Facing the legal and structural issues of cross-border LBOs in Asia

Parts of Asia are ripe for the kind of explosion in leveraged buy-outs seen in the US and Europe in the 1980s and 1990s. Richard Gray of Milbank, Tweed, Hadley & McCloy LLP, Hong Kong, examines the legal and structural issues which this potential new market must address

The 1980s saw widespread corporate and financial restructuring in the US, as businesses sought to improve investment returns for shareholders. From the heightened merger and acquisition activity emerged investment funds specializing in buyouts of existing businesses with borrowed money (leveraged buy-outs, or LBOs), enhancing yields through greater leverage. The acquisitions by the investment funds and increases in debt levels forced companies into more disciplined operations, further increasing shareholder values. These transactions spread to Europe, particularly in the mid-to-late 1990s.

In the aftermath of its financial crisis, conditions in certain parts of Asia are conducive to leveraged transactions similar to those previously seen in the US and Europe. Companies are more willing to sell assets, and prices are falling. At the same time, transparency and shareholder value are higher priorities. The amount of private equity funds earmarked for Asian investments has never been higher, and banks are increasingly willing to provide financing in well-structured transactions.

The continued globalization of LBOs presents an opportunity to analyze many of the legal and structural issues that exist in this specialized type of finance.

Financing structure

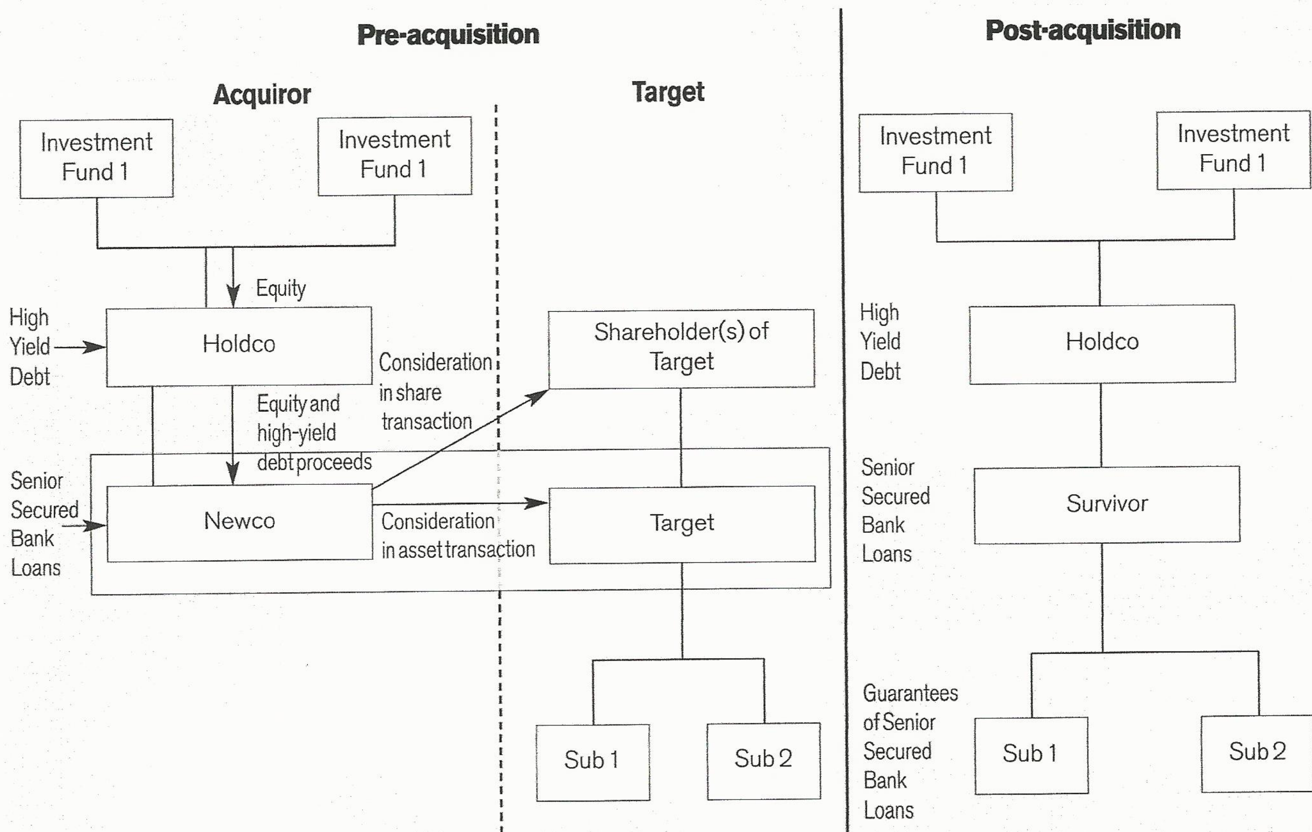
Although the structures for financing acquisitions vary widely – and are heavily influenced by tax and corporate considerations affecting the acquisition itself – a typical LBO structure is set out in Figure 1. This structure assumes that the acquisition is financed from three sources: equity investments from financial sponsors, high-yield bonds issued as mezzanine finance, and senior secured bank loans. The equity investments are made by the financial sponsors into a newly-created, special purpose holding company (Holdco), which downstreams the funds as equity into a newly-created, special purpose acquisition company (Newco). Holdco issues high-yield bonds and downstreams the proceeds as equity or debt into Newco, and Newco borrows additional funds on a senior secured basis. The proceeds of the equity investments, high-yield bonds and senior secured loans are used to buy assets or shares of a third party (Target). Several observations should be noted.

