

1st P+P White Paper

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THE RESTRUCTURING OF A PRIVATE EQUITY FUND'S PORTFOLIO COMPANY PRIOR TO INSOLVENCY

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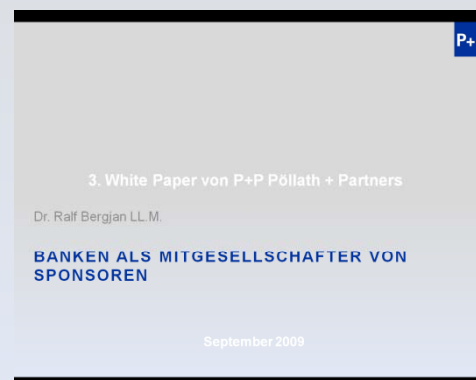
Objective of P+P White Paper

Investors require a great variety of information regarding current legal and tax developments in order to take optimal decisions for their investments. This information is quite often not purposefully prepared for the investors' demands. For this reason, P+P has started its new line of P+P White Paper.

The P+P White Paper is primarily intended for internal use and shall present important legal and tax issues in the areas of M&A and Private Equity – from fund structuring to the acquisition of an enterprise to restructuring issues – ordinarily structured and with a practical focus.

The authors of P+P White Paper are lawyers and/or tax advisors of P+P Pöllath + Partners who are experts in the respective areas.

Upcoming P+P White Paper:



Executive Summary

- ▶ Factors critical for the success of a restructuring of portfolio companies outside of insolvency proceedings are: efficient planning of restructuring, a solid restructuring opinion as well as restructuring contributions of all parties.
- ▶ Parties to a consensual restructuring are, in general, the portfolio company, the senior lenders, the mezzanine lenders, management holding a participation in the portfolio company as well as the sponsor and co-sponsors, if any.
- ▶ If the portfolio company is extremely close to insolvency, then restructuring is under such time pressure that it requires efficient proceedings.
- ▶ In specific cases, the execution of an insolvency (plan) proceedings can be preferable to a contractual restructuring of the portfolio company.
- ▶ The sponsor can choose from a great variety of possible restructuring contributions: contribution of fresh money, granting of collateral, debt buy-back etc. The legal and tax risks for private equity funds resulting from such potential restructuring contributions will be discussed in the 2nd P+P White Paper "Risks of Restructuring Contributions by Private Equity Funds".
- ▶ Also the (senior and mezzanine) debt providers can contribute to the restructuring of a portfolio company in various different ways: standstill agreement, adjustment of credit facility documentation, debt equity swap, debt mezzanine swap etc. Specifics of the participation of banks in the equity of a portfolio company will be dealt with in the 3rd P+P White Paper "Banks as Co-Shareholders of Sponsors".

The objective of a restructuring outside of insolvency proceedings is to secure the continuation of an enterprise in a crisis. In general, efficient restructuring planning, a restructuring opinion as well as restructuring contributions of all participants are needed.

Purpose

- ▶ Continuation of enterprise to be re-routed to success by reconstructing contributions of all parties.
- ▶ Use of the flexibility of a contractual solution vis-à-vis insolvency proceedings determined by law.

