Distressed Portfolio Companies
Imminent Conflicts of Interest for Private Equity Sponsors

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Part I: Post-LBO Structure of Portfolio Company
**Post-LBO Structure of Portfolio Company (1)**

- **Sponsor**
  - Controls Portfolio Company as (majority) shareholder (Exception: PIPE investments)
  - Has granted equity and/or shareholder loans, but is under no obligation to provide further funding
  - May provide services to Portfolio Company (or may be connected with Portfolio Company by other contractual arrangements)

- **Portfolio Company and Acquisition Vehicle(s) (NewCo(s))**
  - Post-acquisition steps taken to optimize structure
    - Tax unity (*Organschaft*)
    - Merger (*Verschmelzung*)
    - Other debt push-down measures
    - Intra-group debt/cash pool
  - Services acquisition debt and working capital debt
  - Is bound by covenants from debt financing arrangements
Post-LBO Structure of Portfolio Company (2)

- Senior and mezzanine lenders (or holders of high-yield bonds)
  - Receive interest and amortization payments
  - Monitor compliance with covenants
  - Benefit from upstream guarantees and security from various subsidiaries
  - Subordination structure (structural vs. contractual) with intercreditor agreement governing waterfall and seniority of claims
  - Trading of debt (at or close to par)

- Other creditors (depending on business of Portfolio Company)
  - Have an interest to get paid
  - May be interested in continuing business relationships
  - May be secured or unsecured
Post-LBO Structure of Portfolio Company (3)

- **Sponsor**
- **Management Shareholders**
- **Other Minority Shareholders**

**NewCo or two NewCos**

- 100% – Share Pledge
- Various structural measures (merger, etc.) possible

**Portfolio Company**

- **Encumbered Assets**
- 100% – Share Pledges

**Sub A**

**Encumbered Assets**

**Sub B**

**Unencumbered Assets**

**Senior Term Facilities**

**Revolving Credit Facility**

**Mezzanine Term Facility / High Yield Bonds**

**Accession Agreement**

**Majority Shareholder**

**Management Shareholders**

**Other Minority Shareholders**

**Sub C**

**Sub D**
LBO-Structure in an evolving Financial Crisis (1)

- Projections made prior to LBO too optimistic
- Business of Portfolio Company is not developing as expected
  - Economic downturn
  - Negative performance of customers affects Portfolio Company (e.g., automotive suppliers)
  - Other potential negative impacts
- Portfolio Company generates lower EBITDA than projected
- Steering into heavy waters
LBO-Structure in an evolving Financial Crisis (2)

- Result: Default risk under debt financings
  - Covenant breaches
  - Liquidity problems
  - Payment defaults

- Lenders become nervous
  - Early involvement of lenders in case of financial covenant breaches
  - Later in case of covenant lite financings
  - Impact in case of waiver/standstill requests

- Other creditors (e.g., credit insurers) react and increase pressure

- Trading of debt: Distressed debt investors join the syndicates, in some cases with very small investments
Part II: Frame Set of Interests and Typical Conflicts
Key Roles/Interests in Restructuring Negotiations (1)

- Sponsor
  - Initial steps
    - Support negotiations of Portfolio Company regarding waiver/standstill requests or other preliminary measures
    - Subordinate claims under shareholder loans to avoid insolvency of Portfolio Company
  - Restructuring negotiations: Sponsor can take more or less active approach
    - Active: Participate in restructuring (develop restructuring plan/scenario, provide additional equity or debt financing)
    - Active: Act as moderator between the parties, particularly if (national) corporate and insolvency law gives shareholder bargaining power
    - Passive: Limit losses to the extent possible and avoid remaining liabilities
    - Passive: Avoid reputational issues
Key Roles/Interests in Restructuring Negotiations (2)

- Portfolio Company/Management
  - Initial steps
    - Negotiate waiver/standstill requests or other preliminary measures
    - Request other preliminary measures to avoid insolvency
  - Restructuring negotiations: Portfolio Company/Management can take more or less active approach
    - Active: May be under an obligation to file for insolvency
    - Active: May try to shield operating business from LBO debt by raising arguments under financial assistance rules (Repudiation)
    - Active: Protect value, the business and own position
    - Active: Develop restructuring plans/scenarios and facilitate to support restructuring negotiations
    - Passive: Avoid personal liability
    - Passive: Obtain advice/support from auditors, consultants and legal advisors
- In case of in-court restructuring: Insolvency receiver/insolvency court as additional parties
Key Roles/Interests in Restructuring Negotiations (3)

- Lenders (Senior/Mezzanine) and Bondholders
  - Initial steps: Standstills, waivers/amendments, bridge loans/fresh money
  - Restructuring negotiations: Lenders can take more or less active approach
    - Active: Align interests and coordinate actions with other lenders (contact additional lenders and establish lender committees)
    - Active: Large lenders try to preserve value (by leading the restructuring) and to benefit from upside potential
      - Main force in developing a restructuring concept – obtain advice/support from restructuring advisors (restructuring opinion)
    - Passive: Assess situation and own position as secured creditor
      - Request information or bank meetings
      - Develop recovery scenarios (who am I competing with?)
      - Take account of possible subordination of existing loans
      - Sub-Participations: Participants entitled to vote in the syndicate?
    - Passive: Possible nuisance value of small and passive lenders
  - Parties to the negotiations will change due to trades of debt
Typical Conflicts of Interest (1)

