# Reykjavik Fleet Leasing

MEMORANDUM

From: Agnar Skarlasson, CEO
To: Helen Haraldsdottir, CFO
Subject: Acquisition in Malaysia

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We have the opportunity to make a bid on a multi-branch car dealership that has come up for sale in Malaysia. The price is approximately RM 280 million, and the company is relatively debt free. The company has a large portfolio of leases (about RM 135 million) which could serve as support for debt financing, reducing our equity requirement in the acquisition.

This acquisition might be a good fit for our fleet leasing business, and would be attractive if we can finance the acquisition mostly with debt.

On the other hand our legal counsel in Kuala Lumpur has warned us that making the purchase with funds that have been secured by the target company's assets may fall afoul of Section 67 of the Companies Act of Malaysia.

Please read the attached article and give me your recommendation.

factor influencing selection of the law firm. Nevertheless, 4% of the respondents in UK considered price as the most important factor, 15% from Switzerland, 8% from Germany and 11% from Benelux.

Getting it right from the start is important when entering into commercial ventures. Thus, it is crucial for the client to be able to foresee any risk involving his intended commercial venture so as to achieve its ultimate goal. Therefore, he must be advised on managing the risks and hence, a competent commercial lawyer is the answer. A competent commercial lawyer is one who understands that the role of a commercial lawyer is not merely procedural but is one who is able to provide value added service throughout the commercial venture. Commercial lawyers not necessarily merely advise as to the legality of the commercial venture and their service does not stop the moment the agreement is executed.

What is exactly the role of the commercial lawyers in managing the risks of such venture? As mentioned previously, a commercial lawyer must be knowledgeable and experienced in the client's business. Therefore, preliminary investigations and due diligence are the basic steps of identifying and managing the risks. Later on, he must be aware of the operating environments and the entire process of the venture so as to provide necessary advice to the client. In handling the situation, only a well-versed lawyer knows how to choose the appropriate solution in handling risks, be it through controlling or sharing, transferring, financing or better still by avoiding the risks altogether. Likewise, the task of a competent lawyer is also to educate the client of such risks.

To a certain extent, in-house counsel provides a benchmark to be observed by the commercial lawyers. This is evidenced through a study of how the in-house counsel defines excellence in delivery. Perhaps, these measures are the exact definition of a competent commercial lawyer. The lawyer should support corporate transaction by providing good and timely advice. Again, what does 'good' and 'timely' mean? He must understand comprehensively of the transaction in accordance with its past, present and future and advise accordingly.

Despite aiming to obtain maximum benefit from the transaction, the lawyer should never disregard ethical standards. The business should be carried out legally, as inevitably it will enhance the credibility of the client. Thus, the lawyer is responsible to help the company uphold its ethical standards.

The important task of commercial lawyers at this juncture is to advocate the notion that their function is all-embracing. The clients must be practical in balancing their needs of a competent commercial lawyer and managing their monetary issues in dealing with the fees. As the legal profession has been associated with high fees and due to such belief, some try to avoid engaging lawyers in their business. On the part of the lawyers, it is their right to get commensurate fees for their services. However, it must not be forgotten that the clients have the right to get the best service.

# PROHIBITION AGAINST FINANCIAL ASSISTANCE : AN OBSTACLE TO LEVERAGED BUY-OUT DEALS IN MALAYSIA

By: Md Riyadh Dahalan
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## Introduction

The budget tabled by Prime Minister Datuk Seri Abdullah Ahmad Badawi last year includes a proposal to abolish section 132G of the Companies Act 1965 which prohibits companies from entering into transactions to acquire the shares or assets of another company in which its shareholder or director has a substantial interest. This proposal is part of an effort by the Government to re-energise the Malaysian corporate sector by encouraging more mergers and acquisitions. The Government hopes that through this proposal, obstacles faced by the corporate sector to undertake merger and acquisition activities in the past would be removed, thus helping Malaysian companies to survive the challenges of the new economy and globalisation.

However, there is another major impediment in the Companies Act that the corporate sector wish the Government could consider amending or repealing i.e. section 67. This is the provision that relates to the prohibition against companies giving financial assistance for the purchase of its own shares.

**Section 67 of the Companies Act**

Section 67 (1) reads:

*"Except as is otherwise expressly provided by this Act no company shall give, whether directly or indirectly and whether by means of a loan guarantee or the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company or, where the company is a subsidiary, in its holding company or in any way purchase deal in or lend money on its shares."*

From the above, it would be apparent that section 67(1) is triggered by the following elements:

(a) there must be some kind of financial assistance given by the company; and

(b) the financial assistance is given for the purpose of or in connection with a purchase or subscription for any shares in the company or its holding company.

