AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for Today's Busy Insolvency Professional

# Reflections on Loan-to-Own Trends

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**About the Author**

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In the past year or so, there have been a number of "loan-to-own" cases that raise familiar issues in a new context.[1] In the typical case, a hedge fund or distress investor (here a financier) makes a secured loan (usually with first priority, but sometimes *pari passu* with an existing lender) and also takes an equity stake in a borrower (borrower). The loan has typical secured loan documents (and, also, a risk-related interest rate); the package often comes with board membership and various equity-type rights (*e.g.*, registration).

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Normally, though, the financier will not have voting control, and generally, its equity interests tend to be in the 25 percent range. The transaction frequently occurs when the borrower is in some form of financial distress, and may anticipate a second-stage transaction (*i.e.,* a refinancing or even a bankruptcy), and the documents contain required and forbidden terms, significant controls and veto rights in the second stage transaction.

## Sequence of "Loan-to-Own"

The economics of the "loan-to-own" transaction are simple. The financier thinks the borrower's business is worthy of an investment or even ownership, but is overleveraged. Hopefully, the financier's equity stake will become valuable. But if the borrower can't work its way out of financial distress, the financier will don its secured creditor hat and essentially propose to convert all or part of its debt to equity so that it owns the borrower, pay those creditors necessary to the business and other creditors up to the financier's valuation of the business, and eliminate the "out-of-the-money" creditors and equity classes. Existing managers will be offered options to stay or be given attractive severance packages, and will thus have incentives to support a transaction favorable to the financier. The entire restructure and any second-stage bankruptcy will be done on fast track, thus minimizing opposition, competition and expense. At all times, the fully-secured financier has its ultimate threat to foreclose, which will leave all other constituents with little or nothing. Finally, the fact that the financier lacks voting control means that the financier can absent itself from loan approvals and other key board decisions, and thereby resist a claim that it is a "controlling shareholder." Of course, the financier is never far away and casts a big shadow.

Not surprisingly, the out-of-the money creditors and equityholders (objectors) howl. Most often, they will claim that (1) management and the board (and possibly the financier) have breached fiduciary obligations (or that the financier aided and abetted such breaches), (2) the value of borrower is much more than the financier says it is, (3) there was an inadequate effort to try to find a better transaction, (4) the financier's secured loan should be equitably subordinated, (5) the financier's secured loan should be recharacterized as equity and/or (6) any bankruptcy plan that implements the transaction proposed by the financier is not undertaken in good faith.[2]

## Breach of Fiduciary Obligations

The alleged breaches of fiduciary obligations take many forms, but at the outset it is necessary to eliminate those based on the sequence of events that led to the financial distress existing when the financier first came on the scene (caused by the borrower's pre-existing business model, bad management, excessive costs, weak operations and execution, poor financial controls, uncompetitive products or services, or other problems). So, the objectors must show that the breach-of-fiduciary-duty obligations came in connection with, or after, the arrangements made with the financier. The fact that the financier drove a hard bargain, and the borrower didn't have many options, is inherent in the pre-existing situation. Put another way, the borrower's unattractive choices do not turn hard negotiating into a tort.

Showing that directors or management breached fiduciary obligations under these circumstances is not easy.[3] Obviously, a breach of a duty of care could arise if there was inadequate consideration of options, failure to read documents, inadequate time, absence of competent professional advice or similar circumstances, but such a case is difficult to make for most well-advised borrowers. Moreover, directors have important protections under the business-judgment rule and exculpations provided in statutes and corporate

1 Some examples of such cases are *In re Repository Technologies Inc.*, 47 BCD ¶240 (Bankr. N.D. Ill. 2007); *In re MarketXT Holdings Corp.*, 361 B.R. 369 (Bankr. S.D.N.Y. 2007); *In re Radnor Holdings Corp.*, 353 B.R. 820 (Bk. D. Del. 2006); *In re Oneida Ltd.,* 351 B.R. 79 (Bankr. S.D.N.Y. 2006); *In re Granite Broadcasting Corp.*, 2007 WL 1492465 (Bankr. S.D.N.Y. 2007).

2 These are, of course, somewhat overlapping. With luck, the objectors may also assert avoidance actions against the financier based on pre-bankruptcy payments or the taking of additional collateral, and assert that the financier is an insider based on its stock ownership or, even better, a "controlling shareholder" based on its *de facto* "control" and possible board membership.

3 It has been made more difficult by *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 2007 WL 1453705 (Del. 2007), which held that creditors cannot sue directors for breaches of fiduciary duty in the zone of insolvency and can only sue derivatively for such breaches upon actual insolvency.

documents. In some cases, it may be possible to show conflicts of interest if management and directors stand to benefit from the financier's proposed transaction and there is no approval by a disinterested majority of directors; but even here, a court may find that the transaction satisfies the "entire fairness" standard. While sometimes it may be possible to show control and dominance, a well-advised financier generally will be sufficiently circumspect in its actions to avoid this risk (with its minority stock position, absence of operating control and nonparticipation in board decisions affecting itself furnishing important legal protections). Case law also suggests that neither significant board membership, nor the ability of the financier to gain board seats, is alone a ground for liability, and even if the financier holds equity, it is protected in enforcing its creditor rights upon the borrower's default. Certainly, the financier has no obligation to grant forbearances, waivers and favorable (read non-market) terms because it is also a stockholder.

