Delaware Bankruptcy Decision Upholds Loan By Private Equity Firm to Portfolio Company

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In a recent decision, the U.S. Bankruptcy Court for the District of Delaware held that secured loans made by a minority equity investor in a distressed company were true debt transactions, and should not be subordinated or recharacterized as equity in the company's bankruptcy.[1] The Court also permitted the investor to credit-bid its loans to acquire the company's assets at a bankruptcy auction. Although the investor had been accused by the company's unsecured creditors' committee of engaging in a "loan to own" scheme, and of exercising control over the company, the court found that the investor had acted in "good faith" throughout its dealings with the company, "with a view to maximize [the company's] value to all constituents."[2]

BACKGROUND

In the summer of 2005, Radnor Holdings sought to raise a combination of new debt and equity to fund working capital and an expansion of its growing business. The transaction was shopped in the marketplace by Radnor's placement agent. Tennenbaum Capital Partners was ultimately selected and it lent Radnor $95 million in secured debt and purchased $25 million in preferred stock, accompanied by warrants that allowed Tennenbaum to own certain levels of Radnor common stock and obtain increased board representation depending on the company's EBITDA performance. The preferred stock purchase also gave Tennenbaum the right to designate one board member (of a four member board), and one board observer, rights it exercised, as well as the right to increase its representation on the board if Radnor failed to achieve certain EBITDA levels, a right it never exercised.

Radnor fell well short of its projected financial performance. In the spring of 2006, it faced a cash crunch, and at Radnor's request, Tennenbaum agreed to lend an additional $23.5 million in secured debt to meet Radnor's short term liquidity needs. In July 2006, Radnor's revolving lenders cut off funding under its working capital facility, leaving the company no alternative but to file for bankruptcy. At Radnor's request, Tennenbaum provided a stalking-horse bid on Radnor's assets. Radnor convinced Tennenbaum that without such a bid, the bankruptcy case would go into "free fall," which would lead to a significant loss of value for all stakeholders.

The creditors' committee sued to prevent Tennenbaum from credit-bidding its debt investment, alleging that Tennenbaum engaged in an "improper and inequitable strategy to acquire" Radnor's assets through its investments in the company and improperly exercised "substantial control" over

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1 *Official Comm. of Unsecured Creditors of Radnor Holdings v. Tennenbaum Capital Partners*, __ B.R. __ , 2006 WL 3346191 (Bankr. D. Del. Nov. 17, 2006) ("*Radnor*").

2 *Radnor,* 2006 WL 3346191, at * 16.

Radnor's business affairs. The committee asked the court to subordinate or disallow Tennenbaum's loans, or recharacterize them as equity.[3]

After two months of pre-trial discovery and an eight-day trial, Judge Peter Walsh, a veteran Delaware Bankruptcy judge, issued a decision in favor of Tennenbaum on all counts of the committee's complaint. The committee immediately appealed.[4] Four days after issuing his decision, Judge Walsh approved the sale of Radnor's assets to Tennenbaum.[5] Tennenbaum completed its acquisition of Radnor's assets on December 1.[6] The committee appealed Judge Walsh's sale order that same day, and both appeals are currently pending.[7]

DECISION AND ITS PRACTICAL IMPLICATIONS

The most significant aspect of the *Radnor* decision is Judge Walsh's refusal to recharacterize Tennenbaum's loans as equity investments. Generally, a court may recharacterize a loan as equity if it determines that the parties intended it to be, and subsequently acted as if it were, an equity investment. The overarching inquiry "in a recharacterization case is the intent of the parties at the time of the transaction," measured by the terms of the transaction documents, the facts and circumstances surrounding the making of the loans and the economic reality of the circumstances.[8]

The Court found that both loans were intended to be, and were in fact, true debt and not equity. Tennenbaum and Radnor consistently referred to the loans as debt transactions; the transaction documents contained typical loan terms (fixed maturity date, fixed interest payments, default provisions, no voting rights); and the loans were treated as secured debt instruments, the proceeds of which Radnor used for working capital and to pay down existing debt. Judge Walsh rejected the committee's "loan to own" allegation because Tennenbaum made a significant equity investment at the time of the first loan transaction. Judge Walsh also rejected the argument that recharacterization was warranted because "no prudent lender" would have loaned money to Radnor, noting that at the time of the initial loan, Radnor shopped around in the marketplace and "may have been able to borrow a similar amount from another lender, based on the number of interested investors."[9] Even

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3 *Complaint*, Adv. No. 06-50909 (PJW) (Oct. 31, 2006).

4 *Notice of Appeal*, Adv. No. 06-50909 (PJW) (Nov. 20, 2006).

5 *Sale Order*, Case No. 06-10894 (PJW) (Nov. 21, 2006).

6 *Business News in Brief: Tennenbaum Capital Completes Radnor Holdings Deal*, Phila. Inquirer, Dec. 1, 2006, at D3.

7 *Notice of Appeal by Official Comm. of Unsecured Creditors of Order Approving Sale of Substantially All of Debtors' Assets*, Case No. 06-10894 (PJW) (Dec. 1, 2006).

8 *Radnor,* 2006 WL 3346191, at *13.

9 *Radnor,* 2006 WL 3346191, at *5, *14.

more significant was that in rejecting the "no prudent lender" argument, the Court said that it is "legitimate for an existing lender to extend additional credit to a distressed borrower as a means to protect its existing loans."[10] The Court's statement in support of lenders lending additional amounts in distressed situations helps to undo some of the damage caused by some earlier recharacterization decisions, decisions which unreasonably burdened lenders facing a recharacterization attack with showing that their rescue loans would have been made by new third party lenders.

Judge Walsh determined that Tennenbaum's designation of one board member, which flowed from its minority equity position, did not put the firm in control over Radnor's operations or its board and was therefore immaterial to the issue of recharacterization.[11] He found particularly relevant the facts that the Tennenbaum director abstained from voting on the board's decision to accept the second Tennenbaum loan and resigned from the board before Radnor and Tennenbaum negotiated the stalking horse bid. Judge Walsh further noted that the uncontroverted testimony established that the Tennenbaum director "consistently acted in the best interest of Radnor."[12]

Judge Walsh's decision is very helpful to private equity and similar investors who provide either an initial investment in a company or a follow-on investment partly in the form of debt. We caution that Judge Walsh did not address whether a loan made by a private equity fund or similar investor that has majority ownership and control of the board would be recharacterized as equity. But the case does provide some comfort to an individual firm in a consortium that collectively has control of a company, where the individual firm provides additional financing and the other firms do not.

It is also important to note that Judge Walsh's decision turned primarily on the scrupulous and well-documented process Tennenbaum followed in avoiding conflicts of interest when investing in Radnor. The absence of a factual record of operating or board control or misconduct preserved Tennenbaum's debt investment and gave Judge Walsh a basis to conclude that Tennenbaum had acted in good faith and should be permitted to purchase Radnor's assets.

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10 *Radnor,* 2006 WL 3346191, at *14.

11 *Radnor,* 2006 WL 3346191, at *9, *14.

12 *Radnor*, 2006 WL 3346191, at *9.