Testing the Limits of Lender Liability in Distressed-Loan Situations

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As has been well-publicized recently, businesses are increasingly turning to private investment firms for needed financing, via either secured or unsecured loans or equity investments. When some of those businesses inevitably head into chapter 11, private investment firms sometimes find themselves defending their conduct vis-à-vis the ailing companies. In a decision sure to give such firms comfort, a Delaware bankruptcy court recently denied equitable subordination of a private investment firm's claims in respect of loans made to a debtor and its affiliates shortly before their bankruptcy filing and refused to recharacterize those loans as equity. The bankruptcy court also dismissed breach-of-fiduciary duty claims against a former director of the debtor, who was a partner in the investment firm, as well as aiding-and-abetting claims against the firm itself.

Background

In June 2005, a little more than one year prior to the bankruptcy filing by Radnor Holdings Corp. and its affiliates (collectively, "Radnor"), Radnor's financial advisor counseled that it would be in the company's best interests to raise a combination of debt and equity to fund working-capital needs and expansion plans. To determine market interest in such a transaction, the financial advisor contacted several private investment firms, including Tennenbaum Capital Partners, LLC ("Tennenbaum"), which indicated that it was willing to provide financing and/or new capital on an expedited basis.

Tennenbaum agreed to loan Radnor $95 million on a senior secured basis (the "Senior Financing") and to purchase $25 million of Radnor's preferred stock, which included detachable warrants giving Tennenbaum the right to acquire common stock based on Radnor's gross earnings. At the time, Radnor had outstanding $70 million in senior secured notes, $130 million in unsecured notes and a revolving credit facility. The proceeds of the Senior Financing were applied to, among other things, redeem all of the existing senior secured notes and pay down the credit facility. In connection with the new financing, Tennenbaum entered into an investor rights agreement with Radnor's shareholders that gave Tennenbaum the right to: (i) designate one member and one observer to Radnor's board; (ii) increase Tennenbaum's representation on the board if Radnor did not meet certain gross-earnings thresholds; and (iii) veto certain employment agreements and transactions with affiliates. Tennenbaum later exercised its right to designate one member and one observer to the board, designating José E. Feliciano, a partner in Tennenbaum, as a board member and another individual as the board observer. At the time the rights agreement was signed, Radnor represented to Tennenbaum that it was solvent.

Cash flow and liquidity problems resulting from a steep decline in earnings prompted Radnor to seek a further $23.5 million capital infusion from Tennenbaum in 2006. Tennenbaum, however, was willing to provide the funds only in the form of a secured loan, which it did on April 4, 2006 (the "Additional Financing"). Tennenbaum also agreed to roll over $3.2 million in interest due on the Senior Financing into the Additional Financing. In connection with the second financing transaction, Radnor again represented to Tennenbaum that it was solvent.

Radnor’s board of directors approved each of the financing transactions. Mr. Feliciano was not a member of the board at the time it approved the Senior Financing and, because of his affiliation with Tennenbaum, abstained from voting on the Additional Financing. In addition, 95 percent of Radnor’s unsecured noteholders consented to the Additional Financing.

In June 2006, Radnor’s revolving credit facility lenders threatened to cut off funding under Radnor’s working capital facility: in July 2006, they actually did so, precipitating Radnor's chapter 11 filing in August 2006. Mr. Feliciano resigned from Radnor’s board in June 2006, and the following month, Radnor approached Tennenbaum about providing a stalking-horse bid for Radnor’s assets through a chapter 11 sale process. Although hesitant to do so, Tennenbaum agreed because, without a stalking-horse bid, Tennenbaum believed that Radnor would lose substantial value due to either a prolonged reorganization case or a liquidation. After Radnor’s chapter 11 filing, the bankruptcy court approved as being in the best interests of Radnor’s estate auction procedures for Radnor’s assets that included Tennenbaum’s stalking-horse bid.

