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Recent Developments in Acquisition Finance

by Jeffrey M. Katz and Scott M. Zimmerman

Certain recent legal developments will likely impact acquisition finance. This article will survey some of the more notable ones.

We discussed in the last newsletter the Eleventh Circuit Court of Appeals' decision in *In re Tousa*,[1] in which the court affirmed a bankruptcy court decision ordering the return of more than $400 million that had been repaid to prior lenders of a parent company in connection with a subsequent secured financing to the parent and its subsidiaries. Among the key elements of the decision were findings that the subsequent financing was a fraudulent transfer in respect of the subsidiaries not obligated on the loan to the parent entity repaid with the proceeds of the financing, and that various of these subsidiaries were or became insolvent at the time of such financing, despite representations and opinions as to their solvency given at the time.

A recent decision of a U.S. District Court in Indiana highlights some of the risks stemming from *Tousa* in the acquisition finance context, particularly for leveraged buyout financing.

In *Mathioudakis v. Conversational Computing Corp.*,[2] the District Court refused to dismiss an action to hold an individual, who was both the controlling shareholder and chief executive officer of a corporate borrower, personally liable for a loan made to the corporation which he had not personally guaranteed, on a theory of "piercing the corporate veil." Ordinarily the lack of a personal guarantee for a corporate loan would mean a lack of personal liability for control persons and executives on the corporate loan. The court's decision to "pierce the veil" and hold the individual personally liable was based on both an intentional misrepresentation by the individual to the lender on which the lender relied, and the undercapitalization of the corporation at the time of the loan.

In 2005, defendant Stephen Rondel, founder and chief executive officer of Conversational Computing Corp., requested and received a loan from plaintiff Michael Mathioudakis, based on Rondel's representation that his company was about to receive a substantial wire transfer from a foreign investor and was in need only of short-term financing in order to meet upcoming payroll. Rondel represented that the wire transfer was all set, and was being held up only on account of procedural issues relating to Patriot Act requirements that would be resolved quickly. The loan was made to the company and, as noted, not guaranteed by Rondel personally.

The corporate borrower never received any of the foreign investment as Rondel had represented, defaulted in repayment of the loan to the lender, filed for bankruptcy protection, and was found by the bankruptcy

court to have been undercapitalized at the time the loan was made. On the basis of Rondel's intentionally misleading the lender into believing a substantial foreign investment in the company was imminent, when nothing of the sort was the case, and the finding that the corporate borrower was undercapitalized at the time, the court refused to dismiss plaintiff lender's action for personal liability against Rondel on a theory of piercing the corporate veil, notwithstanding the absence of his personal guarantee of the loan.

Under a strict reading of the court's decision, which applied Indiana state law on veil-piercing, the court held that the undercapitalization and intentional misrepresentation alone were enough, as a matter of law, not to dismiss the action for personal liability against Rondel. Whether the executive making the misrepresentation was also the controlling shareholder seemed not directly relevant to the court's analysis, so long as the injustice or fraud perpetrated by the misrepresentation was sufficient. Indiana state law requirements for veil-piercing are easier to satisfy than the corresponding requirements of many other states, including New York, for example, where there is a strong line of authority limiting successful veil-piercing to claims against controlling shareholders. Between New York, where this and other more stringent requirements for veil-piercing apply, and Indiana, where cases have allowed such claims to go forward against non-shareholders and under somewhat looser criteria generally, lie a host of other states' laws falling at various points along the continuum of veil-piercing requirements.

In terms of the issue of solvency of the various obligors in a borrowing group in the acquisition finance context, such issue is fundamental, especially in leveraged buyout financings featuring liens granted by the target entities, where the proceeds typically are used by the acquiror to finance the acquisition, and will not be paid to or held by or for the benefit of the target entities. Under the rationale of *Tousa*, to the extent any of the relevant entities is rendered insolvent by the financing, there is a risk that the financing could be unwound as to such entity on fraudulent transfer grounds.

In this light, some financing arrangers have begun requesting that borrower groups make solvency representations for each entity in the consolidated group on a stand-alone basis. Such a representation has not yet by any means become market practice, or even common for that matter. However, if a borrower should consider making such a representation individually for one or more of the relevant subsidiaries serving as guarantors, it will need to be very cautious in doing so, especially given the rationale of a case such as *Mathioudakis*. For if a solvency representation for a particular entity within a consolidated borrower group is deemed by a court (after the fact) to have been intentionally misleading, or perhaps made even with a reckless disregard as to whether it was true, such misrepresentation and insolvency together, under the rationales of *Tousa* and *Mathioudaki*s, may potentially give rise to assertions of personal liability against the executive who made the false representation as to solvency, at least where a lender could show reasonable reliance on it.