First, although the debt is raised to enable the equity investors to make the acquisition, it is structured to be without recourse to the equity investors. Indeed, it would be unusual for financial sponsors to be liable for debt incurred to finance an acquisition, and many LBO funds are prohibited by law or by their constitutive documents from incurring such liabilities.

Second, the fact that the high-yield debt is issued by an entity separate from, and whose sole asset is, the borrower of the senior secured loans, means that the claims of the holders of the high-yield debt are structurally subordinated to the claims of the senior secured lenders. This can be an important requirement for senior secured lenders. Because the holders do not have claims against the post-acquisition operating company (Survivor), they will be unable to institute bankruptcy proceedings against Survivor, or exercise other rights against Survivor, if the cash flows of the acquired business are insufficient to service both the senior secured loans and the high-yield debt.

The holders are dependent upon dividends from Survivor if and when declared and paid, and these dividends will be restricted by corporate law

Figure 1: Finance structure



and covenant restrictions imposed by the senior secured lenders. An alternative would be for Newco to issue high-yield debt which is contractually subordinated to the senior secured loans. However, contractual subordination has not been tested in many courts outside the US, and therefore is generally considered less protective of the interests of senior secured lenders. Indeed, contractually subordinated debt is virtually unprecedented in the Asian markets in the context of acquisition finance. Even in the US, where contractual subordination has been tested and is more common, subordinated creditors have certain procedural rights, both in and outside bankruptcy proceedings, that can constitute bargaining chips capable of being exchanged with senior lenders for distributions from debtors to which the subordinated creditors are not strictly entitled.

Next, senior secured lenders find significant value in using a holding company structure, even where a transaction does not involve mezzanine debt, or where the mezzanine debt is contractually rather than structurally subordinated. They would generally require a pledge by Holdco of the shares of Survivor as part of their collateral. This pledge is a significant addition to the security interest they would also require in the assets owned by Survivor, both since it is generally easier to sell a business through foreclosure by a share sale than by an asset sale, and since it is usually difficult to obtain a valid, perfected security interest in all of the assets constituting the acquired business. A holding company is needed to accomplish this pledge, since it is usually impractical or impossible for the group of financial sponsors to do so.

