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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

6 Considerations For Investors As Recession Looms

By **Brian Hail and Rick Hyman** (February 15, 2023, 1:52 PM EST)

Brian Hail

Rick Hyman

In today's environment of rising interest rates and general economic uncertainty, many investments face distress amid declining economic returns and performance.

Of course, many investments, whether loans, equity capital or otherwise, were originally structured in a different economic environment. But, as stated in a quote often attributed to Warren Buffett, "only when the tide goes out do you discover who has been swimming naked."

As we enter what many commentators think may be a looming recession, investors may be surprised that their swimwear has seemingly vanished upon entry into the surf.

Given the strength and longevity of the most recent investment cycle, many professionals may not have direct experience with a meltdown or an investment that sours.

A hypothetical distressed situation might begin with a private equity fund or lender, referred to here as the investor, that made capital investments in a growing technology business, who we'll call Company A. The investor might have received preferred or common equity, warrants, and delayed disbursement term loans. To secure the debt, the investor received a security interest in substantially all of Company A's assets, including a pledge of Company A's interests in its subsidiaries.

The investor also received a right to designate a member of Company A's board of directors, or a designated director, and the investor appointed an executive to fill the seat. Company A had been building its business and soliciting capital. Unfortunately, Company A now encounters operational problems, its product launch is delayed and Company A needs capital.

This scenario, and many derivations of it, present the investor with a minefield of business and legal issues. Below are steps an investor should consider as storm clouds first appear.

1. Be sensitive to potentially conflicting fiduciary duties and confidentiality issues.

Most designated directors likely perceive that their primary role is to monitor and secure the investment of that which designated them: in this case, the investor. A designated director often reacts to turmoil at

Company A through an investor-lens: What does it mean for the investor and its investment?

The law, however, cautions against taking that narrow view, and requires a perspective shift. A director, designated or not, has a duty of loyalty to Company A, not to the investor.

Delaware, for example, imposes a duty of "uncompromising" loyalty to all the corporation's stockholders and allows no dilution of this obligation where one holds dual or multiple directorships or owes fiduciary obligations to multiple entities.[1]

Thus, individuals who act in a dual capacity "owe the same duty of good management to both corporations … this duty is to be exercised in light of what is best for both companies," according to the Delaware Supreme Court's 1983 decision in Weinberger v. UOP Inc.[2]

Importantly, a designated director may have learned critical information at board meetings that is confidential to Company A and that can't be shared with the investor absent an express agreement. The dilemma is not hard to imagine: The investor is faced with a request for capital, while its designated director has confidential knowledge of troubled operations.

But the director owes a duty to Company A, not to the investor in its capacity as lender. To complicate matters, if the designated director is also an investor officer or director, he or she owes fiduciary duties to the investor. In theory, a designated director should disclose to the investor information material to the proposed investment and to the investor's position with Company A.

To escape this quandary, the designated director could recuse itself from discussion and consideration of these issues with both Company A and the investor. But that defeats the purpose of the designated director's role, which is to observe, manage and guide Company A's business and to protect the investor's investment.

The law provides no definitive safe harbor for a designated director, other than to be mindful of what duties are owed to whom. The designated director is in a precarious position and must be vigilant as to whose interests are represented, the source of information and to whom that information belongs, and then to act in Company A's best interest.

If the designated director is unable to do so because of duties owed to the investor, then they must consider whether to recuse themselves from acting on behalf of both companies and/or whether to resign from board membership. While such action may not seem to be in the investor's immediate best interests, it removes the director from an irreconcilable conflict and may mitigate the risks of a claim from an alleged breach.

To prevent these conflicts, investors may consider placing their designees in board observer roles, which allow them access to board meetings but not to assume the fiduciary duties of directors themselves. In addition, the issues faced by a director in a limited liability company may differ if the governing agreements explicitly disclaim fiduciary duties.

2. Gather relevant documents and perform lien searches.

After closing, transaction documents are all too often filed away or secreted in email folders and forgotten. But, loan documents and investment agreements get modified or extended, bylaws get amended, etc.

Critically, security agreements and loan documents, which often require post-closing actions to secure and enforce their terms, may not be housed with the other loan documents. A critical first step is to locate the operative copies of the governing deal documents. Such documents should also include potentially applicable insurance policies, particularly if representation and warranty insurance was obtained.

An associated step is to run tax lien and Uniform Commercial Code lien searches for the company and its assets. While the deal documents may preclude a borrower from granting a security interest to a third party, contractual and/or statutory liens may arise through lax oversight or a failure to pay vendors or taxes.

Those searches, generally run in the jurisdiction where the borrower is organized, can provide critical insight on a company's financial and operational status, including the nature and priority of competing obligations.

In addition, it is critical to locate or compile an accurate capitalization table. Often early-stage companies have multiple equity offerings, multiple classes and types of stock, outstanding warrants and options, and outstanding SAFEs, or simple agreements for future equity.

The company may have multiple credit obligations including working capital lines of credit, senior, junior and mezzanine debt, and vendor financing. The record-keeping on these multiple equity and credit obligations may be less than perfect.

