Hedge Funds: Lessons Learned from the *Radnor* Decision

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There's a new player seated at the financial table: hedge funds. While hedge funds "were originally designed to invest in equity securities and use leverage and short selling to 'hedge' the portfolio's exposure to movements of the equity markets, hedge funds utilize a wide variety of investment strategies and techniques."[1] Many hedge funds are very active traders of debt and equity securities and have been showing up more often in the market for distressed investments, which leads them to be involved in bankruptcy proceedings.

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Hedge funds can participate in a bankruptcy case in a variety of ways, including (1) members of bank syndicates holding first- and second-lien debt, (2) buyers of distressed unsecured debt, (3) debtor-in-possession (DIP) lenders, (4) purchasers of claims or equity or (5) sponsors of a reorganization plan. Accordingly, hedge funds are also the new players seated at the bankruptcy table. While some demonize hedge funds, others view hedge funds as particularly useful in the restructuring context because they are not constrained to make only one single type of investment and are not bound by banking regulations, which makes them much more nimble than traditional lenders and able to adapt their strategies to the particularities of a debtor and its creditor constituencies. This article seeks to explore the nature of hedge funds, their participation in the bankruptcy process (and some words of caution about future litigation against hedge funds) and a recent bankruptcy case in which hedge funds played a significant role.

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What Exactly Is a Hedge Fund, Anyway?

Looking to the Wikipedia[2] definition: A hedge fund is a lightly regulated private investment fund charging a performance fee and typically open to only a limited number of investors. The term "hedge fund" is not a specific legal one but is used to distinguish lightly regulated funds generally open to only a limited number of investors, from retail investment funds, which are widely available to the general public, including "mutual funds." Retail funds are generally limited to being "long" in the market by buying instruments such as bonds, equities or money market instruments, and may have a limited ability to enter into derivative contracts. Hedge funds do not suffer such restrictions and are limited only by the terms of the contracts governing the particular fund. Depending on their "investment guidelines" and the "style" of the fund, hedge funds may enter into futures, swaps and other derivative contracts. In this way, hedge funds are able to create more complex investment strategies which may, for example, profit in times of market volatility, or even in a falling market. Because of usual limits on investor numbers of minimum investment amounts, hedge funds are normally open only to professional, institutional or otherwise accredited investors.

Hedge Funds and the Bankruptcy Process

Jo Ann J. Brighton

Debtors in bankruptcy have never been as highly leveraged as they are right now. The trend in chapter 11 cases is an increasing number of quick going-concern §363 sales of assets followed by confirmation of a liquidation plan, rather than a negotiated reorganization plan. In contrast to the negotiated plan where many disputes are resolved through negotiation and distribution rather than litigation, a quick §363 sale can leave unsecured creditors with nothing if the sale proceeds are insufficient to pay even the secured debt in full. Never before have creditors had more incentive to be as creative—and aggressive—as possible in order to create any meaningful recovery for unsecured creditors in bankruptcy cases. A creditors' committee that is unable to negotiate an "*SPM*[3] carve-out" from the sale proceeds for the benefit of unsecured creditors is left with either (1) trying to stimulate a competitive auction process that will generate a surplus after secured debt has been paid in full or (2) little more than the ability to establish a litigation trust that will be able to pursue preferences, fraudulent transfers and causes of action that might exist against the pre-petition actors in the saga that brought the debtor to its financial knees.

The likely targets for scrutiny, and hopefully some recovery from D&O insurance proceeds, are the officers and

1 "The Differences Between Mutual Funds and Hedge Funds," *Investment Company Institute*, March 2005.

2 Wikipedia® is a registered trademark of the Wikimedia Foundation Inc.

3 *See Official Creditors' Committee v. Stern (In re SPM Manufacturing)*, 984 F.2d 1305 (1st Cir. 1993).

directors, as well as others who are arguably in control of the debtor. The "mortar fire" approach and search for a deep pocket of recovery against those in control of a company harkens back to the days of lender-liability litigation, when creditors or equityholders would launch a panoply of accusations at the secured lender when a loan went into default and the secured lender took any action to recover on its loan.