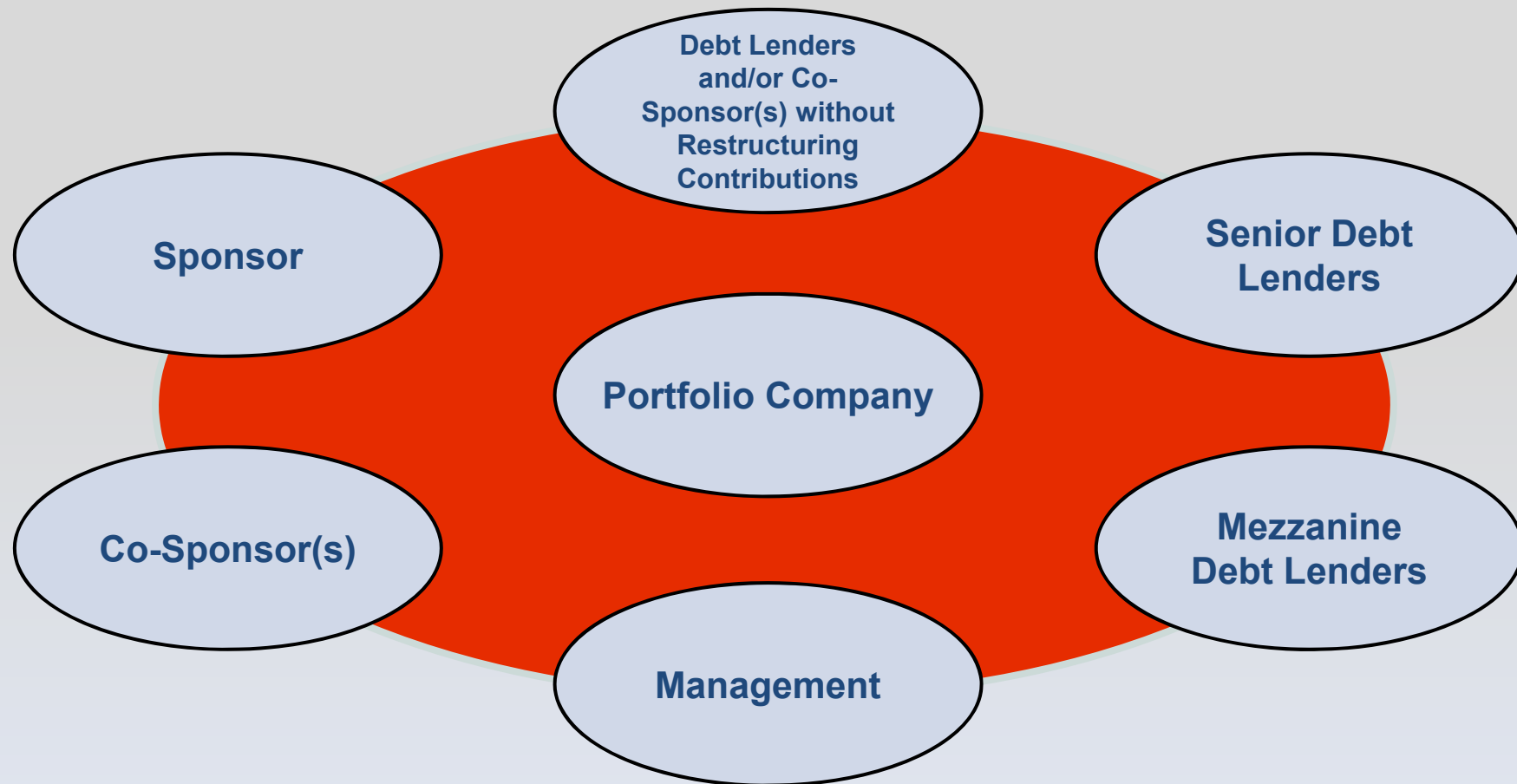
Success factors

- ✓ Early and efficient restructuring planning may allow for a consensual solution prior to the obligation to file for insolvency proceedings.
- ✓ A solid statement within a restructuring opinion regarding the ability to restructure an enterprise is the fundamental basis of all subsequent restructuring contributions.
- ✓ The restructuring contributions of all parties depend on the fact that all other parties make significant restructuring contributions, too.
- ✓ Due to the significant time pressure in a moment of crisis, a restructuring requires consistent proceedings and speedy implementation.

