FROM THE EDITOR

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Making The Most Of Bad Deals

Buyout firms saddled with a sputtering portfolio company have plenty of options to salvage their investments. And they're getting more aggressive about deploying them.

This winter, for example, as part of a pre-packaged Chapter 11 filing for Penton Publishing, **MidOcean Partners** and **Wasserstein Partners LP** stood to emerge from the ordeal with healthy minority stakes after agreeing to put in up to $51.2 million in fresh capital, even as the debt load plummeted by $270 million. **Catterton Partners**, **Golden Gate Capital** and **Sun Capital** have also recently emerged with equity stakes in companies following Chapter 11 filings, or planned to.

"In my practice I've seen many more constituencies willing to work toward a creative, consensual solution than they have been in the past," said **Henry P. Baer Jr.**, who represents private equity shops in restructurings as a partner at Finn Dixon & Herling LLP.

To be sure, taking an aggressive stance against already-aggravated creditors poses risks. But experience has taught that lenders have short memories, in part because the officers who made the bad loans don't necessarily feel the pain of having to work them out, according to **Henry F. Owsley**, CEO of New York-based investment bank Gordian Group LLC. His firm is advising private equity firms or their portfolio companies in at least four troubled situations.

And the rewards of getting tough with lenders are compelling. In ordinary times, enduring a write-off or two in a large portfolio may not be such a big deal for a buyout shop. Not so today. In the aftermath of the Great Recession many firms have sustained hits across their portfolios. The viability of their firms could well hinge on how hard they fight for every scrap, even in situations they might have walked away from a few years ago. Said **Peter S. Kaufman**, president of the Gordian Group: "They're more focused on their returns in this cycle, and a lot of them are a lot less willing than they used to be to leave shekels on the table."

The principle of "absolute priority" calls for no class of creditors or equity holders to receive money until more senior classes get fully paid. But even equity holders that are obviously out of the money have recourse. One of the biggest leverage points, according to **Manny Grillo**, chair of the financial restructuring practice at Goodwin Procter LLP, is the desire by creditors to avoid a Chapter 11 filing. Operating in bankruptcy court is expensive, involving the payment of hefty fees to advisers—costs that eat into the recoveries that the creditors realize.

To avoid that fate, Grillo said, creditors often favor out-of-court restructurings. But whereas in bankruptcy court creditors don't need shareholder approval to enact a restructuring plan, or to force a sale, out of court they do. By threatening to withhold their blessing of an out-of-court restructuring plan, buyout firms can try to negotiate a better outcome, such as by keeping a minority stake in the company post-restructuring, or getting a portion of proceeds from a sale even if ostensibly out of the money.

Another leverage point stems from the fact that even in Chapter 11, the board of a debtor company enjoys an 18-month period of exclusivity in which to propose a turnaround or liquidation plan. Until that period is up, creditors can't force their own plan on the company. Arguably, this lets the board, and by extension the buyout firm that controls it, threaten to hold the company hostage—to let the business run further into the ground, say, eroding value further—unless creditors agree to its demands.

Among other strategies that buyout firms can deploy:

- Putting more equity into the company to get it back into compliance with covenants and to demonstrate ongoing commitment to the business;
- Buying up a material portion of the senior debt to squeeze out the junior debt through a debt-for-equity conversion, assuming the loan documents allow it;
- Suggesting to creditors that, by accepting a distressed exchange, waiving covenant breaches, amending terms, or forbearing on penalties, they'll do better in the long run by letting the portfolio company grow its way out of trouble.

The relative negotiating power of creditors and debtors in troubled situations naturally ebbs and flows with market conditions. Is debtor-in-possession or exit financing difficult to come by, as it was during the latest credit crunch? Advantage buyout firm, since a bankruptcy filing would be less viable. Are loan-to-own buyers circling, making generous offers to buy debt? Advantage creditors, which now have the option to cash out rather than go along with the turnaround plan. In fact, that loan-to-own firms had been fairly quiet during the peak of the credit crunch helps explain why buyout shops succeeded at the negotiating table.

Over the last several weeks market conditions seem to be swinging back in the favor of creditors. But they should still expect to meet stiff resistance from buyout shops feeling pressure to keep their limited partners happy. "No one really wants to walk away with a donut from a deal," said Grillo.