

PRIVATE EQUITY’S OVERLEVERAGING OF PORTFOLIO COMPANIES

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ABSTRACT

With record-low interest rates, private equity has seen unparalleled activity in recent years. Though thriving, private equity firms have proved to be guilty of overleveraging their portfolio companies as general partners. The results of overleveraging have been varied. At one end, firms seem dedicated to a portfolio company’s restructuring, investing further and pledging more capital in hopes of future growth. At the other end, firms wishing to exit their investment, redeem debt previously given to a portfolio company at a premium and engage in a quick sale thereafter, leaving that company unable to satisfy its future obligations. Firms that engage in this behavior have exposed a hole in the legal framework of private equity. This Note addresses the varied results of overleveraging and advocates for enhanced fiduciary duties of the general partners and expanding the duties of the indenture trustee for pre-default behavior. These measures would prevent domestic firm general partners from engaging in improper redemptions that would prevent the portfolio company from paying its obligations.

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INTRODUCTION

In 2014 and 2015, over \$1.2 trillion was invested in private equity, the industry’s greatest mark since the financial crisis.¹ The steady level of near-zero percent interest rates in recent years has certainly helped the industry. In the typical leveraged buyout, the private equity firm will buy a public or private company using about 60% to 90% debt financing

1. Dan Primack, *2014 Was a Huge Year for M&A and Private Equity*, FORTUNE, (Jan. 5, 2015, 11:56 AM), <http://fortune.com/2015/01/05/2014-was-a-huge-year-for-ma-and-private-equity/> [<http://perma.cc/43BD-8CEZ>]; *PE by the Numbers*, AM. INV. COUNCIL, <http://www.investmentcouncil.org/private-equity-at-work/education/pe-by-the-numbers/> [<http://perma.cc/34EP-3TV7>] (last updated Mar. 2016).

mainly provided by banks.² With the cost of borrowing so low, private equity managers have been able to expand their investing power, resulting in steady investment in private equity while other sectors of the economy have struggled.³

In the months following the U.S. financial crisis, the Federal Reserve instituted its own set of crisis-related special programs, such as the substantial purchase of long-term securities, which put pressure on longer-term interest rates and eased overall financial conditions.⁴ Consistently low interest rates set the stage for recovery over the past seven years.⁵ More specifically, these rates have had an impact in private investment, and the private equity market, by spurring much debate about taxing private equity and handling liability for the underlying investments.⁶ While most of the debate has centered on how to tax private equity, this Note focuses on issues of liability for underlying portfolio company debt obligations.

Private equity activity has seen its fair share of borderline predatory overleveraging since the financial crisis.⁷ However, this problem remains unaddressed by Congress, federal agencies, and the states.⁸ On

2. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, J. ECON. PERSPS., Winter 2009, at 121, 124.

3. See *PE by the Numbers*, *supra* note 1.

4. *The Federal Reserve's Response to the Financial Crisis and Actions to Foster Maximum Employment and Price Stability*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm [<http://perma.cc/FMK7-JWHS>] (last updated June 4, 2015).

5. Caroline Baum, *This Economy Needs Ultra-Low Interest Rates Just to Stay Afloat*, MARKETWATCH (Nov. 25, 2015, 8:23 AM), <http://www.marketwatch.com/story/this-economy-needs-ultra-low-interest-rates-just-to-stay-afloat-2015-11-25> [<http://perma.cc/34W4-DP8R>].

6. See generally William D. Cohan, *Low Interest Rates Help Private-Equity Moguls and Hurt Average Americans*, THE NATION (Sept. 18, 2015), <http://www.thenation.com/article/low-interest-rates-help-private-equity-moguls-and-hurt-average-americans/> [<http://perma.cc/9Z7Z-9Y5R>].

7. See *infra* Part II.

8. See generally Mary Jo White, Chair, SEC, *Five Years On: Regulation of Private Fund Advisers After Dodd-Frank*, Keynote Address at the Managed Fund Association (Oct. 16, 2015), <http://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html> [<http://perma.cc/Q448-98YH>]; EILEEN APPELBAUM, CTR. FOR ECON. & POLICY RESEARCH, *PRIVATE EQUITY AND THE SEC AFTER DODD-FRANK* (2015), <http://cepr.net/documents/pe-dodd-frank-2015-01.pdf> [<http://perma.cc/C22Z-2M6X>].

multiple occasions, private equity giants have added struggling companies to their portfolios; once in their possession, the firm essentially strips down the company, issuing more debt than it can handle and channeling the proceeds from the issuance to the general partners.⁹ The company is then left unable to pay interest on the outstanding debt. Accordingly, with decreasing rates, the amount of equity financing in leveraged buyouts, where funds typically borrow outside money, has also steadily decreased as firms opt to secure cheaper debt.¹⁰ The result of such an increase in debt financing has led to more and more portfolio companies overleveraging and eventually having to file for bankruptcy.¹¹ This Note addresses the overleveraging of portfolio companies, how the private equity fund structure allows for it, and how to recover lost funds firms poach from these companies.

Part I discusses private equity funds and their limited partnership structure, as well as the relevant tax and bankruptcy law provisions that allow for debt financing. This section takes a look at the tax and liability benefits of the limited partnership structure, and then it explains the current policy debate regarding the treatment of private equity fund income and other private equity tax issues. It concludes by looking at two ways courts have ensured that private equity firms be held liable for their portfolio company debts. Part II consists of two case studies: Hellas Communications and Colt Defense, both of which were bought up by private equity funds, overleveraged, and restructured. Hellas Communications, a Greek telecommunications services provider, filed for bankruptcy in 2007, and although the company recently emerged from restructuring, it has remained the subject of multiple law suits in different continents for many years. On the other hand, Colt Defense, a nearly 200-year-old American weapon manufacturer, entered reorganization in the summer of 2015 and emerged healthy from bankruptcy in 2016. This section ends by addressing the current market trends of exit strategies and the role that debt financing has played in influencing certain strategies. Part III advocates for a solution in which

9. See Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 126–27 (2013).

10. *PE by the Numbers*, *supra* note 1.

11. Arleen Jacobius, *Private Equity Fund Restructurings on the Rise, Survey Says*, PENSIONS & INVS. (June 7, 2015, 7:00 PM), <http://www.pionline.com/article/20150607/ONLINE/150609891/private-equity-fund-restructurings-on-the-rise-survey-says> [<http://perma.cc/H4GC-LVTS>].

sophisticated contracting parties take it upon themselves to ensure they do not suffer a windfall.

I. PRIVATE EQUITY FUND STRUCTURE AND LAWS

A. REFRESHER ON THE STRUCTURE OF FUNDS & THEIR TAX BENEFITS

1. Fund Structure: Limited Partnership as a Liability Shield

Most domestic private equity funds are organized as limited partnerships, usually in Delaware, and as such contain at least one general partner and at least one limited partner.¹² The private equity fund itself is “a pool of capital with no operations.”¹³ In its simplest form, the firm managing the fund acts as the general partner, while the investors act as the limited partners.¹⁴ The general partner (unless expressly set in the partnership agreement) has unlimited liability and assumes the debts and obligations of the funds, which is therefore usually organized as a limited liability entity (either an LP or LLC).¹⁵ Within this structure, the members or managers of the limited liability entity are typically members or managers of the firm itself.¹⁶ On the other hand, the limited partners—sophisticated and institutional investors—enjoy the benefits of limited liability, and are only liable for the amount of their capital

12. JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 3.01 (2016). *See generally* DEL. CODE ANN. tit. 6, §§ 17-101 to 17-1111 (2016). For a graphical representation of this structure, see Mariya Stefanova, *Private Equity Structures and Their Impact on Private Equity Accounting and Reporting*, FIN. TIMES PRESS (Mar. 16, 2015), <http://www.ftpress.com/articles/article.aspx?p=2316387&seqNum=2> [<http://perma.cc/63F8-BUM4>].

13. Scott W. Naidech, *Private Equity Fund Formation*, PRAC. L. CO. (2011), http://www.msaworldwide.com/Naidech_PrivateEquityFundFormation_Nov11.pdf [<http://perma.cc/M2AM-5FPN>].

14. Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FINANCE 1791, 1793 (2005); Amanda N. Persaud & Adrienne Atkinson, *Private Equity Funds: Legal Analysis of the Structural, ERISA, Securities and Other Regulatory Issues*, in INVESTMENT ADVISOR REGULATION: A STEP-BY-STEP GUIDE TO COMPLIANCE AND THE LAW § 47:1 (Clifford E. Kirsch ed., 3d ed. 2012).

