# Valuation, Deal-Making and Strategic Portfolio Management

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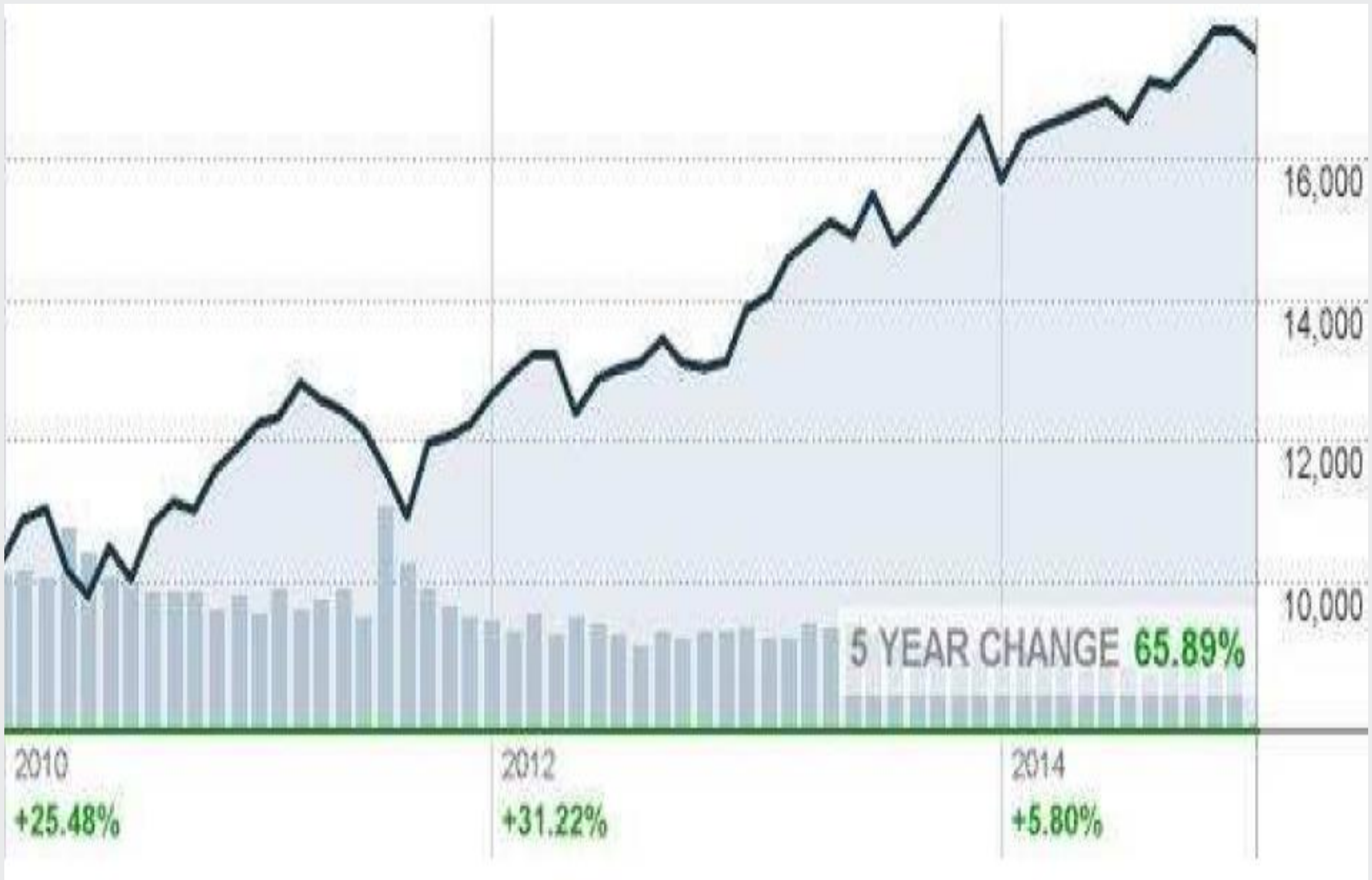
February 26, 2015

# Roundtable Subjects

- Valuations in the Context of Potential Investment Opportunities
- Investment Perspectives
- Risks Regarding Form of Investment (Debt or Equity)
  - Delaware Fiduciary Duties: *CML v. Bax* and *Rural/Metro*
  - Exit Risk: Increasing Frequency of Rapid Section 363 Sales
  - Exit Risk: Credit Bidding Post-Fisker and *Free Lance-Star*
- Investment Risks for Equity Investors
  - Understanding Controlled Group Liability: Pension Obligations
  - Limiting Downside Risk: *Sun Capital* and Controlled Group Liability
  - Fraudulent Transfer Risk: Lessons from *SemCrude* and *Tronox*
  - Capital Call Obligations: Lessons for Equity Investors
- Investment Risks for Lenders
  - Intercreditor Agreements: Trends in Enforcement
  - ROI Risk: Cramdown Interest Rates Post-*Momentive/Till*
  - ROI Risk: Enforceability of Make-Whole Premiums
  - *Codere*: Credit Default Swaps and the "Empty Creditor" Problem

# Valuation in the Context of Potential Investment Opportunities

# Five Year Dow Jones Industrial Average




Valuation, Deal-Making and Strategic Portfolio Management February 26, 2015 3

## Valuation in the Current Economic Climate

- The current economic climate places additional importance on the methodologies employed by experts when valuing companies or assets in a distressed or reorganization scenario
- Market volatility in recent years raises the question of whether the market is the appropriate mechanism to value a company (i.e., for example, whether a section 363 sale is more favorable than distributing equity in the reorganized company to creditors)
  - Is there sufficient liquidity and financing for a sale?
  - Are there sufficient buyers to facilitate a competitive bidding process?
- Similarly, the multiples and comparable companies used by experts to value a company on a going concern basis will receive higher scrutiny
  - Are a debtor’s business plans and projections reliable bases for evaluation?
  - Is the current market a reliable indicator of real value?
- Obviously, valuation is foundational in determining whether to execute on a potential opportunity

## Valuation Methodologies

- The Supreme Court has stated that the best indicator of value, whether valuing a particular asset or an entire business, is the actual sale price. *See Bank of America Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457 (1999) ("the best way to determine value is exposure to a market")
- Recent scholarly debate has focused on whether a sale provides sufficient value to the estate
  - *See* Lynn M. LoPucki & Joseph W. Doherty, Bankruptcy Fire Sales, 106 Mich. L. Rev. 1 (2007) (363 sales undervalue companies when compared to reorganizations) and James J. White, Bankruptcy Noir, 106 Mich. L. Rev. 691 (2008) (responding to Bankruptcy Fire Sales)
- In many situations, multiple valuation methodologies are used to eliminate outliers and derive as accurate an estimate of values as possible given that valuation is an inexact science *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980); *Lippe v. Bainco Corp.*, 99 Fed.Appx. 274, 278 (2d Cir. 2004)
- In addition to valuation, capital providers must weigh other investment considerations -- including legal considerations