Finally, senior secured lenders look for their post-acquisition borrower, Survivor, to be the direct owner of the operating assets. This can be accomplished in two ways. If the acquisition is structured as an asset purchase, Newco can become the operating company, by virtue of its purchase from Target, of all of the operating assets of the business to be acquired. Alternatively, if the acquisition is structured as a share purchase, Newco and Target can merge in a transaction which (by operation of law or by contract) results in the merged operating company being liable for the obligations of Newco with respect to the senior secured loans. Being close to the assets helps the lenders preserve their senior position, in the event of a liquidation of the acquired business. For the same reason, they would typically seek guarantees from all of the subsidiaries of Survivor and first priority, perfected security interests in substantially all of the assets of Survivor and its subsidiaries, all to the fullest extent practicable under applicable law.

Financial assistance

As noted above, an acquisition generally takes the form of an asset purchase or a share transaction (including, for purposes of this analysis, a merger, consolidation or amalgamation of Newco and Target). The choice is generally driven by tax, corporate and commercial considerations. A share transaction, while often more straightforward to execute than an asset acquisition, presents special issues when it is financed with debt. A threshold question is whether the financing is allowable under applicable laws prohibiting a company from providing financial assistance for the acquisition of its own shares. Some jurisdictions, though not the US nor many other countries, have laws similar to Section 151 of the Companies Act 1985 of England, which provides that, subject to certain exceptions:

- "where a person is acquiring or is proposing to acquire

shares in a company, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of that acquisition before or at the same time as the acquisition takes place"; and

- "where a person has acquired shares in a company and any liability has been incurred (by that or any other person), for the purpose of that acquisition, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of reducing or discharging the liability so incurred".

Absent an exception, a financing structure of the type set out in Figure 1 would prima facie violate a law like Section 151, because the target is providing financial assistance for the purchase of its own shares by effectively assuming Newco's liabilities for the senior loans and granting collateral security for its payment. However, *Arab Bank PLC v Merchantile Holdings Ltd* [1994] 2WLR 307 has interpreted this statute to prohibit only English companies from providing financial assistance. Some commentators have also argued that the statute should not be construed to prohibit English subsidiaries from providing financial assistance for the acquisition of shares of their non-English parent companies. Accordingly, where financial assistance prohibitions cannot otherwise be overcome, a seller in appropriate circumstances might co-operate in a pre-sale offshore corporate reorganization that results in the ultimate sale of shares of a non-English company and thereby avoids such restrictions. This approach has also been used in other jurisdictions, where their financial assistance prohibitions can be similarly construed to apply only to domestically organized companies.

Another approach that is commonly available, referred to as a whitewash, allows a private company to provide financial assistance for the purchase of its shares if certain procedural conditions are satisfied. In the Companies Act 1985 of England, these conditions are set out in Sections 155 to 158 and require a special resolution following a declaration of solvency by directors and a report from auditors. In addition, Section 155(2) requires either that the financial assistance not reduce the company's net assets, or that it be provided out of distributable profits.

Fraudulent transfer laws

Laws limiting a company's ability to provide financial assistance for the acquisition of its own shares are intended to protect the creditors of that company. Many jurisdictions without laws prohibiting financial assistance per se nevertheless have other laws with the same effect. In the US, for example, laws defining fraudulent transfers provide that a transfer (which includes not only an outright transfer, but also the granting of a security interest) or obligation is voidable if made or incurred by a company under circumstances where its creditors are actually or constructively defrauded. These laws are codified at the Federal level at Section 548 of the Bankruptcy Code, 11 USC. §548, and in most of the States as versions of the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act. Although the laws vary slightly, a general summary of the constructive fraud provisions is that a transfer or obligation made or incurred by a company will be deemed to be fraudulent if: a) the company does not receive a reasonable equivalent; and b) any one or more of the following factors is also present: i) the company was insolvent at the time or became insolvent as a result; ii) the company was left with unreasonably small capital for the continuation of its business; or iii) the company was unable to pay its debts as they matured. It should be noted that, although the language of the law specifies that the obligation to repay debt incurred as a fraudulent transfer is voidable, the remedy generally applied by courts in such cases is to subordinate the debt to the claims of other creditors rather than to invalidate it.