15. DEL. CODE ANN. tit. 6, § 17-403(b); Kaplan & Strömberg, *supra* note 2.

16. John J. McDonald, *Actions that Private Equity Fund Representatives on Portfolio Company Boards Can Take to Help Avoid Liability*, J. PRIV. EQUITY, Fall 2008, at 1.

contribution.¹⁷ An investment advisor, usually affiliated with the private equity firm (the general partner), provides investment management services to the fund. The investment advisor employs “investment professionals, evaluates potential investment opportunities and incurs the expenses associated with day-to-day operations and administration of the fund.”¹⁸ When the general partner decides to acquire a company through a leveraged buyout, the firm will put some of its own capital into the fund, and the fund will acquire debt financing from a bank to buy up the target company’s shares or buy out the firm’s owners.¹⁹ After such financing, the fund itself will own the company, and the general partner can carry out its target strategy to create value.²⁰

Another advantage of the limited partnership structure is that when the fund seeks debt financing through the fund itself, the firm is able to sever liability for any future default by the fund. The debt liabilities become those of the portfolio companies, by virtue of its ownership by the fund and the structure of the general partner as a limited liability company, enjoying pass-through taxation and a liability shield from the fund’s debts exceeding the general partner’s committed capital.²¹

As evidenced, limited partnerships favor broad freedom to contract, and this also applies to general partner fiduciary duties with respect to the partnership.²² The Delaware Revised Uniform Partnership Act provides that a partner’s fiduciary duties may be expanded, restricted, or altogether eliminated by contract, with the exception of the implied duty of good faith and fair dealing.²³ The Delaware courts have upheld the LP

17. DEL. CODE ANN. tit. 6, § 17-303.

18. Naidech, *supra* note 13.

19. Mark Koba, *Private Equity: CNBC Explains*, CNBC (Jan. 24, 2013, 2:50 PM), <http://www.cnbc.com/id/100405662> [<http://perma.cc/P8FB-SQAW>].

20. *See id.*

21. SCHELL ET AL., *supra* note 12, § 3.01[3].

22. Srinivas M. Raju & Jillian G. Remming, *Fiduciary Duties in the Alternative Entity Context*, AM. BAR ASS’N (Aug. 16, 2012), <http://apps.americanbar.org/litigation/committees/commercial/articles/summer2012-0812-fiduciary-duties-alternative-entity.html> [<http://perma.cc/YDS9-SYBM>].

23. DEL. CODE ANN. tit. 6, § 17-1101(d) (2016) (“To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner . . . the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”). It is also important to note, as many private

and LLC's freedom to eliminate fiduciary duties, including those available at common law.²⁴

2. Debt Financing as a Tax Deductible Expense

Private equity debt financing is tax efficient because of the tax-deductible investment interest expense. Section 163 of the Internal Revenue Code allows for a tax deduction for the interest that accrues on debt.²⁵ When the fund receives cash in exchange for bonds, agreeing to make fixed payments in the future to the bondholder, the fund may deduct the fixed payments.²⁶ These reduced taxes are valuable to firms, and can account for anywhere between 4% and 40% of a firm's value.²⁷ The more a fund leverages, the greater the tax advantage, and with the cost of debt so low, this has proved enticing for fund managers.²⁸

In 2013, three agencies came together to issue guidance to banks about leveraged lending.²⁹ In the release, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency discouraged leveraging greater than six times a company's EBITDA (earnings before interest, taxes, depreciation, and amortization).³⁰ Later on that year, the agencies sent letters to about a dozen large lenders, urging them to comply with the guidance.³¹ In response, Bank of America, Citigroup, and J.P.

equity funds are formed as LLCs, that the Delaware Limited Liability Company Act has an almost identical provision. *See id.* § 18-1101(c); *see also* Raju & Remming, *supra* note 22.

24. *See, e.g.,* Loneragan v. EPE Holdings, LLC, 5 A.3d 1008, 1025 (Del. Ch. 2010) (holding that an LP agreement eliminated the common law duty to disclose in addition to all other fiduciary duties).

25. I.R.C. § 163 (2012).

26. *See id.*

27. Kaplan & Strömberg, *supra* note 2, at 15; *see* Steven Davidoff Solomon, *For Companies, Tax Code Adds to Debt's Appeal*, N.Y. TIMES: DEALBOOK (Feb. 28, 2012, 6:13 PM), http://dealbook.nytimes.com/2012/02/28/for-corporations-u-s-tax-code-adds-to-debts-appeal/?_r=0 [<http://perma.cc/7QXG-6CSE>].

28. Felix Barber & Michael Gould, *The Strategic Secret of Private Equity*, HARV. BUS. REV., Sept. 2007, at 53.

29. Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17,766 (Mar. 22, 2013).

30. *Id.* at 17,773.

31. Gillian Tan, *Banks Sit Out Riskier Deals*, WALL ST. J. (Jan. 21, 2014, 8:07 PM), <http://www.wsj.com/articles/SB1000142405270230430270457933482020153001>

Morgan, among others, decided against financing some corporate takeovers.³² In 2014, the Office of the Comptroller of the Currency's senior deputy comptroller identified private equity as the target of the guidance, as well as a cause of "bad practices" that the agencies were trying to mitigate.³³

In recent years, firms have taken advantage of the tax-deductible expense and reaped the benefits of low borrowing rates. With rates on leveraged loans falling to 5.4% in 2014, albeit with a slight raise in 2015, private equity saw extremely busy years in 2014 and 2015.³⁴ Private equity fundraising hit \$555 billion and \$527 billion in 2014 and 2015, respectively, with just under 50% coming from buyouts.³⁵

In addition to the favorable treatment of the general partner's gains, the partnership structure allows for the pass-through of losses to equity owners, such as the limited partners, but is limited by section 67 of the Internal Revenue Code.³⁶ Moreover, where limited partners are tax-exempt organizations, such as retirement plans, there will be no taxation at the limited partner level. However, this is conditioned on the fund not treating the investments producing the gains as debt-financed, and is therefore inapplicable to the subject of this Note.³⁷

3. Carried Interest

The limited partnership structure also provides various tax benefits, some of which have spurned recent debate. First off, limited

0 [<http://perma.cc/UB5C-Y35T>].

32. *Id.*

33. *Id.* ("The impact on private equity, a significant driver of what we see as risky practices, is an intended consequence of our actions As regulators, we certainly hope to change bad practices and remove the extraordinary froth that's experienced at the peak of a credit cycle. If we can mitigate that, it reduces the size of the valley to follow.").

34. BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2016, http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf [<http://perma.cc/9Q2H-XRR6>]; *see also* BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2015, at 25, 26 fig.2.2, http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2015.pdf [<http://perma.cc/LSM9-UXYG>].

35. *See* BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2016, *supra* note 34, at 2 & fig.1.2.

36. Persaud & Atkinson, *supra* note 14, § 47:3.1[A][5].

37. *Id.* § 47:3.1[A][2].

partnerships permit a “pass-through” structure for purposes of U.S. federal income tax, meaning there is no federal income tax at the entity level on either capital gains or other income.³⁸ However, that income from the sale of portfolio investments is subject to taxation when it is funneled to the general partner and limited partners.³⁹ If the fund’s partners are individuals and the investment had been held for more than one year, the gains are taxed once at preferential long-term capital gains rates.⁴⁰ This characteristic of the private equity fund structure has raised much political debate over the past fifteen years, with many believing these profits, or carried interest, should be treated as ordinary income, rather than capital gains.⁴¹

If income generated from ownership interests in partnership funds was treated as ordinary income rather than capital gains, it would likely be subject to a 35% tax rate—the maximum rate on ordinary income and short term capital gains—rather than its current 20% rate.⁴² Congress and other politicians have spent a great deal of time arguing about this loophole.⁴³ On one side of the debate, some believe that this is clearly ordinary income, compensating the fund managers for their services in managing companies and selling them off at a profit, and thus should be

38. *Id.* § 47:3.1[A][1].

39. *Id.*

40. *Id.*

41. Ryan Ellis, *Taxing Carried Interest Capital Gains as Ordinary Income is a Very Bad Idea*, FORBES (Sept. 4, 2015, 5:06 PM), <http://www.forbes.com/sites/ryanellis/2015/09/04/taxing-carried-interest-capital-gains-as-ordinary-income-is-a-very-bad-idea/> [http://perma.cc/YN3P-HXJ4].

42. This income was previously taxed at the prior rate for capital gains of 15%. *See* Steven D. Bortnick, *Basics of Private Equity Taxation*, PEPPER HAMILTON LLP (Jan. 17, 2012), <http://www.pepperlaw.com/resource/2137/4H1> [http://perma.cc/5LNC-A944]; Dean Baker & Grover Norquist, *Kill the Private-Equity Tax Break*, BUSINESS WEEK (Aug. 2007), http://www.businessweek.com/debateroom/archives/2007/07/kill_the_privat.html [http://perma.cc/WPA9-LHFS]. Although the current rate is now at 20%, the argument in favor of applying the ordinary income rate to income generated from ownership interests in partnership funds still stands. *See* Eileen Appelbaum, *Private Equity Tax Breaks: How Long Will They Last?*, FORTUNE (Apr. 10, 2014, 6:05 PM), <http://fortune.com/2014/04/10/private-equity-tax-breaks-how-long-will-they-last/> [http://perma.cc/KE5H-BD2Q].