# Investment Perspectives

## Goldman Sachs – 2015 Investment Outlook

- Goldman believes the US economy is transitioning from a substandard recovery to an above-trend expansion
  - Each of the major growth headwinds that have plagued the US in recent years—fiscal retrenchment, high unemployment and consumer/financial sector deleveraging—is abating
  - This inflection point is reached just as the engine of US growth, the consumer, is set to receive a notable boost from falling energy prices – Goldman believes that these factors should underpin stronger consumer spending, an ongoing housing recovery and continued business investment
  - Goldman's forecast for US Real GFP Growth is 3.00 to 3.75%
- While Goldman acknowledges that the current bull market will eventually end, it believes that the relevant question facing investors today is whether its apex will occur in 2015 or worse yet, has already happened
  - Goldman believes that this "running of the bulls" will continue, albeit at a pace more akin to walking as the levers of equity returns—valuations, margins and sales growth—are still working but they're becoming more difficult to pull
  - Goldman's End 2015 Central Case Target Range for S&P 500: 2,075–2,150, which implies an upside of 1–4% from current levels

# Goldman Sachs – 2015 Investment Outlook (cont.)

- Goldman observes that Eurozone equities have not been firing on all cylinders despite triple-digit price returns since the trough of the financial crisis in 2009
  - They think a still-expanding economy, further euro depreciation and highly accommodative ECB policy are set to reverse the recent earnings slide in the Eurozone and support past valuation gains in the year ahead
  - Goldman's End 2015 Central Case Target Range for Euro Stoxx 50 (Eurozone) is 3,300 to 3,500, which implies an upside of 5–11% from current levels
- On the fixed income front, Goldman believes that investors should favor credit over duration risk by tactically underweighting a portion of their investment-grade fixed income allocations and overweighting US corporate high-yield credit
  - Gradually rising interest rates imply negative returns for US investment-grade fixed income and global 10-year government bonds, because today's scant yields are not sufficient to offset falling prices
  - At the same time, Goldman sees scope for US credit spreads to decline as stronger US growth keeps default rates at below-average levels
  - Goldman's 2015 Forecast for End of Year 10-Year US Bond Yield is 2.25 to 3.00%, up from 2.15% at the end of 2014

# Goldman Sachs – 2015 Investment Outlook (cont.)

- While Goldman acknowledges that after years of underperformance culminating in a perfect storm of headwinds last year, emerging market equities are naturally on the radar screen of many contrary investors, it remains circumspect for several reasons
  - Most emerging market countries actually trade at or above their historical valuation levels and absolute valuations thus do not yet provide a large enough margin of safety to justify an overweight
  - Areas of undervaluation that do exist are in fundamentally unattractive sectors, namely Chinese banks and Russian energy where the risk that a portion of one's investment could be permanently impaired is uncomfortably high in these types of state-owned and/or highly leveraged entities
  - Goldman also believes that valuations are likely to remain under additional pressure this year, as investors demand an even higher risk premium for slowing growth in China, continued geopolitical uncertainty and the prospects of the Federal Reserve raising interest rates
  - Goldman's End 2015 Central Case Target Range for MSCI EM (Emerging Markets) is 930 to 1,020, which implies a return of <-3> to 7% from current levels

## An Investor's Perspective

- We spend considerable time analyzing the aggregate leverage of a business – financial leverage, operating leverage (exposure to cyclicality) and industrial leverage (exposure to increased competition, regulatory pressure or secular decline)
    - The goal is to minimize the risk of permanent capital loss – high aggregate leverage increases the risk of a restructuring
- Low valuation coupled with moderate aggregate leverage increases margin of safety
    - Oftentimes dislocation events/overhangs result in depressed valuations
    - Bankruptcy filings and other types of distressed restructurings are good examples of dislocation events
    - The complexity of the bankruptcy process also often creates additional valuation discount – being able to successfully navigate such a process can result in value creation

## An Investor's Perspective (continued)

- Being able to invest in both equity and credit is essential
  - We first estimate the enterprise value of a business and then factor in how that value is and could be distributed across the capital structure under a variety of scenarios
  - In some cases distressed debt offers the most attractive risk/reward
  - In other cases, understanding a company's actual restructuring risk introduced by its debt structure (covenants, etc) can result in the determination that significant value should accrue to the common equity (i.e., often the equity market overestimates true default risk and over-discounts equity values as a result)
- Restructuring is generally cyclical – identifying good businesses going through bankruptcy proceedings can result in outsized returns
  - The drivers of those returns can be generated through:
    - a successful financial restructuring;
    - a successful operational restructuring;
    - further business optimization and intelligent capital allocation

# A Capital Markets Perspective

## A Capital Markets Perspective

- The likelihood of closing any lending transaction (including rescue financings, DIP financings and Exit Financings) is an essential factor for borrowers to consider when seeking capital – and the rules have changed
- Leverage lending guidelines established in 2013 by the OCC and FDIC and which are applicable to banks and bank holding companies impact the ability of banks and most large investment banks to provide leveraged loans to borrowers
  - Any transaction that is in the neighborhood of Debt to EBITDA of 6x will be heavily scrutinized by any such lender to ensure compliance with the guidelines
  - The guidelines are applicable to all transactions -- whether they are best efforts or underwritten, whether the bank will take a hold position or not
  - One large financial institution was publicly criticized for having entered into certain transactions during 2014 and all banks are being monitored carefully
- It will be very difficult for any lender to know whether a leveraged deal can be completed unless the part of the bank that has approval for such issues, typically credit and compliance, will approve it

# A Capital Markets Perspective (continued)

- This new credit approval paradigm is opening up the doors for many non-bank lenders to act as an alternative source of capital in leveraged and distressed transactions
  - Increasingly, we expect to see large alternative asset managers trying to fill the vacuum created by commercial and investment bankers being either unable or unwilling to finance difficult leveraged transactions
  - However, given the size of the balance sheets of these alternative managers, no single lender will likely be able to take on multi-billion loan, which means borrowers are going to need to 'club up' those deals if banks will not participate

