

LBO LITIGATION, FINANCIAL PROJECTIONS AND THE CHAPTER 11 PLAN PROCESS

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I. INTRODUCTION

A. LBOs and the Rehabilitative Goal of Bankruptcy

The bankruptcy law is fundamentally rehabilitative in its object.¹ Congress and the courts have traditionally shaped the bankruptcy law to provide a “fresh start” for honest debtors who suffer financial reverses in their business or personal affairs.² The commencement of a bankruptcy case automatically provides instant relief for debtors,³ and in a chapter 11 case the confirma-

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¹ See Klee, *Timbers, Ahlers and Beyond*, ANN. SURV. BANKR. L. 1, 10 (1989) (discussing purpose of chapter 11 proceeding); see also Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 442 (1984) (analysis of the effects of cramdown in confirming a plan of reorganization).

² See, e.g., *Burlingham v. Crouse*, 228 U.S. 459 (1913) (holding that under § 70(a) of the Bankruptcy Act of 1898 life insurance policies with no cash surrender value remain property of bankrupt); *Compass Inv. Group v. Maidman (In re Maidman)*, 668 F.2d 682 (2d Cir. 1982) (applying Bankruptcy Act of 1898 to land trusts).

³ See 11 U.S.C. § 362(a) (1988). Bankruptcy Code § 362(a) provides:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. § 78eee(a)(3)), operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the

tion of a plan of reorganization discharges the debtor's debts not preserved by the plan, and provides a new opportunity for success of the enterprise.⁴

The chapter 11 reorganization process is designed to preserve an enterprise based on a realistic plan for the future operation of the debtor's business, and the post-confirmation payment of its reorganized debt. A feasible reorganization avoids the alternative of liquidation, which would most likely return less to creditors and equity security holders than they would receive in a reorganization. Because the reorganization of a company preserves jobs for its employees and the rehabilitated company continues to purchase goods and services, a reorganization also enhances the local and national economy and promotes the public good. Consequently, public policy favors bankruptcy reorganization.

debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

Id.

⁴ See *id.* at § 1141(d); Code section 1141(d) provides:

(d)(1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan—

(A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g), 502(h), or 502(i) of this title, whether or not—

(i) a proof of the claim based on such debt is filed or deemed filed under section 501 of this title;

(ii) such claim is allowed under section 502 of this title; or

(iii) the holder of such claim has accepted the plan; and

(B) terminates all rights and interests of equity security holders and general partners provided for by the plan.

(2) The confirmation of a plan does not discharge an individual debtor from any debt excepted from discharge under section 523 of this title.

(3) The confirmation of a plan does not discharge a debtor if—

(A) the plan provides for the liquidation of all or substantially all of the property of the estate;

(B) the debtor does not engage in business after consummation of the plan; and

(C) the debtor would be denied a discharge under section 727(a) of this title if the case were a case under chapter 7 of this title.

(4) The court may approve a written waiver of discharge executed by the debtor after the order for relief under this chapter.

Id.

The historic perception that seeking bankruptcy relief is immoral has given way to the current view that bankruptcy is an essential and significant tool for business debtors. Bankruptcy is being used by some of America's largest corporations. The Bankruptcy Code of 1978 (the Code) heralded the notion that bankruptcy is designed to provide relief for, rather than stigmatize, those who invoke its provisions. The very language of the Code, which automatically grants "an order for relief" upon the voluntary commencement of a bankruptcy case,⁵ instead of an "adjudication in bankruptcy" dictated by the former Bankruptcy Act,⁶ ushered in the current era in which seeking relief in bankruptcy is acceptable to the business community.

Rehabilitation is a prime goal of chapter 11, but not its only goal. The bankruptcy law is the engine that drives the process for ferreting out financial wrongdoing that has injured creditors and shareholders. Financial excesses, mismanagement, negligence, fraud, or other causes of a debtor's failure are investigated and the facts reported to the interested parties and the public.⁷ The bankruptcy court is then available as a forum in which legal liability may be imposed on the responsible parties,⁸ and remedies provided to injured creditors and shareholders. In a sense, the bankruptcy law is the conscience of the business community; it brings the judicial microscope to bear on the business organization that has failed and imposes liability on those whose wrongdoing was responsible for the failure.

⁵ *Id.* at § 301.

⁶ Former 11 U.S.C. § 1(2) defined "adjudication" to mean a determination that a person is a "bankrupt". 11 U.S.C. § 1(2) (1976).

⁷ In a chapter 11 case, if the court does not order the appointment of a chapter 11 trustee pursuant to § 1104 of the Code, the court is required, upon a request of the party in interest or the United States trustee, to order the appointment of an examiner to conduct an investigation of the debtor if "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5 million." 11 U.S.C. § 1104(b) (1988). It has been held that if such debts exceed the \$5 million threshold, the appointment of an examiner is mandatory. *In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990) (citing 11 U.S.C. § 1104(b) (1979 & Supp. 1989)). Under § 1104(c), the United States trustee, following the making of such court order, appoints the examiner after consultation with parties in interest, subject to approval of the court. *See* 11 U.S.C. § 1104(c) (1988). The examiner's statement of his investigation is filed, as required by § 1106(a)(4)(A) and § 1106(b) of the Code. *Id.* at § 1106(a)(4)(A), § 1106(b). Upon filing, such statement becomes a public record open to examination by every entity at reasonable times without charge, as provided by § 107 of the Code. *Id.* at § 107.

⁸ This is made possible through, for example, the avoiding powers provided by §§ 544-548 of the Code, *id.* at §§ 544-548, and the provisions for the disallowance of claims pursuant to § 502(b) of the Code, *id.* at § 502(b).

The proliferation of business bankruptcy filings in 1990⁹ is reflective in large part of the availability of unrestricted credit to fund huge leveraged buyout transactions (LBOs), and the voracious appetite of business managers and investment bankers for squeezing enormous short term profits out of otherwise healthy businesses unable to shoulder the debt imposed on them in these transactions. Indeed, the growth in the number of LBOs was massive during the 1980s. Since 1981, when the aggregate value of LBOs was about three billion dollars in America, such transactions increased to an aggregate value of over forty-two billion dollars in 1988.¹⁰ The risks of "leveraging", however, were brought into sharp focus by a number of events in the late 1980s, including a stock market crash in 1987, the collapse of the "junk bond" market, and the downfall of Drexel, Burnham & Company which ultimately filed for bankruptcy in 1990, and the rippling effect of the savings and loan fiasco.

A common reason for the bankruptcy of many large corporations today was the overleveraging of their assets rather than a failure of their business operations. Excessive debt burdens were heaped on healthy businesses during the 1980s in LBOs. Now that so many companies, including some household names, are in chapter 11, LBOs have fallen into disfavor and recoupment of large losses is being sought from those who caused them. For example, a member of the House Judiciary Committee stated at a hearing held on March 1, 1990 examining the causes for the failure of Drexel, Burnham, which had a leading position in financing LBOs with "junk bond" issues:

Mr. Speaker, in the days of the Old West the robbers would ride out of town — saddlebags bulging with stolen money — just before the posse rode into town.

We had another wild west adventure the other day, Mr. Speaker [referring to Drexel's payment of bonuses to executives shortly before its bankruptcy filing].

Only this time the bad guys did not wear red bandannas and buckskin vests. They wore Hermes ties and Saville Row suits.

⁹ The number of chapter 11 filings increased to 19,591 in 1990 from 7,828 in 1981; see 20 BANKR. CT. DECISIONS, WEEKLY NEWS AND COMMENT, Issue 20, A3, November 15, 1990.

¹⁰ See Cieri, Heiman, Henze, Jenks, Kirschner, Riley & Sullivan, *An Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts*, 45 BUS. LAW. 333, 333-34 (1989).

This time they didn't ride out of town on horses but on BMW's and Rolls Royces.

....

I hope we can change the bankruptcy code to give trustees added authority to go behind fraudulent transfers of corporate wealth designed to defeat legitimate claims of creditors and rank and file employees.

Mr. Speaker, I want to rewrite that old West scenario. I want the posse to ride into town before the bad guys ride out.¹¹

That is not to say that using junk bonds or other debt instruments to finance large LBOs is necessarily illegal or unethical. At the same Congressional hearing on March 1, 1990, Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve Board, testified that some junk bond financing serves valid business objectives.¹² Junk bonds are an obvious and potentially valuable source of venture capital. It would thus be counterproductive to the national economy to legislate junk bonds out of existence. The better alternative is to recognize of the abuses and excesses of the 1980s, and a return to fundamental financial yardsticks rather than excessive leveraging predicated on overly optimistic projections of future revenue and expense, which contain no leeway or margin for error and lack a reasonable relation to historical performance. A leveraged buyout transaction using junk bond financing may be sound if it is predicated on reliable business forecasts and supported by rational assumptions about the particular company and the industry in which it operates.