43. *See, e.g.*, American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong.; Job Creation and Tax Cuts Act of 2010, S. 3793, 111th Cong. At this time, there has been no legislative action to address the tax treatment of carried interests.

taxed as such.⁴⁴ On the other hand, some argue that this compensation for managers is not a salary because of the risk incurred in their investment, and that labor, at times, may receive capital-gains treatment.⁴⁵ However, Congress has yet to pass any laws changing the taxation of profits from private equity activities.⁴⁶

B. LEGAL FRAMEWORK FOR FUND LIABILITY FOR PORTFOLIO DEBTS

1. Federal Fraudulent Transfer Law, State Fraudulent Transfer Law, and Unjust Enrichment Claims

The Bankruptcy Code grants an estate in bankruptcy certain avoidance powers for preferential and fraudulent transfers under sections 547 and 548⁴⁷ to protect companies and their creditors from certain transactions.⁴⁸ Section 547 allows a trustee to avoid as a preferential transfer

any transfer made by an insolvent debtor in the ninety days preceding bankruptcy, where the transfer (i) was made to or for the benefit of a creditor; (ii) was made for or on account of an antecedent debt owed by the debtor; and (iii) enabled the creditor to receive more than it otherwise would have under the provisions of the Bankruptcy Code.⁴⁹

Section 548 provides that

a trustee of a bankruptcy estate may avoid as a constructively fraudulent transfer any transfer or obligation incurred by a debtor within the two years before the date of the filing of the petition when

44. *Should Carried Interest Be Taxed as Ordinary Income, Not as Capital Gains?*, WALL ST. J. (May 14, 2012), <http://www.wsj.com/articles/SB10001424052702304811304577370062392150338?mg=id-wsj> [<http://perma.cc/QB87-7UUK>].

45. *Id.*

46. *See id.*

47. 11 U.S.C. §§ 547-548 (2012).

48. John Ames et al., *Preferences and Fraudulent Transfers Under the Bankruptcy Code: A Primer in Pain*, in THE AMERICAS RESTRUCTURING & INSOLVENCY GUIDE 2008/2009, at 107 (2008).

49. *Lehman Bros. Holdings v. JPMorgan Chase Bank, N.A.*, 469 B.R. 415, 435 (Bankr. S.D.N.Y. 2012).

made in exchange for “less than reasonably equivalent value” and that left the debtor insolvent.⁵⁰

In 1984, Congress amended the Bankruptcy Code to include an exemption from fraudulent transfer avoidance—section 546(e)—for margin payments or settlement payments made between “financial participant[s]” in connection with a securities contract that lacked an actual intent to defraud.⁵¹

In recent years, the law of fraudulent and preferential transfers has been expanded into the private equity context, specifically to overturn certain leveraged buyouts (“LBOs”).⁵² During the recession in the United States, highly leveraged portfolio companies proved unable to stay afloat during the economy’s downward spiral, and in turn led creditors and debtors to seek to recover payments made to the companies’ selling shareholders as part of the LBO.⁵³ Private equity firms open themselves to this fraudulent transfer litigation where they overvalue a target company and render that company insolvent by loading on new debt.⁵⁴ In these situations, the firm exposes not only the acquired company, but also its new investors.⁵⁵ Both the Second and Third Circuits have extended the availability of section 546(e)’s

50. *Id.*

51. 11 U.S.C. § 546(e); see Samir D. Parikh, *Saving Fraudulent Transfer Law*, 86 AM. BANKR. L.J. 305, 335 (2012).

52. See Grant Vingo, Michael Bernstein & Stewart Aaron, Arnold & Porter LLP, Financial Markets Regulatory Roundtable: The Use of Fraudulent Conveyance Principles to Overturn LBOs (June 6, 2012), <http://files.arnoldporter.com/nyrr-principles%20to%20overturn%20lbs%20-%20june%206%202012.pdf> [<http://perma.cc/Y3G6-A3YC>].

53. Ilkka Perheentupa & Jonathan L. Sagot, *Private Equity Alert: Caveat Vendor – Mitigating Fraudulent Conveyance Risk*, WEIL GOTSHAL, at 1 (May 2010), http://www.weil.com/~media/files/pdfs/private_equity_alert_may_14_2009.pdf [<http://perma.cc/2PAW-UQHR>]. To protect against this type of fraudulent transfer claim, selling sponsors can attempt to frame these transactions as “settlement payments” within the scope of Section 546(e). *Id.* at 2.

54. Nicholas F. Kajon, *Dividend Recaps: Why Some of Today’s Private Equity Deals May Become Tomorrow’s Fraudulent Conveyances*, STEVENS & LEE (Jan. 20, 2007), <http://www.stevenslee.com/dividend-recaps-why-some-of-todays-private-equity-deals-may-become-tomorrows-fraudulent-conveyances/> [<http://perma.cc/J23P-QX27>].

55. *Id.*

exception for settlement payments,⁵⁶ while the Eleventh Circuit has declined to apply the safe harbor where the financial institution does not “acquire[] a beneficial interest in either the [transferred] funds or securities.”⁵⁷

As an alternative to proceeding under section 548, states also have their own fraudulent transfers statutes.⁵⁸ The benefit of these statutes is typically a longer claw-back period from which to recover transfers, while the major downfall is their requirement for an actual unsecured creditor with standing to bring the complaint.⁵⁹

In suits where plaintiff creditors bring fraudulent transfer claims, a plaintiff may also bring an unjust enrichment claim.⁶⁰ For example, under New York law, an unjust enrichment claim is unavailable where it “duplicates, or replaces, a conventional contract or tort claim,” but such a claim will not be dismissed on the basis that they are “duplicative of fraudulent transfers claims.”⁶¹ Despite the availability of an unjust enrichment claim, this remedy for defrauded creditors is relatively new and courts have only recently started to uphold such claims.⁶²

56. See Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (*In re Quebecor World (USA) Inc.*), 719 F.3d 94, 98 (2d Cir. 2013); Lowenschuss v. Resorts Int’l, Inc. (*In re Resorts Int’l, Inc.*), 181 F.3d 505, 516 (3d Cir. 1999).

57. See *Munford v. Valuation Res. Corp.* (*In re Munford, Inc.*), 98 F.3d 604, 610 (11th Cir. 1996) (per curiam). For a complete discussion regarding the application of section 546(e), see Parikh, *supra* note 51, at 337–48.

58. See *Avoiding Fraudulent Transfers*, VEDDER PRICE, at 4 (2002), <http://www.vedderprice.com/files/Publication/91c17fac-ae6a-4a05-a16418c97905ee09/Presentation/PublicationAttachment/7710c995-93cd-43b0-b62e-5183411bb6fd/Avoiding%20Fraudulent%20Transfers.pdf> [<http://perma.cc/LF4P-NE3C>].

59. See *id.*

60. *Hosking v. TPG Capital Mgmt., L.P.* (*In re Hellas Telecomms. (Lux.) II SCA*) (*Hosking II*), 535 B.R. 543, 585 (Bankr. S.D.N.Y. 2015) (citing *Corsello v. Verizon N.Y., Inc.*, 967 N.E.2d 1177, 1185 (N.Y. 2012)).

61. *Id.*

62. *Compare Samiento v. World Yacht Inc.*, 883 N.E.2d 990, 996 (N.Y. 2008) (upholding an unjust enrichment claim’s dismissal where there was “an adequate remedy at law”), *with Hosking II*, 535 B.R. at 585 (upholding an unjust enrichment claim where it is “validly pleaded in the alternative” to other claims).

2. *Sun Capital: Introducing Fund Liability for Portfolio Company Obligations*

In *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, the First Circuit introduced the precedent that firms can and should be liable for certain obligations of their portfolio companies under a specific set of circumstances.⁶³ In 2007, two funds of Sun Capital Advisors, Inc.,⁶⁴ Sun Fund III and Sun Fund IV, acquired complete ownership in Scott Brass, Inc. (“SBI”), a Rhode Island corporation, which participated in a New England based multiemployer pension plan.⁶⁵ In 2008, SBI experienced declining copper prices, which reduced the value of its inventory and caused it to breach its loan covenants and lose its access to credit.⁶⁶ As a result, it stopped contributing to the pension plan, and therefore became liable for its proportionate share of the plan’s unfunded vested benefits pursuant to section 4201 of the Employment Retirement Income Security Act (“ERISA”).⁶⁷ This triggered over \$4.5 million in withdrawal liability.⁶⁸ However, in November 2008, SBI became the subject of an involuntary chapter 11 bankruptcy proceeding.⁶⁹ As a result, the pension plan demanded that the two funds owning SBI pay the full amount of withdrawal liability, claiming that the funds “entered into a partnership or joint venture in common control with SBI and were therefore jointly and severally liable for SBI’s withdrawal liability.”⁷⁰

In 2010, the funds filed an action in federal court seeking a declaration that they were not subject to liability under the two-part statutory test required by ERISA.⁷¹ The test provides that in order “to

63. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 139–44 (1st Cir. 2013).

64. Sun Capital Partners, Inc. is global private equity firm with over \$9.1 billion of capital under management. *About Us*, SUN CAPITAL PARTNERS, INC., http://www.suncapart.com/?page_id=10 [<http://perma.cc/GXD4-6XKT>].

65. *Sun Capital*, 724 F.3d at 135–36.

66. *Id.* at 136.

67. *See* Employee Retirement Income Security Act of 1974 § 4201, 29 U.S.C. § 1381 (2012).