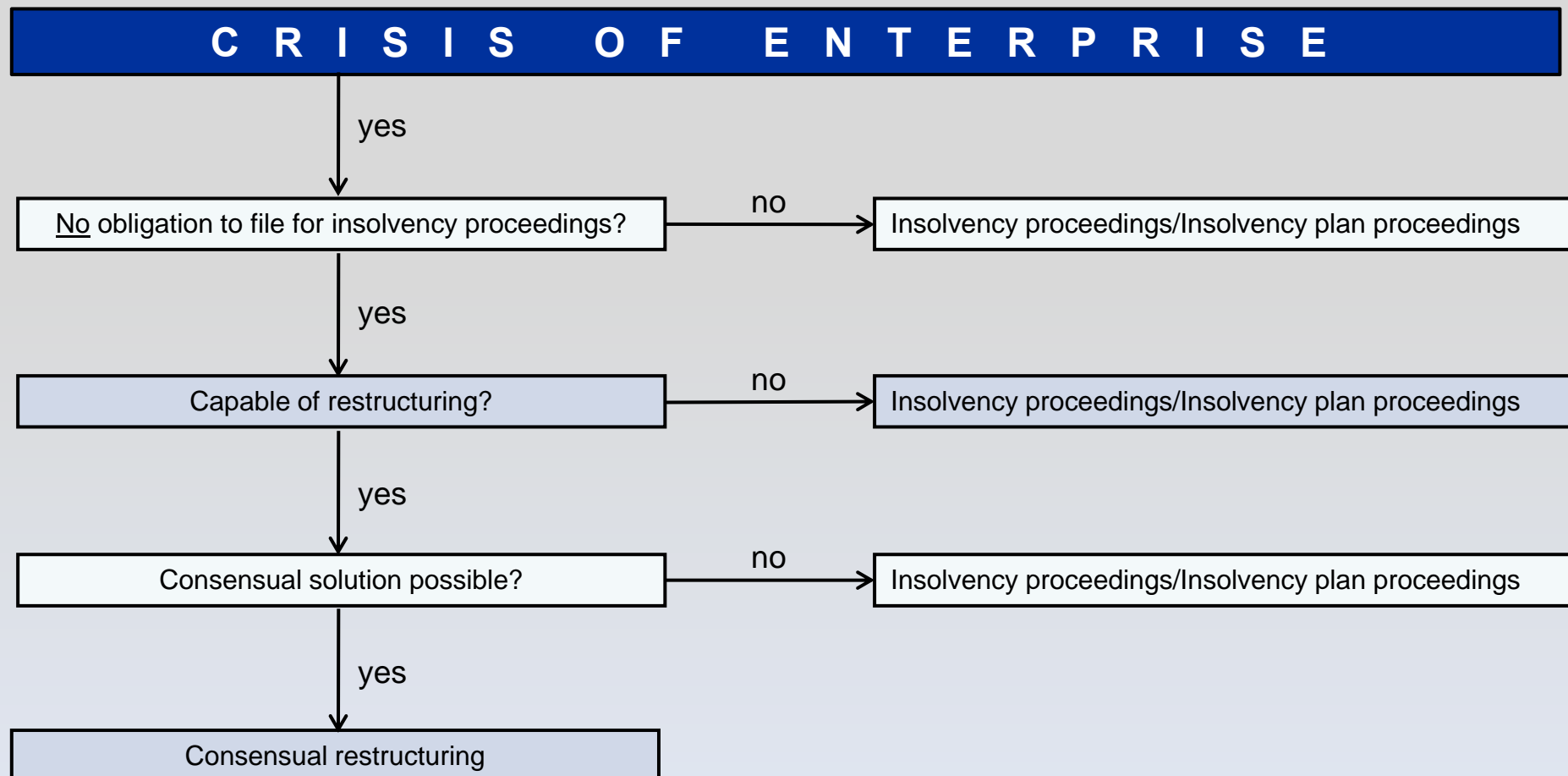
Situation of sponsor

- ▶ In general, a consensual restructuring is not possible without significant restructuring contributions by the sponsor.
- ▶ If the sponsor is prepared to make restructuring contributions then each single case requires a decision as to which form of contribution is best suited.
- ▶ In deciding on a specific contribution, the interest of the sponsor, the requirements of the portfolio company as well as the contribution of the other parties need to be reviewed.

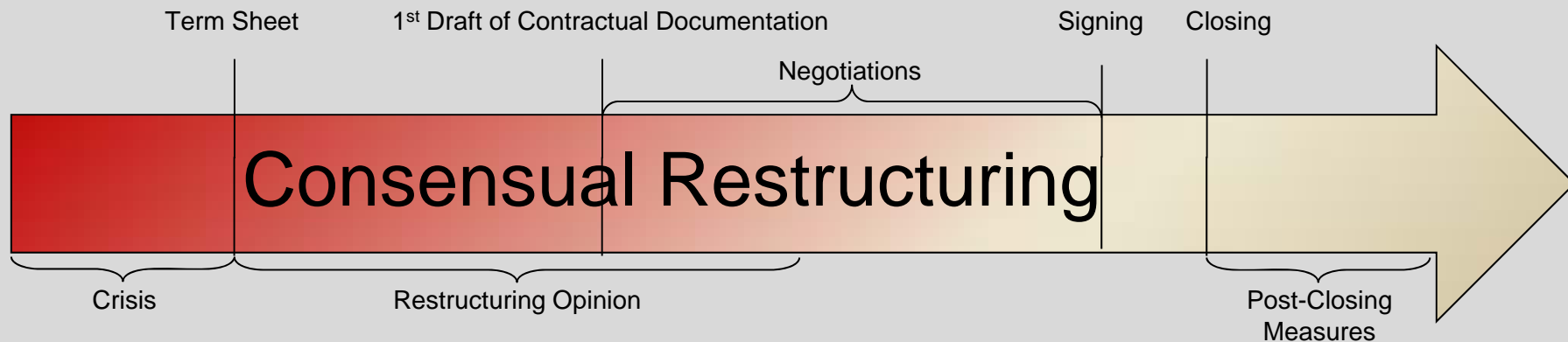
Various parties to a consensual restructuring make the restructuring process rather complex.