B. Nature of an LBO

In a typical large LBO transaction, the "target" company, in addition to its existing debts, assumes massive new debt obligations to Institutional lenders and the purchasers of publicly issued debt securities, which advance the funds used to acquire all of the target's outstanding common stock from the old stockholders, usually at a premium. The assets of the target company are pledged as security for some or all of the LBO loans and the new group that acquires ownership of the equity in the target makes a relatively small investment.

In a typical LBO the target company gets no benefit from the

¹¹ 136 CONG. REC. H432 (daily ed. Feb. 26, 1990) (statement of Cong. Mazzoli).

¹² 136 CONG. REC. H432 (daily ed. Feb. 26, 1990) (statement of Alan Greenspan, Chairman, Federal Reserve Board).

transaction. The massive funds, generated by the debt it assumes and the security interests it creates in its assets in favor of the lender, are used to pay the old stockholders. Not only is there no benefit to the target company, but an LBO often weakens it by the imposition of a huge debt burden. If the target company can shoulder the new debt, the LBO may turn out to be a success for the promoters of the transaction and the new equity owners, in addition to the former shareholders who receive premium prices for their shares. If the enterprise fails, however, the target company will find itself in a chapter 11 proceeding in which the LBO transaction may be examined under applicable law, to determine whether the target company either became insolvent or was left so financially weak as a result of the LBO as to justify unwinding the transaction or otherwise restoring to the target company or others injured by the LBO the fruits gained by the promoters and others who profited from it.

C. The Role of Projections

LBO transactions in the 1980s were typically predicated on the basis of projections of future available cash at levels sufficient to service the enormous debt obligations imposed on the target company. These projections were used to induce investors and lenders to invest the cash required to pay out the old stockholders and to pay the fees incurred in the transaction. As expected, if the projections of future revenues predicted to be available to pay operating costs of the business and to repay the LBO obligations turned out to be wrong, the LBO target would run out of cash and the LBO would fail under the weight of the debt burden imposed on it; the target would be saddled with debt from which it received no benefit.

The reliability of financial projections is dependent on the accuracy and completeness of the assumptions upon which they are predicated. Consequently, a prediction that a company will have sufficient future cash to meet its debt service obligations may turn out to be wrong if a material assumption was incorrect or a significant fact was not considered or reflected. If a cash projection was incorrect, it may later be found that the LBO left the company without sufficient capital. Such a finding could lead to a ruling that the LBO involved a fraudulent conveyance or a violation of a corporation law restricting the payment of dividends or other distributions to shareholders.

D. LBOs in the Bankruptcy Courts

Federal bankruptcy law¹³ and state laws, including state debtor/creditor, corporation and tort laws, may be invoked by injured creditors and shareholders to challenge the validity of the original LBO transaction and hold those legally responsible for their losses. The bankruptcy process under the Code brings to bear the legal and equitable concepts by which failed LBOs are tested and the rights of injured parties vindicated. While the bankruptcy laws are designed to rehabilitate business debtors, they also serve to correct abuses and to provide a remedy to those who have suffered financial losses despite the protections afforded by the disclosure and anti-fraud provisions of the securities laws. The bankruptcy process is the conscience of the financial community and the means for the articulation of time-honored ethical principles that call for fair dealing by the promoters of business transactions¹⁴ and those in a position of trust by reason of their roles in structuring them.

Key actors in LBO transactions often wear two hats: corporate directors voting for the LBO and leaders of the new ownership group, financial advisors and underwriters of LBO debt securities, or the preparers of projections for the LBO offering and the recipients of huge contingent fees payable if the LBO is completed. While such conflicts were often disclosed in the LBO offering material, a long line of authority stands for the proposition that disclosure of a conflict of interest by a professional may not alone be sufficient to cure the conflict and justify serving conflicting interests.¹⁵ It is well settled that fiduciaries and others in a position of trust cannot occupy a conflicting position with impunity and must deal fairly with those who have a right to rely

¹³ 11 U.S.C. § 544, § 548 (1988).

¹⁴ See, e.g., *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928) (holding that coadventurers managing leased property were subject to fiduciary duties and owed the duty of finest loyalty to each other).

¹⁵ See, e.g., *In re BH&P, Inc.*, 119 Bankr. 35, 42 (D.N.J. 1990) (acting as trustee for two bankruptcy estates and for one of their creditors, which was another bankruptcy estate, constituted an impermissible conflict of interest in violation of 11 U.S.C. § 101(13)(E), and § 701(a)(1) (1988)); *In re Kendavis Indus. Int'l, Inc.*, 91 Bankr. 742, 754 (Bankr. N.D. Tex. 1988) (attorney for debtor corporation who makes agreement with shareholder, director or management of the debtor, or with some control party, to protect that party's interest, has an actual conflict of interest and may be disqualified and disallowed fees under 11 U.S.C. § 327 (1988)); *In re Roberts*, 75 Bankr. 402, 405-07 (Bankr. D. Utah 1987) (law firm that is prepetition creditor is disqualified from representing chapter 11 debtor in possession under 11 U.S.C. § 101(13) and § 327(a)).

upon them.¹⁶ When an LBO fails and ends up in a bankruptcy court, it is likely that the LBO transaction will be examined and those responsible for its failure held accountable to the injured parties.

The process for investigation and determination of both liability and the remedy is complex in a bankruptcy case. Because of the protracted and contested character of the investigative and adjudicatory bankruptcy process, it can be expected that in many cases the imperative for negotiating a settlement of the disputes arising out of the LBO will prevail. Those who have suffered losses may resolve their claims against potentially responsible parties through negotiation and settlement rather than by litigating to final judgment.

While settlement may often be the wiser course, a litigation advantage may be sought by either side, serving to delay the commencement of settlement negotiations and complicate the chapter 11 process. Claims arising out of a failed LBO may be addressed in pre-bankruptcy litigation or negotiations as well as in the context of a bankruptcy case in which the failed LBO company is the chapter 11 debtor. The difficulty entailed in the resolution of such a controversy in the pre-petition setting is perhaps greater than within the framework of a bankruptcy case itself because, unlike the more formalized chapter 11, the pre-petition dialogue lacks a formal structure to encourage a negotiated settlement.

This article will explore post-bankruptcy problems posed by a failed LBO transaction including an examination of claims arising from an LBO that may be available in the chapter 11 context, the legal standard applied to evaluate the reasonableness of financial projections which underpinned the LBO, and the processes for the assertion and resolution of LBO claims after the target becomes a chapter 11 debtor.

II. FINANCIAL PROJECTIONS UNDER THE JUDICIAL MICROSCOPE

A. *Introduction*

In order to determine whether a debtor has viable legal claims arising out of an LBO, an important threshold inquiry is

¹⁶ See *Mosser v. Darrow*, 341 U.S. 267, 271 (1951) (holding reorganization trustee liable for profits earned by his assistants when they traded in securities of debtor's subsidiaries); *Woods v. City Nat'l Bank & Trust*, 312 U.S. 262, 268 (1941) (holding that compensation should be denied a claimant who was subject to conflicting interests when representing members of the investing public).

whether the projections, used by the issuers and underwriters to sell the debt and equity securities issued to public and private investors to fund the LBO, were formulated in accordance with the applicable legal standards. These forecasts are essential in both structuring LBO transactions and in obtaining the funds required for their consummation. If the projections of future revenue, other sources of cash, or expenses were unsound, then the corporation very well could have been left with insufficient capital in light of its business needs. That is a key inquiry in a fraudulent conveyance analysis. Legal liability may be incurred by those who were responsible for preparing and evaluating erroneous projections, including the LBO target's management and the financial advisors to the target or to the buyout group.

B. Financial Projections and the Roles of the Financial Advisor

Forecasts are prepared by issuers, sometimes alone, and sometimes in conjunction with outside financial advisors. The issuer's financial advisor may perform two different functions in connection with a particular proposed transaction. The advisor may provide guidance on the structure and soundness of the proposed LBO transaction and also perform a concurrent underwriting function involving the sale and distribution of the securities that generate the funds needed to consummate the transaction. In some instances, outside financial advisors, if only because of their own expertise, occupy a dominant role in the preparation of financial projections, including the determination of the assumptions that serve as the foundation for the projections. Financial advisors earn significant fees for these services, which may be contingent on the consummation of the transaction. They thus have a vested interest in the successful completion of the proposed transaction.