With the backdrop of the changing nature of bankruptcy cases, the quick sale of assets in bankruptcy cases and the incentive for creative and aggressive litigation against officers and directors (and others in control), hedge funds have entered the bankruptcy arena. New filings are likely to have hedge funds in various parts of the debtor's capital structure. In addition, hedge funds hold a large volume of ready capital, which can fund a §363 sale, provide DIP financing or purchase "reorganization equity." A new phrase referred to as "loan to own" has recently cropped up, referring to the more aggressive strategies being pursued by hedge funds. Notably, hedge funds lending in a bankruptcy scenario generally have different goals than traditional lenders—they do not necessarily need to look at the long-term prospects of a particular business. Hedge funds may be looking to throw some needed cash into a company, bump up the price of the loan or the assets a few points, sell it quickly and then get out. In fact, the hedge fund's own structure may require the short-term perspective. These authors believe that hedge funds are likely to be a ready target for a new type of lender-liability mortar fire litigation: The combination of aggressive lending strategies, participation in equity and very deep pockets surely points to a bull's eye on hedge funds. For example, if the hedge fund is a holder of both debt and equity, a DIP trying to reorganize its business using the special tools available in a bankruptcy case or an organized creditor constituency looking to enhance its recovery will take advantage of the mixture of interests held by the hedge fund to frame any possible argument to enhance its leverage against the hedge fund. For example, are there good-faith issues in the "loan-to-own" situations or in a hedge fund essentially propping up a company for a short term return on investment ultimately to the detriment of creditors? Can hedge funds be responsible for the deepening insolvency of a company? Can the actions of hedge funds control a company in such a way as to create equitable-subordination concerns? What about when hedge funds are in two (or more layers) of debt—can the claim be consolidated into one claim? Recently, a hedge fund came under fire in a decision handed down on Nov. 16, 2006, in the chapter 11 cases of *Radnor Holdings Corp., et al* in Delaware.[4]

The Radnor *Bankruptcy Cases*

When Radnor had financial problems, hedge fund Tennenbaum Capital Partners LLC, along with two of its affiliated hedge funds (collectively referred to as TPC), got involved at the invitation of Lehman Brothers, which had been hired as Radnor's investment banker. TCP made a commitment to purchase $25 million of preferred stock in Radnor and to loan Radnor an additional $95 million on a secured basis. The preferred stock investment closed first with TCP acquiring warrants that would allow TCP to own up to 15.625 percent of Radnor depending on EBITDA performance. As is common with an equity investment,

[4] *The Official Committee of Unsecured Creditors of Radnor Holdings Corp., et al. v. Tennenbaum Capital Partners LLC; Special Value Expansion Fund LLC; Special Value Opportunities Fund LLC and Jose E. Feliciano* (*In re Radnor Holdings Corp., et al.*) Adversary Proceeding No. 06-50909, Chapter 11 Case No. 06-10894 PJW (Bankr. D. Del. Nov. 2006).

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TCP entered into an investor's rights agreement pursuant to which it obtained the right to (and did) designate one of the four members of Radnor's board of directors, to increase that representation if certain levels of EBITDA were not met, and to veto certain employment agreements and transactions with affiliates. At all times, however, TCP held less than 20 percent of the equity of Radnor.

The secured loan TCP made to Radnor was used to refinance Radnor's existing $70 million of senior secured notes, to pay down $4.7 million of equipment loans, to pay down the existing revolving credit facility and to fund working capital and growth initiatives.[5] TCP later provided Radnor with an additional secured loan of $23.5 million enhanced in part by the personal guaranty of Radnor's largest shareholder. TCP thus found itself occupying both debt and equity positions in Radnor as well as participating in management by appointing a designee to the Radnor board.