68. *Sun Capital*, 724 F.3d at 136.

69. *Id.*

70. *Id.*

71. *Id.* at 137; *see also* Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1301(b)(1).

impose withdrawal liability on an organization other than the one obligated to the [pension plan], two conditions must be satisfied: 1) the organization must be under common control with the obligated organization, and 2) the organization must be a trade or business.”⁷² The district court agreed with the pension plan, basing its decision wholly on the second part of this test.⁷³ On appeal, the First Circuit applied an “investment plus” approach to evaluate the “trade or business” prong in determining whether the funds were more than mere passive investors.⁷⁴ After a lengthy discussion, the court held that Sun Fund IV met the “trade or business” prong.⁷⁵ The First Circuit remanded the decision to the district court to determine the status of Sun Fund III and to determine the issue of common control for both funds.⁷⁶

While the decision in *Sun Capital* turned on liability under a statutory test required by ERISA, the court engaged in two important discussions regarding general fund liability for portfolio company obligations. In the first one, the court addressed the underlying issue in the carried interest debate—namely, that because of the fees granted to the general partners of funds and the nature of their involvement in the funds, they are carrying out a business and should be treated as such under the law.⁷⁷ In the second discussion, the court introduced an important point about the role of the general partner to break the liability shield for the partners under Delaware law.⁷⁸ The court stated:

Here, the limited partnership agreements gave the Sun Funds’ general partners the exclusive authority to act on behalf of the limited partnerships to effectuate their purposes. These purposes included managing and supervising investments in portfolio companies, as well as “other such activity incidental or ancillary thereto” as deemed advisable by the general partner. So, under Delaware law, it is clear that the general partner of Sun Fund IV, in

72. *Sun Capital*, 724 F.3d at 138.

73. *Id.* at 137.

74. *Id.* at 141.

75. *Id.* at 148-49.

76. The court stated that in order to be considered an employer under ERISA both prongs of the test must be met. *Id.*

77. *Id.* at 143.

78. *Id.* at 146-47.

providing management services to SBI, was acting as an agent of the Fund.⁷⁹

Although the scope of the court's decision was limited to the specific issue of whether the funds could be held liable under ERISA, *Sun Capital* raised an important issue in fund liability for portfolio companies that courts will likely face more frequently as private equity continues to grow.

II. THE VARYING RESULTS OF OVERLEVERAGING: HELLAS COMMUNICATIONS, COLT DEFENSE, & MARKET TRENDS IN EXITS

This part provides examples of the varying results that occur when funds overleverage their portfolio companies. Part II.A examines Hellas Communications. Although the company emerged from bankruptcy and is currently operational, it remains the subject of various lawsuits in the United States and abroad because of redemptions made by its private equity owners prior to the company's sale.⁸⁰ Part II.B examines Colt Defense, which filed for bankruptcy in June of 2015 and successfully reorganized in January 2016.⁸¹ Part II.C demonstrates other effects of overleveraging through market research; namely, how overleveraging in private equity has affected the exit strategies used by firms.⁸²

A. HELLAS COMMUNICATIONS: A FOREIGN COMPANY WITH DOMESTIC APPLICATIONS

1. *About Hellas Communications*

Hellas Communications is one of the largest and most innovative telecommunications companies in Greece.⁸³ The company was founded in Greece in 1992 and began providing mobile telecommunications services in the Greek market in 1993.⁸⁴ In 1997, the company was the

79. *Id.* at 147.

80. *See infra* Part II.A.

81. *See infra* Part II.B.

82. *See infra* Part II.C.

83. The company is now known as WIND Hellas Telecommunications S.A. *Company Profile*, WIND, <http://www.wind.gr/en/wind/gia-tin-etaireia/etairiko-profil/> [<http://perma.cc/E2RG-5DZZ>].

84. *Id.*

first to launch prepaid phone service in Greece, and in 2003, it made the first 3G call in Greece.⁸⁵ By the end of 2004, the company had 2.3 million customers, reported sales of €840 million, and an operating income of approximately €121 million.⁸⁶

In April 2005, Telecom Italia sold its ownership in Hellas Communications to two large global private equity firms, London's Apax Partners ("Apax") and Texas Pacific Group ("TPG"), for €1.6 billion (about a 17% premium above share price).⁸⁷ This was the largest leveraged buyout Greece had ever seen,⁸⁸ financed mostly through borrowed funds from JPMorgan and Deutsche Bank.⁸⁹ Apax and TPG set up multiple entities under Luxembourg law in preparation for the acquisition, including "Hellas," "Hellas I," and "Hellas II."⁹⁰ The firms acquired an 80% majority stake in the company through eight investment funds and obtained financing through these entities.⁹¹ Hellas II was the direct owner of Hellas Communications, but Apax and TPG used other investment funds to issue debt and redeem its equity stake, as described below.⁹²

85. *Id.*

86. Press Release, Apax Partners, Apax Partners' Funds and Texas Pacific Group to Acquire Control of Tim Hellas Telecommunications S.A. in a 1.1 Billion Euro Transaction (Apr. 4, 2005), <http://www.apax.com/news/apax-news/2005/april/apax-partners%E2%80%99-funds-and-texas-pacific-group-to-acquire-control-of-tim-hellas-telecommunications-sa-in-a-11-billion-euro-transaction/> [<http://perma.cc/XR7L-BJZ7>].

87. *Id.*

88. *Another Greek Tragedy*, THE ECONOMIST (June 20, 2015), <http://www.economist.com/news/finance-and-economics/21654680-pressure-mounts-two-private-equity-giants-did-very-well-out-disastrous> [<http://perma.cc/J5UJ-59GS>].

89. Press Release, Apax Partners, *supra* note 86.

90. See *Hosking v. TPG Capital Mgmt., L.P. (In re Hellas Telecomms. (Lux.) II SCA)* (Hosking I), 524 B.R. 488, 497 (Bankr. S.D.N.Y. 2015); see also *infra* fig.1.

91. See *Hosking I*, 524 B.R. at 497; see also *infra* fig.1.

92. See *Hosking I*, 524 B.R. at 497; see also *infra* fig.1 (showing that Hellas II is the direct owner of TIM Hellas Communications S.A.).

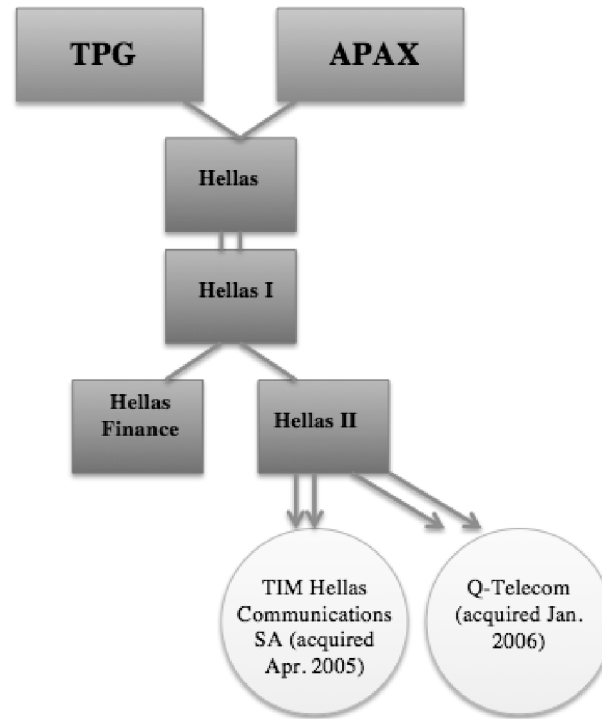


Figure 1: Glimpse at Hellas Communications Ownership Structure⁹³

Upon taking a majority equity position in the company, the firms began issuing debt and cancelled their equity interests in the portfolio company.⁹⁴ The firms then used Hellas II and other entities to acquire another portfolio company, Q-Telecom, a business unit of a large mobile network operator in Greece.⁹⁵ This highly leveraged acquisition closed in January 2006.⁹⁶ The debt was primarily issued by Hellas II.⁹⁷ The

93. Ownership structure is derived from the facts of the case and does not include other Hellas entities not pertinent to the discussion. *See Hosking I*, 524 B.R. at 497.

94. *Id.*

95. *Id.* at 497-98.

96. *Id.*

97. *Id.*

firms then began loading up the funds with debt.⁹⁸ By December 2006, Apax and TPG redeemed just shy of €1 billion from debt issuances by Hellas I (€973.7 million).⁹⁹ This included a redemption of “Luxembourgish instrument[s]” called convertible preferred equity certificates (“CPECs”) at 35 times their par value.¹⁰⁰ In February 2007, Apax and TPG sold Hellas and its subsidiaries to the Italian corporation Weather Investments S.p.A., later renamed WIND Telecom S.p.A.¹⁰¹ The sale went for €500 million of equity and €2.9 billion of net debt.¹⁰² At this point, Hellas II’s financial statements reflected that its debt obligations had resulted in a loss of more than €259.5 million, and the company was leveraged at 12.4 times EBIT (earnings before interest and tax).¹⁰³ By 2009, Hellas II went into administration in the UK.¹⁰⁴

2. Proceedings

As early as 2012, the liquidators that were appointed to Hellas II filed lawsuits against Apax and TPG based on debt issued in 2006.¹⁰⁵

98. The specifics of these transactions are described in depth in the court’s decision. *Id.* at 497–99.

99. *Id.* at 498; see Gretchen Morgenson, *Judge’s Ruling Offers Peek into Private Equity’s Secret World*, N.Y. TIMES (Sept. 4, 2015), http://www.nytimes.com/2015/09/06/business/judges-ruling-offers-peek-into-private-equitys-secret-world.html?_r=0 [<http://perma.cc/6976-5EW3>].