# Risks Regarding Form of Investment (Debt or Equity)

## Overview of Delaware Fiduciary Duties

- D&Os of Delaware corporations and LLCs owe fiduciary duties to the company they serve
  - Duty of care—duty to act in an informed and considered manner
  - Duty of loyalty—duty to act on an independent and disinterested basis and in a manner honestly believed to be in the best interests of the company
- Fiduciary duties owed to a solvent entity inure to the benefit of equity holders
- Duties owed to an insolvent entity, in contrast, inure in the first instance to the benefit of creditors
  - Creditors of an insolvent Delaware corporation have derivative standing to bring fiduciary duty claims
  - In contrast, creditors of a Delaware corporation cannot bring *direct* fiduciary duty claims
- Waiver of fiduciary duties
  - LLCs—all duties other than the implied covenant of good faith and fair dealing are waiveable
  - Corporations—fiduciary duties generally are not waivable, but the charter can exculpate directors from violations of the duty of care (though not the duty of loyalty)

## Fiduciary Duties to Creditors after CML v. Bax

- *CML v. Bax*—no derivative standing for LLC creditors
  - Practitioners and commentators long assumed that creditors of an LLC had the same right as creditors of a corporation to pursue derivative fiduciary duty claims
  - But, in *CML v. Bax* (2011), the Delaware Supreme Court held that the LLC act bars derivative suits by LLC creditors
    - » The plain language of section 18-1002 the LLC Act restricts derivative actions to members of the LLC and assignees of LLC interests
    - » The Delaware General Corporation Law lacks a corollary restriction
      - Thus, creditors of a Delaware corporation retain standing to assert derivative fiduciary duty claims despite *Bax*
- Insolvency or near-insolvency may create moral hazards for directors and officers, encouraging risky decisions that could spur a recovery but more likely will deepen the company's trouble
- Delaware does not recognize a standalone cause of action for "deepening insolvency"

# Implications of Bax

- Lacking derivative standing to pursue fiduciary duty claims and an independent cause of action for deepening insolvency, LLC creditors must rely on contractual remedies to protect themselves from the consequences of insolvency; lenders might consider incorporating into loan documents
  - More expansive information rights
  - Strict MAC/fundamental change covenants
  - Stricter limitations on distributions to members
  - Rights to become an assignee or member upon default
  - Approval rights for significant transactions
- Lenders should also consider that borrowers may seek to convert corporations to LLCs to take advantage of *Bax*
  - If the lender's consent is required for such conversion, the lender should consider the consequences of *Bax* before approving the conversion
- Bankruptcy considerations
  - Whether a UCC could pursue derivative fiduciary duty claims against a Delaware LLC
  - Consider *Bax* before negotiating a plan that assigns derivative claims to a litigation trust or similar vehicle

## *Rural/Metro*: Implications for Fund-Affiliated Directors

- The Delaware Court of Chancery's recent *Rural/Metro* decision demonstrates the potential conflicts facing fund-affiliate corporate directors
  - In late 2011, Rural/Metro entered into a going-private transaction with Warburg Pincus
    - » A director affiliated with Coliseum (which held a significant minority stake in the company) was instrumental in advocating a sale and driving the sale process
  - Shareholders sued, alleging that
    - » The sale fell outside the range of reasonableness
    - » The company's directors breached their fiduciary duties in approving the sale
    - » The company' financial advisors aided and abetted the directors' breaches of their fiduciary duties
- The court made clear that a director's mere affiliation with an activist investor does not constitute a breach of fiduciary duties; a concrete and pertinent conflict must be identified
  - Nonetheless, the court indicated that, had the Coliseum-affiliated director not previously settled, he would have been held liable for breaching his fiduciary duties because
    - » The sale fell outside the range of reasonableness
    - » The director's support for a near-term sale was motivated by Coliseum's philosophy of monetizing its investments within three to five years and conflicted with the company's existing business plan, which emphasized organic growth

## Implications for Fund-Affiliated Directors (Cont.)

- When marketing a company, boards and directors should observe the following considerations to bolster the credibility of the sale process and minimize the risk of fiduciary duty claims
  - Appointment of a special committee does not abdicate the board's responsibility for the sale process; the full board should diligently monitor the process and exercise reasonable oversight
  - The special committee should include at least one truly independent director, free from actual or potential conflicts
  - The board and special committee should accurately document their decision-making process
- During the current cycle (i.e., 2008 – present), debtors have succeeded in consummating section 363 sales significant more rapidly than in the past (measured by the median number of days between the petition date and the closing date) – 19 days now vs 66 days then
- The Final Report and Recommendations of the ABI Commission to Study the Reform of Chapter 11 expresses concern that section 363 sales are now occurring too quickly and recommends a "60-day moratorium" on such sales, "absent the most extraordinary circumstances, which must be established by clear and convincing evidence"

## *Exit Risk: Credit Bidding Post-Fisker and Free Lance-Star*

- Right to credit bid
  - A key protection for secured lenders in a chapter 11 sale—allows the lender to bid its secured claim in a sale of the collateral, thereby ensuring that the collateral is not sold for an unreasonably low price
  - Codified in section 363(k) of the Bankruptcy Code
- State of the law prior to 2014—strong protection for credit bidding
  - *RadLAX*: 2012 Supreme Court decision holding that the debtor cannot abrogate a secured creditors' right to credit bid by instead providing the secured creditor the "indubitable equivalent" of its secured claim; overruled the Third Circuit's contrary decision in *Philadelphia Newspaper* (2010)
  - *SubMicron*: 2006 Third Circuit decision holding that an undersecured creditor may credit bid up to the face amount of its claim (i.e., including the unsecured deficiency portion of its claim); the same is true even if claim is entirely underwater
  - Underwater junior liens: *In re PW, LLC* (9th Cir. B.A.P. 2008) controversially held that free and clear sales must generate sufficient proceeds to satisfy all secured claims, unless the underwater junior lienholders consent
    - » But *Boston Generating* and *CyberDefender,* recent Southern District and Delaware bankruptcy court decisions, respectively, hold that debtors may sell free and clear of underwater junior liens, without the consent of the junior lienholder, thus making clear that the major jurisdictions will not follow *PW*

