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INTRODUCTION

This guide sets out an overview of United States laws dealing with the concept of financial assistance in connection with an M&A transaction. Such financial assistance transactions are more commonly referred to as leveraged buyouts ("**LBOs**") in the United States. Therefore, the term LBO will be used herein, rather than financial assistance.

GENERAL OVERVIEW

- ### What is an LBO?

  In general terms, an LBO is the acquisition of all (or a majority) of the stock or assets of a target company, where the major portion of the purchase price is financed through the incurrence of debt by the target company and secured by the target company's assets. Leverage comes from taking advantage of the lower cost of funds provided by lenders and the deductibility of the cost of debt capital. The lenders look primarily to the target's free cash flow and secondarily to the target's assets to establish a borrowing base. The LBO allows the purchaser to acquire the target with a relatively small cash expenditure.

- ### For what purposes are LBOs used in the United States?

  LBOs are typically used for three (3) purposes: (i) taking a public company private; (ii) financing a spin-off; and (iii) carrying out a private sale of a company or its assets. Public to private transactions can either be friendly, such as when existing management purchases the company for itself with plans to operate it as a private company, or hostile, which may involve an investor intent on buying, reorganizing, and then reselling the company to realize a high return (either as a private sale or as part of a public offering). A spin-off might occur where a company uses an LBO to raise money by spinning off a division of the company, either to return money to the company's investors or because of a need for liquidity. Finally, an LBO can be used to finance a private sale, such as when the employees of a company desire to acquire the company but lack the financial resources to finance the acquisition.

- ### What are the origins of LBOs in the United States?

  The first US transactions that resemble the modern LBO occurred in 1955 when McLean Industries purchased Pan-Atlantic Steamship and Waterman Steamship for $49 million. McLean borrowed $42 million and used $7 million in preferred stock to close the deal, but then used $20 million of the cash and assets received from the deal to reduce the debt. The transaction that is widely viewed as having launched the LBO era of the 1980s was the purchase of Gibson Greetings by Wesray Capital, a private equity firm founded by former US Secretary of the Treasury William Simon and Ray Chambers, for $80 million, of which only $1 million was contributed by Wesray. Just sixteen months later, Gibson Greetings completed a $290 million initial public offering ("**IPO**"), which netted Wesray a $210 million return on its $1 million investment.

- **Are LBOs permitted under US law?**

  LBOs are not directly regulated or prohibited under US law. However, the use of LBOs in the United States can implicate federal and state fraudulent transfer and insolvency laws and application of such laws should be considered when contemplating an LBO transaction.

  The propriety of a particular LBO generally is raised only after the target company fails or files bankruptcy proceedings and is unable to repay its own creditors. In that circumstance, questions may be raised as to whether the target's incurrence of debt to finance the LBO, or the use of its assets to repay the acquisition debt, constituted fraudulent transfers.

EFFECT OF FRAUDULENT TRANSFER LAWS ON LBOs

- **To what extent can US fraudulent transfer laws be used to avoid an LBO transaction?**

  The legal bases for attacking an LBO as a fraudulent transfer are embodied in the United States Bankruptcy Code (the "**Bankruptcy Code**"), namely 11 U.S.C. §§ 548 and 544, and state fraudulent transfer laws, including the Uniform Fraudulent Transfer Act (**UFTA**) and its predecessor, the Uniform Fraudulent Conveyance Act, which together have been adopted by 46 of the 50 US States, plus the District of Columbia and the US Virgin Islands. These laws govern both intentional fraud and constructive fraud. Constructive fraud exists where irrespective of the parties' intent the net effect of the transaction entails decreasing of the target company's net worth and impairing the rights of its creditors.

  - Intentional Fraud: When determining whether a transfer constitutes an intentionally fraudulent conveyance, there are two (2) relevant inquiries: (i) whether the debtor or person making the conveyance has put some asset beyond the reach of creditors which would have been available to them at some point in time but for the conveyance; and (ii) whether the debtor transferred property with an intent to defraud, delay, or hinder the creditor. Because it is rare to have direct evidence of actual intent, circumstantial evidence (i.e., "badges of fraud") is generally alleged to prove an intentional fraud claim. Among the "badges of fraud" (circumstances so commonly associated with fraudulent transfers so as to give rise to an inference of fraudulent intent) cited by US courts in making a finding of intentional fraud are:

    - the absence or inadequacy of consideration;
    - the family, friendship, or close associate relationship between the parties;
    - the retention of possession, benefit, or use of the property in question;
    - the financial condition of the party sought to be charged both before and after the transaction in question;
    - the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors;
    - the general chronology of the events and transactions under inquiry;
    - a transfer for no consideration when the transferor and the transferee know of the claims of creditors and know that creditors cannot be paid;
    - the existence of an unconscionable discrepancy between the value of the property transferred and the consideration received therefor;
    - the involvement of secrecy or concealment; and

- a questionable transfer not in the usual course of business.