A restructuring outside of insolvency proceedings can only be successful if (i) there is no obligation to file for insolvency proceedings, (ii) the company is capable of being restructured and (iii) a consensual solution among all parties is not completely futile.



The high time pressure associated with the restructuring of an enterprise close to insolvency requires a detailed step plan.



Step-plan of consensual restructuring	
1st step	Agreement of a term sheet specifying the various restructuring contribution of parties and proceeding of restructuring.
2nd step	Drafting or update of restructuring opinion which evaluates the enterprise's capability for restructuring.
3rd step	Submission of a 1 st draft of contractual documentation (restructuring agreement, shareholder agreement, amendment to loan facility documentation, collateral agreements, management participation program etc.)
4th step	Negotiation of agreements among all parties (portfolio company, senior lenders, mezzanine lenders and shareholders – in each case with restructuring contributions – as well as shareholders and/or lenders without restructuring contributions, management etc.)
5th step	Signing of restructuring agreement providing as a framework agreement to the complete restructuring; upon signing of the restructuring agreement all other agreements or amendments to other agreements are automatically finalized.
6th step	Execution of restructuring contributions (closing), e.g. contribution of fresh money, waiver of claims, granting of collaterals etc.
7th step	Due to the high time pressure, technical measures may be delayed until after closing (for example optimization of corporate and/or tax structure). The parties should be legally protected by providing for a condition subsequent.

A consensual restructuring has a variety of advantages vis-à-vis insolvency proceedings or insolvency plan proceedings but also some disadvantages.

	Consensual restructuring	Insolvency plan proceedings	Insolvency proceedings
Advantages	<ul style="list-style-type: none"> ✓ Great amount of flexibility through restructuring by contract, independent from liquidator or/and insolvency court. ✓ "Quiet" proceedings possible to avoid negative publicity for both the private equity fund as well as the portfolio company. ✓ Speedy proceedings possible. ✓ Lower (indirect) costs through little negative publicity and speedier proceedings. ✓ Restructuring contributions by former creditors more likely than in an insolvency (plan) proceeding. ✓ Flexibility to terminate restructuring negotiations in favour of implementation of insolvency (plan) proceedings. 	<ul style="list-style-type: none"> ✓ Proceedings are aimed to continue the enterprise, not to liquidate it. ✓ Until the insolvency plan enters into force, the liquidator retains its usual special rights: e.g. simplified termination of employment agreement and other long term agreements, liquidator may prevent secured creditors to immediately realize collateral etc. ✓ By forming creditor groups for creditor resolutions, the potential of minority creditors to block decisions can be reduced. ✓ Possibility to finance through insolvency means (<i>Insolvenzgeld</i>). 	<ul style="list-style-type: none"> ✓ Only limited potential of certain creditors groups to jeopardize proceedings. ✓ Transferring restructuring (<i>übertragene Sanierung</i>) generally independent from fulfilling future entrepreneurial targets. ✓ In general, no financial contribution of sponsor required. ✓ Liquidator will receive special rights to easily facilitate a transferring restructuring, for example simplified termination of employment agreements and other long term agreements, liquidator may prevent secured creditors to immediately realize collateral etc.
Disadvantages	<ul style="list-style-type: none"> ✗ Generally, financial contribution of sponsor necessary. ✗ Consensual solutions always required with the imminent risk that certain creditors (for example mezzanine lenders) who have "nothing left to loose" might frustrate the strategy of cooperation. ✗ Lesser means to handle potential conflicts among different creditor groups (for example creditor with or without collateral). ✗ Special rights as provided for insolvency proceedings cannot be applied so that for example an unilateral termination of long term agreements is not possible. 	<ul style="list-style-type: none"> ✗ In general, the execution of an insolvency plan requires financial contributions of the sponsor. ✗ Negative publicity of an insolvency might result in the loss of further turnover of portfolio company as well as in a negative image of sponsor. ✗ Approval of majority of all creditor groups required which might result in delays or even failure of insolvency plan. ✗ Special rights of liquidator are only blunt instruments as insolvency plan proceedings require the cooperation of the various creditor groups and liquidator will in general not jeopardize such cooperation by the use of such special rights. ✗ Subject to legal challenge. 	<ul style="list-style-type: none"> ✗ In most cases liquidation of an enterprise is not attractive to sponsor, as the proceeds generated through liquidation will in general be only sufficient to satisfy other creditors. ✗ Negative publicity of an insolvency might result in the loss of further turnover of portfolio company as well as in a negative image of sponsor. ✗ Payment of liquidation surplus to sponsor very unlikely. ✗ Approval of creditor committee/creditor meeting required for a transferring restructuring. ✗ A statutory liquidation is in general the most cost intensive procedure.