By their nature, projections of future performance of the business and its available cash cannot have a higher quality than the assumptions upon which they were predicated. Despite the care with which experienced personnel may prepare projections, they sometimes turn out to be wrong. The reliability of projections may be affected by the inherent difficulty of estimating future revenue and income with a high degree of mathematical certainty. In some instances, unfortunately, the projections turn out to be wrong because the assumptions did not comport with historic performance or a rational perception of conditions which might occur in the future. Moreover, when financial advisors

sometimes accept the assumptions provided by the target's management without independent verification and testing, their theory may be that it is management's function to construct the assumptions and the financial advisors's function to create the financial structure of the LBO on the basis of the values derived from the projections produced by management.

The experience of the 1980s and the recent failure of many of the highly leveraged transactions generated during that decade provide substantial evidence that many LBOs were based on faulty assumptions. The securities laws may not have been adequate to warn potential investors of the risk factors they faced. Boiler plate disclaimers may not have provided an adequate warning that projections are merely predictions of the future, that their underlying assumptions may have been unfounded, and that the projections may prove to be wrong.

C. Projections Take on a Life of Their Own

The temptation of participants in an LBO to place heavy reliance on projections is understandable. The consummation of any business transaction usually involves consideration of what will happen to the business and what its cash resources will be in the future. Financial projections are the principal means for evaluating the future.

Projections tend to take on a life and reality of their own. They are usually reflected in sophisticated computer runs and models which are packaged in neat booklets and carry the endorsement of the senior management of the target company and well-respected investment banking and accounting firms. The physical attractiveness of the presentation and the professional endorsements of the quality of the projections, however, should not blur the fact that by their nature projections are merely opinions as to what may happen in the future, rather than reality, and that projections can be no stronger than the accuracy and completeness of the assumptions upon which they are predicated. Accordingly, when projections upon which an LBO was premised are challenged in litigation, they should not have the benefit of a presumption of correctness. The assumptions underling projections are scrutinized in the ensuing litigation for accuracy and adequacy as well as for their reasonableness.

D. The Legal Test Applied to Determine the Adequacy of Projections and Their Underlying Assumptions

When an LBO target becomes a chapter 11 debtor, an examination of the projection involves a bipartite inquiry. First, were the assumptions underlying the projections fairly made, and grounded on the prior and current experience of both the company and other companies in the same field of business in which the company engaged? Second, was there a failure to factor into the projections all of the risks or other circumstances that had a foreseeable impact on the future revenue and income of the enterprise?

Honesty of purpose and "good faith" on the part of the financial personnel who prepared the projections are not necessarily relevant to whether the projections were accurate or incorrect predictions of future revenue and income. Projections turn out either to be correct or incorrect. Only to the extent that projections and underlying assumptions may also involve an element of judgment are honesty of purpose and freedom from conflict of interest relevant to whether liability should be imposed after projections turn out to be wrong.

1. In General

At the heart of the post-bankruptcy examination of an LBO is the testing of the adequacy of the financial projections of revenues and cash flows used as the basis for fixing the financial terms of the LBO. Projections of future cash resources are the principal tools used by corporate managers and outside financial advisors and investment bankers to determine the amount and repayment terms of the debts incurred by the target company in an LBO. The amount paid to the shareholders of the target company for their shares is also a direct function of the amount borrowed, the interest rate and the terms of repayment. If the projections are accurate, the target company should have sufficient capital and be able to meet its new debt burden. If the projections are wrong and there is insufficient margin for error, the enterprise may eventually fail; if it subsequently cannot obtain fresh financing or cash from other sources, it will end up in bankruptcy.

When an LBO investment is under consideration, investors expect that, based on the projections produced by the business and financial professionals, the target company will be able to shoulder its new debt burden. If the advice given by corporate

managers and financial advisors turns out to be wrong but was supported by logical underpinnings, one might assume that those who structured the transaction and provided the financial guidance with honesty of purpose should sustain no legal liability for the losses suffered even though the projections turned out to be inaccurate.

As taught many years ago by a pre-eminent jurist: "The life of the law has not been logic; it has been experience."¹⁷ While logic is an important ingredient of reliable projections, they must also reflect experience. If any significant assumption on which a projection is based is either erroneous or fails to reflect financial or human experience, the resulting prediction that there will be sufficient cash available to service the debt in future years will likely turn out to be unreliable. Indeed, despite the logic employed in the preparation of projections, the lack of correct or complete assumptions dictated by historic performance of the enterprise may cause the projections to be inaccurate.

In a typical case of a failed LBO, the target had historical or pre-LBO earnings below the earnings projected for future years as the basis for estimating the amount of debt the company could carry. Projections that are not consistent with historical income may for that reason fail the legal test for their acceptability. In *In re Keeshin Freight Lines, Inc.*¹⁸ the future earnings projections of an LBO target predicted earnings that were consistent with the amount earned during the company's two best earlier years, but not with a number of other prior years in which the earnings were substantially less. The court ruled that taking historical earnings into account was important in formulating a prediction for the future. The court stated:

It appears that 1941 and 1948 were, therefore, unusual years, involving circumstances which were distinctly out of the ordinary, and there is no proof that the circumstances under which those earnings were produced were ever repeated during the other past years of the company's history. However, even if 1941 and 1948 were not abnormal years, it was erroneous on the part of the witness to single out the two years of highest earnings and rely exclusively on them in estimating future earnings expectancies. The record does not disclose any logical reason why only the two highest years should have been used. Certainly, a more proper and reliable estimate of future earnings expectancies that can reasonably be expected

¹⁷ O.W. HOLMES, THE COMMON LAW 1 (1881).

¹⁸ 86 F. Supp. 439 (N.D. Ill. 1949).

to be produced would have been to take into consideration all of the other years in the company's past history.

It is proper to examine the past earnings history of a business in considering whether or not a future earnings estimate is reasonable. The federal courts have recognized the desirability of taking a number of years of past earnings into consideration in arriving at a reasonable estimate of future earnings capacity of an enterprise. In [a Second Circuit case] the court, through Judge Learned Hand, approved of taking either five or eleven years. In [a Michigan District Court case] a fifteen-year period was approved.¹⁹

A projection based on a misleading predicate will thus fail the legal test for acceptability. Of course, projections may be unreliable for a variety of other reasons, including a failure to take into account certain risks that may later come to pass, or the failure to properly analyze the company's core business or how the company fits in the market in which it engaged in business.

2. Certain Bankruptcy Code Provisions

Financial projections perform a significant function in applying various provisions of the Code. Financial projections of future revenue and other cash resources of the debtor are uniformly found in disclosure statements transmitted to the creditor and shareholder electorate whose votes on a proposed chapter 11 plan of reorganization are solicited pursuant to section 1125(b) of the Code.²⁰ Although section 1125(b) expressly permits a court to approve a disclosure statement without a valuation of the debtor or an appraisal of its assets, information as to future income is usually necessary to provide "adequate information" as required by section 1125.²¹ Such information is required for the creditors to make an informed judgment as to whether the future payments promised to them under the proposed plan of reorganization are realistic commitments or the product of merely speculative promises or empty hopes.

Projections of future revenue are also usually placed in evidence at the section 1128²² hearing on confirmation in order to satisfy the "feasibility" requirement for confirmation contained

¹⁹ *In re Keeshin*, 86 F. Supp. at 443 (citing *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945); *In re Barlum Realty Co.*, 62 F. Supp. 81 (D.C. Mich. 1945)).

²⁰ 11 U.S.C. § 1125(b) (1988).

²¹ *Id.* at § 1125(a).

²² *Id.* at § 1128.

in section 1129(a)(11) of the Code.²³ Under that provision, a proposed plan of reorganization cannot be confirmed unless the court finds that confirmation of the plan "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor. . . ."²⁴ Projections of future cash resources are thus necessary to establish that the debtor will have the means to perform its commitments under the proposed plan of reorganization to make the promised future payments rather than to default and find itself in need of debtor relief once again.

Despite the importance and frequent inclusion of financial projections in disclosure statements, and their introduction into evidence at confirmation hearings, there is a surprising dearth of case law establishing the legal standard governing the preparation of a financial projection.²⁵ Instead, the reported cases deal primarily with whether a debtor has established by sufficient evidence the feasibility of its proposed plan of reorganization. Feasibility requires proof of sufficient sources of cash, including future earnings, or a realistic program for the disposition of assets not required for the debtor's ongoing business operations. The cases principally reflect the courts' analysis of whether the projections introduced into evidence at a confirmation hearing were credible or unreliable as "speculative, conjectural or unrealistic predictions."²⁶ Projections should be compatible with the company's historical financial performance, including its recent progress or lack of progress during the pendency of the chapter 11 case. As viewed by some courts, the debtor's post-petition

²³ *Id.* at § 1129(a)(11).