In the US, fraudulent transfer laws were first held to apply to an LBO in *US v Gleneagles Inv Co*, 565 F Supp 556 (MD Pa 1983). The reasoning of the court, which has been followed in many other US cases, was that, after giving effect to all of the various steps in the transaction, the company left with the obligation to repay the acquisition-related indebtedness (and liens securing the same) did not benefit from the transaction because the proceeds of the indebtedness were paid to the target's shareholders as consideration for the sale. This reasoning may apply in a transaction structured as set out in Figure 1, where Survivor results from a Newco/Target merger. Although it will be difficult, or impossible, to fully eliminate the fraudulent transfer risk in many transactions, the risk can be significantly minimized by obtaining and analyzing historical and projected balance sheets and cash flows (and possibly third-party appraisals) demonstrating solvency on a balance sheet basis, sufficient capital and ability to service debt.

In cross-border transactions, a conflicts of laws analysis will determine the applicability of fraudulent transfer laws. Courts in the US have generally followed the "most significant relationship" approach of the Restatement (Second) of Conflict of Laws (1971) or (in cases in New York and California) the "governmental interest" approach in fraudulent transfer conflicts of laws decisions. The application of these approaches does not lead to predictable results. However, courts in the US have unanimously rejected a governing law provision in an agreement as affecting the outcome of a choice of law determination in this context. See, for example, *FDIC v British-America Corp*, 755 F. Supp 1314, 1325 (EDNC 1991). Accordingly, the choice of New York law (or the law of any other jurisdiction) to govern a financing agreement would not be relevant to the applicability of fraudulent transfer laws in the US.

Public tender offers

If the shares to be acquired are those of a public company, the lenders will be interested in ensuring that the acquisition complies with laws governing public tender offers. In addition, unless the transaction is structured as a direct, one-step merger between the Newco and the target, the acquisition (and therefore the financing) will probably take place in at least two steps. The first step will be the taking up of, and payment for, shares tendered under the offer. Since it is very unlikely that 100% of the shares will be tendered, the second step will be a squeeze-out of the remaining, minority shareholders. Having obtained a minimum controlling number of shares, Newco would generally effect this squeeze-out according to procedures set out in the applicable corporate laws, such as by a merger pursuant to a shareholder vote (including the vote by Newco of its newly acquired shares).

As noted above, senior secured lenders will expect Newco to become the direct owner of the operating assets after the acquisition is consummated, in order for them not to be structurally subordinated to other creditors of the acquired business. They will also expect collateral security in substantially all of the assets of the acquired business, as well as 100% of the cash flows of the acquired business to be available to service the senior secured loans. Since these expectations will not be satisfied unless the minority shareholders can be squeezed out, the senior secured lenders will need to understand the applicable corporate and securities laws to ensure that Newco will be able to achieve this end.

Margin regulations

Another matter to be addressed in financing the acquisition of a public company is the applicability of and compliance with the US margin regulations. Regulation U of the Board of Governors of the US Federal Reserve System, 12 CFR Part 221, provides, as a general rule, that no lender may extend or arrange credit, secured directly or indirectly by margin stock, for the purpose of buying or carrying margin stock in an aggregate amount exceeding 50% of the value of its margin stock collateral. Regulation U also requires registrations and filings for certain margin lenders and for certain margin loans. Because this regulation, its exceptions and its interpretive rulings are extremely technical, it should be examined carefully in the context of any particular transaction. However, for purposes of this article, it should be noted that: a) margin stock includes equity securities (including American Depositary Shares, or ADSs) listed on the New York Stock Exchange, the American Stock Exchange or Nasdaq; and b) indirect security is defined very broadly and may include not only traditional pledges, but also negative pledges and restrictions on sales.

A seminal interpretation of the margin regulations, referred to as "the junk bond interpretation" and codified at 12 CFR 221.124, ruled that indirect security would presumptively exist in a tender offer for margin stock made by a special purpose vehicle. The Board reasoned that a special purpose acquisition vehicle has no assets to support the credit other than margin stock, and that it might have to hold the margin stock for a significant and indefinite period of time if defensive measures are taken by the target company to contest the takeover. By the same reasoning, the Board acknowledged that this presumption would not apply if a merger agreement between the acquiring and target companies existed at the time the loan proceeds were disbursed, or if the obligation to make loans is contingent on the vehicle's acquisition of the minimum number of shares necessary under applicable law to effect a merger between those companies without the approval of the shareholders or board of directors of the target company.

