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Private Equity Newsletter

Insiders' Loan to Cash-Strapped Company Cannot Be Equitably Subordinated Without Specific Evidence of Actual Harm to Creditors

PENpoints

Private equity sponsors contemplating loans to financially distressed portfolio companies can reduce the risk of equitable subordination by properly structuring their loans and ensuring that the proceeds are used for a proper purpose.

Private equity sponsors and other insiders of a financially distressed portfolio company often must decide whether to make loans to the company to help it avoid bankruptcy. Unfortunately, such loans do not always succeed in averting bankruptcy. Once a company enters bankruptcy, these loans, particularly when structured as secured loans, can become subject to intense scrutiny by creditors seeking to enhance their recoveries by equitably subordinating the resulting claims under Bankruptcy Code section 510(c).

Section 510(c) permits a bankruptcy court (subject to appeal) to subordinate one claim to another claim or even to an equity interest if the party making the claim engaged in inequitable conduct that resulted in actual injury to the debtor and its stakeholders. Insiders contemplating loans to financially distressed portfolio companies can reduce the risk of equitable subordination by properly structuring the loans and ensuring that the proceeds are used for a proper purpose. A federal appeals court decision recently demonstrated the importance of both points—as well as the importance of the insider avoiding even the appearance of "overreaching."

The *SI Restructuring* Opinion

In 2007, a Texas bankruptcy court equitably subordinated two secured loans made to the debtor prior to bankruptcy by two individuals who were principal shareholders, directors and officers of the debtor. As part of the second loan, the two individuals were granted liens on the debtor's property to secure *existing* personal guarantees of the debtor's pre-existing debt. The bankruptcy court concluded that, in obtaining those liens, the two individuals had "grabbed for as much as they could get[,] and they got it all."[1] The district court later affirmed the bankruptcy court's decision to equitably subordinate the two secured loans.

On June 20, 2008, the Fifth Circuit Court of Appeals reversed the bankruptcy and district courts' decisions. In so doing, the appellate court held that, before an insider's claim may be equitably subordinated:

- The insider must have engaged in inequitable conduct; and
- The inequitable conduct must have harmed the company and its unsecured creditors.

Even then, that claim may be equitably subordinated only to the extent necessary to offset actual harm.

The Fifth Circuit reversed the bankruptcy court for two primary reasons:

- There were no findings of inequitable conduct regarding the first of the two secured loans.
- Even if the insiders had engaged in inequitable conduct or obtained an unfair advantage in making the second loan, the bankruptcy court did not find that the loan harmed unsecured creditors as a class. Indeed, the loan pro-

ceeds had been used to pay some (but not all) of the unsecured creditors. The court was clear in holding that such unequal treatment did not constitute harm to unsecured creditors for purposes of equitable subordination.

The Fifth Circuit also found that the two individuals had not gained an unfair advantage or otherwise harmed the debtor when the debtor's assets were used to secure their guarantees at the time the second loan was made. The debtor never defaulted on the principal obligation, and so the guarantees were never triggered. The court concluded that, "[b]ecause no claim ever arose on these guarantees, no harm resulted."[2]

Lessons Learned from the *SI Restructuring* Case

The Fifth Circuit opinion illustrates certain considerations that a financially troubled portfolio company and its board of directors on one hand, and private equity sponsors and other insiders on the other, should take into account regarding an insider's potential loan to the troubled company. For example, the company and its board of directors should, among other actions:

- Ensure that the loan proceeds are used to maximize enterprise value, without harming the company or its creditors. For example, in the *SI Restructuring* case, the proceeds from the second loan were used to pay some—but not all—unsecured creditors, thereby keeping the company operating.
- Evaluate whether alternative sources of liquidity may be available—and the terms thereof—when determining whether to enter into the insider loan.
- If possible, consider utilizing a process for board consideration and approval of the insider loan as a related-party transaction, such as formal board approval by disinterested board members after a thorough—and documented—review.

The insider/lender also should be mindful of not overreaching. The insider/lenders in *SI Restructuring* were accused of overreaching when they obtained liens to secure their pre-existing personal guarantees of corporate debt. They avoided equitable subordination of their loans in part because the guarantees were never called. The court may have reached a different conclusion if the guarantees had in fact been called and the insider/lenders had tried to enforce their liens.

The *SI Restructuring* case supports the making of loans by PE sponsors or other insiders to a financially distressed portfolio company in situations where the loan is intended to help support the company through difficult times, prior to making any such loans. However, insiders should carefully deliberate about the proposed transaction in consultation with their professional advisers, particularly as to insiders' fiduciary duties and the proposed transaction's potential risks.

[1] *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355 (5th Cir. 2008). All quotations and similar references throughout the remainder of the article refer to this opinion.

