Breaking Up With a Portfolio Company without Breaking the Bank

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Portfolio companies sometimes fail. This obviously isn't breaking news, as master funds routinely divest themselves of investments. Sometimes the investment never worked out, or the portfolio may have simply run the course of its natural shelf life. Whatever the impetus may be, it's important to understand that there are many ways effectively to wind down and dissolve a portfolio company.

Choosing the dissolution method most advantageous for the dissolving company and the master fund requires consideration of several factors. Certainty of process and cost, and minimizing exposure for the parent and its designated executives must play into the analysis. While bankruptcy remains a common vehicle for winding down a subsidiary, the time and cost involved are not always worth the benefits.

Chapter 11 can be time-consuming (also not breaking news) because it requires the expenditure of significant resources and a focused management team and won't result in a discharge in the liquidation context. Chapter 7, while potentially more efficient than Chapter 11, prompts the appointment of an independent trustee who will almost certainly investigate the actions or inactions of the master fund and/or its directors. Additionally, neither Chapter 7 nor Chapter 11 automatically effectuates the dissolution of the subject portfolio company following liquidation and the distribution of its assets.

So what is a fund to do when it wants to wind down a portfolio company but doesn't want to incur the costs associated with a Chapter 11 filing or go through the hassle of Chapter 7? State law dissolution is an often overlooked, yet cost-effective and efficient, option. Delaware state law provides viable alternatives to a bankruptcy filing that may be attractive to a private equity fund looking to quickly dispose of an insolvent or otherwise disadvantageous holding, particularly in the case of a wholly owned portfolio company with a relatively simple capital structure.[1]

Under Delaware law, a corporation may be liquidated and dissolved outside of bankruptcy in one of two ways: through an unsupervised process, the non-safe harbor dissolution, or a court-supervised process, the safe harbor dissolution.[2] These state law bankruptcy alternatives allow funds to liquidate and dissolve a portfolio company, while maintaining some degree of control over the process and back-end protection against contingent and unknown claimants.

Regardless of the method selected, a parent fund may decide to invoke the assistance of a court-appointed receiver who can replace the portfolio's management team to liquidate and dissolve the company.[3] This article provides a brief overview of these increasingly commonly used bankruptcy alternatives, which in the right situation offer a master fund increased control, flexibility, and efficiency in the liquidation process.

Delaware Dissolution Procedures

Pursuant to Section 275 of the Delaware General Corporation Law (DGCL), a Delaware corporation may dissolve if a majority of stockholders entitled to vote approve the measure. In the case of a wholly owned or majority-controlled subsidiary, the master fund need only execute a simple written consent to effect the dissolution. Following stockholder approval, the corporation files a certificate of dissolution with the Delaware secretary of state, at which time operations terminate and business ceases.[4] The dissolved company continues legally to exist for three years for purposes of liquidating its assets and settling its affairs.[5]

As previously noted, Delaware offers two methods of dissolution. Both

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allow a corporation to wind up its affairs and distribute remaining assets while protecting the corporation's stockholders and directors, in varying degrees, against liability for their roles in approving and effecting the dissolution.[6] Choosing which alternative works best in a given situation largely depends on the complexity of the company's affairs and capital structure and on the level of protection desired by the company's management and stockholders.

Regardless of the option selected, the appointment of a receiver can add an additional layer of protection for directors and stockholders by replacing prior management with a court-approved fiduciary to oversee the liquidation and distribution of the company's assets. This can be a particularly attractive option for a portfolio company whose management is comprised of employees and/or executives from the master fund.

Non-Safe Harbor Dissolution. The non-safe harbor dissolution is the most efficient and cost-effective vehicle available under the DGCL to dissolve a company and distribute its assets. In a non-safe harbor dissolution, the corporation liquidates its remaining assets, administers claims similar to the bar date process commonly used in the bankruptcy context, and adopts a plan of dissolution and distribution.

The plan must make reasonable provisions to (1) pay all known claims and obligations, (2) compensate claimants in pending actions against the corporation, and (3) compensate claimants with claims that may arise within 10 years of the date of dissolution.[7] If the company has insufficient assets to pay the claims against it, the plan may provide for the ratable satisfaction of claims of equal priority (*e.g.,* general unsecured claims).

Because there is no court oversight, the non-safe harbor dissolution is more streamlined than the safe harbor dissolution. However, a non-safe harbor dissolution does not insulate stockholders, officers, or directors from liability to underpaid creditors, or if any reserves established under the plan for contingent or otherwise unknown claims later prove to be inadequate in light of facts reasonably available to the company at the time it approved the plan.

Safe Harbor Dissolution. The safe harbor dissolution method involves the same steps as non-safe harbor dissolution, but provides the dissolved company's stockholders and directors with a higher level of protection. To take advantage of the safe harbor provision of the DGCL, a company must petition the Delaware Court of Chancery to approve the amount of its proposed reserve for contingent and unknown claims that may arise within five years of dissolution.

There is no magic amount that constitutes an acceptable reserve. Rather, the amount must be reasonable based on facts available at the time the decision is made. If the court approves the reserve as adequate under the circumstances, contingent and future claimants may only look to the reserve for satisfaction of their claims. In other words, the reserve is the sole source of funds available for contingent and unknown claimants and therefore serves as a practical limitation of liability for the dissolved company's management and stockholders. Directors and officers shall not incur any personal liability to the company's claimants, and shareholder liability shall not exceed the amount distributed to such shareholder under the plan (*i.e.,* there is no liability where there is no distribution to equity).