## Exit Risk: Credit Bidding Post-Fisker and Free Lance-Star

- Two 2014 decisions—*Fisker* and *Free Lance-Star*—have muddied the waters by suggesting that courts have broad discretion to limit credit bidding based on an amorphous “for cause” standard
  - Prior to *Fisker*, section 363(k)’s “for cause” exception was generally thought to be fairly narrow—i.e., tied to bad faith or other misconduct
  - But *Fisker* and *Free Lance-Star* suggest the cause exception can be invoked to encourage competitive bidding or to discourage aggressive loan-to-own strategies
- Distressed lenders should exercise appropriate caution in a loan-to-own scenario
  - Courts are likely to scrutinize credit bidding where the proposed amount of the secured creditor’s bid either precludes a normal sale process or makes the result of that process a *fait accompli*; extra scrutiny is particularly likely where the lender has
    - » Acquired its loans relatively recently
    - » Is seeking an accelerated sale with no or limited postpetition marketing
  - Courts may closely examine the secured creditor’s conduct for evidence of inequitable or bad-faith behavior
  - But neither case suggests that bankruptcy courts have boundless discretion to limit credit bidding; the cases must be read in the context of their particular facts
    - » Significant disputes concerning the validity or perfection of the liens on a material portion of the assets
  - Inequitable or untoward conduct by the secured lender

# Investment Risks for Equity Investors

## Understanding Controlled Group Liability

- Under applicable law, entities related to the Plan sponsor or participating employer are jointly and severally liable for all liabilities if there is an 80% ownership relationship – for example:
  - If company A sponsors a Plan and owns 80% of Company B, then Company B is responsible for Plan underfunding if the pension Plan terminates with the PBGC
    - Company B's assets are also subject to liens if Company A misses contributions to their Plan that aggregate to over $1M
  - If Company Z owns 80% of Company Y, 75% of Company X and 90% of Company W, and there are no other ownership relationships between the companies:
    - Companies Z, Y and W are all liable for pension Plan liabilities and subject to liens related to pensions sponsored by Z, Y and W. They are not liable for any pension Plans at Company X
    - Company X is only liable for any pension Plans that it sponsors
- Attribution rules that aggregate the ownership positions of multiple people/entities can expand controlled group relationships
- Rules for not-for-profit controlled groups are based on measures of control between institutions -- many not-for-profit hospitals sponsor Defined Benefit Plans

# Primer: Defined Benefit Plans

- Defined Benefit Plans pay participants pre-defined monetary benefits at retirement based on specific factors: age at retirement, pay, and years of service
  - A Cash Balance Plan is a type of Defined Benefit Plan that creates paper accounts for participants and credits the participant's account balance each year with a minimum guaranteed rate of return – regardless of the Plan's actual investment performance

## PBGC Insurance Programs

- Qualified Plans are insured by the Pension Benefit Guaranty Corporation – a U.S. government agency
  - The sponsor of a qualified Plan cannot lawfully opt out of PBGC's pension insurance program
  - Plans may be sponsored by either a business entity itself, or by a union that establishes a Plan for union members of participating employers
  - The Plan sponsor must pay to PBGC annually both a flat rate premium (per participant) and a variable rate premium (based on the Plan's funding status)
- PBGC has two types of pension insurance programs – one covers Single Employer Plans and one covers Multi-employer Plans
  - <u>Single Employer Plans</u> are sponsored by and cover employees of a single company
  - <u>Multi-employer Plans</u> are sponsored by unions and cover union members at a variety of employers
  - A third type of Plan, Multiple Employer Plans, are a hybrid of Single and Multi-employer Plans and are treated for funding purposes as Single Employer Plans
    - These are found almost exclusively for non-profit organizations and are very rare

## Single Employer Plans

- Required annual funding is based on the funded status of the Single Employer Plan
- The Pension Protection Act of 2006 (“PPA 2006”) required, amongst other things, amortization of a Single Employer Plan underfunding over seven years, reduced from 30 years, and the use of market based interest rates in calculations of required funding
- As the Federal Reserve dropped interest rates, which helped drive up funding requirements, there have been multiple instances of legislative relief to reduce funding requirements

## Primer: Multi-employer Plans

- The funding rate for a Multi-employer Plan is negotiated in individual union contracts and is tied to the level of benefits be provided and the number of units of work (number of hours is the primary measure)
- PPA 2006 introduced additional funding requirements based on a Multi-employer Plan's funding status, and these are in addition to a contract's negotiated rate
- Burden of additional required funding varies by employer and union
  - Relative bargaining strength determines "who" pays – the employer through increased benefit costs, or employees through reduced/stagnant wages
- Withdrawal liability for employers that decide to leave a Multi-employer Plan is based on underfunding and employer's relative participation rate
  - Rules governing the amount of the withdrawal liability may assign participating employers with a disproportionate share of the liability when they withdraw

# Financial Statement Pension Disclosure

- Single Employer Plans:
  - Audited financial statements must disclose all U.S. Single Employer Defined Benefit Plans and the Plans' funded status
- Multi-employer Plans:
  - Participation in, and liability to, Multi-employer Plans have to be disclosed only if they are poorly funded
  - A company may have significant exposure to Multi-employer Plans and not be required to disclose that exposure in financial statement footnotes

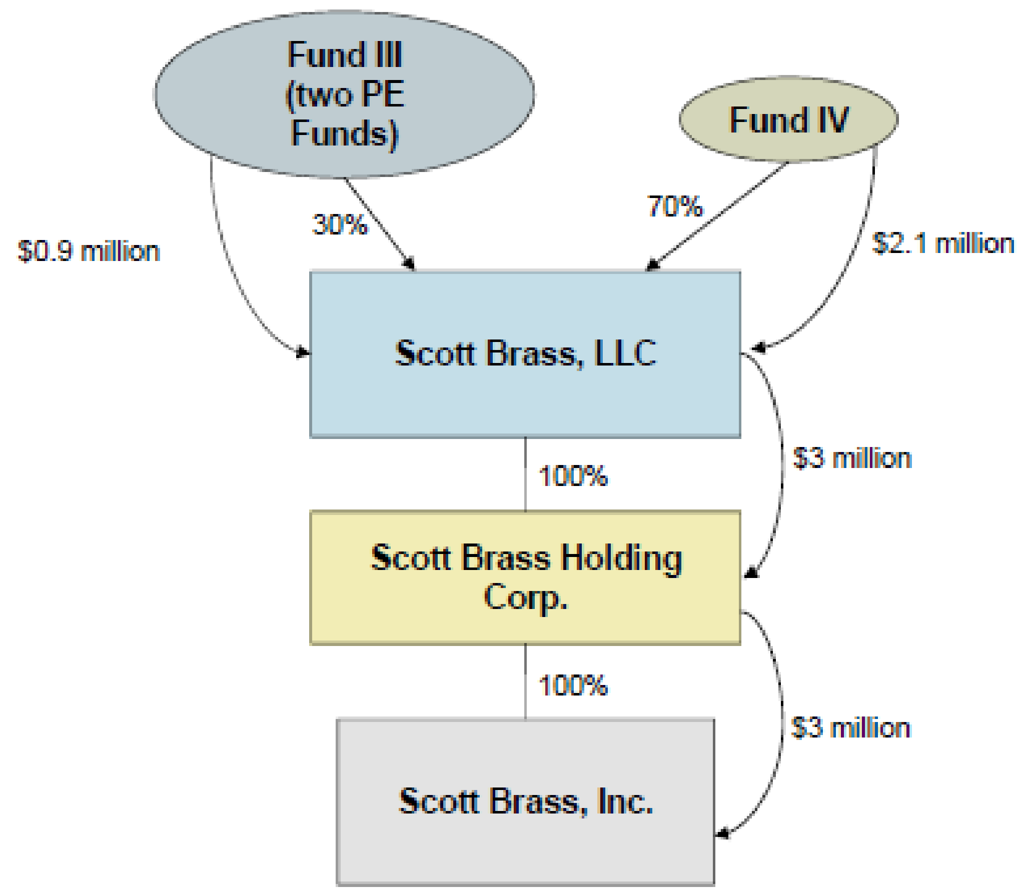
## Limiting Downside Risk: Sun Capital and Controlled Group Liability

