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Holding Debt and Equity Investments in a Financially Distressed Company May Survive Recharacterization Claims

Investors who hold both debt and equity in a financially distressed company may be confronted with efforts to have their debt investments recharacterized as equity. Recharacterization is an equitable remedy that bankruptcy courts have used as a basis to look past the form and characterization of an obligation as debt and find the subject obligation to be equity. In his recent decision in *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.)*, Adv. Proc. No. 06-50909 (Bankr. D. Del. November 17, 2006), the Honorable Peter J. Walsh, Bankruptcy Judge, provided guidance with respect to the risks and merits of recharacterization. In *Radnor*, Judge Walsh held that loans that were intended to be and were treated as true debt investments were not subject to recharacterization by reason of the lender also holding equity interests.

In the summer of 2005, Radnor Holdings Corp. ("Radnor") decided to seek financing for the expansion of its business and for related working capital. Based on advice from its placement agent, Lehman Brothers ("Lehman"), Radnor sought approximately $50 million in new debt and equity capital ($30 million of senior secured debt plus $20 million of convertible preferred stock), intending such liquidity to be incremental to $70 million of existing senior secured notes. Lehman contacted 40 potential investors, including Tennenbaum Capital Partners, LLC ("TCP"), which Lehman ultimately selected to provide the financing. On October 27, 2005, TCP made its initial investment in Radnor thorough a commitment to purchase $25 million worth of preferred stock (the "Preferred Stock") and to lend $95 million in senior secured debt to Radnor (the "Tranche A and Tranche B Loans"), which was used to pay down the $70 million of existing senior secured notes. The Preferred Stock also included detachable warrants that would give TCP the right to own certain levels of Radnor common stock, not to exceed 15.625% of the outstanding stock. TCP simultaneously entered into an investor rights agreement with Radnor's shareholders, pursuant to which TCP was granted the right to designate one member of Radnor's board of directors, which TCP exercised, and certain other customary rights that TCP elected not to exercise. The court also found that TCP never planned to acquire Radnor, either through the initial investment or at any time thereafter.

The Tranche A and Tranche B Loans were at all times treated by TCP and Radnor as debt. They were always referred to as debt and the loan documents contained typical terms and conditions of secured debt instruments. The collateral covered substantially all property, plant, and equipment of Radnor. At the time the loans were made, the value of the collateral exceeded the outstanding amounts of the Tranche A and Tranche B Loans.

Radnor suffered a "devastating" decline in earnings in the fourth quarter of 2005 and the first quarter of 2006 and faced cash flow and liquidity problems. TCP refused a request by Radnor to make an additional equity investment of $23.5 million. However, on April 4, 2006, TCP agreed to provide additional debt financing in that amount (the "Tranche C Loans," collectively with the Tranche A and Tranche B Loans, the "Loans"). The Tranche C Loans were, in general, identical to the Tranche A and Tranche B Loans in all material respects and were secured by the same collateral.

Within approximately three weeks after the closing on the Tranche C Loans, the banks under Radnor's revolving credit facility determined that the borrowing base information provided to them had been inaccurate and that their loans were overadvanced and in June 2006, those lenders threatened to cut off funding under Radnor's working capital facility. On June 14, 2006, Radnor once again retained Lehman to assist in assessing various alternatives for solving its liquidity crisis. In conjunction with Lehman, Radnor determined that an asset sale was the proper course for Radnor to pursue. In July 2006, Radnor's lenders cut off its funding under its working capital facility and Radnor approached TCP about serving as a stalking horse bidder for Radnor's assets. The court found that TCP reluctantly agreed to do so and negotiated an asset purchase agreement with Radnor dated August 21, 2006. On the same date, Radnor and various of its affiliates sought chapter 11 protection. On October 30, 2006, the court granted the official committee of unsecured creditors of Radnor (the "Creditors' Committee") standing to file a complaint against TCP[1] and on October 31, 2006, the Creditors' Committee did so, seeking, among other things, to recharacterize the Loans as equity. The court conducted eight full days of trial to hear the merits of the various claims of the Creditors' Committee.

<u>Denial of Recharacterization</u>

The court noted that in *Cohen v. KB Mezzanine Fund II (In re SubMicron Systems Corp.)*, 432 F.3d 448 (3d Cir. 2006), the Third Circuit explicitly rejected a "mechanistic" approach to the analysis of recharacterization claims whereby a court weighs various specific factors. Instead, the Third Circuit held that the overarching inquiry in a recharacterization case is the intent of the parties at the time of the transaction, determined by a common sense evaluation of the facts and circumstances of a particular

[1] The court found that the recharacterization claim was a direct claim and therefore did not need to reach the issue of whether the claims were colorable or had any basis on the merits, which would have been necessary in order to grant the committee standing had the claims been determined to be derivative.

transaction. Applying that comprehensive analysis of "intent," the court concluded that based on the terms of the documents themselves, the facts and circumstances surrounding the Loans, the reasonable inferences to be drawn as a result, and the economic reality of the circumstances, the Loans were intended to be and were true debt instruments and should not be recharacterized as equity. *Radnor* at 25.