100. *Another Greek Tragedy supra* note 88.

101. *Hosking I*, 524 B.R. at 498.

102. Press Release, Apax Partners, Funds Advised by Apax Partners and TPG Announce the Sale of TIM Hellas to Weather Investments (Feb. 7, 2007), <http://www.apax.com/news/apax-news/2007/february/funds-advised-by-apax-partners-and-tpg-announce-the-sale-of-tim-hellas-to-weather-investments/> [<http://perma.cc/Z2YM-U5CE>].

103. *Hosking I*, 524 B.R. at 498.

104. Helia Ebrahimi, *Wind Hellas To Be UK’s Biggest Pre-Pack Administration*, TELEGRAPH (Nov. 12, 2009), <http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/telecoms/6556553/Wind-Hellas-to-be-UKs-biggest-pre-pack-administration.html> [<http://perma.cc/HGC2-E4JF>]. Administration in the UK is similar to a chapter 11 proceeding in the United States. Both are designed to rehabilitate the company in question and “prevent the creditors’ race for assets by imposing a moratorium against individual creditor actions.” Jodie A. Kirshner, *Design Flaws in the Bankruptcy Regime: Lessons from the U.K. for Preventing a Resurgent Creditors’ Race in the U.S.*, 17 U. PA. J. BUS. L. 527, 534 (2015).

105. See *infra* notes 106–09 and accompanying text.

The suits include: Luxembourg Commercial Court claims,¹⁰⁶ U.S. bankruptcy court proceedings,¹⁰⁷ New York federal court proceedings in the Southern District,¹⁰⁸ and a New York state court judgment.¹⁰⁹

In September 2014, the New York Supreme Court granted summary judgment for certain holders of Hellas Communications debt securities (via the indenture trustee—Wilmington Trust Co. (“WTC”)—and Cortlandt Street Recovery Corp., an assignee for collection).¹¹⁰ The court granted the judgment for recovery of principal and interest under the indenture despite dismissing fraudulent conveyance claims for the plaintiffs’ lack of standing.¹¹¹ However, this judgment remained outstanding as of March 2016, as the named Hellas entities had gone completely bankrupt.¹¹²

In December 2014, WTC received U.S. District Judge J. Paul Oetken’s permission to pursue more entities tied to Hellas Communications for unpaid debt, which WTC asserts can be traced back to the private equity giants who stripped Hellas.¹¹³ Although Judge Oetken initially dismissed the case in March 2014 due to lack of complete diversity of citizenship between the parties, he agreed to reopen the case and allow an amended complaint that dropped certain foreign parties.¹¹⁴ These parties, which included Apax subsidiaries, filed

106. See *Corporate Finance & Insolvency Litigation – Hellas Case: Court Rejects Claim*, KLEYR GRASSO (Jan. 5, 2016), http://www.kleyrgrasso.com/scpt_news/hellas-case/ [<http://perma.cc/E9SV-AUGK>]. The Luxembourg Commercial Court rejected all claims by the Hellas liquidators, asserting that (1) the redemption of the CPECs, the instruments in question, “could not be requalified as illegal dividend distributions to the shareholders” as they were debt instruments, and (2) the repurchase price of the CPECs were not fraudulent, but rather were independently verified to the approval of the Luxembourg Court back in 2006. See *id.*

107. See, e.g., *Hosking v. TPG Capital Mgmt., L.P. (In re Hellas Telecomms. (Lux.) II SCA) (Hosking II)*, 535 B.R. 543 (Bankr. S.D.N.Y. 2015).

108. *Cortlandt St. Recovery Corp. v. Aliberti*, No. 12-CV-8686 (JPO), 2014 WL 6907548 (S.D.N.Y. Dec. 9, 2014).

109. *Cortlandt St. Recovery Corp. v. Hellas Telecomms., S.á.r.l.*, 996 N.Y.S.2d 476 (Sup. Ct. 2014).

110. *Id.* at 498.

111. *Id.*

112. Jeff Zalesin, *Hellas Noteholders OK'd for New \$565M Complaint in PE Row*, LAW360 (Nov. 4, 2015), <http://www.law360.com/articles/723100/hellas-noteholders-ok-d-for-new-565m-complaint-in-pe-row> [<http://perma.cc/9Q7A-XQDG>].

113. *Aliberti*, 2014 WL 6907548, at *3; Zalesin, *supra* note 112.

114. *Aliberti*, 2014 WL 6907548, at *1; Zalesin, *supra* note 112.

a motion to dismiss for lack of personal jurisdiction, asserting the case belongs in Europe where many claims have already been dismissed, but as of this writing there has been no decision on the issue.¹¹⁵

In the U.S. bankruptcy court proceedings, the plaintiffs assert that the company did not have sufficient earnings to cover the various payouts to Apax and TPG's subsidiaries, and, accordingly, such payments should be clawed back as a fraudulent transfer.¹¹⁶ Meanwhile, Apax and TPG claim that the company was in perfectly good health when it was sold in 2007, and the reason the plaintiffs' debt instruments defaulted was solely a result of the financial crisis.¹¹⁷ In the press release regarding the sale, the funds even stated, "During Apax's and TPG's period of ownership, the company was successfully turned round and set on a growth trajectory leading to a significant improvement in all financial and operating key metrics."¹¹⁸ Despite Apax and TPG's best efforts, in early 2015, Judge Martin Glenn granted in part and denied in part four motions to dismiss the complaint in the bankruptcy court proceedings.¹¹⁹ In August of the same year, Judge Glenn granted the liquidators a motion to amend their complaint to add new defendants and assert new claims against the proposed defendants and the original defendants, and to withdraw certain other claims and other defendants from the proceedings.¹²⁰

115. See Plaintiff's Memorandum in Opposition to Defendants' Motion to Dismiss, *Aliberti*, 2014 WL 6907548 (No. 12-CV-8686 (JPO)); Jenna Ebersole, *Cos. Want PE Row Over \$565M Judgment Tossed*, LAW360 (Jan. 22, 2016), <http://www.law360.com/articles/749547/cos-want-pe-row-over-565m-judgment-tossed> [<http://perma.cc/2G5E-JSPD>]; William Louch, *Luxembourg Court Rules in Favour of Apax, TPG in Hellas Case*, FIN. NEWS (Dec. 24, 2015), <http://www.efinancialnews.com/story/2015-12-24/hellas-ii-apax-tpg-luxembourg-ruling> [<http://perma.cc/4UE9-A8MX>].

116. Morgenson, *supra* note 99.

117. *Id.*

118. Press Release, Apax Partners, *supra* note 102.

119. The complaint was dismissed for lack of personal jurisdiction as to Apax and foreign-based entities affiliated with Apax and TPG. The court also dismissed fraudulent transfer claims for lack of standing. However, the court concluded that personal jurisdiction could be exercised over each of the United States-based defendants. *Hosking v. TPG Capital Mgmt., L.P. (In re Hellas Telecomms. (Lux.) II SCA) (Hosking I)*, 524 B.R. 488, 536 (Bankr. S.D.N.Y. 2015); see also *Hosking v. TPG Capital Mgmt., L.P. (In re Hellas Telecomms. (Lux.) II SCA) (Hosking II)*, 535 B.R. 543, 551 (Bankr. S.D.N.Y. 2015) (explaining the procedural background of *Hosking I*).

120. *Hosking II*, 535 B.R. at 595-96.

3. Analysis: A Precedent Set for the Industry

According to emails cited by Judge Glenn in his bankruptcy court decision to uphold complaints against Hellas, certain employees within TPG were aware of the damage to be done to Hellas II upon the execution of the 2006 debt issuances.¹²¹ One email from a TPG executive to an employee at Apax stated that they would be “putting the business under huge pressure,” while another warned of the dangerous position Hellas II would find itself in should the redemption occur.¹²² In addition, there were various inconsistencies in the 2006 debt offerings, such as the prospectus’ description of the issuance as a repayment of “deeply subordinated shareholder loans,” when there were no shareholder loans listed on the company’s balance sheet.¹²³ Thus, it is likely that the case of Hellas II did not just involve a typical overleveraging of a portfolio company, but also fraudulent practices. The situation highlights the extreme practices that the private equity fund structure will allow.

While the parallel case in Luxembourg determined whether the payout was a breach of the country’s corporate laws,¹²⁴ the New York trials still will be important for fund managers. The outcome could prove useful in deterring them from this type of extreme overleveraging, in which firms extract funds from a company for a large, short-term payoff, leaving creditors with an empty promise of debt that is unable to be repaid.¹²⁵ Before Apax and TPG purchased the company, at the year ended December 31, 2004, Hellas Communications had a debt to equity ratio of 1.09 (in thousands of euro, 709,672 total liabilities/650,019

121. *Id.* at 579-81.

