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Ongoing Capital Challenges Portend Continued Portfolio Company Litigation Risk in 2024

The Capital Commitment on **March 28, 2024**

Economic headwinds and the interest rate environment that developed over the course of 2023 increased financial stress on portfolio companies and portend heightened litigation risk in 2024 for portfolio companies and their private fund sponsors. Specifically, interest rate increases that accelerated through 2022 continued in 2023, and compounded existing economic stressors including tight liquidity and inflation coming out of 2020 and 2021, as well as increased cost and other burdens related to ESG and regulatory compliance. These pressures put portfolio companies in often unsustainable financial positions, causing them to prematurely seek liquidity events, violate debt covenants with lenders, and resort to bankruptcy, all of which has led to an increase in disputes and litigation, which we expect to continue in 2024.

While some relief on the interest rate front is on the way, with the Federal Reserve expected to begin to slowly cut rates in 2024, and inflation appears to be easing, it may not be enough to forestall portfolio company disputes and litigation for cash-strapped companies in 2024. We saw this play out in a number of ways in 2023, which may serve as harbingers of what’s to come this year.

Difficult financial conditions strain a portfolio company's ability to continue to fund its operations, forcing the company and/or its investors to seek liquidity events, for example with an exit through the sale of some or all of the equity of the company. Any of these options presents the possibility that aggrieved stakeholders will raise disputes. Aside from the obvious risks of running out of operational runway, disputes over a portfolio company's valuation are a common theme. Whether in an exit or alternative capital raise scenario, certain stakeholders may argue that they have been adversely affected by an unexpectedly low valuation, resulting in post-deal litigation. In other circumstances where less than all of the company is sold, other disputes can arise, such as when existing investors find their investment diluted or "crammed down," a situation where investors are forced by contract or bankruptcy law to accept exit terms that they may view as unfavorable. A valuation process that includes a respected third-party valuation firm that is fully informed based on current and accurate portfolio company financials can mitigate this risk somewhat. We offered some thoughts on valuation issues in last year's top 10, which remain applicable to the challenges portfolio companies will face this year.

Challenging economic times can also result in the breach of debt covenants with lenders. Many portfolio companies carry significant secured debt burdens. Decreased revenues have a direct impact on maintenance debt covenants, as can increased interest expenses resulting from higher rates. Covenant defaults can expose portfolio companies to a myriad of issues from acceleration of outstanding debt to unwelcome changes in control. Careful attention to maintenance covenants, along with open communication about headwinds and expected challenges, can avoid portfolio company disputes with lenders. In other scenarios, restrictive debt covenants can present a unique challenge, for example where lenders or investors are willing to provide cash infusions, such transfusions would trigger a default under the portfolio company's agreements with existing investors, leaving portfolio companies and sponsors with few options to access the needed capital. The inability to continue to fund operations resulting from restrictive covenants can lead to reputational harms and litigation with customers, vendors, and other creditors.

For some portfolio companies, these sustained economic headwinds after years of financial pressure cannot be overcome and will invariably lead to bankruptcy. Bankruptcy comes with its own set of challenges beyond a loss of the sponsor's initial investment—from shining an unwelcome light on prior management, to loss of control, to subrogation issues.

With each of these challenges comes the additional risk that an aggrieved investor, lender, or other stakeholder will pursue claims for liability against sponsors and managers themselves. For example, minority investors who believe their investment has been disproportionately impacted by a sponsor or manager decision may pursue claims of unfair prejudice. In addition, board membership or other control over the business and decision-making processes at a portfolio company can increase the risk of litigation. As we have discussed in our Portfolio Company Playbook, sponsors and managers should pay careful attention to whether their portfolio company oversight could open them up to fiduciary liability or other claims.

This year is expected to bring economic relief on a number of fronts, but managers and portfolio companies alike can look to the outcomes of 2023 for lessons on how to protect their investments and business, as well as to avoid litigation in 2024 and beyond.

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2024.

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