The ensuing months presented a somewhat common story of a company's fall into chapter 11. As raw material and energy prices escalated, Radnor was unable to pass along all of the cost increases to its customers. As a result, it failed to meet its EBITDA forecasts, money became tight and the covenants in the secured loan were breached. Running out of options, Radnor again turned to Lehman Brothers for recommendations. The result was the entry into an asset-purchase agreement and a DIP credit agreement with TCP. The DIP credit agreement allowed Radnor the funds to survive during a §363 sale process. The asset-purchase agreement allowed TCP to purchase all of Radnor's assets as a going concern and to use its secured claims to credit bid in the §363 process. The Radnor board formed a special committee consisting of its only independent director to evaluate the two agreements. The special committee engaged counsel to analyze the validity of the TCP-secured loans as well as to "analyze and advise the special committee as to whether any facts or circumstances which would otherwise warrant re-characterization or equitable subordination" of TCP's pre-petition secured loans. The hiring of counsel to the special committee was made the subject of a first-day motion.[6] The chapter 11 was filed on Aug. 21, 2006, the DIP facility was entered into, the bid procedures motion was filed and the creditors' committee was given a short timeframe to request that Radnor bring an action against TCP.

The creditors' committee faced a daunting task. There was little time to act, let alone investigate. A failure by the creditors' committee to act would likely result in no recovery for unsecured creditors. The DIP facility would not sustain operations long enough to negotiate a reorganization plan. The creditors' committee was concerned that TCP's ability to credit-bid could scare away other bidders wary of spending the time and money to put forth a competing offer and bid deposit only to see TCP up its offer using more of its secured claims rather than new money.

However, the creditors' committee proceeded undaunted. By mid-October, it filed a motion requesting and received authority to sue TCP on behalf of the debtors. It obtained and filed reports from experts to the effect that:

- the special committee did not meet the rigorous standards of independence and disinterestedness that are expected by Delaware courts;
- the asset-purchase agreement and the DIP credit agreement gave TCP an option to acquire Radnor at a discount to its fair market value by giving TCP access to nonpublic information that allowed TCP to value Radnor more accurately than other bidders and to drive away competing bidders; and
- Radnor was insolvent at all relevant times, was left with an unreasonably small capital with which to conduct its business and the unsecured creditors suffered damages in excess of $158.6 million as a result of the diminution in the assets available to satisfy the claims of Radnor's unsecured creditors.

The Complaint

In its ensuing complaint, the creditors' committee accused TCP of having entered into the loans with no expectation of Radnor being able to repay them, but rather as a way to acquire Radnor, a so-called "loan to own" strategy. In the creditors' committee's

5 These facts and others used in this article are taken from the "Amended Findings of Fact and Conclusions of Law," issued on Nov. 17, 2006, by Hon. Peter J. Walsh, U.S. Bankruptcy Judge for the District of Delaware (Adversary Proceeding No. 06-50909).

6 *See* debtor's application for order under Bankruptcy Code §§327(e) and 1107(a) and Bankruptcy Rules 2014 and 2016 authorizing employment and retention of Wilmer Cutler Pickering Hale and Dorr LLP as special counsel to the company acting through the special committee of the board of directors of Radnor Holdings Corp. *nunc pro tunc* to Aug. 25, 2006, dated Sept. 1, 2006.

view, TCP insisted on terms for the secured loan that it knew Radnor could not meet and that guaranteed the loan would go into default. In its lawsuit, the creditors' committee, sought to:

- re-characterize TCP's secured loans to Radnor as equity or, as an alternative, to equitably subordinate TCP's secured claims to the claims of the general unsecured creditors;
- recover from TCP for breaches of its duty of care and duty of loyalty as a *de facto* controlling shareholder of Radnor;
- recover from TCP's designated director on Radnor's board for breach of his duties of care and loyalty and recover from TCP for aiding and abetting those breaches;
- prohibit TCP from using its $128 million in secured claims to make a credit bid on the sale of Radnor's assets;
- avoid as fraudulent transfers the grant of security interests by Radnor in favor of TCP on the basis that they were made with the actual intent to hinder, delay or defraud creditors;
- disallow TCP's proofs of claim;
- avoid TCP's liens; and
- recover as preferences monies Radnor had paid to TCP more than 90 days but less than one year prior to Radnor's bankruptcy filing on the basis that TCP was an insider of Radnor.