²⁴ *Id.*

²⁵ The function of a chief financial officer in preparing a firm projection has been described as follows:

The chief financial officer should be required to conclude that Target will not incur debts beyond its ability to pay as they mature based on projected financial statements which demonstrate that Target will have positive cash flow after paying all of its scheduled anticipated indebtedness. He or she should further conclude that the realization of current assets in the ordinary course of business in addition to the proceeds of contemplated sales of assets not necessary for the continuation of Target's business will be sufficient to pay recurring current debt, short-term debt, and long-term debt service as such debts mature, and that the cash flow of Target and such asset sale proceeds will be sufficient to provide cash necessary to repay long-term indebtedness as such debt matures or that it is reasonably anticipated that long-term debt can be readily refinanced at its maturity.

Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27, 47 (1987).

²⁶ *In re Merrimack Valley Oil Co.*, 32 Bankr. 485, 488 (Bankr. D. Mass. 1983).

performance may itself be viewed as one indicator of the debtor's fate.²⁷

In *In re Lakeside Global II, Ltd.*,²⁸ the court refused to give credence to the debtor's projections of future income and expenses of its apartment property and rejected confirmation of its proposed plan which would have "crammed down" the mortgage holders.²⁹ The court concluded that it was unlikely the mortgagees would receive, under the plan, the present value of their interest in the property in light of the then prevailing economic conditions. Under the plan proposed by the debtor, only minimal interest payments were to be made from the projected net operating income available after payment of all operating costs; the interest rate proposed for the reorganized mortgage debt was a below market rate and, in the earlier post-confirmation years, even below the contract rate provided by the mortgages. The premise of the debtor's proposed plan was an assumption that there would be a significant increase in the value and marketability of its properties beginning two years after confirmation, which was the plan's theory for deferring the commencement of substantial distributions to the mortgage holders until several years hence, when a future sale of or refinancing of the property could take place.

In denying confirmation, the court in *Lakeside Global* enunciated the following basic principle: "When the financial realities do not support the projections or where the proponents' projections are unreasonable, the plan should not be confirmed."³⁰ The plan proposed in that case was not feasible because the amount of cash flow projected to commence in two years was not enough for the scheduled payments. Nor was there a reasonable basis on which to predict that the property could then be sold because a future buyer was not yet known or sure to come on the scene. With respect to the projection of cash, the court observed that the financial history of the debtor's properties cast doubt on the accuracy of the aggressive projections it offered to prove the

²⁷ In *Merrimack Valley Oil Co.*, 32 Bankr. at 488, the court stated that "[w]here a debtor proposes to fund a plan out of operating revenue, its financial record during the pendency of the Chapter 11 is probative of feasibility." *Id.* (citing *In re Northern Protective Servs., Inc.*, 19 Bankr. 802 (Bankr. W.D. Wash. 1982); *In re Western Management, Inc.*, 6 Bankr. 438 (Bankr. W.D. Ky. 1980)).

²⁸ 116 Bankr. 499 (Bankr. S.D. Tex. 1989).

²⁹ See *infra* notes 34-35 and accompanying text for a description of the Code's cramdown provisions.

³⁰ *In re Lakeside*, 116 Bankr. at 507-08.

feasibility of its proposed plan. Specifically, the court recognized that the debtor's income for the last two years before the hearing on confirmation was less than it projected for the future and that its expenses exceeded the budgeted projections. Neither was the court satisfied that there was a reasonable basis upon which to conclude that there would be a significant increase in the value and marketability of the properties two years hence. As stated by the court in *Lakeside Global*:

The court is not reasonably convinced that the market will so dramatically improve that it is legally proper to keep the lienholders in suspense while the investors bide for time. This court has consistently critically analyzed projections by experts testifying on behalf of hopeful plan proponents who represent that the market will improve such as to provide the realty with values in excess of the liens and far above current estimates.³¹

In rejecting the projections offered by the debtor, the court in *Lakeside Global* declined to follow the testimony of the debtor's expert witness, who stated that "rental rates are likely to more than double in the next three to six years."³² The court refused to accept projections of this type that lacked historical foundation or other basis for a predicted future improvement in the occupancy rate of the property in question, especially where there was no evidence that the particular properties were better than others in the area and there were no present offers to purchase the properties. As stated by the court, "[w]hile all speculations are just that, predictions on performance must be met with objective fact and judged in that light."³³ The court's approach in *Lakeside Global* in essence rejected speculation offered by an expert witness as to improvement in operating results and property values in the future, unsupported by present facts and unjustified by historical performance and values. A mere hope for the future is not a sufficient predicate for a projection.

3. *Consolidated Rock Products v. Dubois*

Projections are also important in the context of applying the "cramdown" provisions contained in section 1129(b) of the Code.³⁴ These provisions authorize a court to confirm a plan of reorganization despite the negative vote of a class of claims or

³¹ *Id.* at 508.

³² *Id.* at 509.

³³ *Id.* at 510.

³⁴ 11 U.S.C. § 1129(b) (1988).

equity interests if the plan "does not discriminate unfairly" against the dissenting class and is "fair and equitable" with respect to the dissenting class.³⁵ If the debtor is insolvent, the bankruptcy law views the equity interest as having no value. Under section 1129(b) of the Code, the equity interests may then be extinguished by a "cram down" plan of reorganization over the objection of the class whose members' stock interests are to be extinguished. The value of the debtor enterprise for this purpose may be demonstrated by its projected earning capacity. Although financial projections are at the heart of such determination, the case law under the Code does not provide a concrete legal standard for evaluating the acceptability of particular financial projections.

The principles enunciated fifty years ago in *Consolidated Rock Products v. DuBois*³⁶ continue to be the most articulate pronouncement of the legal standard that a projection must satisfy. The Supreme Court's 1941 decision in *Consolidated Rock Products* best articulates in the bankruptcy law context the legal test which a projection must pass. In that case, the issue was whether the provisions of a plan of reorganization for a parent corporation and two wholly-owned subsidiaries were fair to various bondholder constituencies whose claims had different levels of seniority, and thus in compliance with the corporate reorganization provisions contained in section 77B of the former Bankruptcy Act.³⁷ The Court concluded that the plan of reorganization was unfair. Under the "rule of absolute priority," derived from the original reorganization statutes as amplified in *Case v. Los Angeles Lumber Products Co., Ltd.*,³⁸ it was essential to determine the future earnings capacity of the enterprise in deciding whether a particular plan of reorganization's provisions for junior securities were supported by the reorganization value of the debtor.

In *Consolidated Rock Products*, the Court ruled that the commercial value of an enterprise is a function of "the expectation of income from it," as spelled out by Mr. Justice Holmes in *Galveston, Harrisburg and San Antonio Railway Co. v. Texas*.³⁹ As more recently stated in *In re Equity Funding Corp. of America*,⁴⁰ a projected

³⁵ *Id.*

³⁶ 312 U.S. 510 (1941).

³⁷ Section 77B enacted June 7, 1934 as part of the former Bankruptcy Act.

³⁸ 308 U.S. 106 (1939).

³⁹ *Consolidated Rock Products*, 312 U.S. at 526 (quoting *Galveston, Harrisburg and San Antonio Ry. v. Texas*, 210 U.S. 217, 226 (1908)).

⁴⁰ 391 F. Supp. 768 (C.D. Cal. 1975).

stream of future income has a discounted present value that takes into account an interest factor that reflects both the time value of money and the possibility that the projected income may not be realized. The discounted present value of the projected income is what is known as the "reorganization" or "enterprise" value of the debtor. In a chapter 11 case, the plan of reorganization provides for the issuance or retention of debt instruments and equity securities based upon the plan's allocation of the "enterprise" value among the creditor and shareholder classes. The discount rate used to determine the present value of the future income stream is a function of the rate of return investors would require for the risk of the type involved. The discount rate is the subject of expert opinion and determination by the court.⁴¹ The legal standard governing the appropriate discount rate is that it should be the interest rate that is reasonable in light of the risk involved.⁴²

An evaluation of earning capacity is thus essential for a fair and equitable allocation of the securities of the reorganized entity among the various classes of claimants and shareholders. As stated by Justice Douglas in *Consolidated Rock Products*:

The criterion of earning capacity . . . requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances that indicate whether or not that record is a reliable criterion of future performance.⁴³

Consolidated Rock Products provides several standards to test whether a financial projection is reliable and thus acceptable to a court:

- (1) The projection must be based on an *informed judgment*;
- (2) The estimate must embrace all *facts* relevant to future earning capacity;
- (3) The nature and condition of the debtors' properties must be given sufficient consideration;
- (4) The *past* earnings record must be taken into account; and
- (5) The projection must take into account *all circumstances* bear-

⁴¹ See *In re Jartran*, 44 Bankr. 331 (Bankr. N.D. Ill. 1984).

