave of portfolio company restructurings may not abate for another three to five years.

Most portfolio company restructurings will require a conversion of debt to equity that wipes out the sponsor's equity stake. The buy-out firms seem to be adapting to this potential outcome; however, it is still a surprise to many that their exposure from a failed buy-out could, through litigation, far exceed their original investment. The additional leverage means that when these portfolio companies are restructured, there may be no unencumbered assets, which may prompt unsecured creditors to consider other means of recovery, such as suing 'deep-pocket' sponsors for causing or substantially contributing to the portfolio company's demise.

Businesses fail for many reasons, including those outside management's control; the 'scorched earth' litigation tactics favoured by unsecured creditors are not a cure-all for those failures. Nevertheless, sponsors are increasingly the target of disruptive litigation filed or threatened by unsecured creditors or bankruptcy

trustees. The array of claims conceived by these litigants can seem limitless. This update considers three of particular interest to sponsors:

- The failed buy-out was a fraudulent transfer and the sponsor should be liable as the party for whose benefit the transfer was made (especially in leveraged transactions with an operating company/property company (opco/propco) structure);
- The sponsor should disgorge distributions received from a dividend recapitalization that allegedly rendered the company insolvent; and
- The sponsor is liable for damages under a 'deepening insolvency' theory that it artificially prolonged the company's life, to the detriment of creditors.⁽¹⁾

Fraudulent Leveraged Buy-Outs

When a company acquired through a leveraged buy-out subsequently fails, often for reasons unrelated to the ownership change, years after the fact its unsecured creditors may argue that they were harmed because the company's assets were encumbered by liens for which it received nothing in exchange. These creditors contend, with the benefit of hindsight, that the buy-out left the company in a weakened state with few or no unencumbered assets for them to look to when the business failed. Most of these creditors did not insist on collateral at the time, and in fact benefited by continuing to do business with the company and its new owners. However, in litigation they paint the sponsors as ruthless predators who reap quick returns by descending on healthy companies, wringing out the equity and selling without adding value.

Creditors looking to manufacture a return will consider recasting a buy-out as a fraudulent transfer. There was a rash of such lawsuits following the junk bond market's collapse in the 1990s, mostly brought by failed companies against the lenders which provided the leveraged loans. Now creditors are dusting off the same theories and trying to expand them to sponsors.

There are two types of fraudulent transfer: those made with "actual intent to hinder, delay or defraud creditors", and constructive fraudulent transfers. Actual intent claims are rarely successful, partly because a sponsor can mitigate much of its risk by obtaining a solvency opinion from a reputable adviser firm. In addition, to the extent that the buy-out price is within a market range, the sponsor's equity contribution arguably provides the measure of solvency.

Constructive fraudulent transfers are transfers for less than "reasonably equivalent value" that render a company insolvent or close to it. The courts tend to collapse multiple stages of these transactions and conclude that the target was a mere conduit for the loan proceeds, which went to the former owners, and thus did not receive adequate value for the loan. The inquiry then becomes whether the company was rendered insolvent or close to it. This depends on factors such as:

- how much debt was incurred;
- the time between the transaction and insolvency; and
- whether intervening factors caused the target's insolvency.

Once again, if the price is within a market range, the sponsor's equity contribution is the appropriate measure of solvency. As adeptly summarized by one influential court, "[b]usinesses fail for all sorts of reasons, and the fraudulent conveyance laws are not a panacea for such failures".⁽²⁾

Once a transfer is avoided, its value can be recovered from the initial recipient (the sellers), the entity for whose benefit the transfer was made (the sponsor) and some subsequent transferees. Creditors asserting these claims against sponsors argue that the buy-out was for the sponsor's benefit as the sponsor provided only a fraction of the purchase price required to acquire the target and assumed no liability for the acquisition debt left on the target's books.⁽³⁾

Operating Company/Property Company

Creditors are particularly sceptical of buy-outs with an opco/propco structure, popular where the target holds real estate assets in multiple locations such as large retailers, hotel chains, nursing home operators and gaming companies. In its simplest form, the sponsor splits the target into two entities: an opco to run the business and a property company to hold the real estate. The opco leases the real estate from the propco (commonly a bankruptcy-remote single-purpose entity) and assumes all costs of owning and maintaining the property so that the propco's sole job is to collect rent from the opco and make the mortgage payments.