- Prior to a financial crisis, interests of Sponsor and Portfolio Company (and its management) are aligned (or can at least be reconciled)
  - All parties rely on same financial projections
  - All parties expect ability of Portfolio Company to service acquisition debt
  - Sponsor is legally authorized to exercise shareholder rights
  - Sponsor may give binding instructions to management (e.g., with respect to payments, guarantees, security, etc.); Management will follow such instructions
  - Sponsor and Portfolio Company share legal and other advice
Typical Conflicts of Interest (2)

- In a crisis, interests of Portfolio Company (and management) and Sponsor regularly differ
  - Management may be obliged to file for insolvency irrespective of Sponsor’s interests; Sponsor cannot prevent filing
  - Management may be obliged to leave cash pool/terminate upstream intra-group financing and reclaim liquidity balance
  - Management may be legally obliged to refuse payments to Sponsor
  - Management may try to repudiate acquisition debt and/or collateral granted in connection with acquisition
  - Special situation if management on NewCo-level and on OpCo-level is identical
  - Portfolio Company may be under pressure to request new equity and/or subordination of claims under shareholder loans granted by Sponsor

- In an insolvency, an insolvency receiver will scrutinize past acts by Sponsor
Typical Conflicts of Interest (3)

- Conflicts of interest may jeopardize a successful restructuring
  - Management of Portfolio Company may be inclined and under a legal obligation to act against Sponsor
    - Loss of control of Sponsor over process
  - Other parties may use conflicts of interest as arguments to maximize own position
    - Lenders’ attempt to draw management on their side
  - Professional advisors (acting for Sponsor and Portfolio Company) can no longer advise if faced with a conflict of interest
    - Ad-hoc change of advisors time consuming and inefficient
  - Liability risks for Sponsor if conflicts of interest are ignored (scrutiny of insolvency receiver!)
  - Damage to reputation of Sponsor if conflicts of interest are ignored (scrutiny of insolvency receiver!)
Part III: Practical Implications
Practical Implications (1)

- Identify potential conflicts in advance
  - Review acts taken in the past
    - Commercial and legal relationship between Sponsor and Portfolio Company will be closely analyzed
    - In particular, past payments to Sponsor may be questioned
    - Clean up the structure to avoid negative impacts for the restructuring process
  - Review performance of management
    - Is management expected to be able to complete restructuring?
    - Is management expected to act against Sponsor?
  - If insolvent restructuring is an option expect that insolvency receiver will closely scrutinize relationship between Sponsor and Portfolio Company – in fact in many cases this will be the main focus of his initial review

- Consider conflicts of interest of advisors and ensure independent advice
Practical Implications (2)

- In restructuring negotiations
  - Transparent approach by Sponsor vis-à-vis other parties with respect to conflicts of interest advisable
  - Conflicts of interest should not be ignored but should be openly addressed
  - If conflicts of interest arise in the course of the restructuring, this may require swift changes to the restructuring concept
Recent Case Studies (1)

- Advice to The Vita Group (“Vita”) and its controlling shareholder TPG Capital in a financial restructuring
  
  • Vita was taken private by TPG Capital in a leveraged buyout in 2005. Its main business lines are petro-chemical based products used in the home furnishing and auto sectors.
  
  • As a result of the restructuring, debt in excess of €600m was written down to approximately €100m in exchange for a 40% equity stake in the restructured group. €95m of new secured debt was provided by new money lenders including TPG Capital which remains the largest shareholder with control of the board.
  
  • The restructuring was implemented using a ‘scheme of arrangement’ under the Companies Act 2006. This is a court process which binds consenting and non-consenting creditors if the proposed restructuring is approved at a specially convened meeting by at least 75% by value and more than 50% in number of each relevant class of those creditors. In certain circumstances, a UK scheme can be used for non-UK companies. In the Vita restructuring the scheme related to a company incorporated in Luxembourg. The court itself must also approve the restructuring at a ‘fairness hearing’. The Vita scheme was completed very quickly with the initial hearing on March 27, 2009 and the sanctioning of the scheme on April 22, 2009.
Recent Case Studies (2)

- The restructuring and new financing required the negotiation of complex debt, shareholder and warrant documentation and the release and re-take of a full security package in 18 jurisdictions. Cleary took the lead in advising the group and TPG Capital on the negotiation of the standstills, the term sheets and final documentation for and negotiation of the restructuring, the new financing, the new shareholder arrangements and the management incentive scheme as well as the tax structuring. Cleary also advised throughout on negotiations with trade credit insurers and the lender under a borrowing base revolving credit facility.
Advice to Morgan Stanley, BlueBay and other senior lenders in €434m restructuring of Kiekert group

• Kiekert is a German-based automotive supplier with operations in the US, the Czech Republic and Mexico and was taken private by Permira in a leveraged buyout in 2000.

• As a result of the transaction, €434m of existing debt were restructured. Senior claims were repaid with the proceeds of a new €173m term and revolving credit facilities agreement (including a €20m fresh money facility), which is secured with collateral located in various jurisdictions.

• All remaining senior and mezzanine claims were waived in exchange for the transfer by the prior shareholders of 100% of the equity in Kiekert GmbH, the holding company of the Kiekert group. The new shareholders also provided €20m in new equity.
Recent Case Studies (4)

- Furthermore, certain corporate restructuring were taken with respect to Kiekert group including the implementation of a complex shareholders’ agreement among the new shareholders.

- The transaction was implemented as an out-of-court restructuring.
Summary

- The restructuring of an LBO-transaction has a high potential for conflicts of interest between Sponsor and Portfolio Company.

- When preparing for a restructuring, a Sponsor should review potential conflicts of interest to avoid that they are discovered only in the course of restructuring negotiations.

- If conflicts of interest are ignored, other parties to the restructuring may benefit form them and/or liability risks for the Sponsor may arise.

- Independent advice should be obtained.