⁴² See *In re Monnier Bros.*, 755 F.2d 1336 (8th Cir. 1985).

⁴³ *Consolidated Rock Products*, 312 U.S. at 526.

ing on whether or not the debtor's past earnings record is a reliable criteria of its future earning power.

The five-part legal test for the acceptability of a projection used to determine the debtor's enterprise value, as formulated by *Consolidated Rock Products*, continues to be the most definitive pronouncement on the subject. It should be equally instructive in evaluating the legal sufficiency of projections underlying an LBO.

4. Projections in LBO Litigation

*Credit Managers Association of Southern California v. Federal Co.*⁴⁴ is the most significant judicial pronouncement regarding the legal sufficiency of financial projections used in structuring an LBO. In that case, Federal Company sold 100% of the stock in Crescent Food Company, the LBO target, to Teeple-Reizer Acquisition Company, which was formed by Crescent's senior management to acquire the business. The acquiring company financed its stock purchase by borrowing against the assets of Crescent. Less than a year and a half later, Crescent succumbed to serious financial difficulties and made an assignment for the benefit of creditors. The assignee then sued on behalf of Crescent's creditors to set aside the LBO and to recover the consideration received by Federal for Crescent's stock.

A key issue in the fraudulent conveyance claim asserted against Federal was whether Crescent was left with unreasonably small capital because of the LBO. In defending against that claim, Federal relied heavily on cash flow projections made by General Electric Credit Corporation (GECC), which made a loan secured by all of Crescent's assets to fund the LBO. While GECC predicted that Crescent would have sufficient cash flow to take care of future obligations, the projections turned out to be incorrect; the plaintiff challenged the projections contending that the assumptions underlying the projections were wrong.

The court in *Credit Managers* phrased the question before it as "not whether GECC's projection was correct, for it clearly was not, but whether it was reasonable and prudent at the time it was made."⁴⁵ The court found that the projections were reasonable and prudent when made, concluding that they turned out to be wrong because of two unforeseen events. One was the termination of a business that was one of Crescent's customers, leaving Crescent with substantial excess inventory. The other was a

⁴⁴ 629 F. Supp. 175 (C.D. Cal. 1986).

⁴⁵ *Id.* at 184 (emphasis in original).

three month long strike against Crescent beginning shortly after the LBO was consummated. The court found that neither of these events was predictable when the LBO was consummated.

The lack of foreseeability of the cause of financial failure was the basis of the court's ruling in *Credit Managers* that, although the projections were wrong, Crescent nevertheless was not left with unreasonably small capital at the time of the consummation of the LBO. The principle derived from *Credit Managers* is that a finding that there was sufficient capital may be supported by a cash flow projection that erroneously predicted there would be sufficient cash, so long as it is shown that the projection was prudently prepared at the time of the transaction. The court declared:

As stated at the outset, *the court's task in determining whether Crescent had sufficient capital as evidenced by cash flow projections is not to examine what happened to Crescent, but whether the GECC projections, as modified, were prudent.* The court finds that they were. GECC's analysis throughout, particularly the initial analysis of Crescent's business prospects in [two exhibits], convince the court that Crescent was not undercapitalized at the time of the buyout based on a review and an analysis of projected cash flows. Based on these projections, GECC was willing to lend substantial sums to Crescent both before and after the buyout. Plaintiff is correct (and it is obvious) that the projections were wrong and that Crescent had insufficient capital to withstand the strike and the other setbacks to Crescent's business. But the law does not require that companies be sufficiently well capitalized to withstand any and all set backs to their business. The requirement is only that they not be left with "unreasonably small capital" at the time of the conveyance alleged as fraudulent. The cash flows prove that Crescent did have sufficient capital after the buyout to continue operating.⁴⁶

Significantly, the court stated that while "20-20 hindsight" makes clear that the cash flow projections were wrong, the occurrence of unforeseeable events subsequent to the LBO is not a basis for finding that the company was left with unreasonably small capital as a result of the LBO.⁴⁷ It also follows from the court's approach to the issue of adequate capital, however, that a business must be left with sufficient resources to meet all future contingencies and eventualities to the extent they should reasonably be foreseen at the time of the LBO transaction.

⁴⁶ *Id.* at 186-87 (emphasis added).

⁴⁷ *Id.* at 186-87.

Now that the economic recession in 1990 has extended its impact into the harsh economic decline in 1991, a key issue to be faced by the courts in LBO litigation is whether financial projections that served as predicates for LBO transactions in the 1980s should have made provision for a potential downturn in the economy. The basic question is whether an earnings and cash flow projection not only left a margin for error in the business enterprise itself, but also for the economy in general.

5. SEC Standards for Projections

Except for the general principles stated in *Credit Managers*, case law dealing with fraudulent conveyance claims does not provide objective standards by which to evaluate the acceptability of projections. But additional insight into the legal standard governing projections is gained from the treatment of projections under the securities laws. For almost fifty years prior to 1980, the Securities and Exchange Commission (SEC) had a traditional policy against the use of earnings projections in registration statements and other filings made with the SEC under the Securities Act of 1933 and the Securities and Exchange Act of 1934.⁴⁸ Despite the importance of projections to investors, the benefit from their use was considered to have been outweighed by what was thought to be their unreliable nature.

That policy changed in 1979 when the SEC adopted a "safe harbor" rule providing protection from liability under the federal securities laws for projections made in SEC filings or annual reports to shareholders.⁴⁹ Under SEC Release No. 6084, projections of revenue and income, as well as other statements concerning future economic performance, such as forecasted capital expenditures, are deemed not to be false or misleading under the federal securities laws if they have been (1) prepared with "a reasonable basis" and (2) disclosed in good faith.⁵⁰ In a related 1988 SEC Release, the Commission issued guidelines concerning the inclusion of projections of financial information in filings with the SEC.⁵¹ In that release, the SEC set forth the view that projections are best understood if the underlying as-

⁴⁸ See Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114 (1987).

⁴⁹ See SEC Release No. 6084, effective July 30, 1979.

⁵⁰ *Id.*

⁵¹ Guides for Disclosure of Projections of Future Economic Performance, Securities Act and Exchange Act Release No. 5992, (Nov. 7, 1978).

sumptions are disclosed, but did not adopt a rule making projections *per se* misleading in the absence of a disclosure of the key assumptions. One court has ruled, however, that assumptions underlying a projection must be disclosed "if their validity is sufficiently in doubt that a reasonably prudent investor, if he knew of the underlying assumptions, might be deterred from crediting the forecast."⁵²

"Takeover" litigation has raised the question whether the failure to disclose "soft" information, such as available earnings projections, can result in liability on the part of the tendering party for a failure to provide essential information. In *Starkman v. Marathon Oil Co.*,⁵³ the court ruled that there was a duty to disclose soft information to the target's shareholders only if "the predictions underlying the appraisal or projection are substantially certain to hold."⁵⁴ As stated by the court: "Our approach, which focuses on the certainty of the data underlying the appraisal or projection, ensures that the target company's shareholders will receive all essential factual information, while preserving the target's discretion to disclose more uncertain information without the threat of liability, provided appropriate qualifications and explanations are made."⁵⁵ The court was reluctant to impose a duty of disclosure with respect to the projections under consideration in the case at bar and ruled that disclosure of this uncertain information was discretionary. It reasoned that disclosure of projections or estimated values of assets "could well have been misleading without an accompanying mountain of data and explanations."⁵⁶

Another court, in *Biechele v. Cedar Point, Inc.*,⁵⁷ also declined to mandate the disclosure of projections. It held that the target of a takeover effort had no duty to disclose an appraisal or a five-year cash flow and earnings projection that were prepared for use in connection with pending merger discussions. It is the notion that projections are not inherently reliable, which has led courts not to impose a duty of disclosure. Indeed, there is a concern that liability could result from the disclosure of projections because of their inherently misleading nature. In light of that perception of projections, it seems clear that projections used as a

⁵² *Beecher v. Able*, 374 F. Supp. 341, 348 (S.D.N.Y. 1974) (footnote omitted).

⁵³ 772 F.2d 231 (6th Cir. 1985).

⁵⁴ *Id.* at 241.

⁵⁵ *Id.* at 242.

⁵⁶ *Id.* at 242.

⁵⁷ 747 F.2d 209 (6th Cir. 1984).

basis to prove the adequacy of an LBO target's capital should be closely scrutinized and accepted as prudently prepared only if predicated on realistic and accurate assumptions as to all foreseeable future events and circumstances.