While such deficiencies may be the result of imperfect record-keeping rather than an intent to obfuscate, an incomplete capitalization picture creates confusion and uncertainty as to who owns what and what the company owes to whom.

3. Consider the potential for fraudulent transfer and preference risk.

As distress swirls, the investor should be cognizant that transactions may later be subject to attack as fraudulent conveyances and preferential transfers.

These challenges, or avoidance actions, are often brought by or on behalf of the transferor in an insolvency proceeding, including by creditors with derivative standing, and may seek to unwind transfers and recapture payments made prior to the proceeding.

For example, a trustee of Company A might challenge dividends paid to the investor for less than reasonably equivalent value as a fraudulent conveyance, even if those dividends were made years prior to the bankruptcy and without any element of actual fraud.

The trustee might also challenge as a preferential transfer additional liens granted, or warrants issued, to the investor in exchange for an agreement to forbear from exercising remedies during the year prior to the bankruptcy, given the investor's status as an insider.

While the many issues associated with such transfers are beyond the scope of this discussion, suffice it to say that payments made, new debt obligations incurred and security interests granted — particularly to insiders — that are made while the transferor was arguably insolvent are prime targets for later litigation.

4. Consider the prospect of lender liability claims.

The legal concept of so-called lender liability has undergone evolution over the years — it is not a cause of action itself but rather a term used for a class of causes of action.

Company A, for example, might claim that the investor's actions — or inaction — caused the company's financial collapse, premising its arguments on the investor's exercise of control over Company A — a tort — and a breach of investor's duty of good faith and fair dealing regarding negotiations and handling of its loans to the company.[3]

The degree of control, however, must be extraordinarily significant, and business leverage that arises because of distress and a borrower's need for capital is not lender control that should give rise to a claim. Nonetheless, the theory is not dead, and lenders and investors should model their behavior to defend any such claims.

Related to lender liability is the concept of equitable subordination in bankruptcy. The Bankruptcy Code allows the court, under extraordinary circumstances, to subordinate the creditor's claims to those of other similarly situated or junior creditors. Evidence of wrongful conduct must be present. Not surprisingly, many equitable subordination actions arise in the context of an insider that is also a creditor.

In circumstances where insolvency looms, parties' debt is likely of significantly greater value than its equity interests. The investor is an insider due to its interests in Company A and must always be careful to conduct itself in a reasonable manner so that it does not risk subordination.

5. Consider making a demand to inspect the company's books and records.

Often a distressed company is unable to compile and report financial statements on a timely basis, and thus investors and shareholders can be left with incomplete information. The transaction documents themselves might provide for required reporting, access to books and records, and even audit rights.

Even without a specific contractual entitlement, most state corporate laws, including Delaware and New York, provide equity holders with a statutory right to inspect the company's books and records. In Delaware, Section 220 of General Corporation Law permits a stockholder to access corporate books and records for a "proper purpose." That purpose can be to obtain stockholder lists and addresses, investigate mismanagement or scrutinize potential breaches of fiduciary duty.[4]

Section 624 of New York Business Corporation Law provides shareholders the statutory right to inspect a corporation's books and records. Importantly, limited liability companies may modify a member's statutory rights to access books and records.

While most statutes require a proper purpose for such an inspection, these statutory provisions are typically shareholder-friendly and provide shareholders a powerful tool to scrutinize corporate operations.

6. Locate and study dispute resolution provisions, choice of forum and choice of law provisions.

Transaction documents typically include choice of law and choice of forum clauses, and many also

include specific dispute resolution procedures. Although considered boilerplate, choice of law clauses come in many forms, and the scope of such a clause depends on the exact wording used.

For example, such clauses may or may not include tort claims incident to the contract and may or may not dictate the law for corporate governance claims, which is usually the law of the state of incorporation.

Forum clauses are always important to consider when analyzing litigation options. Dispute resolution provisions often provide a schedule for resolving disputes before litigation, and include steps to be taken according to an agreed schedule.

Common provisions include the requirement of a formal notice of a dispute, a cure period, a period to mediate the dispute or have business people meet and discuss, and then an arbitration agreement, which may include fee shifting for the prevailing party. While arbitration clauses are usually not onerous, dispute resolution procedures can greatly affect the timing and ability to bring claims or force action.

While distress may be inevitable, proper planning can set the stage for a focus on the merits of the investment and head off any number of future problems. No plan is perfect, but awareness and then thoughtful execution of steps to minimize conflict and maximize recovery are in all stakeholders' interest.

Brian Hail and Rick Hyman are partners at Crowell & Moring LLP.

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[1] See Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 187-91 (Del. Ch. 2014), Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[2] Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

[3] See Bailey Tool & Mfg. Co. v. Republic Bus. Credit (In re Bailey Tool & Mfg. Co.), 2021 WL 6101847 (Bankr. N.D. Tex. Dec. 23, 2021).

[4] See NVIDIA Corp. v. City of Westland Police & Fire Retirement System, et al., 282 A.3d 1 (Del. 2022).