

PRIVATE EQUITY & VENTURE CAPITAL | BY GEOFFREY T. RAICHT

Private equity firms: targets for bankruptcy litigation

While the ongoing credit crunch has slowed new private equity transactions, over the past several years the industry has pumped a staggering amount of capital into these types of transactions. In 2007, for example, over \$680bn of private equity money was invested globally, which represented more than a 33 percent increase from 2006. In the United States, some of the companies acquired in these legacy transactions are now either in a bankruptcy proceeding or steadily heading in that direction.

In the current economic environment, many of the companies that enter Chapter 11 seek to sell their assets pursuant to section 363 of the Bankruptcy Code for the benefit of their creditors and do not seek to undertake a true 'restructuring' of their pre-petition obligations or business lines. The proceeds generated from these sales generally fall short of satisfying all pre-petition secured and unsecured claim obligations. As a result, bankruptcy estate fiduciaries seek to recover cash from other sources, which can include the proceeds from preference and fraudulent conveyance actions and other litigations. In order to make any litigation worthwhile, the potential target must be a deep enough pocket to satisfy and make payment on any damage award. With this in mind, estate professionals have increasingly turned their sights to the deepest pocket in this landscape – the private equity firms that currently or formerly own the company in Chapter 11.

Private equity firms are increasingly finding themselves defending their pre-petition acts in the bankruptcy court forum. Commonly, such suits have been brought on account of alleged fraudulent conduct in connection with pre-petition dividend recapitalisations or breaches of fiduciary duties. Some examples include:

In re Powermate Corporation (Bankr. D. Del). In August, 2008, the official committee of unsecured creditors sued an affiliate of Sun Capital alleging, among other things, actual and constructive fraud and breach of fiduciary duties on account of a pre-petition dividend recapitalisation. If successful, the creditors committee could recoup tens of millions of dollars from the private equity parent for the benefit of its constituency.

In re Brown Schools (Bankr. D. Del). In June 2008, the Delaware bankruptcy court concluded that while 'deepening insolvency' is not an independent cause of action, it may be considered as a measure of damages in evaluating conduct that inappropriately prolongs the life of an insolvent entity if a separate cause of action (such as breach of fiduciary duty, etc.) can be established.

In re Refco (S.D.N.Y.). In August 2007, the bankruptcy court appointed trustee sued Thomas H. Lee Partners for breach of fiduciary duty, unjust enrichment, receipt of illegal dividends, fraudulent conveyance and preferences. The suit sought hundreds of millions of dollars in damages and penalties. The crux of the trustee's claim was that Lee overlooked 'red flags' when it acquired the company and took dividends out of the company at the expense of unsecured creditors.

In re KB Toys (Del. Ch.). In 2005, after confirmation of a Chapter 11 plan, a creditor sued Bain Capital in Delaware Chancery Court alleging breach of fiduciary duty in connection with a pre-petition dividend re-

capitalisation which the creditor argued rendered the company insolvent. The creditor sought recovery of, among other things, the amount due on a \$45m PIK note (issued in connection with the original buyout). Without reaching the merits of the suit, the Delaware Chancery Court dismissed the complaint because the cause of action was derivative in nature and could only be brought by the KB Toys bankruptcy estate.

More recently, on 2 September 2008, Mervyn's LLC (a Chapter 11 debtor) sued, among others, its former private equity owners – Cerberus Capital Management and Sun Capital Partners – for a fraudulent conveyance. The complaint was not brought on account of a dividend recapitalisation, but on the grounds that the acquisition of Mervyn's in 2004 'stripped' the department store retailer's valuable assets (owned store locations and below market leases), separated the real estate assets from the retail business with the resulting economic upside benefiting the private equity sponsors and not Mervyn's. Mervyn's seeks a judgment from the bankruptcy court on various prayers for relief and damages including \$1.175bn.

What these lawsuits tell us is obvious: in these difficult economic times there is no one outside the cross-hairs of bankruptcy estate fiduciaries looking for recoveries for their constituencies. And private equity firms that have profited from investments and acquisitions of portfolio companies that are now or will be in Chapter 11 will continue to be one of the prime targets. Based upon the realignment of Wall Street that has been taking place over the past several months (especially during the second week of September) and the continued lack of market liquidity, most crystal balls should be predicting more companies moving into or closer to Chapter 11. In that event, fair or unfair, private equity firms should expect to remain targets and prepare themselves to defend their actions in connection with portfolio companies that file for Chapter 11.

The US is an adversarial legal system and, as such, anyone with a non-frivolous claim or cause of action can bring a law suit against someone else. In this environment, it is easy to speculate that the litigations brought to date, which challenge the very nature private equity firms structure their acquisitions and seek to disgorge the very profits earned by their acquisitions, will deter private equity firms from making future investments. However, it may also be that private equity firms will view the future through a slightly refined prism. Specifically, rather than retreating from investments, private equity firms will dig in and continue with their strategies but sink more time and effort into carefully evaluating their acquisition structures, adhering to their fiduciary duty obligations and accept the principle that the defence of litigations brought by bankruptcy estate representatives is a cost of doing business. Only time will tell how and whether private equity firms will alter their strategies as a result of these litigations. Given the significant profits historically generated from these transactions, it is unlikely that they will be quickly abandoned. ■

Geoffrey T. Raicht is a partner in the Corporate Restructuring and Insolvency group at McDermott Will & Emery LLP.

He can be contacted on +1 (212) 547 5679 or by email: graicht@mwe.com