A number of courts have held that an incorrect projection may be a basis under certain circumstances for imposing liability under section 10(b) of the Exchange Act. In *Isquith v. Middle South Utilities, Inc.*,⁵⁸ the court ruled that a projection may be tantamount to a representation of fact, resulting in the imposition of liability if the predictive statement was false when it was made. Specifically, the court remarked:

Most often, whether liability is imposed depends on whether the predictive statement was "false" when it was made. The answer to this inquiry, however, does not turn on whether the prediction in fact proved to be wrong; instead, falsity is determined by examining the nature of the prediction—with the emphasis on whether the prediction suggested reliability, bespoke caution, was made in good faith, or had a sound factual or historical basis.⁵⁹

Reliability for section 10(b) purposes is dependent on the existence of "a sound factual or historical basis" for the projection.⁶⁰ There must also be "an informed and reasonable belief" as a predicate for a projection if it is to be found to have been prudently made.⁶¹ In *Eisenberg v. Gagnon*, the court stated:

When the opinion or forecast is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry, then the failure to investigate further may "support[] an inference that when [the defendant] expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion."⁶²

Thus, the touchstones of an acceptable projection are a set of assumptions that are (1) predicated on a factual and historical basis, (2) complete and not misleading, and (3) advanced in good faith by those who prepared them.

E. The Valuation Process Used by Financial Experts

Financial experts utilize various means to form opinions as

⁵⁸ 847 F.2d 186 (5th Cir. 1988).

⁵⁹ *Id.* at 203-04 (citations omitted).

⁶⁰ *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985).

⁶¹ *Id.*

⁶² *Id.* at 776 (citation omitted).

to the projected revenues and net income of an enterprise for both transactional planning and chapter 11 purposes. It is common to hear financial experts present detailed valuation analyses supporting their opinions for pricing of particular corporate securities transactions in fraudulent conveyance litigation and to establish enterprise value at confirmation hearings. The valuation process typically employed by financial experts involves analysis of the particular company's historical and projected financial data, a comparison of the company or transaction to similar companies or transactions, or a review of purchase offers for the company or similar companies during an appropriate time frame.

One financial advisor described this deliberative process in his testimony at a hearing to consider confirmation of a "cram down" plan in *In re Allegheny International, Inc.*⁶³ The court described the advisor's testimony regarding the process by which he valued the shares of stock of the reorganized company to be issued to creditors under the proposed plan of reorganization as follows:

[The witness] testified that Smith Barney [the debtor's financial advisor], *inter alia*, reviewed public financial statements, analyzed financial and operating data, prepared discounted cash flow analyses, analyzed individual operating businesses, considered comparable companies that were publicly traded, considered comparable mergers and acquisitions, considered economic and industry data, interviewed senior management, reviewed the stock plan, and performed various other analyses. In addition, Smith Barney considered the results of the extensive solicitation of prospective purchasers of the debtor's businesses, which occurred in August 1988. Smith Barney had conducted that solicitation process and thus was intimately familiar with it.

Smith Barney calculated the net income valuation by taking the debtor's projected net income for the next three years, applying an "appropriate" predetermined multiplier, reducing the results to present values as of March 31, 1990, and dividing by the number of shares to be issued to arrive at the price range per share.

As part of its analysis, Smith Barney thoroughly reviewed six other appliance companies which it considered to be comparable to the debtor. As a part of its analysis, Smith Barney determined the appropriate multiples based on market capital-

⁶³ 118 Bankr. 282 (Bankr. W.D. Pa. 1990).

ization and based on adjusted market value. For market capitalization, the multiple was the price-earnings ratio, which ranged from 10.2 to 13.3. For the adjusted market value, the range of multiples for earnings before interest and taxes (EBIT) was 5.0 to 14.4; the range of multiples for earnings before interest, taxes, depreciation, and amortization (EBITDA) was 4.6 to 9.7.

[The witness] further testified that the appropriate multiple for the net income valuation, based on the multiples for the comparable companies and other factors, was 11.5, which was approximately the mid-point for the comparable companies. Based on the debtor issuing 45 million shares of stock, Smith Barney determined the net income valuation by multiplying the projected earnings for 1991, 1992, and 1993 (\$40.8 million, \$49.6 million, and \$59.5 million, respectively) by 11.5. The product of that calculation was \$469.2 million for 1991, \$570.4 million for 1992 and \$685.4 million for 1993. Those amounts were then reduced to their present value as of March 31, 1990. Smith Barney thought it appropriate to apply a discount factor because of the following factors: the debtor was in a turnaround situation that involved certain unique risks, the debtor had used aggressive projections of sales and income and there were risks of failing to meet such projections, the debtor had failed to meet past projections, the risk the market would apply to securities of an appliance manufacturer emerging from bankruptcy, the return that investors seek for such risk, the return investors may receive in other turnaround situations, the return on leveraged buy-outs, and the possibility that the stock may not be well received in the marketplace. In light of all of these special factors, Smith Barney determined that the appropriate discount rate to determine present value was 25% or 30%. When this rate was applied, it resulted in the stock having a range of value from \$5.73 to \$7.32.⁶⁴

The Committee of Equity Security Holders (Committee) opposed confirmation of the "cram down" plan in *Allegheny International* because it provided no distribution for the present shareholders. The Committee contended that the new shares to be issued to creditors were undervalued and that there was value in the enterprise left for the shareholders based on evidence it proffered of higher projected earnings. The Committee's expert witness criticized the valuation methods employed by the plan proponent's expert. The court nevertheless determined that the proponent's

⁶⁴ *Id.* at 305 (footnote omitted).

evidence on the valuation issue was credible. The proponent's witness concluded that the value of the stock to be issued to the senior classes under the plan would range between approximately \$5.73 and \$7.32 per share, which resulted from applying a discount rate of approximately twenty-five percent to determine present value. According to the proponent's expert, the debtor's sales and income projections were too aggressive and there was risk of failing to meet them in the future, just as the debtor failed to meet its past projections. The opponent's expert, on the other hand, used a lower discount rate of 13.4%. In rejecting that testimony, the court noted that the opponent's expert did not fully consider the possibility that the debtor would fail to meet its forecasts, pointing out that "[i]t is undisputed that the debtor has consistently failed to meet its projections prior to and since the filing of bankruptcy."⁶⁵

It is evident that the methodologies employed by financial experts in formulating projections and opinions as to value involve a variety of complex facts, assumptions, formulae, comparisons and other factors. Many of these factors are not susceptible to precise answers and conclusions. Nevertheless, the court in *Allegheny International* was strongly influenced by the fact that the debtor's operations consistently failed to meet its own projections both before its chapter 11 filing as well as during the pendency of the chapter 11 case. Because the debtor's previous projections lacked reliability, its projections of higher income in the future were rejected by the court for lack of a concrete factual basis upon which to conclude that its future performance would improve. The projections, which the court accepted in *Allegheny International* as more reliable, were the more conservative projections offered by the proponent of a plan of reorganization, rather than aggressive projections offered by the shareholders' committee to oppose the confirmation of a plan that a majority of the shareholders at large had actually accepted. It is understandable that the court opted for more conservative results, which enabled the court to confirm a proposed plan of reorganization broadly endorsed by all equity interests. It is clear from this discussion that the most important factors tending to gain judicial acceptance of proffered projections are (1) consistency of the projection with the debtor's historical performance, and (2) a record of the debtor's meeting its prior projections.

⁶⁵ *Id.* at 306.

III. PROSECUTION OF LBO CLAIMS

A. *In General*

If the projections used to support an LBO transaction turn out to be wrong, the target of the LBO may be compelled to resort to bankruptcy to gain relief from the heavy debt burden that its otherwise sound business enterprise cannot shoulder. The need for bankruptcy relief in such a case is not due to ills in the business operation; rather, it is compelled by the debt service required by the LBO financing which the cash flow of the business cannot support.

From the filing of a chapter 11 case until confirmation of a plan of reorganization for the debtor, enormous professional fees are borne by the debtor estate for its own professional representation and for the representation provided by the professionals who serve official committees formed to represent creditors and shareholders pursuant to section 1102 of the Code.⁶⁶ A debtor's management may therefore try to reach agreement quickly with the committees on terms for the restructure of its various LBO debt and other obligations and to emerge from chapter 11 as soon as possible without pursuing the debtor's fraudulent conveyance, professional malpractice and other claims arising out of its LBO.⁶⁷

The goal of achieving early confirmation of a plan of reorganization, however, may be inconsistent with the debtor's obligation to maximize its estate by vigorous pursuit of the claims that arise out of its LBO. Although the prosecution of causes of action that are based upon fraudulent conveyance and corporate distribution laws may be costly in fees, protracted in duration, and uncertain as to the outcome, a debtor has a fiduciary duty to maximize its assets, which should include the pursuit of its claims at least until they are ripe for settlement.