- <u>Constructive Fraud:</u> When determining whether a transfer is constructively fraudulent, there are two (2) primary elements that must be satisfied. First, the creditor or trustee (if the debtor has filed a bankruptcy or insolvency proceeding) must show that the transfer was not made for a "fair consideration" or "reasonably equivalent value". Whether the debtor received fair consideration or reasonably equivalent value is measured from the perspective of the creditors. Second, the transfer must have adversely impacted the financial condition of the debtor. To do so, the debtor must be: (a) insolvent at the time of the transfer or rendered insolvent by the transfer, (b) left with unreasonably small capital as a result of the transfer, or (c) unable to pay its debts as they become due as a result of the transfer. A debtor is left with unreasonably small capital when although the debtor is technically solvent, it is left with so few assets that its inability to pay debts in the future should have been reasonably foreseeable.

- **Who are the potential targets of a fraudulent transfer following an LBO?**

The potential targets of a fraudulent transfer action include (i) the selling shareholders who are paid the purchase price in connection with the LBO, (ii) the lenders who provide the financing for the LBO, (iii) the debtor's officers and directors who may have authorized the transaction, and (iv) financial advisors who may have helped structure the transaction. The selling shareholders can be required to disgorge the cash or other assets they may have received in connection with the transaction. The claims and liens of the lenders can be avoided and any payments made on account of the debt disgorged. Officers, directors, and financial advisors may be required to disgorge payments or other assets they may have received in connection with the transaction or may be liable for breach of duty in having approved or aided and abetted a transaction that rendered the target insolvent.

- **What is the statute of limitations for a fraudulent transfer claim based upon an LBO?**

Fraudulent transfer claims brought under section 548 of the Bankruptcy Code may only be asserted if the target filed for bankruptcy within two (2) years of the LBO. The reachback period for fraudulent transfer claims under state law varies from state to state; however, the reachback period for claims based upon state law is typically longer than the reachback period under section 548 of the Bankruptcy Code. For example, the reachback period in New York is six (6) years. Further, an even longer reachback period may apply where the transfer could not reasonably have been discovered during the reachback period. In such circumstances, the courts will often permit a claim to proceed if the claim was asserted within a reasonable period of time of being discovered.

LIMITS ON REACH OF FRAUDULENT TRANSFER LAWS

- **Are there any US laws that protect an LBO from attack as a fraudulent transfer?**

Section 546(e) of the Bankruptcy Code protects certain LBO transactions from being attacked as being a fraudulent transfer. In particular, section 546(e) provides that, notwithstanding sections 544 (which incorporates applicable state fraudulent transfer laws, whether based on intentional fraud or constructive fraud), 545 (which is not relevant in connection with an LBO), 547 (which is not typically relevant in connection with an LBO), and 548(a)(1)(B) and 548(B) (which are the constructive fraud provisions of section 548), the trustee or debtor may not avoid a transfer that is a margin payment or settlement payment made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency in connection with a securities contract or forward contract, that is made before the commencement of the bankruptcy case, except under section 548(a)(1)(A) (which is the intentional fraud provision of section 548). The definition of financial institution includes all commercial and savings banks, savings and loan associations, and federally insured credit unions.

Section 546(e) was enacted to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries and to prevent the ripple effect created by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry. Although the purpose of section 546(e) was to protect the public securities markets, most (but not all) US courts have interpreted section 546(e) broadly to prevent avoidance of transfers of consideration to the selling shareholders in all LBOs, including the purchases of private securities of small companies. Accordingly, so long as a financial institution is used to disburse or receive the payments for the shares in the LBO, the LBO will likely be immune from attack as a constructively fraudulent transfer. Section 546(e) provides no protection from fraudulent transfer claims based on an LBO involving intentional fraud during the two (2) year period before a bankruptcy filing. It also does not insulate the officers, directors and professionals for the target company from potential claims based on the injury suffered by the target.

- **Does Section 546(e) of the Bankruptcy Code protect all LBOs from attack under state fraudulent transfer laws?**

No. Section 546(e) only applies where the target has filed for bankruptcy under the Bankruptcy Code. Accordingly, in the unlikely event the target has not filed for federal bankruptcy, state fraudulent transfer claims based on fraudulent LBOs may be asserted in state court. Further, some creditors have attempted to assert direct claims against the participants in an LBO where the bankrupt debtor has relinquished the claim to unsecured creditors. To date, the courts have not provided adequate guidance as to whether such claims will be able to survive a motion to dismiss for failure to state a claim based on federal preemption (i.e., that section 546(e) of the Bankruptcy Code preempts state fraudulent transfer claims not premised upon intentional fraud).

OTHER CONSIDERATIONS

- **Are there any other US laws that must be observed in connection with an LBO transaction?**

The United States is a regulatory heavy jurisdiction with numerous laws and regulations that may need to be reviewed in connection with an LBO transaction. For example, if the LBO involves the sale of public securities, such as part of a going private transaction, then the parties to the transaction will need to comply with public securities regulations. If the LBO transaction results in the merger of two (2) companies in the same industry, compliance with US antitrust regulations will be required. Further, if the target company is part of a regulated industry, such as telecommunications, healthcare, or aviation, then observance of industry specific regulations will be necessary. It is also possible that other laws, such as state bulk sale laws, may need to be observed. US counsel should be consulted to determine which additional laws and regulations may need to be observed in connection with the transaction.