- An employer that withdraws from a multiemployer pension plan and members of its controlled group are jointly and severally liable for the withdrawing employer's share of the plan's unfunded pension liabilities at the time of withdrawal
- Similarly, an employer that contributes to a single employer pension plan and members of its controlled group are jointly and severally liable for any unfunded pension liabilities at the time the plan is terminated
- An employer's "controlled group" consists of the employer and each trade or business under common control with the employer
- In order for a PE fund to be liable for the pension liabilities of a particular portfolio company:
  - the PE fund must be a trade or business
  - the PE fund must own a controlling (generally, 80% or greater) interest in the portfolio company
- If a PE fund is liable for a portfolio company's pension liabilities, other portfolio companies in which the PE fund owns a controlling interest may also be liable

## Sun Capital Background

- The defendants were three PE funds sponsored by Sun Capital Advisors
- In early 2007, the PE funds completed the acquisition of Scott Brass, Inc. (SBI)
  - One PE fund (Fund IV) acquired a 70% ownership interest; the other PE funds (Fund III) acquired the remaining 30%
  - Ownership of SBI was deliberately split among the PE funds in order to avoid exposure to SBI's pension liabilities
- In late 2008, SBI filed for bankruptcy and withdrew from the New England Teamsters & Trucking Industry Pension Fund
- The Pension Fund sought to recover $4.5 million in withdrawal liability from the PE funds, asserting that the PE funds were "trades or businesses" and had entered into a partnership or joint venture that was under common control with SBI

## Sun Capital Investment Structure



## Circuit Court's Decision in Sun Capital

- The First Circuit held that Fund IV constituted a trade or business
- The court determined that the following factors, taken together, were sufficient to show that Fund IV was a trade or business
  - Fund IV received an economic benefit from its investment activities not available to ordinary passive investors because the management fees
  - Fund IV paid to its general partner were offset by the management fees the general partner received from SBI
  - When Fund IV's general partner provided management services to SBI, it was acting as agent of Fund IV
  - Statements in Fund IV's partnership agreement and PPM indicated that a "principal purpose" of Fund IV was to participate in the management of its portfolio companies
  - Fund III and Fund IV's controlling stake in SBI enabled Fund IV to participate in the management and operation of SBI to a far greater degree than a passive investor could control

# Impact of Sun Capital on PE Funds

- Under the approach taken by the First Circuit:
  - a PE fund that owns a controlling interest in a portfolio company may be included in the portfolio company's controlled group if the PE fund
    - receives economic benefits from its investment activity not available to passive investors
    - actively participates, either directly or through its agents, in the management of the portfolio company
    - is established for the purpose of managing the portfolio companies in which it invests
  - if a PE fund is included in a portfolio company's controlled group, other portfolio companies in which the PE fund has a controlling interest may also be included in the same controlled group, exposing the portfolio companies to each other's pension liabilities

## Top Diligence Mistakes When Looking for and Evaluating Pension Liabilities

- ✓ Believing:
  - ✓ the financial statement footnotes discloses all U.S. Pension Liabilities
  - ✓ that companies that currently participate in multi-employer pension plans understand their exposure to the plans
  - ✓ today's funding rules will be tomorrow's rules
- ✓ Not understanding:
  - ✓ controlled groups - who is in; who is not; and why it matters
  - ✓ how multi-employer plans work – funding and withdrawal liability
  - ✓ the health of a multi-employer pension plan impacts the relationship with, and cost of, the union workforce
- ✓ Not expecting PBGC to show up during a deal

## Effectively Evaluating Pension Obligations: The Essential Role of Due Diligence

- Due Diligence is Key
- The Most Typical Problems:
  - You don't know what you don't know, so you don't know what to ask and to look for
  - You don't really understand what you think you know, so you don't ask the right questions or look or ask for the right information/data
- Single Employer Pension Plans – generally well understood
- Multi-employer Pension Plans – poorly understood – even by some participating employers
  - Plans, participation levels, union contracts – things you need to know
  - Impact of new reform legislation – employee issues and cost
  - Contractual and Transactional indemnifications – giving, getting and valuing

## Effectively Evaluating Pension Obligations: The Essential Role of Due Diligence

- Financial Statement Reporting
- Funding
- Controlled Group Issues – Single and Multiemployer Plans
- PBGC Involvement – Wild Card

## Limiting Downside Risk: Minimizing PE Fund's Portfolio Exposure

- It may be possible to minimize PE fund exposure to controlled group liability by:
  - Structure PE fund investments to avoid "under common control" status
    - » Keep individual PE fund holdings below 80%
    - » Keep aggregate holdings by "parallel" PE funds (same general partner, same investments) below 80%
    - » Ideally, keep aggregate holdings by "related" PE funds (affiliated general partners) below 80%
    - » Maintain formalities reflecting separate existence of each PE fund
  - Structuring PE fund documents and operations to decrease the risk of "trade or business" status
    - » Eliminate management fee offset provisions
    - » Restrict involvement of general partner and other agents in the day-to-day management of portfolio investments
    - » Eliminate statements in PE fund documents identifying management of portfolio companies as a principal purpose of the fund

