

THE CATALYST

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PROVIDING VALUE-ADDED CAPITAL

Welcome to our spring newsletter. In this issue we discuss leveraged recapitalizations. While there are numerous benefits to this type of transaction, there also are various issues to consider to properly address certain risks.

We continue to seek to partner with excellent management teams who are looking for more than just capital. We emphasize long term relationships and a process of building value over an extended time horizon.

Thank you for your interest and support.
The Team at Catalyst/Hall

Leveraged Recapitalizations – Can One Be Too Rich or Too Thin

By Rick Herrman, Principal, Catalyst Hall, Houston

We begin by using an analogy to describe recapitalization financing for purposes of this article. Farmer Jones owns a reliable, although aging "cash cow" named Bessie. Bessie produces 100 gallons of milk annually, come rain or shine. Edward, the fashionably dressed investment guy from town, is looking for investments that can reasonably produce a market return. "I'll pay you for 400 gallons of milk today Farmer Jones, in exchange for you assigning me the rights to the next five years' of production", says Edward. "Further Farmer Jones, you'll remain Bessie's owner and only you can grip the udders" (which certainly pleases Bessie, after all these years of familiarity).

Farmer Jones ponders the proposal thinking, "if old Bessie plays out, I'm better off, and if she keeps on producing, Edward does good and so do I". The deal is on, notwithstanding the questions as to the incentives and expectations of the parties, much less the larger issue of the creation of value versus the mere exchange of dollars (those anticipated tomorrow, for those realizable today) at an expected return, resulting from the transaction.



Catalyst | Hall

Catalyst/Hall specializes in middle market equity and mezzanine debt investments from its offices in Dallas, Houston, Oklahoma City, and Westchester (Chicago).

Catalyst/Hall provides capital for growth and expansion, recapitalizations of family owned or closely held companies, generational changes in ownership, and management buyouts.

Over supplied financial markets and lower tax rates for dividends and capital gains have created incentives for owners/operators to consider leveraged recapitalizations (i.e., debt used to fund special dividends or stock redemptions). The benefits include:

- ♦ partial liquidity;
- ♦ risk sharing relating to future "milk production";
- ♦ minimal to no dilution of ownership; and
- ♦ the continuance of "udder" control

So simple, so risk free, so why not move forward with gusto? Obviously Board consent for a dividend or a stock redemption is required. However, owners/directors may be unaware of the risks of such transactions. Excessive distributions resulting in thinly capitalized companies expose the directors and the owners (the cash recipient) to personal liability. The risk (among many) is that an excessive recapitalization is deemed unlawful, exposing the recipients to return the receipts. Owners and Boards should implement procedures for recapitalization transactions to limit potential exposure.

Companies, as separate legal entities, can incur liabilities without exposing their owners or others to liability. To balance the "shield" afforded owners and Boards of companies to personal liability, most states have laws to protect company creditors against excessive owner distributions. Board actions found beneficial to owners and detrimental to creditors may trigger personal liability. The line for director liability is gray. Statutory guidance, based either on a surplus or capital test, often exists as formulae or financial tests defining the "limits" relative to dividends or equity buybacks.

Delaware General Corporation Law provides that a company may pay dividends to owners only for (i) "surplus" (as defined below), or (ii) in the absence of surplus, from cumulative "net profits" in the year of the dividend. Companies may not pay dividends, or repurchase equity if doing so leaves its "capital" impaired, including amounts in excess of the corporation's surplus.

In Delaware a company's capital or surplus is:

- ♦ Capital - the consideration it received for issued and outstanding shares of stock (or ownership);
- ♦ Surplus - the excess of (x) the current fair value of the company's total assets minus (y) the current fair value of the company's total liabilities, less the company's capital (defined above).

Obviously, Board discretion is required in determining surplus. Delaware case law establishes that determining surplus goes beyond mere balance sheet measurement, and can include "going-concern" assessments. The "fair value" of assets (including goodwill) and liabilities (including off balance sheet, and/or contingent liabilities) is dispositive, not simply book value.

