



ROPES & GRAY LLP

PORTFOLIO COMPANY LIQUIDITY
CONSIDERATIONS:
*EQUITY INVESTMENTS AND SPONSOR
LENDING*

April 9, 2020

ROPES & GRAY

Equity Investments

- Where portfolio company performance is negatively impacted to the point that additional equity is needed for an equity cure or liquidity, thought will need to be put into the price at which new equity is invested and related terms (seniority, etc.). For portfolio companies owned by “older” funds with liquidity issues, cross-fund conflict issues may also come into play.
 - Depressed pricing and dilution implicates fiduciary duties to minority shareholders
 - Review shareholder agreements for pre-emptive rights, affiliated-transaction and other applicable provisions
 - Consider special committees, independent directors and/or separate advisors to mitigate potential conflicts of interest – all can slow timing of capital infusion
 - Review credit agreement/indenture requirements/procedures (e.g., around nature of the equity security, use of proceeds, etc.) and consider ratings implications of certain preferred stock investments
 - Consider any special issues in how (and how much) equity investments can be made due to existing co-investors/structures
- Depending on the nature of the portfolio company, co-investors and their rights, a variety of options may be on the table, including creating mechanisms for effectively pricing the equity infusion at a later date (when the total impact is clearer) by initially investing in debt or preferred debt that converts at a price determined once the current situation is settled.
- Consideration should be given to securities law and related disclosure obligations (focusing, in particular, on risk factors) in connection with any equity financing (including offerings under any applicable preemptive rights provisions).

Sponsor Lending

- Fund or affiliated credit fund lending (or already having lent) to portfolio companies (including preferred, converts and other senior securities) implicates the same fiduciary duty and conflict issues as an equity injection, but also:
 - Additional affiliate transaction restrictions in (i) fund agreements and (iii) credit agreement/indentures
 - May not be permitted indebtedness (or be sharply limited) under existing credit agreement/indentures, so may need to be subordinated with PIK interest instead of cash interest
 - Extended preference period in bankruptcy
 - Potential equitable subordination/recharacterization
 - Unlike debt recharacterization, equitable subordination generally requires subordination only to the extent necessary to redress inequitable conduct.
 - Debt recharacterization is an equitable remedy allowing a bankruptcy court to reclassify debt as equity and turns on whether a debt relationship actually exists and on whether the claim involves inequitable conduct
 - The majority of jurisdictions use a multifactor test to determine whether to recharacterize debt, but differ on the weight assigned to the various factors. Courts will generally consider the broad number of factors, and no one factor is controlling.

Fiduciary Duties

- For portfolio companies facing liquidity issues and/or potential insolvency, controlling funds and portfolio boards should be extra mindful of their fiduciary duties
 - To the extent fiduciary duties have not been limited or waived, the fiduciary duty framework during distress is the same as it is ordinarily
 - Duty of care
 - Duty of loyalty
 - Directors enjoy the benefits of the business judgment rule during distress and insolvency but interested transactions may be subject to entire fairness review
 - When a Delaware corporation is insolvent, creditors become primary beneficiaries of board fiduciary duties with ability to bring derivative claims for breach
 - Directors must maximize the value of the entire enterprise (and transactions designed to maximize possible recovery for underwater equity could be recast in hindsight as reckless or uninformed)
 - Sponsors should consider appointing independent directors or forming a special committee to analyze and authorize transactions with insiders (including sponsors) during periods of distress and insolvency
 - Directors can and should increase frequency of meetings and require thorough presentations by officers and advisors before making decisions in periods of distress and insolvency
 - Officers and/or advisors should document the basis or reasoning underlying director and officer decision-making, including through minutes.
 - Board should review exculpation provisions in governing documents and D&O coverage
 - Board can engage a restructuring advisor with expertise in distressed situations

Fiduciary Duties (cont.)

- Joint Representation of Sponsor and Portfolio Company/Parent and Subsidiary
 - The joint representation of a portfolio company and its sponsor and/or a portfolio company parent and its subsidiary is not unusual
 - When a portfolio company is solvent, the interests of all these parties are aligned
 - When a portfolio company is insolvent, interests may diverge, giving rise to potential conflicts
 - Privilege is a key area of concern when one party to a joint representation becomes insolvent
 - Sponsors should be cognizant of these risks when a portfolio company is approaching insolvency and should discuss the benefits and costs of retaining separate counsel with their advisors

Tax Implications

- **Contributions to LLCs Taxed as Partnerships**

- Generates holding period taint; these issues more nuanced and may have other economic impacts if a sell-down is involved
- Consider structure of sell-down to avoid phantom income issues, including setting up separate silos to make new investment and isolate taint in the new silo
- Preference securities may create phantom income issues – tax distributions may not be required by LLC agreement or permitted under credit agreement

- **Contributions to LLCs/LPs Taxed as Partnerships that Own C-Corp Stock**

- Similar issues as those noted above, but holding period planning opportunities may be available at c-corp level if no additional shares are issued
- Redeeming the additional equity in the future before an exit could result in dividend income at the time

- **Contributions Directly to C-Corps**

- Preference securities may create phantom income issues
- Holding period planning opportunities may be available when no additional shares are issued
- Redeeming the additional equity in the future before an exit could result in dividend income at the time

- **Considerations for Debt Investments**

- If issued with OID or accreting non-cash coupon, may result in phantom income issues
- Convertible debt or debt issued together with additional securities may also create phantom income issues