# Fraudulent Transfer Risk: Lessons from SemCrude and Tronox

- Bankruptcy Code section 548 provides that an avoidable fraudulent transfer occurs where a transfer is made for less than reasonably equivalent value and the debtor
  - Was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
  - Was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
  - Intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
  - Made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business
- Most states have enacted the Uniform Fraudulent Transfer Act or Uniform Fraudulent Conveyance Act, which embody similar standards for constructive fraudulent transfers

# Fraudulent Transfer Risk: Unreasonably Small Capital Test

- Courts have described the test for "unreasonably small capital" as follows:
  - *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992):
    - » "[U]nreasonably small capital denotes a financial condition short of equitable insolvency."
    - » "[A]n 'unreasonably small capital' []refer[s] to the inability to generate sufficient profits to sustain operations. Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable insolvency."
  - Unreasonably small capital is "a financial condition sort of equitable insolvency" which focuses on transfers "that leave the transferor technically solvent but doomed to fail." *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278 (S.D.Tex. 2008).
  - "[T]here must be a causal relationship between the [fraudulent transfers] and the likelihood that the Debtor's business will fail. . . . A debtor's later failure, alone, is not dispositive on this issue. The Court's analysis must be done as of the time of the transfers in question." *In re Kane & Kane*, 2013 WL 1197609 (Bankr. S.D. Fla. Mar. 25, 2013)

## Fraudulent Transfer Risk: Unreasonably Small Capital (SemCrude)

- Two fairly recent cases have applied the test for unreasonably small capital and reached different conclusions – *In re SemCrude* and *In re Tronox*
- In *SemCrude*, the litigation trustee challenged two equity distributions of $23M and $25M. The bankruptcy court granted summary judgment finding that the distributions did not leave the company with unreasonably small capital and the district court affirmed
  - Both courts found that the debtors did not have unreasonably small capital because they had a sufficient line of credit available under their credit facility
  - The trustee argued that such line of credit should not be considered because the debtors were engaged in trading activities which violated the credit agreement and which, if known, would have caused the lenders to terminate the facility
    - » The bankruptcy and districts found that it was unclear whether the lenders knew of the trading activities but that this made no difference because (1) if the lenders knew of the activities, they had not terminated the facility and (2) if the lenders did not know of the activities, it was too speculative to determine how they would have reacted and the consequences of that reaction

# *Fraudulent Transfer Risk: Unreasonably Small Capital (Tronox)*

- In *Tronox*, the court found that transactions to spinoff the company's profitable oil and gas assets, free of hundreds of millions of dollars of environmental and tort legacy costs, had left the debtors with an unreasonably small capital
  - In the mid-2000s, Kerr McGee spun off its chemical business from its much larger and more profitable E&P business; billions in environmental and tort legacy were left with the chemical business (renamed Tronox)
  - Tronox transferred assets worth approximately $17 billion and received approximately $2.55 billion in return (of which $2 billion consisted of the assumption of debt)
  - The spin-off left Tronox with unreasonably small capital; it retained $550 million in funded debt and approximately $1.5 billion in legacy liabilities, compared with a total enterprise value of approximately $1.2 billion
- As with *SemCrude*, the court cited the standard from *In re Moody* with respect to whether projections were reasonable, as tested by an objective standard
  - The court considered the testimony of experts for plaintiffs and defendants and found that plaintiff's expert convincingly demonstrated that the projections the company used were unreasonable and based on "sell-side" optimism

# Fraudulent Transfer Risk: Unreasonably Small Capital (Tronox)

- The court dismissed defendants' argument that company could have sold off assets to generate additional cash, finding no authority for "proposition that capital adequacy is shown by a debtor's ability to cannibalize itself and sell off assets piece by piece, until nothing is left"
- Court held that the fact that the company survived for a period after the transaction is not conclusive proof that the company had sufficient capital but is only a factor to consider
  - Here, the legacy costs ultimately contributed to Tronox's failure by preventing the company from accessing the capital markets or engaging in a capital transaction
- Transfer can be fraudulent even if company is not actually insolvent at the time of the transaction. Companies must also consider whether, due to lack of sufficient capital, they are likely to become insolvent following the transaction (i.e., whether they are "doomed to fail")
- The projections on which the company relies in making this determination at time of transaction must be reasonable and based on an objective standard anchored in the company's actual performance
  - Courts in certain circuits will consider the availability of sufficient capital either through existing line of credit or access to the capital markets, but not company's hypothetical ability to sell off assets, in determining whether company had unreasonably small capital

# Capital Call Obligations: Lessons for Equity Investors

- Capital call obligations pose unique risks for equity investors in insolvent partnerships and LLCs: in distressed situations, creditors or a bankruptcy trustee may be empowered to enforce capital call obligations for the benefit for creditors, to the detriment of partners/LLC members
  - The Delaware LLC Act (and similar partnership/LLC laws in other states) permits creditors who reasonably relied on a capital call obligation in extending credit to the LLC to demand enforcement of that obligation
  - In bankruptcy, the trustee/DIP may enforce a capital obligation against the partners/members
    - » In *Iridium Africa* (D. Del. 2004) and *Securities Group 1980* (Bankr. M.D. Fla. 1991), the court enforced capital call obligations, rejecting the argument that such obligations constitute "financial accommodation" contracts that are not assumable in bankruptcy
    - » Additionally, in some cases, the right to make capital calls is pledged to a lender under a subscription credit facility, giving the lender the contractual right to enforce the capital call directly
  - Capital contributed to an insolvent/bankruptcy partnership/LLC pursuant to a capital call is unlikely to generate any return (i.e., it inures to the benefit of creditors, not the contributing equity investor)
- While capital call risks cannot be eliminated, they can be mitigated by
  - Excluding third-party beneficiaries from the partnership or LLC agreement
  - Making capital call obligations discretionary
  - Memorializing funding obligations in side agreements among members, to which the partnership/LLC is not party

# Investment Risks for Lenders

## Intercreditor Agreements: Enforcement Trends

- Investors must choose where in the capital structure to invest, which in turn implicates the enforceability of intercreditor agreements
- Bankruptcy code section 510(a) provides that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law"
- Despite this straightforward statement, bankruptcy courts have varied in their willingness to enforce waiver, limitation and prohibitions on a junior lienholder's ability to act in a bankruptcy proceeding
  - The inconsistent rulings have largely resulted from uncertainty as to:
    - The extent to which parties can agree by contract to deviate from the statutory scheme set out by Congress in the Bankruptcy Code
    - The scope of Section 510(a), *i.e.*, whether it covers only specific subordination provisions or all the related provisions of subordination agreements
  - Over time, bankruptcy courts have become increasingly willing to enforce clear and unambiguous intercreditor provisions, with some exceptions

