A Legal Update from Shipman & Goodwin LLP

Ventures and Intellectual Property Group Letter

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IN SUMMARY:

A FUNNY THING HAPPENED ON THE WAY TO THE BANKRUPTCY COURT . . . MY DEBT BECAME EQUITY!

In considering whether to extend financing to a company in the form of either a capital contribution or loan, one factor investors inevitably evaluate is the likelihood of realizing a return on their investment in the event that the company goes bankrupt. Bankruptcy law offers investors some clarity on this issue, by providing that assets of the bankruptcy estate will generally be used first to satisfy claims of secured creditors, second, to pay claims of unsecured creditors and, finally, to pay claims of equity holders. This priority suggests that a loan, and not a capital contribution, is the right choice for those investors seeking to preserve value should the company go belly up. Potential lenders, however, need to be cognizant of two judicially created doctrines – the ***doctrine of recharacterization*** and the ***doctrine of equitable subordination*** – pursuant to which a lender runs the risk that a court may take the usual payment priority and flip it on its head. Application of either doctrine can result in a lender getting paid after other creditors to the extent of available funds. Because of this adverse result, it is important to be aware of the various factors courts consider in determining whether the doctrines of recharacterization or equitable subordination should apply. Armed with such knowledge, lenders can minimize the risk that their recovery in bankruptcy will be subordinated to that of other creditors.

DOCTRINE OF RECHARACTERIZATION

The term "recharacterization" is generally used to define the process by which a financing transaction that appears, on its face, to be a loan is "recharacterized" as an equity contribution. Recharacterization is a tool that can be used by the debtor in possession, bankruptcy trustee or other creditors to argue that debt should be reclassified as equity. Since debt holders are favored over equity in bankruptcy, recharacterizing debt as equity has the effect of subordinating that creditor's recovery to the recovery of all other creditors.

There has been some disagreement as to whether bankruptcy courts are truly empowered to recharacterize a creditor's loan as an equity infusion. Unlike the doctrine of equitable subordination (discussed below), which is now codified in Section 510 of the Bankruptcy Code, recharacterization finds no express support in the Code. The majority view, however, is that bankruptcy courts do have the authority to recharacterize a purported loan as an equity investment by virtue of the broad equitable powers granted to them under Section 105 of the Bankruptcy Code.

The question of whether debt should be recharacterized focuses on whether the financing transaction had the substance and character of an equity contribution rather than a loan. The test for determining whether a financial relationship is debt or equity is highly fact driven, but the general rule is that the more the transaction possesses characteristics of an arm's length negotiation, the more likely it is that a court will find it has the character of a loan and not an equity infusion.

Courts have not always agreed on specific factors to be considered in a recharacterization analysis, but have historically focused on (i) the formality of the alleged loan agreement, (ii) the financial situation of the debtor at the time that the loan is made, and (iii) the relationship between those owning equity and those making the advance to the debtor. Breaking these three general factors into more specific factors, which are to be applied in light of the facts and circumstances of each case, courts consider

(1) the names, if any, given to the instruments evidencing the purported debt transaction,
(2) the presence or absence of a fixed maturity date and schedule of principal payments,
(3) the presence or absence of a fixed interest rate and schedule of interest payments,
(4) the source of repayments,
(5) the extent of the company's capitalization,
(6) any identity of interest between the creditor and stockholders,
(7) the security, if any, for the loan,
(8) the company's ability to obtain financing from outside lenders,
(9) the extent to which the advances were subordinated to the company's outside creditors,
(10) the extent to which advances were used to obtain capital assets, and
(11) the presence or absence of a sinking fund to provide repayments.

Most recently, the Third Circuit in ***Cohen v. KB Mezzanine Fund II (In re Submicron Systems Corp)*** stressed that the multitude of factors courts have examined in undertaking a recharacterization analysis all coalesce into ***one overarching inquiry, namely, whether the parties intended for a transaction to be loan or an equity contribution.*** The ***Submicron*** court thus rejected the "mechanistic" approach of applying a given set of factors to the analysis of a recharacterization claim in favor of a common sense evaluation of the facts and circumstances surrounding the transaction in order to discern the parties' true intent.

DOCTRINE OF EQUITABLE SUBORDINATION

Like the doctrine of recharacterization, equitable subordination provides a mechanism by which a lender's recovery in bankruptcy may be subordinated to that of other creditors. Unlike recharacterization, however, application of the equitable subordination doctrine is keyed off of the lender's conduct rather than the substance of the financing transaction itself. Moreover, unlike recharacterization, equitable subordination should be applied only to the extent necessary to remedy the inequity or unfairness resulting from a creditor's misconduct and therefore can result in either full or partial subordination of a creditor's claim.