Insolvency and undercapitalization are not identical concepts, of course; yet they are related notions. Insolvency for fraudulent transfer purposes is most often determined on a balance-sheet basis, in terms of the fair value of assets over liabilities on the date in question, whereas undercapitalization generally refers to whether an entity has sufficient capital to run its business given its ongoing access to and sources of capital. In a case in which an entity is determined by a court to have been insolvent for fraudulent transfer purposes, it may be difficult persuading the court that the entity was not also undercapitalized, if the court is considering the issue of veil-piercing asserted by a party in interest.

Tousa is a decision of the Eleventh Circuit Court of Appeals, and *Mathioudakis* one of the U.S. District Court in Indianapolis that applied Indiana state law in its veil-piercing analysis, so there is not much in terms of direct precedential effect for cases in the second and third Federal circuits (including New York and Delaware, respectively). Still, these are potentially significant developments that could lead in certain cases to claims of personal liability that otherwise would seem wholly without merit. Such a claim might be asserted in a case featuring an eclectic mix of variables including a liberal state law on veil-piercing, solvency representations made by a principal executive in respect of an individual entity or entities found to have had little or no basis in fact, a court considering the solvency of individual entities in a consolidated group independently under a *Tousa*-type analysis, and thin capitalization and insolvency of the relevant entity or entities.

A recent decision by the Second Circuit Court of Appeals,[3] in the context of an initial public offering (IPO) of a previously acquired target, provides a measure of clarity for

contracting parties regarding enforceability of certain contractual rights.

Tyco International Inc. (Tyco) had acquired CIT Group Inc. (CIT) in 2001. In the following year Tyco chose to spin off CIT in an IPO, in connection with which CIT would be merged into a Tyco subsidiary that had $800 million of net operating losses (NOLs) that could be used to offset CIT's future tax liabilities. CIT agreed to pay Tyco for its use of these NOLs.

CIT filed for bankruptcy in 2009, before utilizing all the NOLs, and in the bankruptcy process rejected its prior agreement with Tyco obligating it to pay for the NOLs. Tyco accordingly asserted a claim against CIT for breach of contract, typical for contracts rejected by a debtor in a bankruptcy case. However, CIT argued that Tyco's asserted damages ultimately arose in connection with the purchase and sale of CIT equity in the IPO, and should thus be treated like equity interests and subordinated to the claims of CIT's other creditors, under Section 510(b) of the Bankruptcy Code. That section accords a claim for damages arising "from" the sale of common stock with only the priority of an interest in common stock. Tyco asserted that its claims were ordinary breach of contract claims, *i.e.*, obligations, and not equity interests.

The bankruptcy court, affirmed by the Second Circuit, agreed with Tyco and held that Tyco's claims not be treated as equity merely because they had some connection to the purchase and sale of equity in CIT's IPO. The Bankruptcy Code's subordination of claims arising from breach of a contract for the sale or purchase of equity is based on the notion that a party to such a contract with a debtor has the expectations of a shareholder rather than a creditor, and should thus not be allowed to receive a higher priority on account of the breach of an agreement to become a shareholder of the company. Tyco's claim, however, related to its transfer of NOLs to CIT, not to the purchase or sale of equity in CIT. Accordingly, the court allowed Tyco to pursue an unsubordinated debt claim against CIT. The Second Circuit upheld the decision of the bankruptcy court utilizing the same rationale.

This decision is noteworthy because a contrary ruling by the Second Circuit would have created uncertainty for contracting parties in such instances, where their agreement with a debtor is not for the purchase or sale of equity, but consummated within the context of an equity transaction by the debtor. If a tangential connection to an equity transaction would effectively subordinate a party's contractual claim against the entity in question to claims of its other creditors, the same might become an additional hindrance to transacting business with a stressed or distressed entity. The Second Circuit avoided this result with its ruling.

A recent District of Arizona bankruptcy court decision[4] may tip the scales to some degree in favor of a debtor trying to stave off a secured creditor pursuing a loan-to-own strategy in a chapter 11 case.

In this case, the court refused to disqualify a creditor's vote approving a debtor's proposed chapter 11 plan of reorganization, where the debtor and creditor seemingly had cooperated, first, in impairing the creditor's claim in a minor fashion, and then classifying that claim separately, for the apparent purpose of meeting the chapter 11 condition that at least one impaired class approve the plan of reorganization. The plan thus would be confirmable over the objections of other classes of creditors, by having satisfied that condition under the Bankruptcy Code for confirming a plan over such objections.