# Intercreditor Agreements: Enforcement Trends

  - However, there is still conflicting authority and cases addressing these issues in lower courts do not constitute binding precedent; thus, significant uncertainty remains
    - For example, there are nine cases dealing with voting restrictions in intercreditor agreements, of which six upheld the voting limitation and three deemed it unenforceable. Of the five cases since 2010, three upheld the provision and two deemed it unenforceable
- The uncertainty surrounding the enforceability of certain intercreditor provisions, including the various bankruptcy waiver provisions, is a result of the limited and conflicting case law; however, because of this uncertainty, lenders often choose not to litigate intercreditor issues, thus reducing the opportunity for further rulings which could provide additional clarity
  - The uncertainty can give second lien lenders substantial hold-up value, even where the intercreditor language is clear; first-lien lenders often do not have the time to fully litigate the enforceability of intercreditor provisions and, given the current case law, face some litigation risk
  - As a result, lenders often resolve disputes consensually in the context of a larger settlement in a way that may deviate from the strict language of the intercreditor agreement and without a court ruling

# ROI Risk: Pre-Till Approaches to Calculating Cramdown Interest Rates

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| Coerced Loan Approach | • **Interest rate a secured creditor could obtain if it foreclosed on the collateral and reinvested the proceeds.** *See, e.g.*, *Hardzog v. Fed. Land Bank of Wichita (In re Hardzog)*, 901 F.2d 858, 860 (10th Cir. 1990) (chapter 12) ("in absence of special circumstances, such as the market rate being higher than the contract rate, Bankruptcy Courts should use the current market rate of interest used for similar loans in the region"); *Wade v. Bradford*, 39 F.3d 1126, 1130 (10th Cir. 1994) (chapter 11). |
| Presumptive Contract Approach | • **The negotiated contract rate between the parties, subject to adjustments based on the particular facts of the case.** *See, e.g.*, *In re Till*, 301 F.3d 583, 592 (7th Cir. 2002) (chapter 13) (overruled by the Supreme Court). *See also GMAC v. Jones*, 999 F.2d 63, 70-71 (3d Cir. 1993) (chapter 13); *In re Smithwick*, 121 F.3d 211, 215 (5th Cir. 1997) (chapter 13); *In re Smith*, 192 B.R. 563 (Bankr. W.D. Okla. 1996) (Bankr. W.D. Okla. 1996) (chapter 13) (using the contract rate as proxy for market rate absent stipulation or evidence to contrary). |
| Cost of Funds Approach | • **The cost that the creditor would incur to obtain the cash equivalent of the collateral.** *See, e.g., In re Jordan*, 130 B.R. 185, 190 (Bankr. D.N.J. 1991); *In re Rivera*, 144 B.R. 614 (Bankr. D. P.R. 1992); *In re Hardzog*, 74 B.R. 701, 703–04 (Bankr. W.D. Okla. 1987), *modified*, 77 B.R. 840, 841–43 (Bankr. W.D. Okla. 1987). |
| Prevailing Market Rate Approach | • **The market, if an "efficient" market exists.** *See, e.g.*, *In re Monnier Bros.*, 755 F.2d 1336, 1339 (8th Cir. 1985) (application of the prevailing market rate of interest appropriate for chapter 11 cases); *United States v. Neal Pharmacal Co. (In re Neal Pharmacal Co.)*, 789 F.2d 1283 (8th Cir. 1986). |
| Formula Approach | • **Prime plus a risk premium.** *See, e.g.*, *In re Valenti*, 105 F.3d 55 (2d Cir. 1997); *see also United States v. Doud*, 869 F.2d 1144 (8th Cir. 1989) (Chapter 12); *In re Elk Creek Salers, Ltd.*, 286 B.R. 387 (Bankr. W.D. Mo. 2002) (chapter 12); *In re Gorham*, 247 B.R. 272 (Bankr. W.D. Mo. 2000) (Chapter 13); *In re Ehrnhardt*, 240 B.R. 1 (Bankr. W.D. Mo. 1999) (chapter 13); *In re Lockard*, 234 B.R. 484 (Bankr. W.D. Mo. 1999) (chapter 12). |

## ROI Risk: Till's Implications in Chapter 11?

- The facts:
  - Chapter 13 case
  - $4,000 secured claim resulting from $4,895 balance on retail installment contract to purchase a used truck
  - 21% original contract rate
  - Disputed rate used to calculate present value of post-confirmation payments to secured creditor
- In *Till*, the Supreme Court adopted "prime-plus" approach, *i.e.*, the "formula" approach, which is calculated by first taking the prime rate and adding a risk adjustment for the risk of nonpayment, generally between 1% and 3%
- Does *Till* only apply to chapter 13 cases, or chapter 11 cases as well?
  - Footnote 14 to Justice Stevens' opinion says that in chapter 11 "it might make sense to ask what an efficient market would produce"
- Some courts post-*Till* use a two-tiered approach to determine the appropriate cramdown interest rate:
  - First, look to what rate an efficient market would produce
  - Second, if there is no such efficient market, then apply the formula approach
    - » In *Momentive*, Judge Drain criticizes this approach as illogical

## ROI Risk: Cramdown Interest Rate

- Ultimately, despite divergent analyses, the rates arrived upon by courts generally do not stray far from prime plus a risk adjustment of 1% to 3%. There are, however, a few notable outliers
  - *See, e.g.*, *Good v. RMR Invs., Inc.*, 428 B.R. 249 (Bankr. E.D. Tex. 2010) (adopting the 15% contract rate); *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D. N.J. 2010) (using the market rate of 12%, determined based on expert testimony as to the rate of interest paid by comparable gaming companies)
- *Momentive* bench decision on cramdown interest rate consisted of three parts:

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| **1. Formula Approach** | • *Till* formula approach applies (*i.e.*, a near risk-free, near profitless base rate plus, generally, a 1% to 3% risk premium) |
| **2. Base Rate** | • Treasury rate was an appropriate base rate if a slight incremental amount added to account for the lack of risk found in the Treasury rate |
| **3. Risk Premium** | • Risk premiums that fell within the *Till* range of 1% to 3% were adequate |

