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Finance & Transactions Group

# The Practical Lender

Highlighting the practical effects of law on the finance business.

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## Leveraged Buyouts as Fraudulent Transfers

The heyday of highly leveraged transactions in the late 1980s and early 1990s was followed by a spate of failed companies and unhappy creditors. These dynamics resulted in significant developments in the application of fraudulent transfer laws to leveraged buyouts ("LBOs").

Today, the competitive lending market and significant availability of funds have resulted in more highly leveraged buyouts, and more debt, thereby bringing fraudulent transfer analyses back in play. In fact, Reuters Loan Pricing Corp. ("RLPC") reports that LBOs are on track to hit a record $98.8 billion in 2006. RLPC also reports that the debt ratio of the average LBO, measured as a debt multiple of cash flow, is 6.2 for the year-to-date, up from 4.49 in 2001.[1] Secured lenders should have a good understanding of the interplay between LBOs and fraudulent transfer laws in underwriting such transactions (even where lower historical interest rates and industry sectors with strong cash flow make it easier for companies to carry debt).

### *What is an LBO?*

In its most basic form, an LBO involves the acquisition of a company (the "Target") financed primarily by loans made directly or indirectly to the acquiring entity (the "Purchaser") and secured by the Target's assets. The proceeds of the loan secured by the Target's assets are advanced to the Purchaser, which uses the funds to pay the purchase price owed to the selling shareholders of the Target. In addition to being secured by the Target's assets, the loans are often supported by upstream guarantees by the Target.

### *The Elements of a Fraudulent Transfer Under the Bankruptcy Code*

There are two separate types of fraudulent transfers under the Bankruptcy Code:

(1) *Actual fraud* or subjective "actual intent to hinder, delay or defraud" creditors; and

(2) *Constructive fraud*, which requires no intent to defraud.

Although a few courts have applied the actual fraud standard to lenders involved in LBOs, the large majority of cases involve the constructive fraudulent transfer theories. In order to attempt to avoid a leveraged buyout transaction as a constructive fraudulent transfer, the trustee, debtor-in-possession, or, in many cases, the creditors' committee, will assert the following elements:

[1] Source: *Business Week* Online, August 29, 2006, "The Rising Tower of Debt" by Steven Rosenbush.

(a) a transfer by the debtor of value and/or assets—under an LBO, the transfer is likely to be the granting of a security interest in the Target's assets to the lender or an upstream guarantee by the Target;

(b) the debtor corporation does not receive "reasonably equivalent value" in exchange for its security interest or guarantee—at least for that portion of the proceeds that is transferred to the Target/debtor's shareholders, and not retained or used by the Target/debtor itself; and

(c) the transaction left the Target/debtor:

(i) insolvent—here, fair market value of its assets *vs*. all claims, potentially including contingent claims against the Target company;

(ii) with "unreasonably small capital" for its business—usually considered a condition just short of insolvency; *or*

(iii) with debts believed by the Target/debtor to be beyond the debtor's ability to pay as such debts mature.

### *Risk of a Fraudulent Transfer*

The risk of a fraudulent transfer to a secured lender is that the other creditors will claim the lender cannot benefit from its security interest because the borrower itself (as opposed to its shareholders) did not receive any benefit of the loan proceeds (*i.e.*, shareholders benefited at the expense of creditors). As a general matter, the specific risk to the secured lender relates to the amount of proceeds that went to shareholders instead of the borrower.

### *Application of Fraudulent Transfers Analysis to LBOs*

Various commentaries have suggested it is doubtful that any LBO can pass the "reasonably equivalent value" test for that portion of the loan that is paid to the Target's shareholders, as opposed to being used for operations of the Target. Of course, that portion of the loan proceeds that is used to refinance or pay off current secured loans, for purchase of equipment or for operations should provide fair value to the Target, but not the proceeds that go to the shareholders of the Target.

As a result, typically, the most practical defense is that the Target/debtor is not left insolvent or without reasonable capital after the LBO, which should be the focus of underwriting an LBO loan.

### *Practical Lender Tips*

- Confirm by appraisals and/or accountants that the Target/borrower will be solvent and will be left with reasonable capital after the LBO. An appraisal or accountant's opinion prepared at the time of the transaction is typically more credible to a Court than one conducted years later at the direction of a trustee or debtor-in-possession in fraudulent transfer litigation.

- The lender should confirm and document, including in recitals and use of proceeds sections in the loan documents, all consideration to the Target/borrower from the loan proceeds that does not go to the shareholders of the Target—

refinancing a current secured loan, a new revolving credit facility, new capital improvements or the purchase of equipment, and the like.

- Courts typically will collapse complicated component transactions used in an attempt to avoid a fraudulent transfer claim, at times suggesting they were used to hinder, delay or defraud creditors. Such complex transactions should have loan agreement recitals reflecting the "enterprise" nature of the relationship among the obligor entities.

- Although the Bankruptcy Code has a two-year statute of limitations for fraudulent transfers, it allows a trustee, debtor-in-possession or creditors' committee to use state-law fraudulent transfer statutes, which typically have a four-year statute of limitations, but the specific statute should be reviewed.

- *Scienter* or intent is not an element of constructive fraudulent transfer analysis—the lender's good intentions and belief at the time of the LBO that there is reasonably equivalent value in exchange for the security interest or guarantee, the debtor is solvent and the debtor would be left with reasonable capital is not relevant, only whether the Court believes it.

### *Conclusion*

A fraudulent transfer analysis should always be considered in underwriting an LBO, and a good underwriting file that provides evidence of solvency, a healthy capital structure and reasonably equivalent value at the time of the LBO is likely to discourage or help with the defense of a fraudulent transfer claim years after the LBO.

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If you have any questions regarding material in this issue of *The Practical Lender* or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor and group Chair, Michael A. Nemeroff (312) 609-7858.

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