Not only the sponsor can choose from large variety of potential restructuring contributions, ...

Major restructuring instruments of sponsors	
Cash contribution (fresh money)	<p>The Sponsor can provide fresh money in different ways:</p> <ul style="list-style-type: none"> • Contribution of new equity by sponsor through share capital increase or payment into capital reserve. • Granting of shareholder loans by sponsor (in certain cases as super senior loan which – in deviation from statutory provisions – ranks pari passu with bank loans).
Collateral sponsor by	<p>Indirect collateral for the liabilities of a portfolio company; such collateral originating from the means of the fund; special scrutiny must be applied to avoid turning the fund into a commercial (<i>gewerblich</i>) entity for tax purposes.</p>
Debt Buy-Back	<p>Upon a debt buy-back, a private equity fund acquires (directly or indirectly) loans granted to its portfolio company at prices "under par"; it is often intended to contribute these loans into the portfolio company and thereby reducing its liabilities and avoiding the breach of financial covenants.</p>
Re-distribution of equity	<p>The re-distribution of equity can result from different reasons:</p> <ul style="list-style-type: none"> • Dilution of co-sponsors who do not provide fresh money. • Participation of debt providers in the equity of the portfolio company. • Transfer of shares in portfolio company to a restructuring fiduciary; such fiduciary maintains contractual fiduciary arrangements vis-à-vis the shareholders (so-called administration trust) as well as vis-à-vis the banks (so-called securitization trust). • New or adjusted management participation program. • Sponsor "hands the keys of the portfolio company over to the banks" (if you don't pay – get out of the way)
Waiver (hair cut)	<p>Waiver regarding repayment of shareholder loans (potentially repayment of waived loans with future profits).</p>
Subordination	<p>Only a "deep" subordination results in loans to be disregarded in an insolvency balance, i.e. the creditor must subordinate its claims to shareholder loans.</p>

... also the banks can use multiple restructuring instruments.

Major restructuring instruments by banks	
Standstill Agreement	The remedies of the banks regarding (in most cases exactly defined) violations of the facility agreements are temporarily terminated and the financial covenants are temporarily suspended, only for the period of the standstill agreement.
Cash contribution (fresh money)	Granting of new loans by debt providers, often ranking superior to old loans ("super senior facility").
Adjustment of loan documentation	<p>Loan documents can be adjusted in various forms:</p> <ul style="list-style-type: none"> • New or suspension of existing financial covenants (reset of financial covenants). • Agreement on capitalization of interest and suspension of repayments. • Waiver of violations against loan documents. • Restriction on transfer of loans by agreeing on a preemptive right of sponsor.
Debt-Equity-Swap	<p>Traditionally, a debt-equity-swap can be realized in two different ways:</p> <ul style="list-style-type: none"> • Subsequent to a reduction of the registered capital (to eliminate an existing adverse balance of the company in crisis), existing claims against the company ("debt") shall be contributed into the company through a capital increase in kind against the issuance of new shares ("equity"). • The holder of the debt receives shares in the company in crisis ("equity") and contribute to the restructuring by way of a subsequent (partial) waiver of its claims ("debt").
Debt-Mezzanine-Swap	In a debt-mezzanine-swap for purposes of restructuring, debt of the portfolio company is transformed into specific capital or equity (jouissance capital with debt-like features) to improve the structure of the balance sheet and to resolve over-indebtedness in the balance sheet.
Waiver (<i>hair cut</i>)	Waiver regarding repayment of shareholder loans (potentially repayment of waived loans with future profits).
Subordination	Only a "deep" subordination results in loans to be disregarded in an insolvency balance, i.e. the creditor must subordinate its claims to shareholder loans.

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