Latitude and discretion mandate Board care, caution and judgment. Remember, courts will review the valuation assessment benefited by 20/20 hindsight. Employ extra care when values utilized are other than book value, including intangibles and contingent liabilities.

Further, Boards must consider fraudulent conveyance allegations per state or federal laws, which can set aside the transaction when a debtor:

- ♦ makes a transfer of goods or money, receiving less than the reasonably equivalent value in exchange;
- ♦ was insolvent at the time of, or as a result of, the transfer;
- ♦ made the transfer with the intent to incur (or should have known it was incurring) debts beyond its ability to pay.

What's the concern? In most states, directors incur personal liability for their willful or negligent conduct with respect to dividends or distributions made in violation of the law. Boards authorizing dividends or redemptions sans adequate surplus or inducing impaired capital have made unlawful distributions. In Delaware, Directors are liable to the company, or, in the event of company dissolution or insolvency, to the creditors, for up to six years following any such "unlawful" payment. For claims successfully asserted, directors are liable for the payment amount, plus interest, from date of distribution.

Most states recognize the business judgment rule as a Director safe harbor, in cases of unlawful dividends or redemptions. To benefit from this rule, Directors must prove their good faith, their exercise of care and diligence consistent with a person making an informed decision, considering all relevant information. Examples include reliance upon:

- ♦ the books and records of the company;
- ♦ the advice, reports or opinions of the company's officers, employees or Board committees; or
- ♦ reports of independent experts selected with care, provided the expert acted within their competence.

Securing a third party valuation or solvency opinion is not "irrefutable proof" of business judgment, but may indicate a Board's prudent exercise of informed judgment. A qualified advisor will address relevant state or federal statutes, while providing an analysis of the balance sheet and/or cash flow statement, projections, industry conditions, etc., in determining the adequacy of surplus or capital. Minimally, the Board should take the following steps:

- ♦ hold a formal Board meeting to discuss the recapitalization transaction, versus relying on a written consent of directors;
- ♦ have a CFO prepare a good-faith calculation of surplus (or other applicable criteria), with a certificate executed by company officers (CFO and CEO);

- ♦ question the CFO and management regarding the assets (including intangible assets and intrinsic enterprise value) and liabilities (including contingent liabilities), and the overall future business prospects that could affect the determination of the legality of the recapitalization; and
- ♦ consult with company counsel regarding the state and federal laws applicable to the proposed action.

Making informed decisions based on knowledge of the applicable legal criteria will help ensure that owners and Boards avoid unnecessary risks, and unintentionally discovering that one can be too rich or too thin.

Ron Nixon Gives Presentation at the University of Houston

In March, Ron Nixon was invited to give a presentation at the University of Houston. He spoke to a Business Graduate School class regarding private equity. He discussed its role in the economy, the lessons learned during many years of investing and how the private equity industry is changing to meet the needs of middle market companies.

Rick Herrman Judges Southwest Business Plan Competition

Rice University held its 4th annual Southwest Business Plan Competition. The competition included graduate students from 36 of the top universities and colleges in United States and international schools. The plans ranged from high tech to biotech, to consumer products, to industrial products, to restaurants and to business and personal services. The keynote speakers included a leading partner of Sevin Rosen Funds, and Rod Canion, founder of Compaq (now HP). The quality of the presenting teams and the educational and networking experience for all the participants was both impressive and enjoyable.

LHC Group Moves Headquarters

On April 13, 2004, portfolio company LHC Group had a dedication ceremony for the opening of its new headquarter offices. In attendance were many of LHC's customers, employees, patients and stakeholders. Also attending was Louisiana Governor Kathleen Babinequx Blanco. LHC provided a brief statement of thanks to the many people who have contributed to the company's tremendous growth. Today, in its 10th year, LHC Group employs nearly 3,000 people and provides a full range of services in three states, with projected revenues exceeding \$100,000,000 for 2004.

For more information go to our Website :: www.catalysthall.com