In the seminal case, *Benjamin v. Diamond (In re Mobile Steel Co.)*, the Court of Appeals for the Fifth Circuit established a three-part test for determining whether a creditor's claim should be equitably subordinated. According to *Mobile Steel,* in order to prove that equitable subordination is warranted, it must first be shown that the creditor engaged in some type of inequitable conduct. Courts have determined that fraud, illegality, breach of fiduciary duties, undercapitalization of the company at the time of the loan, and the lender's use of the debtor as a mere instrumentality or alter ego are the types of conduct that may, under the right circumstances, give rise to a claim for equitable subordination. Second, such inequitable conduct must either have resulted in injury to other creditors of the debtor or conferred an unfair advantage upon the creditor whose claim is susceptible to subordination. Finally, subordination of the claim must be consistent with the provisions of the Bankruptcy Code.

Many cases involving recharacterization and equitable subordination arise in the context of a loan made to a financially distressed company by the company's existing lenders, who may also be insiders of the company. Given such parties' relationship to the company, it can appear as though the purported debt is really an equity infusion structured as a loan solely to gain an advantage over the company's equity in the event of a bankruptcy. Recent cases, however, have clarified that a claimant's status as an insider and the debtor's undercapitalization alone will normally be insufficient to support a determination that a claim should be recharacterized or equitably subordinated. Such courts reason that, in most circumstances, insiders are the only parties willing to risk making a loan to a struggling business, and that they should not be deterred from making good faith loans by the threat of subordination in the event of a bankruptcy. Moreover, these courts recognize that when dealing with a distressed company, traditional factors that lenders consider in extending financing - such as a company's capitalization, solvency, and ability to repay debts - by necessity do not apply.

While cases like ***Submicron Systems*** should give lenders to a distressed company some comfort that their bona fide loan will be respected as such if the company files for bankruptcy, lenders should nonetheless remain cognizant of the doctrines of recharacterization and equitable subordination when entering into lending transactions so as to minimize the likelihood that their claim will be subordinated to the recovery of other creditors in the event of a bankruptcy.

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Editor's Note: The general principles summarized above are intended to be an overview only, and the contents of the article are not necessarily reflective of the views of our clients. This article is intended to inform the reader of challenges that may be made to the form and priority of financing transactions in a bankruptcy context, and the discussion is not intended to relate to any actual or anticipated litigation; every case must be analyzed independently in light of the specific circumstances at issue.

VENTURE BRIEFS

SEC CLARIFIES BEST-PRICE RULE IN TENDER OFFERS

The SEC recently adopted amendments to its tender offer rules to clarify that the best-price rule only applies to consideration offered and paid for securities in the tender offer and not to consideration paid to security holders for employment compensation, severance and other employee benefit arrangements so long as the latter are not calculated based on the number of securities tendered. Before the amendments, the best-price rule provided that "[t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during the tender offer." This language led some courts to interpret the rule to require that compensatory payments paid to employees who were also security holders, like the CEO, needed to be included in the calculation to determine what consideration had to be payable to all security holders with respect to the tender of their securities. Since take-over or change-of-control transactions often involve negotiations to retain key employees or require severance for departing employees, the courts' interpretations of the best-price rule made it difficult to achieve the desired economic outcomes in a tender offer, leading parties to favor merger structures instead. The SEC wanted to be "structure neutral" so it adopted the amendments to make it clear that true employee-related compensation is not to be included in determining what the best price is for tendered securities. Having the compensation committee or special committee of independent directors of the target or the bidder approve the compensatory arrangements provides a non-exclusive safe harbor that the compensation arrangements are just that, thereby satisfying the amended rule provisions.

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EMPLOYMENT CONTRACT TRUMPS STOCK CERTIFICATE

You might assume that if you have a stock certificate with your name on it, you own the number of shares stated on the certificate. However, the holding in a recent Virginia Supreme Court case concluded otherwise. In ***Barber v. VistaRMS, Inc.,*** the court found that an employment agreement stating that ownership of company stock would immediately cease at the conclusion of one's employment was the controlling factor in deciding ownership. VistaRMS, Inc. extended ownership in its stock beyond its three original shareholders first in 1998, then again in 1999 and 2002. The 1998 agreement and its subsequent addenda stated that an employee's common stock ownership ceased upon cessation of employment by VistaRMS for any reason, voluntarily or involuntarily, or as a result of death. The facts of ***Barber*** presented ample opportunity to resolve the issue of stock ownership. VistaRMS terminated Barber in January 2004. At that time, Barber executed a separation agreement which terminated his rights to all employee benefits including stock and stock options. When Barber learned later in 2004 that there was a possibility that VistaRMS would be selling to another corporation, he requested access to the corporate records in order to determine what monies he was owed. VistaRMS refused Barber's request for access to the corporate records asserting that he was not a shareholder, and Barber subsequently sought court redress. The Virginia Supreme Court ultimately decided this case in VistaRMS's favor. Barber had asserted that, despite his termination, he remained the record shareholder on the corporate books and, pursuant to the stock certificate in his name, the shares were never transferred. VistaRMS, however, contended that the true ownership of the shares was governed by the 1998 agreement, the 1999 and 2002 addenda, and the separation agreement. The Virginia Supreme Court affirmed the trial court ruling and held that Barber's ownership of shares in VistaRMS ceased immediately upon the termination of his employment, that Barber was not a shareholder of VistaRMS and consequently, that Barber lacked standing to pursue his legal claims. In reaching its conclusion, the court maintained that boilerplate language in a stock certificate did not negate the clear intention of the parties to discontinue an employee's ownership in the corporation's stock when the employment relationship ceased. The Barber decision was unequivocal. In Virginia, a series of employment agreements stating the status of ownership of stock will trump the name written on the stock certificate in situations where these documents cannot be reconciled. Only time will tell if other states will follow the lead of this Virginia decision.