The bankruptcy court later authorized Radnor’s official committee of unsecured creditors to commence litigation on behalf of the estate against Tennenbaum and Mr. Feliciano. In its complaint, the committee sought, among other things, to: (i) recharacterize the financing provided by Tennenbaum as equity; (ii) equitably subordinate Tennenbaum’s claims; (iii) recover damages for Mr. Feliciano’s alleged breach of his duty of loyalty to Radnor; and (iv) recover damages for Tennenbaum’s alleged aiding and abetting a breach of fiduciary duty.

Recharacterization, Equitable Subordination and Fiduciary Duties

Recharacterization of debt as equity is a common-law equitable remedy principally imposed in cases where an insider purports to loan money to an undercapitalized company. In many such cases, creditors argue that the money should be considered a capital contribution and treated as equity rather than debt. Although some courts have adopted multifactor tests for analyzing recharacterization claims, in *Cohen v. KB Mezzanine Fund II (In re SubMicron Systems Corp.)*, the Third Circuit rejected what it deemed to be a "mechanistic scorecard," opting instead to focus on the parties' intent at the time of the transaction through a common-sense evaluation of the facts and circumstances.

Equitable subordination, a common-law remedy codified in section 510(c) of the Bankruptcy Code, seeks to remedy misconduct that causes injury to creditors (or shareholders), or confers an unfair advantage on a single creditor at the expense of other creditors. Under section 510(c), bankruptcy courts may use equitable subordination to subordinate "all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." Under prevailing case law, the party seeking subordination must prove that: (i) the claimant engaged in inequitable conduct; (ii) such conduct either caused injury to the company's creditors or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim is not inconsistent with the Bankruptcy Code. The degree of inequitable conduct required varies, depending upon whether or not the creditor is an "insider" of the debtor. For insiders, inequitable conduct is generally found if the claimant has: (i) committed fraud, illegality, or breached its fiduciary duties; (ii) left the debtor undercapitalized; or (iii) used the debtor as a mere instrumentality or alter ego.

Directors of a corporation owe certain fiduciary duties to the corporation and its stockholders, one of which is the duty of loyalty. The duty of loyalty generally requires that directors and officers act in the interests of the corporation and its stockholders and subordinate any conflicting interests. In assessing whether a director's conduct amounts to an actionable violation of a fiduciary duty, courts generally apply a principle of deference referred to as the "business judgment rule." As enunciated by the Delaware Supreme Court in *Brehm v. Eisner*, courts will defer to directors' business decisions

> unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

The Bankruptcy Court's Decision in *Radnor*

In considering the committee's recharacterization claim, the bankruptcy court determined that Radnor and Tennenbaum had intended all of the loans to be true debt instruments rather than equity. The court rejected the committee's allegation that, because Tennenbaum knew of Radnor's liquidity crisis when it made the loans, "no prudent lender" would have extended the financing. According to the court, it is perfectly legitimate for a lender to loan additional funds to a distressed borrower as a way to protect an existing loan.

The bankruptcy court concluded that Tennenbaum did not exercise a sufficient degree of control over Radnor to justify recharacterization of its debt as equity. Tennenbaum's designation of Mr. Feliciano as only one of four board members, the court noted, was immaterial to the control issue. The court likewise held that Tennenbaum's receipt of nonpublic information (via its role as lender), its unexercised right to obtain additional board seats and its right to obtain additional equity did not constitute the level of control necessary to support recharacterization. The inquiry,

the court emphasized, should focus on whether the lender exercised control over the debtor's day-to-day operations, which Tennenbaum did not.

Addressing the committee's equitable-subordination claim, the bankruptcy court determined that Tennenbaum had at all times acted in good faith to maximize Radnor's value to all constituents. It concluded that Tennenbaum had not acted inequitably, and had neither injured Radnor's creditors nor created an unfair advantage for itself. The court found, moreover, that: (i) the loans enhanced Radnor's liquidity (thus allowing its operations to continue); (ii) the Senior Financing reduced the company's net indebtedness; and (iii) the unsecured noteholders (who held a majority of the seats on the committee) expressly consented to the Additional Financing. The court rejected the committee's contention that Tennenbaum was an insider of Radnor, finding that Tennenbaum had never exerted control over Radnor's day-to-day operations and thus was not a "person in control" of Radnor, such that it would qualify as an insider under the statutory definition of the term. Explaining that any influence that Tennenbaum had over Radnor was merely indirect, arising from Tennenbaum's rights under the loan documents, the court stated that reasonable financial controls negotiated at arm's length do not convert a lender to an insider. In the absence of any evidence of inequitable conduct by Tennenbaum, the court ruled that equitable subordination of its claims was unwarranted.