Dissolution by Receiver. Regardless of the manner of dissolution selected, a stockholder may petition the court to appoint a receiver to oversee the dissolution and liquidation processes. The receiver, who needn't be a lawyer, steps into the shoes of management and takes charge of the company's assets.

The receiver may collect any outstanding debts, reconcile claims, and do all other acts that might be done by the corporation and may be necessary to effect the full and final liquidation of the company and the distribution of its remaining assets.[8] While the Court of Chancery sets forth default rules to govern the receivership, a corporation may propose its own rules and procedures, subject to court approval.

Why Choose Delaware Dissolution?

Delaware dissolution procedures offer two mechanisms that allow a corporation to design a dissolution that best fits the goals of the company and/or its stockholders. Non-safe harbor dissolution allows a corporation to liquidate and dissolve quickly and efficiently. Also, because

it is accomplished without court oversight, the corporation remains in control of how quickly or slowly the dissolution progresses. Control over the process allows for flexibility in how the corporation distributes its assets and when it effects the dissolution.

This flexibility can substantially reduce the costs associated with the dissolution. This method has proven particularly effective for a corporation that has few creditors and a defined universe of potential claimants. For example, a company that has ceased operations and maintains limited assets may find a non-safe harbor dissolution desirable because it likely knows what creditors hold claims, what (if any) additional claims may arise, and any other issues that may impact go-forward liability. A company in that situation efficiently can account for these foreseeable issues in the plan of dissolution.

On the other hand, a corporation that has more liability exposure (either current or future) or desires additional protection for its stockholders and management may opt for a safe harbor dissolution or seek the appointment of a receiver to minimize any current or future risk. Companies with more complex structures and diverse creditor bodies or those that manufacture hazardous products (*e.g.,* products containing asbestos) may want the comfort of a court-approved reserve to insulate a parent and directors from future claims.

Though it can cost more than non-safe harbor dissolution, a safe harbor dissolution, with or without a receiver, can still be accomplished quickly and more efficiently than a bankruptcy filing. The Delaware Court of Chancery, as a court of equity, is sympathetic to the time sensitivities at play in many business transactions and will promptly—at times, within hours—avail itself to a corporation when the circumstances justify such treatment.

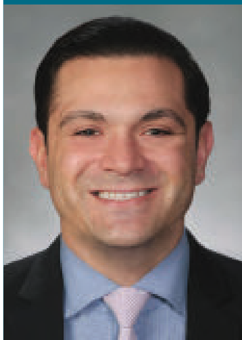
In addition, Delaware's broad equitable powers and abundant body of case law empower the court to make swift decisions to resolve issues that arise during the liquidation and dissolution processes. Though safe harbor dissolution may be more time-consuming, it can often accomplish the corporation's goals more quickly, efficiently, and cost-effectively than a protracted bankruptcy, while also providing significant protections to the corporation's directors and stockholders.

Finally, a receiver can serve as a helpful intermediary between the corporation and the court. Delaware law allows the corporation to identify and propose a receiver, which, subject to court approval, oversees the winding-down and dissolution process. This flexibility can be particularly useful if the corporation is engaged in a specialized business, has a unique structure, or remains subject to certain constraints, such as time or impending transactions among related entities, to which the court may be sensitive or for which court intervention may be helpful.

Bankruptcy Alternatives

While bankruptcy remains the most common way to wind down a portfolio company, it is not the only option. In certain situations, state law liquidation and dissolution can be more cost-effective than bankruptcy and permit a company to retain greater control over the process, while also insulating management and its parent master fund from future liability.

However, unlike its bankruptcy counterpart, state law generally does not provide for an automatic stay of litigation and collection efforts. While the Court of Chancery can be receptive to requests to halt a proceeding or foreclosure, a company may not always avoid aggressive creditors trying to subvert the dissolution process. Thus, it is important to consider the benefits and consequences of state law liquidation and dissolution as compared to a bankruptcy filing and tailor the course of action based on the company's particular needs and circumstances. ■



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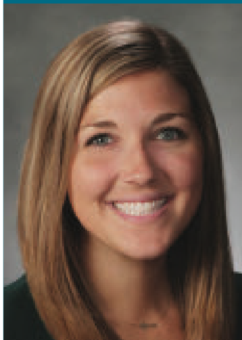

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[1] Determining the best method to wind down a portfolio must start with an analysis of the company's capital structure. Warring creditor constituencies or several tranches of competing funded debt may make a streamlined state law dissolution impracticable.

[2] 8 *Del. C.* Sections 280-81(a) (safe harbor); Section 281(b) (non-safe harbor).

[3] 8 *Del. C.* Sections 279; 291.

[4] The effective date of the certificate of dissolution may be up to, but not more than, 90 days after the filing of the certificate of dissolution, which affords the company time to wind up its affairs. 8 *Del. C.* Section 103(d).

[5] 8 *Del. C.* Section 278.

[6] See 8 *Del. C.* Section 282 (limiting stockholder liability to the amount distributed to him or it in the liquidation); 8 *Del. C.* Section 281(c) (immunizing directors from personal liability if certain procedures followed).

[7] 8 *Del. C.* Section 281(b).

[8] 8 *Del. C.* Section 291.