Frequently, the targets of the debtor's LBO causes of action include major creditors whose claims arise from loans that were made to provide the cash needed to fund the LBO and financial advisors who helped engineer the deal. The support of the LBO lenders, however, is usually needed by the debtor to gain the requisite acceptances of the debtor's proposed plan of reorganiza-

⁶⁶ 11 U.S.C. § 1102 (1988).

⁶⁷ See the court's description of testimony given by the debtor's president in *In re Revco D.S., Inc.*, 118 Bankr. 464, 467 (Bankr. N.D. Ohio 1990). He testified that the pursuit of any litigation by the debtor to recover on its LBO claims would be a "disaster" for the debtor's business and for "the on-going plan negotiations." *Id.*

tion. For this reason, a debtor's management may prefer not to pursue the debtor's LBO claims against its major pre-petition lenders. An abandonment of LBO claims, however, may be injurious to the economic interests of certain classes of creditors or shareholders. This squarely raises the question whether the debtor has a duty to prosecute such claims either to judgment or an arm's-length settlement, or has the legal right to abandon such claims in its business judgment in order to achieve early confirmation at the expense of enhancing the estate through recoveries on its LBO claims.

B. The Duty of the Trustee or Debtor in Possession to Enforce LBO Causes of Action

By the terms of section 541(a) of the Code, the filing of a chapter 11 petition for reorganization creates an "estate."⁶⁸ The estate is comprised of all the property listed in that section, including "all legal or equitable interests of the debtor in property."⁶⁹ Section 541(a)(1)'s reference to "all legal or equitable interests of the debtor in property" includes all causes of action belonging to the debtor.⁷⁰

A chapter 11 debtor in possession is charged with the performance of most duties of a trustee.⁷¹ As the Supreme Court stated in *Commodity Futures Trading Commission v. Weintraub*,⁷² "the trustee is accountable for all property received and has the duty to maximize the value of the estate."⁷³ Because the debtor's causes of action existing at the petition date constitute property of the estate, the debtor is obliged to take steps to maximize their value through prosecution to judgment or through a fair and arms-length settlement for the benefit of the estate. Thus, in *In re E.F. Hutton Southwest Properties II, Ltd.*,⁷⁴ the court observed that "[i]f an action belongs to the estate, the trustee has the power and duty to prosecute the action for the benefit of all creditors

⁶⁸ 11 U.S.C. § 541(a) (1988).

⁶⁹ *Id.*

⁷⁰ *Id.*; *Louisiana World Exposition v. Federal Ins. Co.*, 858 F.2d 233, 245 (5th Cir. 1988); *Mixon v. Anderson (In re Ozark Restaurant Equipment Co., Inc.)*, 816 F.2d 1222, 1225 (8th Cir. 1987), *cert. denied*, 108 S. Ct. 147 (1987); *American Nat'l Bank of Austin v. Mortgageamerica Corp. (In re Mortgageamerica Corp.)*, 714 F.2d 1266, 1274 (5th Cir. 1983).

⁷¹ See 11 U.S.C. § 1106(a), § 1107(a) (1988).

⁷² 471 U.S. 343 (1985).

⁷³ *Id.* at 352 (citing 11 U.S.C. § 704(2), § 1106(a)(1), § 704(1)).

⁷⁴ 103 Bankr. 808 (Bankr. N.D. Tex. 1989).

and shareholders in the estate."⁷⁵

C. Prosecutorial Discretion is Limited by Law; the Business Judgment Rule Does Not Authorize a Decision not to Prosecute a Cause of Action

Failing to prosecute a cause of action and allowing a statute of limitations on the claim to expire would be tantamount to an "abandonment" of estate property.⁷⁶ The statutory and applicable case law establish that a trustee or debtor in possession does not enjoy the power to give away valuable estate property and justify such a waste of assets under the guise of good business judgment. The Code expressly provides, in section 554(a), that before the court may authorize the abandonment of any estate property, the trustee or chapter 11 debtor in possession must establish that all the statutory criteria for abandonment have been met: that the property in question is "burdensome to the estate" or that it is "of inconsequential value and benefit to the estate."⁷⁷

Moreover, several doctrines developed by the courts place additional restrictions on any "discretion" that a trustee or debtor in possession might have to abandon estate property that even go beyond the express statutory requirements of "burdensomeness" and "worthlessness" set forth in section 554. Indeed, the absolute statutory power of a debtor to abandon worthless property is even limited by the courts to preclude an abandonment of environmentally infected property that poses a danger to health or safety.⁷⁸ In *In re Beker Industries Corp.*,⁷⁹ the court, relying on *Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*,⁸⁰ held that the debtor could not abandon its burdensome partnership interest in a non-debtor mining partnership, because such an important asset could be abandoned only where it com-

⁷⁵ *Id.* at 812.

⁷⁶ A bankruptcy trustee or debtor in possession in a chapter 11 case is authorized by Code § 554(a), after notice and a hearing, to abandon property of the estate "that is burdensome to the estate or that is of inconsequential value and benefit to the estate". 11 U.S.C. § 554(a) (1988).

⁷⁷ *Id.* See also *Morgan v. K.C. Mach. & Tool Co. (In re K.C. Machine & Tool Co.)*, 816 F.2d 238, 245 (6th Cir. 1987) (quoting 11 U.S.C. § 554(b) (Supp. 1986) (which authorizes court to order trustee to abandon property of the estate)).

⁷⁸ *Midlantic Nat'l Bank v. New Jersey Dep't of Env'tl. Protection*, 474 U.S. 494, 498-500, *reh'g denied*, 475 U.S. 1090 (1986).

⁷⁹ 64 Bankr. 900 (Bankr. S.D.N.Y. 1986), *rev'd on other grounds*, 89 Bankr. 336 (S.D.N.Y. 1988).

⁸⁰ *Id.* at 910 (citing *Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983)).

plied with the statutory voting, disclosure and confirmation safeguards of the chapter 11 plan confirmation process. Thus, if resolution of an LBO cause of action would have a substantial impact on the debtor's reorganization, that fact may require that an abandonment be authorized only if the test for an abandonment contained in section 554 has been satisfied, and then only pursuant to a confirmed plan of reorganization.⁸¹

Perhaps the first authority to recognize the trustee's affirmative duty to prosecute all causes of action and the applicability of abandonment concepts to causes of action is *In re Moore*.⁸² There, the court held that a chapter 7 trustee cannot abandon estate property simply by failing to administer the asset and by filing a "no asset" report. In *Moore*, the court observed that the debtors' pre-petition "lender liability" claims against a bank and its officers were assets of the estate that could not be abandoned by a chapter 7 trustee without giving notice to creditors and an opportunity for a hearing. The court was asked to rule on a motion by the bank to compel the trustee to "administer" the lender liability claims and to compel the trustee to accept the bank's offer to purchase the claims for the sum of \$5,000. Previously, the trustee had rejected the bank's offer and determined that he was not going to pursue the litigation as an asset of the bankruptcy estate. The trustee argued that the "business judgment" rule allows a trustee to exercise "unfettered discretion" to abandon assets that he alone considers to be of inconsequential value and benefit to the estate.

The court in *Moore* rejected the trustee's invocation of the business judgment rule, citing (1) the language of section 554, (2) section 704, which mandates that the trustee "collect and reduce to money the property of the estate" and "be accountable for all property received,"⁸³ and (3) the Supreme Court's unequivocal statement in *Commodity Futures Trading Commission v. Weintraub*⁸⁴ that a trustee has the "duty to maximize the value of the estate."⁸⁵ That duty is also imposed on a chapter 11 debtor in possession by Code section 1107.⁸⁶

The standard applied by the court in *Moore* in reviewing the

⁸¹ See, e.g., *In re Crowthers McCall Pattern, Inc.*, 120 Bankr. 279 (Bankr. S.D.N.Y. 1990).

⁸² 110 Bankr. 924 (Bankr. C.D. Cal. 1990).

⁸³ 11 U.S.C. § 704 (1988).

⁸⁴ 471 U.S. 343 (1985).

⁸⁵ *Id.* at 352.