BATAA/Kierland, the debtor, in the period leading up to its chapter 11 filing, financed its purchase of certain computer equipment and, after the filing, agreed with the lender that the interest rate on the loan would be reduced to 5% from 8%. The loan was classified separately by the debtor and also classified by the debtor as impaired in its reorganization plan, and the equipment lender then proceeded to approve the plan. A disapproving creditor challenged the separate classification, claiming that the debtor had colluded with the lender in bad faith to artificially create an impaired creditor class that would vote to approve its plan of reorganization. The challenging creditor claimed that the equipment lender's vote in favor of the plan was not made in good faith and should be disqualified (or "designated"), asserting that the equipment lender's approval was given merely to increase its prospects for future business with the debtor on its emergence from chapter 11.

The court was unwilling to consider possible ulterior motives of the debtor or the equipment lender, and found that the lender's voting for plan approval to enhance its prospects for future business with the debtor was in fact a legitimate objective of the equipment lender, because it had acted in its own enlightened self-

interest and as a creditor. The court found no indication of fraud or attempt by the lender to obtain more than it otherwise was entitled to under the Bankruptcy Code.

The court also held that it was not improper for the debtor to have created, in contemplation of its bankruptcy filing, a new creditor class that it believed would be receptive to its reorganization plan, and that it would not inquire into the debtor's motives for classifying and treating different claims as it did nor consider alternate classification and treatment alternatives the debtor might have employed. The court cited the decision of the Second Circuit Court of Appeals in *In re DBSD North America, Inc.*[5] in support of its decision, a case we had discussed in an earlier newsletter.

The case supports a debtor's ability, at least in some measure, to creatively classify its claims in coordination with certain favored creditor constituencies in order to enhance prospects of confirming its proposed plan of reorganization, and to begin laying the ground for this ahead of its bankruptcy filing. This could potentially frustrate the objectives of other creditors, which otherwise may be well-situated to control the case and have their own plan of reorganization approved. For example, a secured creditor whose claim is impaired and holds what appears to be the fulcrum security in the case, potentially could be thwarted or delayed by a plan of reorganization proposed by the debtor that is approved by another impaired creditor class creatively classified by the debtor and structured in coordination with it. This potentially could occur in a case in which a bankruptcy judge can find the technical criteria for plan confirmation over creditor objections satisfied, and where the objecting creditor pursues a type of distressed or other investment strategy that the judge in question does not admire.

A final note follows up on an item previously reported, and concerns new Treasury Regulations that apply to debt instruments issued on or after November 13, 2012, expanding the definition of when a debt instrument is considered to be "publicly traded" for purposes of determining its issue price. The determination of the issue price of a debt instrument can have a significant impact both on the borrower and on the holder of the instrument. It is particularly important in the case of a debt-for-debt exchange, including when an amendment of debt causes a "significant modification" for U.S. federal income tax purposes (treated as a taxable exchange of hypothetical "old" debt for hypothetical "new" or amended debt). In such circumstances, the amount of the issue price of the "new" or amended debt instrument is of great importance because

1. the amount of original-issue discount associated with the "new" or amended debt instrument is determined based on the difference between the instrument's issue price and its stated redemption price at maturity,
2. the issue price is used to determine whether the borrower has (and the amount, if any, of) cancellation-of-debt income taxable to the borrower resulting from the exchange, and
3. the determination of the holder's gain or loss from the exchange depends on whether the holder's basis in the "old" debt instrument is greater or less than the issue price of the "new" debt instrument.

The new regulations could be relevant, for example, in the case of a portfolio company amending its loan agreement for covenant relief, in exchange for fees or increased loan pricing. The new regulations increase the likelihood that a loan amendment could result in substantial cancellation-of-debt income for the borrower, depending on the amount of discount (if any) at which its debt was trading and other factors. A borrower considering an amendment to its loan documentation should therefore carefully consider possible tax implications and the possible impact of these new regulations.

We look forward to updating you on additional developments in the next issue.

Footnotes

1 *In re Tousa, Inc.*, 680 F.3d 1298 (11th Cir. 2012).

2 *Mathioudakis v. Conversational Computing Corp.,* 1:12-cv-00558, 2012 WL 4052316 (S.D. Ind. Sept. 13, 2012).

3 *In re CIT Group Inc.*, 479 F.App'x 393 (2d Cir. 2012).

4 *In re BATAA/Kierland, LLC*, 476 B.R. 558 (Bankr. D. Ariz. 2012).

5 *In re DBSD North America, Inc.,* 634 F.3d 79 (2d Cir. 2011).

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