At the end of the lengthy trial, Bankruptcy Judge Walsh found that the creditors' committee had not proven its case and that existing statutes or case law precluded it from succeeding. The bankruptcy court held against the creditors' committee and in favor of TCP on all counts—a result that likely caused many a cheer from the secured-lending community and boards of directors everywhere. Further, the decision will likely cause secured creditors and boards of directors to continue to look kindly on Delaware as a venue of choice for bankruptcy cases. It will be interesting to see if future debtors will take into account the perspective of the Delaware Bankruptcy Court, and the seemingly high bar it has set for re-characterization and other claims against hedge funds, when determining where to file a bankruptcy case.

There are a number of important lessons for hedge fund investors in the Bankruptcy Court's decision in *Radnor* including:

- While re-characterization was a difficult cause of action to prove in the past, Judge Walsh has made it even more difficult in that he expanded the focus with respect to the intent of the parties. Judge Walsh utilized the established factors for a recharacterization action pursuant to *Submicron* and *AutoStyle Plastics* and determined that recharacterization should focus on the question of the parties' intent at the time of the transactions. If the parties intended a loan, then the court will not re-characterize the loan debt as equity. However, to determine the parties' intent, the court may look at various factors, and in doing so the court found that they favored a conclusion that debt was intended:
  - The transaction documents referred to the obligations as debt;
  - The parties consistently referred to the obligations as "loans" or "indebtedness;"
  - The debt instruments contained a fixed maturity date;
  - The hedge fund lender was given the right to enforce the payment of principal and interest;
  - The transaction documents did not contain voting rights;
  - The loans were treated as priority debt instruments and the proceeds were used for working capital and to replace and/or pay down existing debt; and
  - The transaction documents provided the lender with a security interest given priority in a liquidation or insolvency.

Judge Walsh stated that it is simply not enough to re-characterize a loan on the basis that the borrowers were experiencing a liquidity crisis at the time of the loan.

- TCP's ability to designate a board member and the fact that it designated a board member did not make it an "insider" for purposes of the Bankruptcy Code. While the board member was an "insider" of Radnor, the hedge fund that designated the board member was not.
- The provisions in TCP's credit agreement did not make TCP an "insider" of Radnor. Day-to-day control is necessary for "insider" status, and the opportunity to exercise control, if not exercised, does not made a creditor a person in control, and therefore, not an "insider."
- The TCP-designated director's abstention from voting on matters that involved TCP was a significant factor in protecting that director from a finding that he breached his duty of loyalty to Radnor.
- All allegations that the TCP-designated director breached his duty of care to Radnor failed because Radnor, a Delaware corporation, had a Certificate of Incorporation that contained an exculpation clause permitted by §102(b)(7) of the Delaware corporate laws. (Such a provision being part of the certificate of incorporation should be on the checklist of any prospective director of a Delaware corporation considering taking such a position.)
- TCP obtained solvency certificates from Radnor officers at the time of its loans to, and investments in, Radnor. These helped TCP avoid an "aiding and abetting a breach of fiduciary duty" claim.

Overall, the *Radnor* decision can be construed as a victory for secured lenders and insiders, or those who are alleged to be insiders. A more general observation can also be made with respect to the bankruptcy court's inability to determine that any of the allegations in the complaint were the proximate cause of the damages alleged. Further, computation of the damages would have been a difficult hurdle for the creditors' committee to get over as well.

Conclusion

Clearly hedge funds will continue to provide funds to willing businesses in a variety of forms (*i.e.*, debt—whether secured or unsecured, or senior or subordinated—and equity). As the law of averages implies, combined with the increasing highly leveraged nature of companies these days, a certain percentage of those companies will stumble and wind up in (or near) bankruptcy. The question is not whether hedge funds will be targeted by debtors and creditors for attack as they try to enhance their own position in bankruptcy cases, but rather how long will it take for hedge funds to be at the defendant table in litigation before they get gun-shy and start pulling back—much like secured lenders have done in as a result of the lender liability wave in the '80s. Being forewarned is being forearmed, and the lessons outlined above can help hedge funds structure such investments and act in a manner that protects their investments and decreases the possibility of successful litigation. ■