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Portfolio Companies in Distress:

Navigating the Risks from SVB and Other Threats to Liquidity and Solvency

The Capital Commitment on **March 30, 2023**

Everything, everywhere, all at once is our risk thesis for 2023, but one must not forget about concentration risk. This issue has rocketed up diligence agendas for LPs and GPs alike as the collapse of Silicon Valley Bank proved it really was *the* bank for venture capital.

The entry of SVB into receivership on March 10, 2023 highlighted just how central it had become to U.S. venture capital, providing deposit and credit facilities not just to asset managers, but also to many (and in some cases the vast majority) of their portfolio companies and investors. While deposit accounts were protected in full, companies unable to access those accounts for several days faced significant disruption. Further, while borrowers were still bound by terms of credit agreements, there was no immediate obligation on the Federal Deposit Insurance Corporation (FDIC) as receiver to honor drawdown requests (although the bridge bank did announce it would honor credit facilities). Net asset value (NAV) lines, subscription lines and investors' own deposit and credit lines were also affected. The deposits and loans of SVB were acquired from FDIC by First Citizens Bank on March 27, 2023.

The parallel troubles of crypto specialist Signature Bank (the majority of whose deposits and branches were sold to New York Community Bancorp on March 19, 2023) and national Swiss institution Credit Suisse (acquired by UBS on the same date) emphasized that private capital remains instinctually linked to traditional banking, not just in terms of wider market trends but also in reliance on its fundamental services. The U.S., UK and Swiss governments quickly acted this month, together with the banking industry, to take decisive steps to reassure the public and the markets but this likely won't be the last such shock.

Financial distress of investee companies, whether in the form of sudden lack of access to cash as with SVB or longer-term liquidity concerns, raises a myriad of issues for asset managers, especially where investor representatives sit on the boards of their portfolio companies.

First, and most immediately, cash flow issues can put companies at risk of default under their loan terms. Sponsors that decide to provide rescue cash to their investee companies to prevent or cure such a default must look carefully at the terms of any emergency issues or creation of new shares to ensure they follow the process in the Articles or Shareholders' Agreement and abide by any pre-emption rights. These areas are prime ground for minority shareholder petitions and challenges. Sponsor-appointed board designees must also be alert to their personal conflicts and ensure these are declared and managed.

Second, several U.S. states impose civil or criminal liability on directors and officers where a company fails to pay wages. This was an acute concern for many companies banking with SVB. Similar payroll delay or "wage theft" laws exist in other non-US jurisdictions, including Norway and certain Australian states.

Next, the duties of directors may change even before the moment of insolvency. Directors of companies in or approaching the "zone of insolvency" need to be aware that, in some jurisdictions including the UK, they may need to start to take interests of creditors into account even before the onset of (or inevitability of) a formal insolvency process, while maintaining their duties to shareholders. Delaware law negates fiduciary duties to creditors, even in insolvency, to avoid putting directors and officers into analysis paralysis as to which constituents to serve.

Where a portfolio company enters insolvency, insolvency practitioners, bankruptcy courts, and other parties in interest have wide powers to review transactions and payments, often looking back several years in the event of alleged undervalues, constructive or actual fraud on creditors, or impermissible transfers. Under the English scheme, liquidators in previous downturns looked closely at fees charged by asset managers for services to portfolio companies to ensure these were genuine repayments of intra-group debt, and recapitalizations to ascertain if there was any claim against a private equity shareholder or related individuals. They also investigated recent share repurchases as these may give rise to a separate power to require contributions from past directors and shareholders.

The typical exculpation and indemnification provisions in fund documents, or D&O insurance, applying to directors often contain carve outs for fraud and intentional conduct (although see the SEC's recent proposals discussed in our forthcoming post on the topic). Typically, chapter 11 plans in the U.S. contain similar exculpation clauses intended to insulate directors and other stakeholders from liability in carrying out the bankruptcy cases. But there is a growing circuit split in the U.S. regarding whether such clauses are permissible because they are tied up in the dispute over the statutory and constitutional questions as to whether non-debtors can be released. Some actors, such as a trustee or statutory committee member, have quasi-immunity by virtue of their serving as officers of the court.

In short, March 2023 has been a salutary reminder of the need for two core fundamentals: cash and diversification (including in where you keep your bank account).

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