Finally, and significantly for many cross-border transactions, 12 CFR 221.6(c) exempts from the purview of Regulation U credit extended outside the US by banks.

Credit support from subsidiaries

When a target company has subsidiaries, the upstream guarantees and collateral security to be provided by those subsidiaries to support the acquisition-related debt will present additional issues. Certain of these issues may arise under financial assistance restrictions or the fraudulent transfer laws discussed above. Techniques have evolved in the US to mitigate the risks imposed by fraudulent transfer laws in the context of upstream credit support, principally caps on the guaranteed or secured amount, and contribution agreements, to reduce the likelihood that individual subsidiaries would be rendered insolvent by providing the support. Issues arising under corporate laws make it necessary to confirm that the support is within the corporate powers of the subsidiaries, since they may be deemed not to receive corporate benefit from the transaction, and that the support will not violate laws governing dividends and distributions. Finally, if any subsidiary is less than wholly owned, there may be legal and commercial issues relating to the interests of minority shareholders.

Due diligence

The highly leveraged nature of acquisition financing prompts lenders to play a much more active role in the due diligence process for the acquisition, than they might in a general purpose financing for a highly-rated borrower. Indeed, it should be noted that lenders have more money at risk than financial sponsors in a transaction where the amount of debt exceeds the initial equity investment. While lenders typically allow the equity investors to take the lead in the due diligence process, the lenders expect to participate in the business, legal and tax due diligence for the target company as well as for the form and structure of the acquisition itself. This will include the terms and conditions of the acquisition agreement in a negotiated transaction, since it may contain contingent liabilities for the acquiror and would usually contain material rights in favour of the acquirer flowing from representations and warranties and indemnities granted by the seller. Indeed, the acquirer's rights under the acquisition agreement are typically assigned to the senior secured lenders as collateral security. If there are material tax assumptions flowing from the structure of the acquisition, the lenders may seek independent assurance as to the validity of those assumptions. Finally, the lenders want to know that the acquisition is duly and validly consummated in accordance with all applicable laws and material contractual restrictions. These issues affect the lenders, not only because they could have an adverse impact on the ability of the acquirer to repay the loans, but also because lenders will want to avoid liability or reputational damage from having financed an illegal or improper transaction. The lenders may satisfy themselves as to some of the legal issues by their receipt of legal opinions, including an opinion of counsel to the seller.

Terms of credit

The terms of an acquisition financing reflect the credit risk of the borrower and the purpose of the credit, and a senior bank financing is structured to encourage the borrower to repay the debt as quickly as possible. Although the pricing of senior secured loans starts high, it is often subject to pre-agreed reductions as leverage is reduced, referred to as "grid pricing". Covenants include not only financial ratios, usually based on cash flows, but also tight restrictions or prohibitions on asset sales, acquisitions, investments, liens, indebtedness, dividends and capital expenditures. Representations and warranties support the due diligence needs referred to above, and typically cover both the target company and the acquisition. Lenders also require prepayments from all or a portion of excess cash flow and the proceeds of asset sales, casualty events, and newly issued debt and equity. Since the identity of the equity sponsors is important to the lenders, a change in control or ownership of the acquired business constitutes an event of default. The terms of high-yield debt are less restrictive than the terms of senior secured loans, because high-yield debt typically has a longer tenor and more onerous prepayment provisions than senior secured loans, and because it is typically more difficult (or costly) to obtain waivers or consents from bondholders than from banks.

Conclusion

Leveraged acquisition finance is a complex legal product that presents many more issues than a general purpose credit for a highly-rated borrower. The legal advice required cuts across traditional practice areas and may encompass expertise in banking, mergers and acquisitions, securities, tax and other areas. As the globalization of this form of finance progresses, the ways in which issues are handled in one part of the world will serve as useful guides in others, taking into account local law and practice. ∎