122. *Id.*

123. Gretchen Morgenson, *Private Equity’s Trojan Horse of Debt*, N.Y. TIMES (Mar. 13, 2010), <http://www.nytimes.com/2010/03/14/business/14gret.html> [<http://perma.cc/2RYP-DX9K>].

124. Louch, *supra* note 115; *see also* Morgenson, *supra* note 99.

125. Had Hellas II been a domestic fund, such as a Delaware LP, with direct on-shore investors, the court would also address the issue of whether the leveraged recapitalization was a fraudulent transaction under U.S. bankruptcy law. *See* Eva Davis & Hamed Meshki, *Trends in Private Equity Exits*, KIRKLAND & ELLIS (Sept. 2010), <http://www.kirkland.com/siteFiles/Publications/ARTICLE%20PDF%20-%20PRINTING%20ALLOWED%20-%20PLC%20-%20E%20Davis.pdf> [<http://perma.cc/BD9Z-4RFP>].

Shareholders equity).¹²⁶ At the year ended December 31, 2006, immediately prior to the sale by Apax and TPG, but following Hellas II's debt issuance to the firms, Hellas Communications found itself with a debt to equity ratio of 68.1 (in thousands of euro, 1,988,267 total liabilities/29,208 total equity).¹²⁷ That leverage ratio increased the following year after the sale of Hellas Communications.¹²⁸ After the departure of Apax and TPG, the company went through a very complex, global restructuring in 2010, with its bondholders taking 100% of the company's shares in return for waiving a €1.225 billion debt obligation.¹²⁹

B. COLT DEFENSE: A SUCCESSFUL INVESTMENT, DESPITE LEVERAGE AND DEFAULT

Colt's Manufacturing Company is "one of the world's oldest most renowned designers, developers and manufacturers of firearms."¹³⁰ The company traces its roots back to 1836, when the company's founder, Sam Colt, opened his first factory in Paterson, NJ, where he developed and produced the pocket, belt, and holster model pistols along with two types of rifles.¹³¹ By 1847, Colt received his first government order from the U.S. Ordnance Department for one thousand of his pistols.¹³² In 1851, Colt became the first American manufacturer to open a plant in England, incorporating under the name of Colt's Patent Fire Arms Manufacturing Company.¹³³ The company has been manufacturing firearms since its inception, arming American officers in both World

126. TIM HELLAS TELECOMMS. S.A., ANNUAL REPORT 2004, at 16 (2004).

127. TIM HELLAS TELECOMMS. S.A., ANNUAL REPORT 2006, at F-49 to F-50 (2006).

128. *Id.*

129. Anousha Sakoui, *Wind Hellas Secures Debt Revamp*, FIN. TIMES (Oct. 18, 2010), <http://www.ft.com/intl/cms/s/0/1a77f54c-dab6-11df-81b0-00144feabdc0.html#axzz3t9Iupy88> [<http://perma.cc/N63P-PNUG>]. See generally Colin Chang et al., *WIND Hellas: A Complex Restructuring in a Global Recession*, WHITE & CASE LLP (Feb. 24, 2011), http://www.whitecase.com/sites/whitecase/files/files/download/publications/article_wind_hellas_complex_restructuring.pdf [<http://perma.cc/2BSK-ZZCT>] (providing an in-depth look at the restructuring).

130. Colt Defense LLC, Annual Report (Form 10-K) (Mar. 20, 2014).

131. *History*, COLT, <http://www.colt.com/Company/History> [<http://perma.cc/4BZU-XG3S>].

132. *Id.*

133. *Id.*

Wars, Korea, Vietnam, Afghanistan, and Iraq.¹³⁴ Despite its rich history as a pioneer in the gun industry, much of the company's history has been plagued by commercial crisis.¹³⁵

In the 1970s and 1980s, Colt's Manufacturing Company and other American gun manufacturers began to lose large government contracts to foreign gun makers.¹³⁶ In 1992, the company filed for bankruptcy court protection.¹³⁷ In 1994, the company found a buyer in Donald Zilkha, a wealthy Manhattan-based Iraqi banker from the family investment firm Zilkha & Co., who purchased Colt for a mere \$27 million.¹³⁸ Although Zilkha had hoped to help consolidate the market and acquire some foreign gun producers, in the end, his efforts proved futile.¹³⁹ This was most evident when his hand-picked CEO made a set of proposals that riled up Second Amendment activists, followed by the failure of the company's "smart gun."¹⁴⁰ By 2002, a Greek banker at Zilkha & Co., Ionnis Rigas, had started handling much of the oversight of Colt's Manufacturing Company.¹⁴¹ Rigas had formed his own firm, Sciens Capital Management ("Sciens"), holding investment interests in Athens and London, and saw an opportunity with Colt's Manufacturing Company.¹⁴² He arranged for a spinoff of the military business into what is now known as Colt Defense.¹⁴³

Sciens would put Colt Defense through "the private equity leverage wringer," loading the company with debt while receiving cash distributions.¹⁴⁴ According to *Bloomberg BusinessWeek*, the following were the highlights of the Colt Defense series of debt-financings:

The 2005 SEC filing shows payouts totaling \$40 million over the two prior years—a significant amount for a company in such fragile

134. Paul M. Barrett, *Why Colt Can't Shoot Straight*, BLOOMBERG BUSINESSWEEK (May 29, 2014), <http://www.bloomberg.com/bw/articles/2014-05-29/colts-curse-gunmakers-owners-have-led-it-to-crisis-after-crisis> [<http://perma.cc/6FLR-CVAV>].

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

financial health. In 2006, another SEC filing shows, the company redeemed “members’ equity” worth \$41 million. In 2007, Colt Defense agreed to borrow \$150 million in a “leveraged recapitalization” that featured distributions to “members” of \$131 million. In 2009 it borrowed an additional \$250 million, while multimillion-dollar payouts continued. For 2010, Colt Defense had sales of \$176 million—more than double what they were in 2004—but registered an \$11 million loss.¹⁴⁵

These transactions elicited suspicion from people like Merrick Alpert, an advisor and, later, senior vice president of Colt’s Manufacturing Company, who said, “You didn’t have to work at Colt Defense to know it had put itself in a dire situation.”¹⁴⁶ Despite signs of hope for increased revenues, Sciens’ attempt to turnaround Colt Defense failed.¹⁴⁷ The company had issued too much debt and, by 2014, it sought an additional \$4.1 million in liquidity from Morgan Stanley to make a \$10.9 million interest payment to bondholders in November.¹⁴⁸ At this point, it was clear that Colt Defense would be unable to meet its bond obligations due in May 2015 without restructuring the debt.¹⁴⁹ The company finally filed for chapter 11 bankruptcy protection in June 2015 in the wake of various accounting problems and the failure to complete its annual SEC filing.¹⁵⁰ Unlike the case in Hellas Communications, Colt

145. *Id.*

146. *Id.*

147. Andrew Schouler & Robert Crowley, *Analysis: Firearms Maker Colt a Cautionary Tale for Defense Contractors*, NATIONAL DEFENSE MAGAZINE (Dec. 15, 2014), <http://www.nationaldefensemagazine.org/blog/Lists/Posts/Post.aspx?ID=1699> [<http://perma.cc/W4U4-G658>] (“The subsequent transfer of Colt’s control to Sciens Capital Management did not change much. Colt was saddled with leveraged recapitalizations that left the company with \$300 million of debt, at least \$131 million of which was used to make distributions back to Sciens in 2007.”).

148. Stephanie Gleason, *Colt Warns It Could Miss May Bond Payment*, WALL ST. J. (Nov. 26, 2014, 11:22 AM), <http://www.wsj.com/articles/gun-maker-colt-warns-on-missing-2015-targets-1417018925> [<http://perma.cc/JV9V-47HC>].

149. See Joy Ferguson, *Colt Defense Warns It Might Miss May 2015 High Yield Bond Payment*, FORBES (Nov. 26, 2014, 11:08 AM), <http://www.forbes.com/sites/spleverage/2014/11/26/colt-defense-warns-it-might-miss-may-2015-high-yield-bond-payment/#1241cd4b3308> [<http://perma.cc/GNB6-DYMZ>].

150. Matt Jarzemsky, *Colt Defense Files for Chapter 11 Bankruptcy Protection*, WALL ST. J. (June 15, 2015, 8:12 AM), <http://www.wsj.com/articles/colt-defense-to-file-for-chapter-11-bankruptcy-protection-by-monday-1434310925> [<http://perma.cc/BK>].