[2] The Fifth Circuit also joined the Third Circuit Court of Appeals in rejecting "deepening insolvency" as a theory of damages. Deepening insolvency "has been defined as prolonging an insolvent corporation's life through bad debt, causing a dissipation of corporate assets." Here, the Fifth Circuit held that deepening insolvency could not be used to determine whether an insider's loan (or any other conduct) caused harm for purposes of determining whether to equitably subordinate the resulting claim.

As the court noted, "deepening insolvency as a measure of harm depends on how the company uses the proceeds of the loan in question and 'looks at the issue through hindsight bias.'" The court explained that such hindsight bias should not be applied to directors who choose to continue a company's operations in the hope of improving creditor recoveries. If directors were subject to such hindsight bias, they effectively would "become … guarantor[s] of success," which would hold the directors to a much higher standard of conduct than "the appropriate exercise of their business judgment."

If you have any questions about the matters addressed in this Kirkland PEN article, please contact the following Kirkland authors or your regular Kirkland contact.

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Shanghai Moves to Ease Foreign Investment

PENpoints

Following earlier moves in Beijing and Tianjin, Shanghai will now allow foreign investors to register as local equities investment firms.

Shanghai will now permit qualified foreign investors, including buyout, venture capital and hedge funds, to register as local equities investment firms. The August 11, 2008 circular, issued by agencies of the Shanghai Municipal Government, is an attempt to attract more foreign investors to Shanghai, China's financial center. Previously, the central government allowed Beijing and Tianjin to give local status to foreign investors.

To date, most foreign investors have operated in China via a representative office or other consulting arrangement, creating substantial operating hurdles, including labyrinthine government approvals to purchase domestic Chinese entities and burdensome foreign exchange controls. The circular does not expressly simplify approval procedures, and key governmental agencies have not yet reacted to it. Nevertheless, it is an attempt by certain government agencies to incentivize foreign investors.

Under the circular, foreign investors in Chinese equities can register an entity with local investment company status in Shanghai upon payment of initial capital of at least 100 million yuan ($14.56 million). If the entity is a limited partnership, there is no partnership-level taxation. The individual general partners will be taxed at a rate up to 35%; the capital gains tax rate for individual non-executive partners is 20%.

A locally registered entity could raise funds from domestic investors in the growing RMB denominated funds market, although any of its dollar denominated funds would be subject to existing regulations and controls.

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China's New Antitrust Law Puts New Burdens on Companies Doing Business in China

PENpoints

China is spending significant resources to enforce its new Anti-Monopoly Law, which could have far-reaching effects.

China's new Anti-Monopoly Law (the "AML"), effective August 1, 2008, could have a substantial impact on companies doing business in China or with Chinese companies. Like United States and European Union competition laws, the AML covers anticompetitive agreements, abuse of dominant market position and mergers or other transactions that may eliminate or restrict competition.

Many details of the AML have yet to be determined, including whether China will enforce the AML vigorously and fairly against all firms, regardless of origin. But, recent merger control rules under the AML now require pre-notification of transactions based on certain global and China sales thresholds. Moreover, because it appears that China plans to spend significant resources to enforce the AML and non-compliance may be costly, any firm, including financial sponsors, that engages in a transaction or has business involving China should take measures to ensure compliance with the AML.

Read more on China's new AML in this August 2008 *Kirkland Alert*.

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SEC Clarifies that Rule Regulating Cash Payments to Placement Agents Does Not Apply to Fundraising by Private Funds

PENpoints

The SEC rejects previous Cash Solicitation Rule interpretations to state that the Rule no longer applies to investors in private funds, as private fund investors are not considered "clients" of the investment adviser.

On July 15, 2008, the SEC staff issued an industry-favorable no-action letter (the "Interpretive Letter") clarifying that registered investment advisers who pay a person to solicit prospective investors to invest solely in a private fund may (in some cases) avoid compliance with the technical requirements of the "Cash Solicitation Rule" under the Investment Advisers Act of 1940 (the "Advisers Act").

The Cash Solicitation Rule generally prohibits registered investment advisers ("RIAs") from compensating someone for placement or solicitation activities unless, among other things, the RIA and the solicitor have entered into a written agreement, the solicitor delivers to prospective investors written disclosure of certain matters and the solicitor is not subject to certain disqualifications under the Advisers Act.

Previously, the SEC staff interpreted the Cash Solicitation Rule to apply to solicitations of investors in private funds.[1] The Interpretive Letter supersedes and rejects this view and acknowledges that while the language of the Cash Solicitation Rule may be read as applying to private funds, the SEC staff no longer believes the Cash Solicitation Rule should apply in that context, because the staff (relying in part on the decision in *Goldstein, et al. v. Securities and Exchange Commission*[2]) does not view private fund investors as "clients" of the investment adviser for purposes of the rule.