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"HEDGING STRATEGY" THWARTED

The Delaware Chancery Court recently narrowed the circumstances under which shareholders may use §220 of the Delaware General Corporation Law to inspect the books and records of publicly traded corporations involved in going private recapitalization transactions. In ***Polygon Global Opportunities Master Fund v. West Corp.,*** Polygon, a hedge fund, had purchased shares in West after West announced a going private recapitalization. Polygon then sought to inspect West's books and records under §220. The court denied Polygon's request because §220 requires the shareholder to have a proper purpose for the request and Polygon failed to articulate such a proper purpose. Polygon asserted three purposes for inspecting West's books and records: (1) to value its shares in order to determine whether to seek an appraisal; (2) to investigate wrongdoing related to the recapitalization; and (3) to communicate information to other shareholders and encourage them to seek an appraisal. The court rejected Polygon's first purpose because West had publicly disclosed, as a result of the recapitalization, all material information necessary for Polygon to determine whether to seek an appraisal. Although Polygon might have been able to discover this information in an appraisal action, the court held that it would not grant access on the prospect that Polygon may initiate such an action. The court also rejected Polygon's second purpose because it would violate Delaware's public policy against purchasing stock in order to attack a transaction that occurred previously. Polygon purchased its shares not only knowing of the recapitalization transaction, but because it believed the consideration was too low. Accordingly, the court concluded that it would violate Delaware public policy for Polygon to use §220 to investigate a transaction of which it had knowledge at the time it purchased the stock. Finally, the court summarily rejected Polygon's third purpose because it was wholly dependent on the propriety of the prior two purposes, which the court had previously rejected.

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CONGRESS ACTS ON BANK BROKERAGE SERVICES

Seven years ago, the Gramm-Leach-Bliley Act attempted to move the financial services industry to functional regulation so that banks that provided brokerage services, for example, would be regulated as brokers by the SEC when traditionally banks had been able to provide a wide variety of services but had been exempt from broker registration. While such an approach might provide a level playing field across different types of entities, the implementation of functional regulation has been stalled since banks and bank regulators have opposed the approach, believing that banks' traditional services should not be disrupted and that banks are already highly regulated. Congress recently enacted the Financial Services Regulatory Relief Act of 2006, and one of it provisions entitled "Broker Relief" sets the wheels in motion to resolve the stalemate. The Act requires the SEC and the Board of Governors of the Federal Reserve System to jointly adopt a single set of rules within 180 days of the enactment of the Act to implement the exceptions from the definition of "broker" applicable to bank activities. Prior to the adoption of the joint rules, the SEC and Board of Governors are directed to consult with and obtain the concurrence of the various federal bank regulators. The Act also overrides previous rule making in this area by the SEC. We'll have to stay tuned for the resolution of this turf battle, but perhaps the title "Broker Relief" will be a clue as to which way the wind is blowing.

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DIRECTOR INDEMNIFICATION NOT AN ABSOLUTE RIGHT

A corporation may agree to indemnify directors in connection with actions brought against them. However, the U.S. Court of Appeals for the First Circuit in ***Happ v. Corning Incorporated*** held that a director's right to indemnification is not absolute. Happ, a director of Corning, was the beneficiary of an indemnification agreement whereby the company agreed to indemnify him against all costs of defending an action so long as he acted in good faith and in a manner he reasonably believed was not contrary to the best interests of the company. However, pursuant to the indemnification agreement, Happ also executed an undertaking which provided that he would repay the legal expenses advanced by the company if it were determined that he wrongfully used insider information for his personal gain. Happ was found guilty of insider trading.

Happ argued that Corning was not entitled to repayment because:

(1) the undertaking was invalid because it was procured by duress;

(2) even if the undertaking was valid, the more general standard for indemnification set out in the indemnification agreement should apply; and

(3) even if the undertaking provided the governing standard for Corning's right to repayment, that standard had not been satisfied because it was not held that Happ acted for his personal gain.