Defense's creditors included 2700 "mom and pop" bondholders who represented about one quarter of the value of the bond debt.¹⁵¹ This further complicated Colt Defense's efforts to reach a deal without filing for bankruptcy.¹⁵²

Unlike its earlier bankruptcy in the 1990s, however, Colt Defense was able to escape a fire sale by successfully planning and exiting from an accelerated chapter 11 restructuring.¹⁵³ Showing signs of life by late September 2015, the company was awarded a \$212 million multi-year contract with the U.S. Department of Defense.¹⁵⁴ On November 10, 2015, the company announced the U.S. Bankruptcy Court for the District of Delaware's approval of its disclosure statement for plan of reorganization.¹⁵⁵ The plan received the support of Sciens and the owners of more than 60% of Colt's senior outstanding notes due in 2017.¹⁵⁶ In January 2016, the company successfully emerged from restructuring.¹⁵⁷

5M-X7RY]; Geoffrey Smith, *Gun Maker Colt Files for Chapter 11 Bankruptcy Protection*, FORTUNE (June 15, 2015, 6:03 AM), <http://fortune.com/2015/06/15/colt-gun-chapter-11-bankruptcy-protection/> [<http://perma.cc/3CR7-GVNN>]. For documents, court filings, and other information about the Colt Chapter 11 proceedings, visit <http://www.kccllc.net/coltdefense>.

151. Jarzemsky, *supra* note 150.

152. *Id.*

153. Press Release, Colt, Colt Defense Emerges from Chapter 11 Restructuring - Iconic American Brand Looks to Future with Stronger Capital Structure and Enhanced Liquidity (Jan. 14, 2016), <http://www.colt.com/Media/Press-Releases/articleType/ArticleView/articleId/141/COLT-DEFENSE-EMERGES-FROM-CHAPTER-11-RESTRUC> TURING—Iconic-American-Brand-Looks-to-Future-with-Stronger-Capital-Structure-and-Enhanced-Liquidity [<http://perma.cc/6FZE-DTA3>].

154. Press Release, U.S. Dep't of Defense, Release No: CR-184-15 (Sept. 25, 2015), <http://www.defense.gov/News/Contracts/Contract-View/Article/620608> [<http://perma.cc/2SD3-PSP6>].

155. *Colt Defense Announces Court Approval of Disclosure Statement for Plan of Reorganization*, BUSINESS WIRE (Nov. 10, 2015, 6:53 PM), <http://www.businesswire.com/news/home/20151110007074/en/Colt-Defense-Announces-Court-Approval-Disclosure-Statement> [<http://perma.cc/UB8A-38WL>].

156. Anders Melin, *Colt Defense, 179-Year-Old Gunmaker, Nears Exit From Bankruptcy*, BLOOMBERG BUSINESSWEEK (Oct. 10, 2015, 1:01 PM), <http://www.bloomberg.com/news/articles/2015-10-10/colt-defense-179-year-old-gunmaker-nears-exit-from-bankruptcy> [<http://perma.cc/XW8P-DRJZ>].

157. Press Release, Colt, *supra* note 153.

The case of Colt Defense is very unique from most private equity leveraged portfolio companies. For one, Sciens had held its ownership stake in Colt Defense for over fifteen years, and offered to buy out up to \$108 million in senior loans and \$20 million in bankruptcy financing if bondholders would accept a 55% haircut on their debt.¹⁵⁸ This was perhaps Sciens' most profitable move at the time for Colt Defense so as to retain its investment.¹⁵⁹ Had Sciens sold off Colt Defense following its leveraged recapitalization in 2007, as Apax and TPG did in the case of Hellas Communications, Colt Defense's creditors would have likely found themselves in the same situation as those of Hellas Communications, with little opportunity for redress.¹⁶⁰

C. MARKET TRENDS AMONG PRIVATE EQUITY FUNDS: HOW LEVERAGING AFFECTS THE EXIT STRATEGY

As lower interest rates led to increased leverage among portfolio companies similar to those described above,¹⁶¹ they simultaneously brought a sharp increase in the number and value of exits by the investing firms.¹⁶² 2014 had a record \$456 billion in buyout-backed exits, and 2015 came in just under at \$422 billion.¹⁶³ This section briefly addresses the exit trends that funds have used in recent years, including IPOs, strategic secondary sales, and the leveraged recapitalization plans.

According to the Bain & Company Global Private Equity Report for 2015, 2014 was "the year of the exit,"¹⁶⁴ partially due to the rise in

158. Peg Brickley, *Showdown Looms in Bankruptcy of Gun-Maker Colt Defense*, WALL ST. J. (June 16, 2015, 6:18 PM), <http://www.wsj.com/articles/showdown-looms-in-bankruptcy-of-gun-maker-colt-defense-1434493099> [<http://perma.cc/9FQA-GWFB>]; Alexander Gladstone & Hema Oza, *Colt Sponsor Sciens Locks and Loads Stalking Horse Bid of Its Own*, DEBTWIRE (June 11, 2015), <http://www.debtwire.com/info/2015/06/11/colt-sponsor-sciens-locks-loads-stalking-horse-bid/> [<http://perma.cc/77EC-64QU>].

159. Barrett, *supra* note 134.

160. Conversely, had Hellas Communication's managers opted not to sell the company immediately following the redemption, the funds would not currently be the subject of multiple law suits. *See supra* Part II.A.3.

161. *See supra* Parts II.A, II.B.

162. *See* BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2016, *supra* note 34, at 20; BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2015, *supra* note 34, at 4.

163. BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2016, *supra* note 34, at 20.

164. *See* BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2015, *supra* note 34, at iii.

IPOs and strategic secondary sales.¹⁶⁵ While many of these exits can be explained by the global economy's general recovery over the past few years,¹⁶⁶ the increase can be explained, in part, by near-zero interest rates.¹⁶⁷ The increase in buyout-backed exits via IPOs and strategic sales is due to the desire of managers to take advantage of rates while they are low.¹⁶⁸ The United States expects to see a very slow path to rate increases.¹⁶⁹ When the rates rise, private equity investment will become less appealing and more expensive.¹⁷⁰ For now, private equity firms are taking advantage of favorable valuations, and hope to free up capital, and make further investments while the cost of borrowing is low.¹⁷¹ "A slow rise in rates means sellers who cash out will still have good reason to put their money back to work through acquisitions, since fixed income investments will still offer low yields, and the equity market has again shown it can swiftly transform into a sea of volatility."¹⁷² Additionally, interest rates affect the market for public offerings, and it has been projected that the IPO market will slow as interest rates rise.¹⁷³ Similarly, the market for strategic secondary sales is more appealing in

165. See *id.* at 3.

166. RR DONNELLEY, VENUE MARKET SPOTLIGHT: PRIVATE EQUITY EXITS 3 (2014), <http://www.rrdonnelley.com/venue/media/November-VMS.pdf> [<http://perma.cc/24VL-3FMC>].

167. BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2015, *supra* note 34, at iii, 1–2.

168. See generally *id.*

169. David Harrison & Michael S. Derby, *Janet Yellen Says Global Uncertainty Justifies Slower Path of Rate Increases*, WALL ST. J. (Mar. 29, 2016, 5:57 PM), <http://www.wsj.com/articles/yellen-says-global-uncertainty-justifies-slower-path-of-rate-increases-1459268438> [<http://perma.cc/S8M2-U5UB>].

170. See William D. Cohan, *Low Interest Rates Help Private-Equity Moguls and Hurt Average Americans*, THE NATION (Sept. 18, 2015), <http://www.thenation.com/article/low-interest-rates-help-private-equity-moguls-and-hurt-average-americans/> [<http://perma.cc/NQW6-39DZ>].

171. See generally BAIN & CO., GLOBAL PRIVATE EQUITY REPORT 2015, *supra* note 34.

172. Matt Porzio, *The Fed's Interest Rate Decision: What It Means for M&A*, FORBES (Sept. 14, 2015, 10:52 AM), <http://www.forbes.com/sites/mattporzio/2015/09/14/feds-interest-rate-decision-means-ma/> [<http://perma.cc/K3YY-JEVY>].

173. David J. Goldschmidt & Yasmeena F. Chaudry, *US IPO Market Review and Outlook: Can the Pace Continue?*, SKADDEN (Jan. 2015), <http://www.skadden.com/insights/us-ipo-market-review-and-outlook-can-pace-continue> [<http://perma.cc/F5M8-G5P9>].

the face of low interest rates.¹⁷⁴ Corporate M&A remains one of the most popular exit strategies for private equity and is expected to continue to thrive as long as rates remain low.¹⁷⁵

Lastly, the case of Hellas Communications shed a great deal of negative light on a partial exit method—the leveraged recapitalization.¹⁷⁶ Leveraged recapitalization is a strategy in which a company “takes on significant additional debt with the purpose of either paying a large dividend or repurchasing shares,” resulting in an overleveraged company.¹⁷⁷ The leveraged recapitalization by Apax and TPG in Hellas Communications drew criticism because of the immediate sale after overleveraging.¹⁷⁸ That, however, is not the ideal situation in a leveraged recapitalization; rather, a leveraged recapitalization works well where a company’s growth rate is increasing and the owners are trying to obtain some liquidity while maintaining the ownership position.¹⁷⁹

174. Jeff Golman, *Exit Strategy: Why Secondary Deals Are Becoming First Choice*, FORBES (May 20, 2014, 10:17 AM), <http://www.forbes.com/sites/jeffgolman/2014/05/20/exit-strategy-why-secondary-deals-are-becoming-first-choice/#102b83d85fe0> [<http://perma.cc/RHC7-LQPJ>] (“Record low interest rates have enabled companies, such as private equity firms, to leverage transactions in a relatively inexpensive manner. PE firms, as a result, have increased the amount of leverage used to finance the transactions, allowing them to bid more aggressively than strategic buyers and offer a higher purchase price.”).