There are many ways in which companies can be caught by the provision of section 67. Financial assistance within the prohibition includes the giving "whether directly or indirectly" by means of "a loan, guarantee or the provision of security or otherwise any financial assistance..." The term "or otherwise" is not to be construed *ejusdem generis* to loan, guarantee or security" for the genus has already been stated, namely the giving of financial assistance, and it is resonated in various decided cases that legislature did not intend the phrase to be narrowly construed. As stated by Hoffman J. in the case of ***Charterhouse* Investment Trust Ltd & Ors v. Tempest Diesels Ltd. [1986] BCLC 1:**

*"The words (giving financial assistance) have no technical meaning and their frame of reference is in my judgement the language of ordinary commerce. One must examine the commercial realities of the transaction and decide whether it can properly be described as the giving of financial assistance by the company, bearing in mind that the section is a penal one and should not be strained to cover transactions which are not fairly within it."*

**The Purpose of the Prohibition against Financial Assistance**

The cogent principle of company law embodied in section 67 is almost as well entrenched as the well known corporate veil principle. The purpose of the prohibition against financial assistance is to prevent acquiring companies from using the assets of cash-rich target companies to finance the acquisition of the latter. The prohibition is mainly aimed to protect the interest of creditors and minority shareholders of such target companies.

It is important to note that the prohibition only applies where there is a nexus between the financial assistance and the purchase of or subscription of the shares of the company. The expressions 'for purposes of' does not mean intention and the expression 'in connection with' are words that can be widely interpreted. Although it has been said in past judicial decisions that genuine commercial transactions, which are entered into by the purchaser for purposes of assisting a debt-laden company, would not contravene section 67, such argument would not be tenable if the sole object of the transaction is to financially assist the said acquisition.

**Example of Acts Caught under Section 67**

The provision of section 67 is wide enough for the courts to apply it to various leveraged buy-out structures which companies have tried to implement in the past. One simple example is where the target company or any of its subsidiaries makes a new loan, or makes early repayment on an existing loan (unless, it appears, it is "on demand" indebtedness) in connection with the acquisition, even if the terms of the loan are advantageous to the company. Another example of a prohibited act is where, as a condition of the acquisition of shares, the target company and/or its subsidiaries sells assets at a discount or buys assets from a party which then uses the proceeds of that sale to acquire shares in the target company and/or of its subsidiaries.

The provision of section 67 even extents to circumstances where the target company or its subsidiaries makes a gift that would amount to a gross overpayment to its shareholders. However, where there are reserves available for dividend and it is properly declared and leveraged for the acquisition finance repayment, the issue of contravention of section 67 may not arise. The uncertainty that usually arises in such situations is the issue of defining the parameters of the notion 'properly declared'. The notion is still vague and is yet to be narrowly interpreted. There are, however, cases decided in the past that drew boundaries to this notion. In the Australian case of ***Milburn v. Pivot (1997) ACLC,*** it was held that a special excessive dividend pay-out to shareholders, if it was in connection with the purchase of the company's shares or the shares of the holding company, it would tantamount to the contravention of section 67.

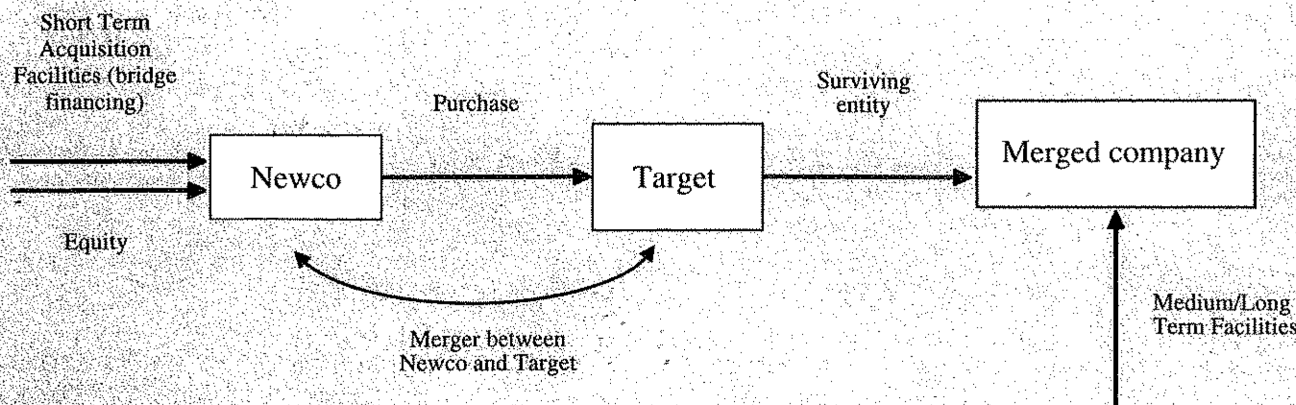
**Impediments to Leveraged Buy-Out (LBO) Deals and Possible Ways to Avoid the Pitfall**

The attraction for any company to undertake an LBO exercise is the prospect of leveraging upon the cashflow of the target company to finance or part finance the LBO. The prohibition imposed on companies to upstream any benefits from its newly acquired company (for purposes of the acquisition finance repayment), not only burdens the balance sheet of the acquiring company but also limits the growth of merger and acquisition activities in Malaysia. Unlike in other jurisdictions (e.g. the UK) where there are "whitewash procedures" for private companies to be exempted from such prohibition, Malaysian company law imposes a blanket prohibition against any company providing financial assistance in any LBO deals.

