

## LEVERAGED BUYOUTS

### Avoidance in LBOs

If the Target's business fails, or its creditors are not paid, the payments made or security interests created in the LBO transaction can be subject to attack under both bankruptcy and state law, under a variety of theories, as being fraudulent conveyances, illegal or improper redemptions, dividends or distributions, violations of bulk transfer laws, or subject to equitable subordination

### Fraudulent Conveyance

Actual fraudulent conveyances are transfers made or obligations incurred with the actual intent to hinder, delay or defraud creditors

Constructive fraudulent conveyances are transfers made or obligations incurred that, even lacking actual intent, are avoidable

- For the benefit of creditors

- Using different, more objective criteria relating to the debtor's financial condition

- And the economic realities of the transaction

Principle behind avoiding constructive fraudulent conveyance

- It is unfair for a financially distressed entity gratuitously to transfer its assets or encumber its property

The UFTA in Section 5 and the UFCA in Section 4 provide for the avoidance of constructively fraudulent conveyances

- Based on "balance sheet" insolvency

- Only by creditors existing at the time the transfer was made or the obligation was incurred

Actual fraudulent conveyances and constructively fraudulent conveyances can be avoided if there are subsequent creditors

- Based upon other indicia of a debtor's distress

Key cases involving LBOs include:

- Gleneagles

- Tabor Court Realty

- McClellan Realty

- Ohio Corrugating Co

- Anderson Industries

Gleneagles involved findings of intentional fraud and an actual purpose

- An egregious set of facts

- Normal LBOs negotiated at arms' length should be distinguishable from Gleneagles

In re: Kupetz before the Ninth Circuit

- Upheld the validity of the LBO transaction and did not void it under fraudulent conveyance statutes

- Lent support to position that it is only in those cases where there is actual proof of intent to hinder, delay or defraud creditors

- that fraudulent conveyance laws be applied to void an LBO

- Heavily influenced by a lack of evidence of intent to defraud

- Fraudulent conveyance laws were designed to protect creditors from **secret** transactions by debtors

- Same rules should not apply when the transaction is made public

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### Reachback Provisions

S 548 limits a trustee's avoidance powers to those transactions occurring within 1 year of the petition

S 544(b) actions based upon the state law use the state's statute-of-limitations period

S 546(a) limits the time for the trustee to institute the suit is fixed as two years from his appointment

The UPTA Section 9 provides for a 4-year statute-of-limitations that expands upon S 548's limitation

Whenever the US is a creditor, it has unlimited reachback per Gleneagles

### Actual Fraudulent Conveyance

Badges of actual fraudulent conveyance may include:

Participant's knowledge that the structural and financial aspects of the transaction will prejudice the target's creditors

Transfer assets away from the target and add additional liabilities without corresponding economic benefits

### Constructive Fraudulent Conveyance

Avoidable if:

Debtor receives less than "reasonably equivalent value" for the transfer made or obligation incurred **and the debtor**

Was insolvent at the time or becomes insolvent due to the transfer made or obligation incurred

Was engaged in a business for which it had or retained unreasonably small capital, or

Intended to incur or believed it would incur debts beyond its ability to repay

The key issue is the value received by the debtor (in re: Ohio Corrugating)

The value determination may depend upon whether the court views the various transactions as separate and distinct or as one integrated

If separate and distinct, there needs to be a question of fair consideration dealt with

If integrated, the debtor neither receives nor retains value for the transfers made or obligations incurred

If the debtor is merely a conduit to transfer loan proceeds to its shareholders, it retains no value from the loan

Lenders' counsel in LBOs typically attempt to structure the transaction to maximize the direct value given to the debtor initially

And to ensure that the lender acts in good faith to determine that pro forma the business is solvent and can service the debt incurred

### Affiliate Guarantees

Upstream and cross-stream guarantees are commonly thought to confer no benefit to the debtor

Downstream guarantees may confer benefit on the debtor-parent if it increases the value of the parent's stock in the subsidiary

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### Insolvency Tests

S 101(31) defines insolvency:

That financial condition wherein an entity's debts are greater than all of the entity's property

At a "fair valuation"

But not including property fraudulently transferred or exempt property

Fair valuation defined per GAAP: what can be realized from the assets through sales within a reasonable time

By a "capable and diligent businessman" from an "interested buyer"

Some typical off-balance sheet items such as unfunded or underfunded pension liabilities may dictate a finding of insolvency

UFCA S 2(1):

Where the "present fair salable value" of the debtor's assets < probable liability for existing debts

As these debts become absolute and matured

"Present fair salable value" has been held to be close to liquidation value

UFTA S 2(a):

if the fair value of its liabilities > the fair value of its assets

Excludes property encumbered by a valid lien

S 2(b): a debtor's failure to pay its debts as they become due creates a rebuttable presumption of insolvency