The bankruptcy court concluded that the committee's breach-of-fiduciary duty claim against Mr. Feliciano also lacked merit. Neither of the two transactions cited in the complaint — the Additional Financing and Tennenbaum's stalking-horse bid — involved Mr. Feliciano. He abstained from voting on the financing and had resigned his seat on the board prior to any

discussions concerning a possible stalking-horse bid. In addition, the court emphasized, the evidence did not indicate Mr. Feliciano used his board seat to pressure the other directors into approving either transaction. Explaining that, under Delaware law, an insider's bid to purchase a company or its assets is not a per se breach of fiduciary duty, the court ruled that Mr. Feliciano did not breach his fiduciary duties by using his knowledge about Radnor in connection with the stalking-horse bid. Moreover, the bankruptcy court concluded, it had previously determined that the stalking-horse bid was in Radnor's best interests and the bid later proved to benefit Radnor, circumstances that precluded any finding of fiduciary improprieties on the part of Mr. Feliciano.

Turning to the aiding-and-abetting claims against Tennenbaum, the bankruptcy court noted that, under Delaware law, the committee was required to prove that a fiduciary relationship existed, a fiduciary duty was breached, and the nonfiduciary defendant knowingly participated in that breach. According to the court, even if Radnor's board owed fiduciary duties to unsecured creditors, none of its actions would have breached those duties. Delaware law, the court explained, does not require an insolvent company's board to cease operations and liquidate. Rather, the court observed, "directors of an insolvent company may pursue strategies to maximize the value of the company, including continuing to operate in the hope of turning things around." Subject to the business-judgment rule, the board may approve actions that could potentially improve results — even if such actions increase the company's liabilities.

The bankruptcy court determined that Radnor's board had a good-faith basis for continuing the company's business plan in an attempt to turn the company around, instead of liquidating, because unsecured creditors would have incurred a substantial loss if Radnor had liquidated prior

to closing on the Senior Financing. In the absence of any breach of fiduciary duty to Radnor, the court ruled, the committee's aiding-and-abetting claim against Tennenbaum must fail. Furthermore, the court held, the committee could not prove that Tennenbaum knowingly participated in a breach of a fiduciary duty because Tennenbaum had reasonably relied on Radnor's officers' representations that the company was solvent at the time of the loans.

Analysis

Radnor Holdings can be viewed as a case study on the limits of lender liability in distressed-loan situations. Private equity and hedge funds are deploying enormous resources in distressed markets as primary lenders, second-lien lenders and investors both in and outside of bankruptcy. The ruling is instructive both in assessing the risks associated with distressed investment opportunities and in gauging the limitations of lender proactivity in striving to limit credit exposure in the event of a bankruptcy filing. The messages borne by *Radnor Holdings* are that: (i) without any evidence of bad-faith, improper motive, or undue influence or control, secured lenders need not be wary of exercising their bargained-for rights and remedies; (ii) making additional loans to a distressed company in an effort to protect existing loans does not in and of itself warrant recharacterization or equitable subordination of the lender's claims if the borrower later files for bankruptcy; and (iii) a company's board cannot be second-guessed for pursuing informed turnaround strategies, including the incurrence of additional debt, in a good-faith effort to regain fiscal well-being. All of this should come as welcome news for lenders and corporate fiduciaries.

Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006).

Cohen v. KB Mezzanine Fund II (In re SubMicron Systems Corp.), 432 F.3d 448 (3d Cir. 2006).

Brehm v. Eisner, 746 A.2d 244 (Del. 2000).