

Beyond the Tipping Point: A Strategic Shift in the Relationship Between Investors and Their Portfolio Companies

By Craig A. Newman and David W.T. Daniels

The credit crisis has introduced a new and adversarial dimension into the relationships between hedge fund or private equity investors and their portfolio companies. In today's environment, there is increasing conflict between investors and portfolio companies on issues ranging from funding to direction of the business. While investors have historically worked cooperatively with their portfolio companies to address these issues, the realities of the current business environment, as well as time pressures and capital constraints, have led some investors to consider and ultimately use litigation as an option to protect the value of their holdings.

A significant win recently secured by RK&O provides a window into a litigation strategy pursued by one investor faced with a limited time window, a deteriorating equity position and few, if any, practical alternatives. In that case, RK&O persuaded the U.S. District Court for the Southern District of New York to issue a "mandatory" preliminary injunction granting RK&O's client interim control over the management of a portfolio company, pending a full trial on the merits of the investor's claims. *Oracle Real Estate Holdings I LLC v. Adrian Holdings Co. I, LLC*, 582 F. Supp. 2d 616 (S.D.N.Y. 2008). This strategy not only helped the investor position the dispute for a settlement, but it provided RK&O's client with the opportunity to step into the shoes of management and immediately begin executing a plan to preserve investment value while litigation was still pending.

The Investment

A New York-based fund invested in a real estate development company which owned parcels of undeveloped property. The properties secured substantial bank debt. In return for the investment, the investor had

the right to share in profits from the refinancing, development or sale of these properties under a negotiated payment schedule contained in the parties' investment agreement. The owner of the real estate development company had the option either to pay the negotiated amount upon expiration of the agreement or transfer ownership of the company to the investor. In the case of a breach of the investment agreement, the investor also had the right to declare a default and accelerate the agreed-upon payments or ownership transfer.

Given the deteriorating real estate market, the developer was unsuccessful in efforts to refinance or develop the properties. A cash crunch resulted, and by 2008 the developer stopped paying interest on its bank loans, failed to pay real estate taxes and failed to pay vendors who in turn perfected mechanics' liens on the properties. These defaults placed the properties at substantial risk of foreclosure which would have effectively wiped out the investor's interest in the properties. After unsuccessful efforts to resolve the situation, the investor declared a default under the investment agreement and demanded transfer of the company's ownership interest. The developer refused to comply with that demand or with other efforts to restructure the investment.

A Litigation Strategy To Preserve Value

Because the changed circumstances brought about by the credit crisis left it with no other practical alternatives, the investor filed suit to protect its rights. The investor faced an acute problem: discovery and trial would likely require many months or even years of litigation, during which time the value of its investment could well be destroyed through foreclosure or bankruptcy. Given these

Memorandum

May 27, 2009

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circumstances, the investor’s litigation strategy focused on the need for immediate injunctive relief to preserve its investment. Upon filing its lawsuit, the investor sought a “prohibitory” temporary restraining order preventing the developer from taking any action outside of the ordinary course of its business, including the filing of bankruptcy. The Court granted that order. Having preserved the status quo, the investor then sought a “mandatory” preliminary injunction requiring the developer to transfer interim control and management of the company to the investor, pending final resolution of the lawsuit. The investor sought that additional relief so that it could step into the shoes of the developer’s owner and deal directly with the banks, creditors and other constituents.

Court Grants Preliminary Injunction To Transfer Control

The Court granted the investor’s request and issued a preliminary injunction ordering the developer to transfer voting control over the company to the investor for the duration of the lawsuit. The Court’s decision hinged on its finding that the investor would be irreparably harmed without the benefit of immediate injunctive relief.

The Court found irreparable injury because the investor sought (1) to enforce a particular bargained-for remedy (i.e., to control the real estate development company), (2) that the value of that right was difficult to quantify, and (3) that the right could be meaningless or substantially diminished in value absent injunctive relief. In applying that standard, the Court reasoned that that the value of the right was difficult to quantify because it depended entirely on the skill and resources of the controlling party. As the Court explained, “To an unskilled and uncapitalized investor, [the real estate development company] is little more than many acres of heavily indebted undeveloped land; to a Warren Buffet, it is perhaps a significant investment opportunity.”

Lessons Learned

This decision provides an illustration of the changing dynamics between investors and their portfolio companies. While most investors consider litigation an

option of last resort, that is no longer the case. When faced with portfolio company conflicts, investors should consider the following:

- Any delay in assessing the investor’s legal rights and options may lead to significant and potentially irreversible value destruction. Take the time to thoroughly analyze your investment rights;
- Litigation is no longer off limits as an option to preserve value and in fact may be the investor’s best alternative as a tool in managing a portfolio, particularly when faced with intractable conflicts with management; and
- As the Court’s opinion in this case demonstrates, in situations where corporate control is at issue investors may be able to preserve value by exercising their control rights through an injunction or other extraordinary relief at the outset of a lawsuit without the expense and delay of lengthy court proceedings.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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