Opponents argue that these structures are designed principally to strip valuable real estate out of a company because, unlike a traditional buy-out where the target continues to own the property subject to the lenders' lien, in an opco/propco structure, the opco sells the property, forgoing any residual interest, but still services the mortgage by paying rent to the propco.

There is nothing inherently improper about buy-outs with opco/propco structures. Rather, the structure enables companies to access the real estate capital markets, which generally loan more against real estate at lower interest rates than standard commercial loans. The structure may also provide tax advantages to propcos that elect to be taxed as real estate investment trusts.

These theories are at the centre of the Chapter 11 of department store chain Mervyn's. In 2004 Mervyn's was sold to a private equity group and split into an opco/propco structure. In 2008 Mervyn's filed Chapter 11 in Delaware. The company promptly sued its lenders, sponsors and parent, alleging that the transactions had robbed the company of valuable real estate assets. The lawsuit is in the early stages of pre-trial litigation and is being watched closely by sponsors.

Dividend Recapitalizations

Creditors of failed companies also scrutinize prior payments to, or for the benefit of, sponsors, especially dividends financed through recapitalizations. When conditions are right, a company may incur additional debt in order to pay a special dividend, enabling its sponsor to realize a return earlier in the life of its investment. The net effect is that the company takes on more debt and the sponsor recovers some of its investment without diluting its equity.

Dividend recapitalizations exploded in popularity a few years ago, due in part to a reduction in the tax rate for corporate dividends to 15%. Although a relatively new phenomenon, the amounts involved are significant - in 2007 dividends paid from sponsored recapitalizations totalled \$49 billion.

Opponents argue that a dividend recapitalization weakens a company by adding debt to the balance sheet while cash is siphoned off to the sponsor. Those arguments ignore longstanding precedent that it is perfectly appropriate for a subsidiary to declare a dividend for its parent, and doing so by taking on debt is fine provided that the dividend is permitted under state law, which generally requires only that the company not be rendered insolvent or close to it.

Although there are few reported lawsuits challenging dividend recapitalizations, an increase seems likely, at least until a body of law develops to enable litigants to weigh the merits of their positions. The current benchmark case is the original Chapter 11 of KB Toys in Delaware. In 2000 KB Toys was acquired by sponsors and in 2002 it issued debt in order to pay bonuses and dividends to the sponsors. In 2004 KB Toys filed Chapter 11, following which the sponsors were sued in state court in Delaware and Massachusetts. Both lawsuits alleged that the recapitalization rendered the company insolvent. The lawsuits were settled for an undisclosed sum.

Another example is the Chapter 11 of Powermate in 2008. Unsecured creditors challenged a dividend recapitalization alleging that, following a spike in earnings after Hurricane Katrina, the company, which produces power generators, incurred debt to pay a dividend to its sponsors, rendering it insolvent. The lawsuit was settled for a relatively modest distribution.

Some recapitalizations will be at greater risk than others. The prudent sponsor will ensure that the company is not rendered insolvent in the wake of the dividend payment. Although not required, sponsors may take measures to reduce their risk by, for example:

- having the transaction approved by independent directors, if available;
- giving a special committee access to its own legal and financial advisers; and
- where the dividend is sufficiently large, obtaining a solvency opinion.

Deepening Insolvency

A third source of potential liability for sponsors is where creditors assert a claim for deepening insolvency - that is, that the sponsor wrongfully prolonged the company's life to recoup its investment or collect dividends, to the detriment of creditors. This theory was prevalent a few years ago but lost traction and is no longer recognized as an independent claim by most courts. However, it remains relevant, if for no other reason than

the size of the damage awards sought, which in almost every case will far exceed the sponsor's investment. Also, deepening insolvency may be the appropriate measure of damages for another claim, such as a breach of fiduciary duty claim. Courts have tended to rein in that use as well; however, in a recent decision that some experts argue may have breathed life back into deepening insolvency, the Delaware Bankruptcy Court refused to dismiss a trustee's lawsuit against a sponsor that included fiduciary duty claims with deepening insolvency proposed as the measure of damages.

