

Client Alert

A report
for clients
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Radnor Holdings: Delaware Bankruptcy Court Validates Secured Creditors' Workout Strategies And Credit Bid Over Unsecured Creditors' Objections

In the *Radnor Holdings* Chapter 11 case, Case No. 06-10894 (PJW) (Bankr. D. Del., November 17, 2006), the Delaware Bankruptcy Court has reinforced a secured lender's ability to take reasonable, market-tested actions to protect its position. The court overruled the objections of the official unsecured creditors' committee (the "Committee") to the "stalking horse" credit bid of the debtor's pre-petition secured lenders (hereinafter, the "Lenders"), allowing the Lenders' claims in full and approving the Lenders' credit bid as the highest and best offer for the debtor's assets.

This decision follows two recent Third Circuit opinions which also refused to recast pre-bankruptcy financings in ways that would undo the claims, rights and protections commonly bargained for by lenders and exercised in times of borrower distress. In its January 2006 *Submicron Systems Corporation* decision, 432 F.3d 448 (3d Cir. 2006), the Third Circuit upheld the sale of the debtor's assets to a group that included its secured lenders, rejecting recharacterization and equitable subordination as contrary to the parties' intent as evidenced through a common sense evaluation of the facts and circumstances surrounding the transaction. The Third Circuit's *Owens Corning* decision on substantive consolidation, 419 F.3d 195 (3d Cir. 2005), ruled that since the existence of inter-affiliate guarantees of the debtor's bank debt and a

material degree of operational coordination and management of the affiliates resulted from arms-length negotiations and were common in lending arrangements, those deal terms alone would not support the pooling of assets and liabilities of affiliated debtors to implement distributions to all creditors of all debtors.

The Facts

Ten months before the company's Chapter 11 filing, the Lenders invested \$120 million in Radnor – \$95 million in secured debt and \$25 million of preferred equity – and, among other things, were granted (and exercised) the right to appoint one designee to the company's four member board of directors, and one board observer. The funds were used to retire \$70 million of senior secured notes, to refinance or reduce certain other existing indebtedness and to provide Radnor with enhanced liquidity.

Shortly after closing, Radnor missed its 2005 EBITDA projections by a significant margin. Six months later, faced with what was believed to be a short-term liquidity issue, the Lenders provided an additional \$23 million of secured financing. The company's noteholders received a payment from this financing for their consents. Notwithstanding this additional liquidity, Radnor's financial condition continued to deteriorate. Three months after the second financing, Radnor's working capital lenders (not affiliated with the Lenders) cut off funding, resulting in the debtor's August 2006 Chapter 11 filing. At the company's request, the Lenders provided a "stalking horse" bid, which contemplated payment for substantially all of the company's assets through the Lenders' credit bid of a portion of their claims.

The Committee's Lawsuit

While the Committee supported the entry of a bidding procedures order and waived its right to object to the sale, the Committee apparently was convinced that the sale process would result in no recovery for unsecured creditors. In an attempt to defeat the proposed sale, the Committee filed a

lawsuit against the Lenders, seeking to (i) recharacterize as equity or equitably subordinate the approximately \$128 million of secured loans provided by the Lenders to Radnor; (ii) prevent the Lenders from being the "stalking horse" bidder and from credit bidding their secured claims in satisfaction of the purchase price, (iii) disallow the Lenders' claims, and (iv) obtain damages against the Lenders on various theories including breach of loyalty and care, aiding and abetting breach of fiduciary duty and other misdeeds. The Committee argued that the Lenders had pursued an improper "loan-to-own" strategy designed to overload Radnor with debt that could not be serviced, while using its preferred equity stake to play an active role on the debtor's board, all to facilitate what the Committee asserted was the Lenders' ultimate goal — to obtain ownership of Radnor's assets at depressed values, leaving no recovery for the approximately \$150 million of unsecured bond and trade creditors.

The Court Rules in Favor of the Lenders on All Counts

Following an eight day trial held over an accelerated time frame, the Bankruptcy Court ruled for the Lenders on all counts. The Bankruptcy Court closely followed the *Submicron Systems* decision in ruling against the Committee's recharacterization and equitable subordination claims. The court found that the Lenders' investments were made based upon the debtor's well thought out, albeit optimistic, bottoms-up financial projections, and noted that other potential financing sources existed at the time of the initial lending. The court further found that at the time of the Lenders' initial investments, the parties' intent was clear – the original secured loans were a true debt investment by the Lenders, in contrast to their preferred stock investment. Citing *SubMicron*, the court ruled that the Lenders' knowledge of Radnor's liquidity crisis at the time of the second, \$23 million loan was insufficient to support recharacterization, noting that it was legitimate for an existing lender to extend additional credit to a distressed borrower as a means to protect its existing loans.

The court also held that the Lenders did not exercise control over the debtor's day-to-day operations, because they did not dictate corporate policy or disposition of corporate assets without limits. The court agreed with the Lenders that it is not unusual for lenders to have designees on a company's board, monitor the business and exert influence regarding financial transactions, particularly when a company is distressed. Such typical activities, by themselves, in the absence of objectionable behavior, are not tantamount to control. Similarly, the Court found that the Lenders' access to non-public information was insufficient to establish insider status, especially where the same information was shared with other potential bidders.

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Implications for Secured Lenders

The *Radnor Holdings* case reinforces the principle that the rights and remedies of secured lenders should be respected absent evidence of bad faith, improper motive or undue control. Lenders and investors — particularly those holding both debt and equity positions, having or considering appointing board designees, and seeking to exercise other significant debt or equity-based rights — need not fear of litigation tactics used by other constituencies to gain leverage. Nonetheless, given the intense scrutiny of lenders' pre-bankruptcy credit and recovery decisions by other creditors of a distressed company, rights and recovery strategies should be pursued with care for the specific facts of the situation at hand. If you would like more information about the *Radnor Holdings* case or the steps you can take to structure and protect your distressed investments, please contact one of the attorneys in our Bankruptcy and Reorganization Practice Group.

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