These same issues may, of course, arise at a second-stage bankruptcy sale or plan, but then there may truly be few or no alternatives (if only because of the hard bargain initially driven by the financier). Nevertheless, the same principles apply.

Another possible breach-of-fiduciary-duty argument is a version of "deepening insolvency" (*i.e.,* that the borrower's directors and management made the situation worse by doing the transaction with the financier, rather than filing a bankruptcy case, and the financier aided and abetted the breach). Recent case law has, however, raised serious questions about deepening insolvency as a substantive theory, holding that directors have no duty to liquidate a troubled company, that directors are not guarantors of the success of their business strategies, and that they are insulated from any negligence or breach of duty of care by exculpation provisions common in corporate charters. Moreover, some courts have held that there is no liability for a new financing because it adds assets as well as liabilities, and often improves liquidity. In short, the deepening insolvency theory probably won't help the objectors.[4]

## Value/Better Transaction Was Available

The claim is that the borrower made an inadequate effort to obtain a better deal and/or that the financier's proposed transaction understates the value of the borrower. The first is essentially a process argument. If objectors can show that alternative transactions were not pursued, that unrealistic or inappropriate limits were placed on the search, that reasonable possibilities were not explored or similar process issues, there may be a case. But any efforts to obtain a better deal (or higher price) may be limited by the borrower's then-situation (including its financial, business and legal situation), and the immediacy of its need; and, in the second stage, by the legal rights of the financier. Naturally, the borrower must be prepared to show that an adequate effort was made and that it had competent professional advisors assisting in the process. But one can't insist on miracles.

Value is, essentially, a question of fact, which generally affects the second-stage transaction. However, courts are understandably reluctant to accept valuation testimony by experts as a substitute for actual experience in the marketplace. Bankruptcy judges often urge dissenters who can afford to do so to "put up or shut up" if they disagree with the financier's valuation. Recent decisions have also expressed a fair amount of disquietude with expert valuation testimony on numerous grounds, including the wide variation in valuation resulting from small differences in the metrics applied, and vague feelings that the expert testimony is MAI (made as instructed).[5] Indeed, the Supreme Court may be said to favor a market approach in such situations.[6] In short, the chances of proving a value significantly higher than suggested by the financier and borrower are not great, absent a *bona fide* offer from a third party.

## Equitable Subordination

Courts generally will subordinate the claim of a creditor because of improper actions or conduct to the prejudice of other creditors. Although there is much law on equitable subordination, most of it involves closely-held corporations, and affiliates and insiders of the debtor. Much of it, too, involves informal and ill-planned transactions, and a relative absence of legal advice and documentation.

Again, one starts with the proposition that the financier is not responsible for the situation existing when it came on the scene and that, given the borrower's distress, the financier cannot be faulted for driving a hard bargain. Indeed, in some situations, the financier simply takes over or refinances an existing loan (usually with a bank). Moreover, at stage two, the financier will claim to be taking legitimate creditor enforcement steps and will argue that its lack of "controlling stockholder" status precludes liability, and its original transaction is protected by the prior approval of independent directors.

The strongest arguments for subordination arise when (a) the financier and borrower both know that the debt is not likely to be paid and that future arrangements will have to be made, (b) the Loan documents contain covenants that cannot be met and "builds in" a future default, (c) the financier and borrower establish deadlines for achieving business results and/or proposing or completing a restructuring transaction which cannot realistically be met and/or (d) the transaction already involves planning for a bankruptcy in which the financier will, or is likely to, obtain ownership of the borrower. But, it is not clear that any of these facts prejudice or harm creditors. Rather they may reflect the distress situation itself and the financier's enforcement of its bargained-for rights. To be sure, if there is evidence that the borrower is seeking to shift some of the debt burden from the financier to other creditors or future suppliers, this may furnish the necessary harm. But trade creditors are not generally disadvantaged, since the borrower usually continues to operate and pay such creditors (often with funds provided by the financier),

4 *See* Landers, "Deepening Insolvency Comes of Age," NYLJ 10/05/06, *discussing Trenwick American Litigation Trust v. Ernst & Young LLP* 2006 WL 230201 (Del. Ch. 2006). An increasing number of recent decisions have rejected the deepening insolvency concept. *See, e.g., In re Amcast Ind. Corp.,* 365 B.R. 391 (Bankr. S.D. Ohio 2007) (Ohio Law); *In re James River Coal Co.*, 360 B.R. 139 (Bankr. E.D. Va. 2007) (Virginia law); *In re Avado Brands Inc.*, 2006 WL 3832806 (Georgia law); *In re Enivid Inc.*, 46 BCD ¶ 202 (Bankr. D. Mass. 2006) (Mass. law).