"...Proposal to abolish section 132G ... is part of an effort by the Government to re-energise the Malaysian corporate sector by encouraging more mergers and acquisitions... However, there is another major impediment ..... that the corporate section wish the Goverment could consider amending or repealing section 67...."

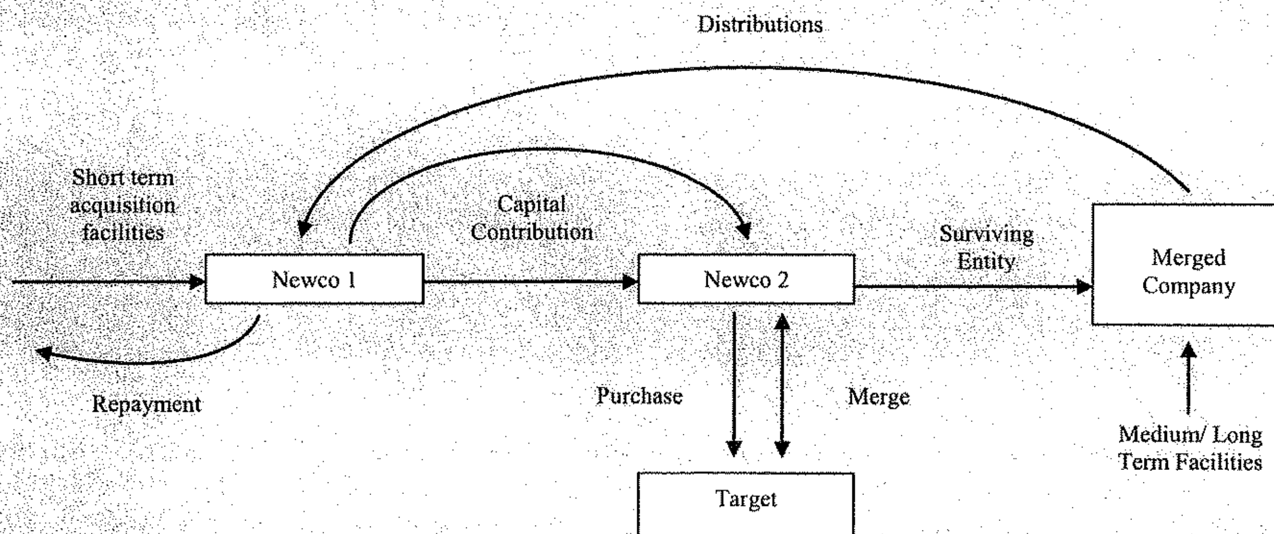
There are various structures (based on our experience) that Malaysian companies have implemented to mitigate the impact of the financial assistance prohibition. The most frequently used structure is as follows:

**Illustration 1 - One-Tier Structure**




Under the structure in Illustration 1 above, once the acquisition of the target company by Newco is completed, the merger of the target company into Newco would take place immediately, or soon after. As far as the provision against financial assistance is concerned, the theory supporting the [illegible]lity of such transaction is that the target company has ceased to exist as a result of the merger and all the assets previously held by the target company is now held by the surviving entity of the merger. Therefore, the surviving entity is free to borrow or give security for the acquisition debt previously incurred by Newco. A variation of the basic structure in Illustration 1 is to adopt a two-tier structure as illustrated in Illustration 2 below:

**Illustration 2 - Two-tier Structure**




The acquisition debt is borrowed by Newco 1, which then uses the proceeds to inject equity into a debt-free subsidiary, Newco 2, which in turn acquires the Target's shares. The post-merger entails the integration of the Target into Newco 2. The Merged Company then secures medium/ long term facilities and pays out a dividend to Newco 1. Newco 1 then repays the acquisition debt from the proceeds of the dividend.

The above illustrations are few of the structures that have been implemented by companies in the past in order to avoid being caught by the harsh prohibition under section 67. Each LBO structure is bespoke; depending on the quantum of the financing facility, the nature of the acquisition exercise and also the financial strength of the target company. As there has not been any ruling or decision by the Malaysian courts on the legality of the structures above, companies are strongly advised to seek detailed legal advice before undertaking any LBO exercise that involves the assets of the target company.