The court rejected all of Happ's claims. The court rejected Happ's duress claims because he was not deprived of a choice, but rather he chose to accept Corning's specific undertaking language so he could promptly receive advances. Additionally, Happ failed to produce evidence that there was no other way to finance the kind of defense that he deemed necessary. The court rejected Happ's second claim that the two agreements should be integrated. Whether separate instruments should be viewed as one integrated instrument depends on the assessment of

(1) the business context in which they were entered into,

(2) the results intended to be accomplished,

(3) the identity of the subject matter addressed in the agreements, and

(4) the timing of the execution of the two documents.

On the facts at hand, the purpose of the undertaking was to vary the standard contained in the indemnification agreement so that the outcome of the SEC case would trigger Happ's obligation to repay the money advanced by Corning. Therefore, it is clear that the parties intended that the standard expressed in the undertaking would govern. Finally, the court rejected Happ's argument that the standard of the undertaking was not met because it was not made clear that he acted for his own personal gain. The stock that Happ traded was his own, satisfying the personal gain requirement; the avoidance of a loss in value that would otherwise have been realized is a sufficient gain. The court granted summary judgment to Corning on its counterclaim against Happ in the full amount of legal fees previously advanced.

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BREACH OF CONTRACT NECESSARILY IS NOT BREACH OF FIDUCIARY DUTY

In a recent decision, the Delaware Chancery Court held that a claim for breach of fiduciary duty cannot co-exist with a breach of contract claim if both claims arise from identical facts. In the same case, the court also found that, upon dissolution of a corporation, it may not be reasonable for such corporation to reserve for the entire "face amount" of its contingent liabilities. The dispute in ***Blue Chip Capital Fund II L.P. v. Tubergen,*** arose when HCS Infusion Services, Inc. ("HCS" or the "Company") distributed proceeds from the sale of substantially all of its assets. The purchase price for the assets was $116 million, but the purchase agreement imposed a two-year, $20 million potential indemnity obligation on HCS. The Company's certificate of incorporation provided for a "Makewell" amount in favor of the holders of Series H Preferred Stock (the "Series H Stock"). The Makewell amount was determined by a formula using the date of liquidation of HCS and the amount of the distributable assets. The lower the amount of the distributable assets, the higher the amount paid on the Series H Stock. One hundred percent of the Series H Stock was held by RDV Corporation and Enterprise Management Fund II L.P. Two HSC directors were officers of RDV Corporation, and one HSC director was a general partner of Enterprise Management Fund II L.P. At the time of distribution, HCS had approximately $62 million in cash. The directors of the company set aside $20 million to cover the contingent indemnity liability under the purchase agreement, bringing the distributable amount of cash down to $42 million. The $20 million reduction in distributable cash raised the Makewell payment from $741,000 to $2.6 million. The other shareholders filed suit derivatively against HCS and its directors alleging breach of fiduciary duty by the directors, in part because of alleged self-dealing since some of the directors were affiliated with the holders of Series H Stock, which disproportionately benefited from their decisions. The other shareholders also made direct claims for breach of contract and an implied covenant of good faith and fair dealing. The defendants moved to dismiss for failure to state claims of action. Defendant directors argued that plaintiffs could not assert both contractual claims and fiduciary claims which arise from the same set of facts and that plaintiffs' complaint alleges nothing more than a contract dispute against the Company. The Chancery Court agreed finding that allowing a fiduciary claim and a contractual claim to co-exist when both claims arise from a dispute over the contractual obligations of a corporation to its stockholders would undermine the "primacy" of contract law. HSC then argued that the plaintiffs' contract claims should be dismissed because, based on provisions of the Company's certificate of incorporation as well as Section 281(b)(i) of the Delaware General Corporation Law, the Company complied with its contractual obligations to the stockholders. The Company's certificate of incorporation provided for the reservation from distributable assets of all debts and liabilities of the company. Section 281(b)(i) of the Delaware General Corporation Law states that "A dissolved corporation . . . (i) shall pay or make reasonable provision to pay all claims and obligations, including all contingent . . . claims known to the corporation . . ..." Reading these provisions in tandem, HSC argued that having satisfied the requirement of Section 281(b)(i), it essentially satisfied its contractual obligation to its stockholders. The Chancery Court disagreed, noting that Section Section 281(b)(i) has no bearing on the Company's contractual obligations to its stockholders. In addition, the Court pointed out that 281(b)(i) requires that a corporation make a reasonable provision for contingent liabilities. Based on plaintiffs' evidence showing that claims against the Company did not exceed $1 million in the aggregate in its 13 year history and that certain stockholders were also liable for portions of any indemnity claims under the purchase agreement, the Chancery Court found that the $20 million reserve may well not have been reasonable.

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