5 *See, e.g., Oneida, supra; In re Nellson Nutraceuticals Inc.*, 356 B.R. 364 (Bankr. D. Del. 2006); *In re Med Diversified Inc.*, 346 B.R. 621 (Bankr. E.D.N.Y. 2006).

6 *Bank of America N.T. & S.A. v. 203 North La Salle Street P'ship*, 526 U.S. 434, 457-58 (1999). *See, also, VFB LLC v. Campbell Soup Co.*, 482 F. 3d 624, 633 (3d Cir. 2007) (to determine value of the debtor after spinoff, "market price [of stock]...is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'")

and since the financier contemplates ultimately owning the ongoing business, it often satisfies their claims in bankruptcy. Moreover, given the borrower's situation, dramatic increases in new debt are unlikely and uncommon. The argument for subordination is even weaker for financial creditors and bondholders since their money is almost always "out the door" when the financier arrives, and they are not in a position to timely advance the funds that the financier is able to provide to the needy borrower.

## Recharacterization

Courts generally will recharacterize debt as equity based on the nature of the transaction and the actions of the parties. As with subordination, most of the existing case law involves closely-held corporations, affiliates, insiders, informal transactions and an absence of legal advice.

The loan-to-own cases invariably start with separate loan and equity documents. In addition, the financier will be careful to act like a "lender" by monitoring the loan, documenting and enforcing defaults, insisting on timely payment of interest, principal and other amounts due, obtaining customary lender information, employing loan-type covenants and the like, and will keep activities wearing its "equity" hat entirely separate. Upon default, the financier, as a lender, will take the same steps a bank lender might take. And ultimately, a case for recharacterization built on the fact that the financier has both debt and equity, is not sufficient. Moreover, courts frequently express a policy against recharacterizing transactions involving third parties rather than insiders and controlling shareholders and, to avoid discouraging lending when the borrower needs it most, tend to reject the argument that debt should be recharacterized merely because no outside lender would have made the loan.

The message of the existing case law is that as long as the financier acts in accordance with its different positions, enforcing its creditor position as per the documents (*i.e.,* just like a bank), and not trying to use its leverage as a creditor to further its position as an equityholder, and vice versa, the loan will not be recharacterized. This means that the financier can enforce default remedies on the creditor side, and negotiate some form of restructuring or prepackaged bankruptcy arrangement that will give it ownership of the borrower by virtue of its creditor position. Of course, the financier must not participate in decisions that affect it (absenting itself from voting on such transactions and obtaining approval from independent directors), but these are not difficult steps, and as a practical matter, the board is usually between a rock and a hard place.

Is there anything the objectors can do? The answer is, probably not much, except to offer a better deal; and that often comes at a price, because the financier has built various forms of compensatory and roadblocking provisions into the documents. What does seem clear is that, in the loan-to-own sequence, the first-stage transaction is critical and offers the greater number of options. Once the first stage is complete, the borrower may be effectively boxed in and have few, if any, alternatives apart from the "own" part of transaction.

## Conclusion

One has a sense that there is something wrong about loan-to-own, but it is hard to say what it is. Perhaps the financier may be accused of opportunistic behavior in a very public way, but that is hardly a basis for legal censure. Perhaps it is that a "true" lender would be more flexible and accommodating in dealing with the borrower's financial difficulties. For objectors, such flexibility could lead to a workout that would be more beneficial to existing creditors and equity than loan-to-own. Unfortunately, such an argument ignores the history of many middle-market (and larger) borrowers who were unable to reorganize because of recalcitrant lenders and equityholders, and were unable to sustain a lengthy restructuring or bankruptcy.

In fact, it may be that the financier may be performing a valuable economic service. There is no indication that the financier takes value from anyone else, because the business is worth what it is worth. What the financier does is to provide liquidity and, at a critical time, offer the opportunity for the business to restructure and emerge stronger in the future. Indeed, the big economic losers may be restructuring professionals who lose the chance to participate in a long and drawn-out restructuring process in the face of a financier who seeks to accomplish its objectives in an efficient, inexpensive and relatively quick manner. Moreover, the typical financier is not shy about introducing efficiencies and investing additional funds to improve the business. If the financier is successful, jobs will be preserved and the enterprise will prosper. In essence, what the financier does is little different from having the debtor file a bankruptcy case and sell its business in a §363 sale (with the lenders getting substantially all of the proceeds). And there is reason to think that the loan-to-own sequence, as effected through a pre-packaged bankruptcy plan, may ultimately be faster, cheaper and more efficient than the §363 sale as part of a liquidating chapter 7 or 11. ■

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