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Distressing Times Pose Special Risks for PE

Traps abound that threaten both the investments and the investors

By Dennis J. White

Keeping a portfolio company on a path toward robust growth and an eventual sale or other liquidity event has never been a cakewalk for private equity investors. In the current environment, it can be a daunting, if not downright dangerous assignment. Tripwires abound that can threaten a company's very existence and in some cases subject the officers and directors to potential personal liability.

These are no ordinary times and so investors, directors and management must be keenly aware of the special dangers they now face. Here are a few examples.

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For instance, investors need to be mindful of liability for payroll and "trust fund" taxes. Stretching out creditors is a fairly standard technique that troubled companies follow to buy time to stay afloat. However, there are certain payables that if not timely settled, can give rise to personal liability on the part of responsible individuals at the company. These involve so-called "trust fund" taxes such as payroll withholdings for tax and FICA, sales and use taxes, and excise taxes. Notwithstanding a company's financial squeeze, special care should be taken to cover such items.

There are also liabilities associated with reductions in force (RIFs). When faced with plummeting revenues, many companies implement a reduction in force. While driven by economic realities, RIFs can often spawn a wave of ensuing lawsuits by former employees alleging the terminations were discriminatory based on age, race, gender or some other protected characteristic. If such terminations involve a "plant closing" or "mass layoff" under the Federal Worker Adjustment and Retraining Notification or WARN Act or similar state law, advance notice to the workforce may also be statutorily required, even if a company files for bankruptcy protection.

These are just two examples of potential issues companies can encounter in this area. The bottom line is that advance planning and consultation with professionals are necessary in order to assess and avoid potential HR-related liabilities.

Taxation of forgiven indebtedness

Distressed companies that are able to negotiate a full or partial forgiveness of indebtedness are sometimes surprised to learn that such relief also results in a cruel tax twist. The company is deemed to have recognized income in the amount of the forgiven indebtedness and may have to pay tax on that sum. Tax may also be triggered if the company's third-party debt is acquired by an equity investor or other related party.

The recently enacted Stimulus Bill provides relief by allowing businesses that repurchase their indebtedness in 2009 and 2010 (or whose debt is cancelled) to elect to defer the resulting recognition of taxable income to 2014. Beginning in 2014, the deferred amount would be taken into income for tax purposes in equal amounts over a five-year period.

Although alluring, investors and management should consider whether these new tax provisions are really the most advantageous from a tax planning perspective. The company may have losses, and so there may be no income on which taxes are due. Also, having an overhanging tax liability that stretches out several years may impede a sale of the company.

Alternatively, it may be preferable to take one's medicine now and move on. In any event, management should proceed only after having developed a thoughtful tax plan.

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Re-characterization of rescue debt

A distressed company's private equity investors can often become its lenders of last resort. However, there is a risk that what starts out as debt may be re-characterized as equity.

This can occur in several ways. The company's existing senior secured lender may demand repayment and the private equity investors may elect to acquire their position. Alternatively, the company may be starved for cash, and the private equity sponsors may be willing to inject additional funds, but not as additional equity.

If the company subsequently enters bankruptcy, its creditors may contend that such investor-furnished debt should be re-characterized as equity that is subordinated to all indebtedness (including trade debt) owed to non-related parties.

Since it is an equitable remedy administered by a bankruptcy judge with a high degree of discretion, there exists no fail-safe approach to avoid such an unhappy result. However, an investor can take steps to enhance the odds that its advances will be viewed as true debt.

The company should proactively pursue other third-party lending sources and document that it has done so.

The transaction documents should mirror traditional loan documents and reflect market terms. To confirm the latter, a fairness opinion can be secured from an independent valuation firm.

If a representative of the private equity lender sits on the board, he or she should abstain from voting and not participate in the board's discussion of the matter. If feasible, the loan should come from a legal entity separate from the one that made the equity investment.

Unlawful stock redemptions and payment of unlawful dividends

Directors also face potential personal liability for the declaration and payment of dividends or the repurchase or redemption of company stock that are later determined to be unlawful. Whether such a transaction is unlawful is determined in hindsight under the technical provisions of the corporation's statute in the company's state of formation.

For example, Delaware law allows dividends to be lawfully paid only out of surplus or net profits in the year in which the dividend is paid or the preceding year. Delaware law similarly bars redemption of stock that would cause the company's capital to be impaired.

The relevant terms used by the state statutes do not necessarily carry the same definitions as those used under GAAP. Consequently, a company and its directors should consult both their lawyers and accountants to determine whether they are on safe ground.

The downside can be horrific for the individuals involved. Directors who willfully or negligently violate the statute can be jointly and severally liable to company creditors for six years after the transaction. Also, the recipients of any such dividends or redemption payments might have to disgorge them if they are successfully challenged as fraudulent transfers.

Liability of directors for breach of fiduciary duties

The directors of a distressed company should expect to receive a high degree of scrutiny and second guessing. Because they represent potential deep pockets with separate insurance, directors from the company's private equity sponsors (along with the sponsors themselves) will be specifically targeted.

As with any company, the directors must first exercise a duty of care that an ordinarily careful and prudent person would use in similar circumstances. The directors also carry a duty of loyalty. This requires them to act in good faith in the best interests of the company and to avoid receiving improper benefits for themselves or their firms. Directors from private equity firms are particularly vulnerable to accusations that they acted in the best interests of their own limited partner investors, not the company.

The directors should ensure that they are well informed, ask questions and identify and evaluate all alternatives. They should hire consultants and professionals such as investment bankers, turnaround experts and lawyers sooner than later. Boards are not expected to be infallible, but they are required to follow a full process. The directors should be thoughtful and deliberative and the minutes should fully reflect the care they take and the time they spend.

When a company becomes insolvent, the Delaware courts have ruled that the creditors take the place of shareholders as residual beneficiaries and have standing to bring claims against the directors on behalf of the company for breaches of their fiduciary duties. Consequently, as a company approaches insolvency, directors need to start considering the creditors, not just the stockholders.

When it comes time to sell the company, directors also have a duty to secure the best price reasonably available under the circumstances. Leaping at the first deal that comes along carries risks.

All these duties make for an abundance of potential liabilities. Consequently, directors should double check the indemnification provisions in the company's organizational documents as well as its D&O insurance policy to ensure they afford the expected level of protection.

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