## ROI Risk: Chapter 11 Cramdowns Since *Till*

- Depending on the jurisdiction, the applicability of the *Till* formula in chapter 11 cases may still be in dispute
  - But investors must be wary of the *Momentive* decision, since Judge Drain is nationally renowned and highly influential
- Regardless of the method employed for calculating cram down interest rates, the rates generally fall within the same range as prime plus 1% to 3%
- In the Southern District of New York, the formula approach applies (*i.e.*, a near risk-free, near profitless base rate plus, generally, a 1% to 3% risk premium)
  - The base rate may be the prime rate or the Treasury rate, depending on the circumstances. It is not clear yet whether another rate, such as LIBOR, could be used
    - » If the Treasury rate is used, debtors may need to adjust that rate to account for the lack of profit and risk inherent in the prime rate, which is not found in the Treasury rate as it is backed by the U.S. government
  - Although the majority approve of risk premiums that fall within the 1% to 3% range, at least some post-*Till* courts have approved of risk premiums that exceed 3%. *See, e.g.*, *In re Rocky Mountain Land Co.*, 2014 WL 1338292 (Bankr. D. Colo. Apr. 3, 2014) (3.75%); *In re GAC Storage El Monte, LLC*, 489 B.R. 747, 759 (Bankr. N.D. Ill. 2013) (5.35%)
  - Also note that, in the context of a cram-up, there is no requirement that the terms of the replacement paper be the same as the original paper. *See In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D.N.J. 2010)

## ROI Risk: Enforceability of Make-Whole Premiums

- “Perfect tender in time”
  - Common law rule that loans must be paid on maturity; no right to pay early
  - Default rule in many American jurisdictions, including New York
- Protections against prepayment in modern credit agreements and indentures
  - “No call” provisions
  - Make-wholes—permit prepayment in exchange for a specified prepayment premium
    - » Fixed premium—borrower pays a premium, typically expressed as a percentage of the principal repaid
    - » Yield maintenance formula
- Key issues in bankruptcy cases
  - Factual (*i.e.*, contract interpretation)—does the credit agreement/indenture clearly require a make-whole despite acceleration?
  - Legal—if so, is the lenders’ claim enforceable under the bankruptcy code and non-bankruptcy law?

## ROI Risk: Make-Whole Premiums and the Importance of Clear Drafting

- Default rule: bankruptcy is not a prepayment event and does not trigger prepayment premiums
  - Bankruptcy results in automatic acceleration of a loan/indenture
  - Thus, discharge/satisfaction of a loan in bankruptcy is presumptively not a prepayment and therefore does not trigger the make-whole
  - Lenders are barred by the automatic stay from rescinding acceleration
- To preserve their entitlement to a make-whole in bankruptcy, lenders must expressly contract around this presumption: the credit agreement/indenture must state explicitly that the make-whole is payable upon acceleration or whenever the loan is paid before the stated maturity
  - Absent explicit language to the contrary, the automatic acceleration advances the maturity date, such that premiums for payment prior to maturity are not implicated
  - Credit agreements/indentures should expressly refer to a premium payable upon acceleration to preempt argument that the claim constitutes unmatured interest, disallowed under section 502(b)(2)
  - *Momentive* and several other cases demonstrate this trend

## Codere: Credit Default Swaps and the "Empty Creditor" Problem

- The "empty creditor" problem—when a borrower is close to a default, lenders who also hold credit-default swaps (CDS) stand to gain if the borrower defaults. Depending on the language of the CDS, the instrument may incentivize lender/CDS holders to hold out from an out-of-court restructuring of the underlying debt, and an empirical study has concluded that CDS trading in a particular entity increases the likelihood of a bankruptcy filing. *See* Subrahmanyam, et al. 2013.
- Justification for an arranged default may be important if a transaction is reviewed by regulatory or judicial bodies
- In *Codere*, GSO defended the arranged default on several grounds:
  - The Wall Street Journal reported that GSO sent a letter and subsequent e-mail to the board, saying it had held talks with the company's bondholders and got assurances that none would use the arranged default to force Codere into bankruptcy
  - Codere, working with GSO and Perella, determined that triggering the credit default swaps was necessary to compel certain bondholders to negotiate; otherwise, Codere may have had to liquidate
  - Codere was already on the brink of insolvency

## Codere: CDS Strategy

- Legal Risk—State Contract Law
  - Generally no duty to disclose information to a CDS-counterparty
  - Implied covenant of good faith and fair dealing
- Performance Risk
  - The CDS-counterparty could refuse to pay if bad facts become known
- Regulatory Risk
  - A novel fact pattern may attract SEC regulatory scrutiny or an SEC investigation
  - Uncertainty as to whether SEC would conclude that an action for violation of the securities laws is warranted
  - The efficacy of defenses to an SEC anti-fraud claim are also uncertain
- Reputational Risk
  - Potential to attract negative media coverage or Congressional interest
  - SEC investigations can impact public perceptions even if favorably resolved and are extraordinarily expensive

## "Empty Creditor" Problem

- Several recent cases provide anecdotal evidence of the "empty creditor" problem:

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| Six Flags (2009) | Six Flags filed for chapter 11 after failing to reach a deal with its creditors. It was reported that a Fidelity mutual fund turned down an offer that would have given unsecured creditors an 85% equity stake, even though according to an analysis by Fitch Ratings, the same creditors would receive at most 10% of equity after a bankruptcy filing, leading to speculation that credit-default swaps were involved |
| General Growth Properties (2009) | General Growth filed for chapter 11 after failing to reach a deal with its creditors. Lawyers involved in the case indicated that CDS holdings were a factor in the default filing for chapter 11 protection. |
| Abitibibowater (2009) | Abitibi filed for chapter 11 after failing to reach a deal with its creditors to extend the maturities of bonds due August 2009. Certain creditors held CDS on the bonds. |
| Unisys (2009) | After two failed exchange offers, Unisys had to offer creditors bonds worth more than par to reschedule debt coming due in 2010. According to the Financial Times, many holders of Unisys debt also held CDS protection. |
| GM and Chrysler (2009) | Both GM and Chrysler filed for chapter 11 after failing to reach a deal with their creditors. In GM, various investors stood to make billions of dollars on CDS if GM declared bankruptcy. In Chrysler, one article speculated that some funds may have had CDS on Chrysler bank debt. |
| YRC Worldwide (2009-2010) | In 2009, initially some creditors opposed the debt-for-equity exchange offer, even though they would likely receive less in bankruptcy than if they accepted the offer. This raised suspicion that the hold-out creditors held CDS positions. Eventually, YRC managed to renegotiate its debt, when the Teamsters union threatened to protest in front of the offices of hedge funds which blocked YRC's debt-for-equity offer. |

**Source: Patrick Bolton & Martin Oehmke, *Credit Default Swaps and the Empty Creditor Problem*, 28 Rev. Fin. Stud. 2617 (2011)**

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