

The Deal Pipeline

[RETURN TO ARTICLE]

Redemption song

David J. Fischer, Jonathan W. Young And Joy Lyu Monahan

Updated 08:00 AM, Jul-02-2010 ET

Under most fund agreements, general partners have several options when a limited partner defaults on its funding obligations. These can include withholding future distributions owing to the defaulting investor, forcing a sale of the partner's interest or redeeming the interest on behalf of the partnership for an amount far below book value.

The choice of which option to pursue, however, is complicated if the limited partner is involved in bankruptcy proceedings, given the tension between the general partner's authority under the fund agreement and how bankruptcy courts will interpret the issue.

Under a well-drafted fund agreement, general partners have significant leverage over a defaulting investor. In particular, the ability to force redemption imposes a painful penalty on the limited partner -- the surrender of its equity for only a fraction of book value. This also gives the general partner and remaining limited partners a corresponding greater interest in the partnership, as they will assume the defaulting investor's share. In the case of a limited partner involved in bankruptcy proceedings, the threat of redemption can also be used to prevent an opportunistic investor from using an automatic stay to dodge its funding obligations to the partnership.



The wildcard for general partners wishing to force a redemption, however, is the extent to which a bankruptcy court will accept this remedy. A court considering this issue faces two countervailing issues. Bankruptcy courts tend, as much as possible, to respect and enforce property rights as they are defined by state law. But bankruptcy courts also focus on maximizing the value of the debtor's assets for the benefit of all creditors, equity holders and other stakeholders. By definition, a forced redemption minimizes the value of the defaulting investor's assets. Yet by enforcing this redemption right, a bankruptcy court unquestionably upholds the partners' bargained-for rights under state law.

The reported decisions addressing this conflict have yielded divergent results. In some cases, the bankruptcy court has viewed this type of forced redemption as a forfeiture that will not be enforced. In the case of *In re Priestley*, 93 B.R. 253 (Bankr. D.N.M. 1988), for example, the court declined to enforce a forfeiture remedy of this nature because enforcement would deplete the estate and reward the movants at the expense of other creditors.

In other reported decisions, bankruptcy courts have honored forced redemption provisions, so long as the defaulting investor surrendering its interest has received fair market value in the transaction.

A buyout clause might be enforced where it provided for a fair exchange of value for the debtor's estate property by requiring a determination of the value for the buyout through negotiation between the debtor and the nondebtor partners or through an independent third-party "unbiased valuation." By contrast, where a buyout provision resulted in an exchange for substantially less than fair market value, a different result might follow.

The closer a redemption provision hews to fair market value of the underlying equity, the more likely such a provision will be enforced by the bankruptcy court. However, where the defaulting investor is engaging in opportunistic behavior, and forcing the other partners to bear a disproportionate share of the funding obligations, the redemption provisions

might be enforced, even where the equity transfers for less than fair market value. General partners faced with a defaulting investor may well wish to test the enforceability of their redemption rights sooner rather than later, if only to highlight the strategic behavior of the limited partner. Specifically, the general partner might file a motion with the bankruptcy court, seeking either to enforce the redemption provision or to require the defaulting investor to come current on its funding obligations. In this way, the general partner will either cut short the opportunistic behavior by its limited partner or implement a redemption that will enhance the value of the equity positions of the remaining partners.

[The complete archive of Industry Insight](#)

David J. Fischer and Jonathan W. Young are partners and Joy Lyu Monahan is an associate with the restructuring and insolvency group at [Edwards Wildman Palmer LLP in Chicago.](#)

[SHARE] [REPRINT] [SAVE TO MY ARTICLES]

THE DEAL PIPELINE CONTENT RELATED TO THIS ARTICLE

Bankruptcy Update | Time Properties Inc.

Jun 17,2010 11:00PM from The Deal Pipeline

Bankruptcy Update | 1191 Wood Run LLC

Jan 27,2010 11:00PM from The Deal Pipeline

Bankruptcy Update | Equipment Acquisition Resources Inc.

Oct 23,2009 11:00PM from The Deal Pipeline

M&A Transaction | D.S. Brown Co.

Sep 02,2008 09:42PM from The Deal Pipeline

Bankruptcy Update | Arthur Machinery Inc.

Apr 02,2009 11:00PM from The Deal Pipeline

[More headlines...](#)

CONTENT FROM AROUND THE WEB RELATED TO THIS ARTICLE

[Privacy](#) | [Terms and Conditions](#) | [My Account](#) | [Contact Us](#)