175. *Id.*

176. See *supra* Part II.A.2-3. Colt served as an example of a more successful recapitalization. See *supra* Part II.B; Barrett *supra* note 134.

177. Ian Giddy, *Leveraged Recapitalizations and Exchange Offers*, NYU STERN, <http://people.stern.nyu.edu/igiddy/levrecap.htm> [<http://perma.cc/T8CS-XY4S>].

178. See *supra* notes 99–102 and accompanying text (describing the redemptions and ensuing sale).

179. *Anatomy of a Leveraged Recapitalization*, MGM CAPITAL PARTNERS BLOG, http://www.mcmcapital.com/mcm-docs/Anatomy_of_a_Leveraged_Capitalization.pdf [<http://perma.cc/N5RX-FLCE>]. Perhaps in hope of avoiding these types of leveraged recapitalizations and sell-offs, SEC Chair Mary Jo White announced in October 2015 that the Commission intends to develop private equity fund restructuring guidelines. White, *supra* note 8. As of May 1, 2016, there had been no releases regarding such guidance.

III. WHAT TO DO ABOUT OVERLEVERAGING: DUTY TO ENSURE COMPANY DEBTS ARE PAID

One option to deter private equity firms from overleveraging portfolio companies would be to eliminate the tax-deductible interest expense and raise taxes on carried interest.¹⁸⁰ This proposal has been at the forefront of various presidential candidates' tax plans in the upcoming 2016 election.¹⁸¹ However, this is an answer geared toward limiting profit windfalls for private equity giants in leveraging companies and appeasing the general public's distrust of Wall Street, rather than ensuring that debt in overleveraged portfolio companies will be repaid. This Note instead advocates for a solution that enhances fiduciary duties to ensure that a target company's debts are paid by parties already involved in the transactions via either the general partner or the indenture trustee.¹⁸²

180. See Toluse Olorunnipa & Angea Greiling Keane, *Obama Renews Carried Interest Tax Fight with Republican Help*, BLOOMBERG POLITICS (Sept. 16, 2015, 3:57 PM), <http://www.bloomberg.com/politics/articles/2015-09-16/obama-dusts-off-carried-interest-tax-fight-with-republican-help> [<http://perma.cc/8EXV-2G26>].

181. See Barney Jopson, *Trump and Clinton Tax Plans Scare Wall Street*, FIN. TIMES (Jan. 14, 2016, 6:40 PM), <http://www.ft.com/intl/cms/s/0/1d8d4fec-bae0-11e5-b151-8e15c9a029fb.html> [<http://perma.cc/4Y78-68L2>]; Andrew Ross Sorkin, *The Surprising Target of Jeb Bush's Tax Plan: Private Equity*, N.Y. TIMES (Sept. 14, 2015), <http://www.nytimes.com/2015/09/15/business/dealbook/jeb-bushs-tax-plan-is-brimmin-g-with-surprises.html> [<http://perma.cc/YSJ7-9UYR>].

182. Additionally, while not a viable solution on its own, it should be noted that this type of asset stripping behavior exhibited in the case of Hellas Communications could be lessened with increased due diligence by creditors when contracting with private equity firms. This was overlooked in that case. Despite being sophisticated investors who purchased Hellas Communications notes, the creditors relied on faulty valuations provided by Ernst & Young. Complaint at 43, *Hosking v. TPG Capital Mgmt., L.P. (In re Hellas Telecomms. (Lux.) II SCA) (Hosking II)*, 535 B.R. 543 (Bankr. S.D.N.Y. 2015); see *EY Hit with UK Fine over Greek Bankruptcy*, FIN. TIMES (June 16, 2015), <http://www.ft.com/fastft/2015/06/16/ey-hit-with-fine-uk-over-greek-bankruptcy/> [<http://perma.cc/TB58-388U>]. Although eventually sanctioned, Ernst & Young was certainly partially responsible for the creditors continued struggle to recover their investments.

A. INTRODUCING FIDUCIARY DUTIES

As previously discussed, Delaware law favors the freedom to contract around fiduciary duties in the LP and LLC setting.¹⁸³ In recent years, Delaware courts have created ambiguity over whether the managers of LLCs may also have default fiduciary duties to the company, leaving the legislature ample opportunity to address this issue.¹⁸⁴ However, the Delaware Supreme Court has yet to address the issue.¹⁸⁵ Given the similar nature of LLCs and LPs, and the similarities between the applicable provisions for fiduciary duties in the Delaware Code,¹⁸⁶ LP fiduciary duties deserve an equal look here. It is important to note that while a person serving on the board of a portfolio company has a duty to the private equity fund employer, there is no reciprocal duty for the general partner to the portfolio company.¹⁸⁷ Rather, the general partner only has limited fiduciary duties of care and loyalty with respect to the limited partners, and generally must maximize the return on their investment.¹⁸⁸ Sometimes these duties supersede the long-term interests of the portfolio company, such as obligations to long-term creditors as evidenced in *Hellas Communications*.

By creating such a fiduciary duty, general partners would not be able to issue debt from the LP and then redeem their own securities, as such a redemption would certainly constitute a breach of fiduciary duty by Delaware corporate law standards.¹⁸⁹ While extending fiduciary

183. See *supra* notes 22–24 and accompanying text.

184. See *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 849–856 (Del. Ch. 2012). In *Auriga*, Chancellor (now Chief Justice) Leo E. Strine, Jr. based his opinion, in part, on a provision in the Delaware Limited Liability Company Act that states, “In any case not provided for in this chapter, the rules of law and equity . . . shall govern.” DEL. CODE ANN. tit. 6, § 18-1104 (2016). The Delaware Revised Limited Partnership Act has an identical provision. *Id.* § 17-1105.

185. Matthew M. Greenberg et al., *Private Equity Fund Considerations in Light of Delaware’s LLC Debate*, PEPPER HAMILTON LLP (Feb. 25, 2013), <http://www.pepperlaw.com/publications/private-equity-fund-considerations-in-light-of-delawares-llc-debate-2013-02-25/> [<http://perma.cc/XZW8-BEWQ>].

186. DEL. CODE ANN. tit. 6, §§ 17-1105, 18-1104.

187. McDonald, *supra* note 16.

188. See UNIF. LTD. P’SHIP ACT § 408 (UNIF. LAW COMM’N 2001).

189. See, e.g., *Agway Gen. Agency, Inc. v. Burkeholder (In re Agway, Inc.)*, No. 04-80269, 2006 Bankr. LEXIS 4552, at *42–43 (Bankr. N.D.N.Y. Mar. 6, 2006) (citing *Lewis v. Vogelstein*, 699 A.2d 327, 336 Del. Ch. 1997) (“Whether or not a transaction

duties to an LP may be an unfavorable idea,¹⁹⁰ it is hardly an unreasonable response.

B. EXPANDING THE INDENTURE TRUSTEE'S DUTIES AND POWERS

Under the Trust Indenture Act of 1939 (the "TIA"), prior to a default, the duties of an indenture trustee are ministerial and narrow, limited to "such duties as are specifically set out in [the] indenture."¹⁹¹ The TIA underutilizes the indenture trustee, who is in a unique position to oversee that debt issuances are not made in vain, or without a chance for repayment. Rather, the indenture trustee should be positioned as what has previously been coined a "supertrustee" with "extensive monitoring rights" that include monitoring compliance with the bond indenture.¹⁹² Thus, where an issuer engages in behavior that makes it clear that there will be no payment of principal and interest, the trustee would have a duty to take action against the issuer on behalf of the noteholder beneficiaries.

CONCLUSION

As evidenced, overleveraging in private equity is not always a problem, but can become one when fund managers engage in behavior that strips a portfolio company of its assets. Something must be done to deter this type of behavior. With interest rates remaining at near floor levels, private equity is expected to see continued growth in the upcoming years, and accordingly, without a change, the same trends in portfolio bankruptcies and overleveraging that come alongside a boom in private equity activity will likely continue. While 2017 is expected to bring about that change through tax code reform,¹⁹³ more is certainly needed to counteract certain devastating results that may occur with overleveraging, as seen in the case of Hellas Communications. Although

constitutes corporate waste depends on whether the transfers or payments in connection with the redemptions served no corporate purpose or were for no consideration.").

190. See, e.g., Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007).

191. Trust Indenture Act of 1939 § 315(a)(1), 15 U.S.C. § 77000 (2012).

192. Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 470 (1999).

193. See Olorunnipa & Keane, *supra* note 180.

the courts have started to realize that private equity funds should be held accountable for company debts through the application of fraudulent transfer law and where ERISA assets are managed, there is more work to be done. Creditors of private equity investments should have a mechanism in place so as to avoid spending years in bankruptcy court with a private equity giant settling debts with creditors. The proposals outlined in this Note are such a mechanism that should be considered.