In connection with the initial debt investment, TCP received representations from Radnor that it was solvent and the court found that it would be "irrational to believe that TCP would have made a $25 million equity investment if it believed Radnor were insolvent at the time." *Id*. at 8. The court, therefore, found that TCP clearly believed there was an upside to its equity investment. Had TCP concocted a "loan to own" scheme, the court noted that, rather than make an equity investment, the logical alternative would have been to make only a debt investment.

However, the court noted that even if it were to "divine the parties' intent by applying the variety of factors considered by other courts in recharacterization cases, the court's decision not to recharacterize the [Loans] would be the same." *Id*. Specifically, the court noted that the Loans (a) were referred to as "debt" and/or "indebtedness" in the transaction documents; (b) were consistently referred to by the parties as "loans" and/or "indebtedness"; (c) contained a fixed maturity date; (d) gave TCP the right to enforce the payment of principal and interest; (e) contained no "voting rights"; (f) were treated as priority debt instruments, the proceeds of which were used for working capital and to replace and/or pay down existing debt; and (g) were secured by security interests entitled to priority in a liquidation or insolvency. *Id*. at 25-26.

Further, the court concluded that "TCP's knowledge that the Debtors were experiencing a liquidity crisis when the Tranche C Loans were made is insufficient to support recharacterization." *Id*. at 26. In *SubMicron*, the Third Circuit expressly rejected recharacterization because it found it was legitimate for an existing lender to extend additional credit to a distressed borrower as a means to protect its existing loans. Based on the Third Circuit *SubMicron* reasoning, the court in *Radnor* was not persuaded by the Creditors' Committee's allegation in its complaint that "no prudent lender" would have made the Tranche C Loans.

Though not determinative of the recharacterization issue, the court also concluded that TCP did not exercise control over Radnor's day-to-day operations and that its designation of one of Radnor's four board members was immaterial. Instead, the court relied on *SubMicron's* observation that it is "not unusual for lenders to have designees on a company's board, particularly when the company [is] . . . distressed." *Id*. (*citing SubMicron*, 432 F.3d at 457-58). Finally, the court noted that TCP's receipt of nonpublic information and its ability to obtain more board seats, which it never exercised, were similarly immaterial.

<u>Lessons to be Learned – How Equity Holders May Reduce the Risk of Recharacterization of their Debt Investments</u>

Lessons may be drawn from the court's ruling in favor of TCP. First, in the Third Circuit, holding both debt and equity of a company that ultimately seeks chapter 11 protection does not necessarily result in recharacterization of the debt position. Second, the court found that it was legitimate for an existing creditor to make additional advances to protect its original debt investment, even when a prudent third-party lender might have refused to extend credit. While it may find comfort in the *Radnor* ruling, an entity that holds debt and equity of an issuer must be focused and disciplined with respect to such investments. It is common for a claim of recharacterization to be accompanied by a separate claim of equitable subordination, which seeks to subordinate debt based on inequitable conduct of the lender. Overcoming a recharacterization claim will be a Pyrrhic victory if the "debt" is equitably subordinated. In *Radnor*, efforts to subordinate failed because of a number of case-specific facts, most especially the fact that TCP did not engage in any wrongful conduct.[2] *Radnor* also reminds all investors that a holder of debt and equity of a financially distressed company may find itself embroiled in recharacterization and equitable subordination litigation, even if such claims are without merit. While in *Radnor* the specific facts and circumstances of the case allowed the lender to defeat recharacterization, efforts to recharacterize will likely remain a weapon in the arsenal of parties seeking to extract value. Risk and outcome may vary case by case and will turn on specific facts, circumstances, judicial perspective, and the exchequer available to fund the fight.

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[2] The court found that the creditors' committee failed to demonstrate that equitable subordination of TCP's claims was warranted as TCP was not an insider, did not engage in misconduct, did not seek to benefit itself at the expense of others, and did not seek to mislead trade creditors, public noteholders, or other stakeholders. To the contrary, the court concluded that TCP acted at all times in good faith with a view to maximize Radnor's value to all constituents. Further, the court noted that even if the more stringent standards of conduct applicable to insiders applied, there was no showing that TCP engaged in wrongful conduct.

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