Under the Interpretive Letter, SEC-registered investment advisers may (in most cases) disregard the requirements of the Cash Solicitation Rule in making cash payments to solicitors of investors in private funds. However, RIAs with solicitation arrangements relating to both private funds *and* managed accounts should continue to comply with the Cash Solicitation Rule, because it may, depending on the "facts and circumstances," still apply in that situation. The Cash Solicitation Rule may also apply if an RIA enters into an investment advisory contract directly with a client in connection with such client's investment in a private fund managed by the RIA.

The SEC staff also noted in the Interpretive Letter that even though the Cash Solicitation Rule would not apply to private funds, anti-fraud rules will generally require disclosure to prospective investors of material facts relating to the investment, including the nature of the solicitation arrangement and of any related conflicts of interest. Investment advisers should therefore continue to disclose solicitation arrangements to prospective investors, *e.g.*, in the investment adviser's ADV Part II or in the private placement memorandum of a fund managed by the investment adviser.

1 See, *e.g. Dana Investment Advisers, Inc.,* SEC No-Action Letter (October 12, 1994); *Dechert Price & Rhodes,* SEC No-Action Letter (December 4, 1990); and *Stein Roe & Farnham Inc.,* SEC No-Action Letter (June 29, 1990).

2 *Goldstein, et al. v. Securities and Exchange Commission,* 451 F.3d 873 (D.C. Cir. 2006). For an analysis of this decision, see the June 27, 2006, *Private Equity Newsletter*.

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Kirkland's Biotechnology & Pharmaceutical Law Seminar
New York, NY - September 18, 2008
Palo Alto, CA - September 25, 2008

Kirkland's Biotechnology & Pharmaceutical Law Seminar will be held on September 18, 2008, in the New York office, and on September 25, 2008, in Palo Alto at the Garden Court Hotel. The program is titled "The Impact of Recent Business and Legal Developments on Biotech and Pharmaceutical Licenses."

IMN's Second Annual Hedge Fund Activism and Shareholder Value Summit
Phoenix, AZ
September 22 - 23, 2008

The summit brings hedge funds, private equity firms and public pension funds together with investment banks, asset managers, corporate finance specialists, securities litigation firms, corporate law firms, advisory firms and proxy solicitors for two days of discussions on current trends and the future outlook for hedge fund activism. Kirkland partner Peter D. Doyle will be a panelist during a session regarding a case study of a proxy battle: "*CSX vs. TCI and 3G Capital.*"

Kirkland's Real Estate Private Equity Symposium
New York, NY
September 25, 2008

Kirkland's third annual Real Estate Private Equity Symposium will focus on "Discovering New Worlds: Real Estate Private Equity in Challenging Times." Panelists will discuss the state of the business and current trends and issues in the global real estate private equity markets. Additional topics include: "Alternatives in the New World" (a discussion of real estate funds), "Convergence of Infrastructure, Real Estate and Private Equity" and a keynote discussion with Neil Bluhm, a principal at Walton Street Capital and one of the pioneers of the real estate private equity business.

PLI's "Mergers and Acquisitions: What You Need to Know Now"
Chicago, IL
September 25 - 26, 2008

This seminar will focus on the new balance of power between strategic and financial buyers, the continuing effects of uncertainty in the credit and equity markets, how contract terms are changing in the wake of the crisis and recent developments in Delaware law affecting M&A, among other topics. Kirkland partner Stephen Fraidin will speak on "Shareholder Activism and the Role of Hedge Funds."

Northwestern's Corporate Counsel Institute
Chicago, IL - September 25 - 26, 2008
San Francisco, CA - December 4 - 5, 2008

The Corporate Counsel Institute provides in-house counsel with updates on legal developments and current issues impacting business. Designed by a committee of general counsel from some of the nation's leading corporations, in-house counsel learn from leading practitioners, academics and regulatory officials and join a group of their peers to network and discuss shared experiences. Kirkland partners Michael D. Wright and Laurence A. Urgenson will speak at the Chicago event, while partner Francesco Penati will speak in San Francisco.

PEI Infrastructure Investor Forum
New York, NY
October 22, 2008

This inaugural forum in New York will look at infrastructure from the perspectives of both fund managers and investors. Kirkland partners Bruce L. Gelman and Thomas A. Geraghty will lead a workshop focusing on "State of the Art Structuring for Infrastructure Funds and Investments."

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Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. *The Lawyer* magazine recently recognized Kirkland as one of the "Sweet Sixteen" firms in "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In 2008, Mergermarket ranked Kirkland first by volume for Global and North American Buyouts in its "League Tables of Legal Advisers to Global M&A for Full Year 2007." Also in 2008, Kirkland received prestigious first-tier rankings in both private equity and fund formation from Chambers & Partners. Kirkland was named the "International Law Firm of the Year" in 2007 by *The Lawyer* magazine.

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