In general, a director owes the corporation and its shareholders a duty of care and duty of loyalty. Once the corporation becomes insolvent, the director's fiduciary duties shift to include the company's creditors. In this context 'insolvency' means that either (i) the company's liabilities exceed the fair value of its assets (the 'balance sheet' test), or (ii) the company can no longer pay its debts as they fall due. In essence, the directors of an insolvent company owe the same fiduciary duties that they always owed to the company, but because the company is insolvent, the stakeholders now include creditors. In some states, the shift occurs earlier when the company enters the zone of insolvency, but the vitality of that doctrine is in question and, certainly in Delaware, directors owe no fiduciary duties to creditors until the company is insolvent.⁽⁴⁾

The duty of care requires a director to act with the care that a prudent person would exercise under similar circumstances. The duty of loyalty obligates a director to put the interests of the corporation above his personal interests (or in this context, the sponsor's interests). The distinction is relevant because, under Delaware law, a corporation's certificate of incorporation can include an exculpation clause that exonerates directors from personal liability for a breach of the duty of care, but not the duty of loyalty. A director's decisions are generally protected by the business judgement rule, which requires only that the director make decisions on an informed basis, in good faith and with an honest belief that he or she is acting in the company's best interests. In instances where a director had personal interest in a transaction or lacked independence, the business judgement rule does not apply and the burden shifts to the director to establish the intrinsic fairness of the transaction, which is a much more difficult standard.

In *Brown Schools* a Chapter 7 trustee sued the sponsor and related parties under various theories, including breach of loyalty. Over several years the company sold assets and used the proceeds to repay debt and pay fees to the sponsor. The company also granted liens to secure the sponsor's sub-debt. In a 2008 decision, the court declined to dismiss the lawsuit and left open the possibility that deepening insolvency could be a measure of damages for breach of loyalty claims.⁽⁵⁾ The case subsequently went to mediation and settled for \$4.75 million.

The lasting impact of *Brown Schools* remains to be seen; notably, the decision was in the context of a motion to dismiss, which required the court to accept the lawsuit's version of the facts as true. Whether the trustee would have prevailed at trial is unknown and the ruling is probably best confined to its facts. However, it seems clear that in the right circumstances, courts may still entertain the notion that a sponsor could be liable for damages in excess of its original investment under a theory that it worsened a portfolio company's insolvency.

Comment

The wave of portfolio company restructurings is surging ahead and with it unsecured creditors, faced with the prospects of diminished or no recoveries, are searching for ways to hold sponsors accountable for the companies' financial collapses. The legal theories themselves are not new (eg, fraudulent transfer, illegal dividend, deepening insolvency), but efforts to expand their use to sponsors are new, and should be monitored closely by sponsors and their counsel.

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Endnotes

(1) Other 'real-world' examples include:

- that the sponsor breached its fiduciary duties, engaged in self-dealing or aided and abetted officers' or directors' breach of their fiduciary obligations;
- all manner of business tort (eg, tortious interference, unjust enrichment, corporate waste);

- fraud or civil conspiracy; and
- indirect claims against the sponsor, such as claims that the directors appointed by the sponsor to the board of the company breached their fiduciary duties or approved illegal dividends, which claims may ultimately be the sponsor's responsibility (if not covered by insurance) under the sponsor's indemnification in favour of its representatives.

(2) *Moody v Security Pacific Business Credit, Inc*, 971 F 2d 1056 (3d Cir 1992), rejecting claims that leveraged buy-out included fraudulent transfers where the company did not fail for 18 months after the transaction and the failure was the result of price slashing and inventory dumping by one of its competitors.

(3) One factor that may add to the number of claims asserted against sponsors is the fact that in some jurisdictions, former shareholders may have a complete defence to a fraudulent transfer claim under Section 548 of the Bankruptcy Code. Those courts have determined that payments to selling shareholders, if by wire transfer, are immune as settlement payments made by a financial institution under Section 546(e) of the Bankruptcy Code. Compare *In re Elrod Holdings Corp*, 394 BR 760, 763 (Bankr D Del 2008) (payments to sellers for privately held securities are settlement payments protected by Section 546(e)) with *In re Norstan Apparel Shops, Inc*, 367 BR 68 (Bankr EDNY 2007) (transfers are not settlement payments if the securities were not publicly held).

(4) Delaware also recently clarified that creditors cannot sue directors directly for an alleged breach of their fiduciary duties and must bring such claims, if at all, only as derivative claims on behalf of the corporation. See *North Am Catholic Educ Programming Found, Inc v Gheewalla* 930 A 2d 92, 101-02 (Del Supr 2007).

(5) See *Miller v McCown De Leeum & Co (In re The Brown Schools, Inc)*, 386 BR 37, 48 (Bankr D Del 2008); but compare *In re SI Restructuring, Inc* (5th Cir 2008) (rejecting deepening insolvency both as an independent claim and a measure of damages under Texas law).

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