⁸⁶ 11 U.S.C. § 1107 (1988).

trustee's authority to abandon an asset was not the business judgment rule, but rather a higher standard. The court explained:

The test involved is a balancing of the principle of discretion which the business judgment rule allows trustees in the management and distribution of estate property, and the duty imposed on trustees to maximize the value of the estate pursuant to the Code. The business judgment rule should allow a trustee discretion in balancing the costs and benefits of administering an asset of the estate. However, if consideration is offered for a cause of action, then the cases are clear that the trustee must take affirmative action to resolve the matter. . . . Although a trustee is not compelled to accept any offer to purchase, solely because "some recovery is better than none at all," a trustee is required to take appropriate *action* to liquidate the assets of the estate. The choice of which type of action (whether it be acceptance of the offer, a counteroffer, negotiation, open bidding, or bringing a formal motion for abandonment) belongs to the trustee within the sound exercise of the trustee's business judgment *so long as the trustee fulfills his statutory duties*.⁸⁷

The sound teaching of *In re Moore* is that the trustee or Chapter 11 debtor is duty bound to "administer" claims and causes of action of significant potential value and must take affirmative action to maximize the estate's recovery.

There are other cases that suggest the contrary point of view that the business judgment rule applies to shield from judicial scrutiny the debtor in possession's failure to prosecute or otherwise maximize the value of its causes of action.⁸⁸ In *In re Revco D.S., Inc.*,⁸⁹ an equity security holder moved for authority to commence suit derivatively on behalf of the debtors against various participants in their December 1986 leveraged buyout. The equity holder urged that the debtors' failure to prosecute certain state law claims as to which the limitations period was about to expire was unjustifiable

⁸⁷ *In re More*, 110 Bankr. 924, 928 (Bankr. C.D. Cal. 1990) (emphasis added).

⁸⁸ See, e.g., *Fluharty v. Fluharty* (*In re Fluharty*), 7 Bankr. 677 (Bankr. N.D. Ohio 1980) (holding that debtor's chapter 13 plan met the "best interest of creditors" test under 11 U.S.C. § 1325(a)(4) (1976) despite refusal to pursue alleged attorney malpractice claim); *In re Wilson*, 94 Bankr. 886 (Bankr. E.D. Va. 1989) (holding that trustee's decision to consent to abandonment of claims under certain conditions is based on his business judgment and entitled to affirmance by court unless evidence shows that value of claims exceeds what would be received from consent arrangement); *United States ex rel. Peoples Banking Co. v. Derryberry* (*In re Hartley*), 50 Bankr. 852 (Bankr. N.D. Ohio 1985) (holding that under business judgment rule guidelines, trustee did not breach fiduciary duty in choosing not to pursue a preference claim).

⁸⁹ 118 Bankr. 468 (Bankr. N.D. Ohio 1990).

and constituted an abandonment of estate assets subject to the standards of section 554 of the Code. The court rejected this approach stating that “[d]ecisions on whether or not to commence litigation rests [sic] with the business judgment of the [d]ebtors.”⁹⁰ That ruling, however, related primarily to the time when the debtor would commence suit on its LBO claims, and by a subsequent order in the case the court directed a committee to file suit on LBO claims when the debtor failed to do so by the time the statute of limitations was about to run on the claims.

The court in *Revco* relied on *In re Hartley*,⁹¹ which suggests that the trustee’s decision whether or not to sue should be reviewed under the business judgment rule. There, the bankruptcy court held that a chapter 7 trustee’s decision not to bring a certain preference action was not cause for his removal. The *Hartley* court opined that the trustee’s decision is “analogous to a business judgment,” relying on *In re Curlew Valley Associates*.⁹² Interestingly, the *Curlew* case involved a challenge to the business judgment of the trustee as to the particular manner of his operating the debtor’s farm, that is, whether to “bale” hay or “cube” hay. Unlike the matter at issue in *Curlew*, abandonment of estate property is not action within the ordinary course of a debtor’s business, which is often tested under a business judgment standard.⁹³ Moreover, the business judgment standard was applied in *Curlew* exclusively in terms of the trustee’s decision to accept or reject an executory contract under the predecessor to section 365 of the Code.⁹⁴ These distinguishing factors make *Curlew* a less than persuasive authority on the abandonment issue.

Indeed, *Curlew* was distinguished in another context on a similar basis. In *In re Public Service Co. of New Hampshire*,⁹⁵ the court, in reviewing a proposed transaction to shift control of the debtor, held that the business judgment standard is not applicable to test transactions out of the ordinary course of business. The court observed:

[T]he labeling of a particular proposed transaction occurring out of the ordinary course of a reorganization debtor’s busi-

⁹⁰ *Id.* at 476 (citing *United States ex rel. Peoples Banking Co. v. Derryberry* (*In re Hartley*), 50 Bankr. 852, 863 (Bankr. N.D. Ohio 1985)).

⁹¹ 50 Bankr. 852 (Bankr. N.D. Ohio W.D. 1985).

⁹² *Id.* at 863 (citing *In re Curlew Valley Assocs.*, 14 Bankr. 506 (Bankr. D. Utah 1981)).

⁹³ *In re Beker Indus. Corp.*, 64 Bankr. 900, 908 (Bankr. S.D.N.Y.), supports the notion that an abandonment of property is not within the ordinary course of a debtor’s business.

⁹⁴ 11 U.S.C. § 365 (1988).

⁹⁵ 90 Bankr. 575 (Bankr. D.N.H. 1988).

ness, as simply a "business judgment" by the debtor, does not insulate the proposed transaction from a more searching view as to its wisdom and reasonableness than was given the hay-harvesting transaction in the *Curlew* case which occurred in the ordinary course of the business operation there involved.⁹⁶

In *Fluharty v. Fluharty* (*In re Fluharty*),⁹⁷ the court was asked to rule on an objection to confirmation of a plan as not being in the best interests of creditors because the trustee did not pursue a malpractice claim against the debtor's former attorney.⁹⁸ The court found that there was no proof that the debtor had a cause of action for malpractice, and thus there was an insufficient prospect of recovery to justify incurrence of the expense of prosecution. *Fluharty* is consistent with the principle, which in a case where a claim can be stated, the trustee must take action to maximize it. By focusing on whether there was any value in the estate's cause of action, *Fluharty* is consistent with the standard of review articulated in *In re Moore*, in that it recognizes that the trustee's discretion in prosecuting causes of action is limited.

The decision in *In re Wilson*⁹⁹ also suggests that the "business judgment" standard applies. However, *Wilson* does not suggest that the debtor in possession may abandon claims in the absence of a hearing by letting the applicable statute of limitations quietly expire. Such inaction is outside the scope of the debtor in possession's authority under the Code. The statutory rules authorizing abandonment must be read consistently with the debtor's duty to maximize the value of the estate's causes of action.

IV. INTERFACE OF FRAUDULENT CONVEYANCE LITIGATION WITH THE PLAN OF REORGANIZATION

A. *In General*

Fraudulent conveyance litigation, particularly of the type that arises out of an LBO, poses various complexities in the chapter 11 context. Complexity results not only from the many factors that enter into financial analysis and conflicting expert opinions on future projected income and present enterprise value, but also from the mountain of paper that is usually generated in an LBO transaction involving substantial dollars. In a typical LBO, the structure may involve several levels of public

⁹⁶ *Id.* at 581 (emphasis in original).

⁹⁷ 7 Bankr. 677 (Bankr. N.D. Ohio 1980).

⁹⁸ *Id.* at 680.

⁹⁹ 94 Bankr. 886 (Bankr. E.D. Va. 1989).

and private debt, with the LBO debt secured by various security interests, and several levels of preferred and common stock equity financing, as well as a holding company-subsidary structure. LBO transactions are thus typically documented by a multiplicity of lending agreements, registration statements for the offering of debt and equity instruments publicly sold to finance the LBO, proxy statements to solicit the votes for an LBO merger, and complex corporate charter amendments designating the rights and powers of the several classes of stock of the surviving corporation.

The structuring of an LBO transaction by means of a number of independent corporate and financial parts evidenced by sophisticated and extensive documentation has led some legal writers to urge that the traditional fraudulent conveyance laws that emerged in the 16th century to protect creditors from fraudulent transfer were not intended by modern day legislatures to apply to LBOs.¹⁰⁰ Although the court, in its notable decision in *Credit Managers Association of Southern California v. Federal Co.*,¹⁰¹ suggested that fraudulent conveyance laws may not have been intended to apply to LBOs, virtually unanimous authority has developed during the 1980s to establish that the fraudulent conveyance laws unquestionably apply to transfers and obligations that fail the test imposed by fraudulent conveyance laws enacted by states and also by Congress as part of the Code.¹⁰²

It is also probable that the use of multiple interdependent transactions and a multi-corporate setup will not insulate a transfer or an obligation incurred from a fraudulent conveyance attack by separately analyzing and testing each part of the LBO. Instead the interindependent parts have been collapsed by some courts¹⁰³ with the result that the LBO is viewed in light of its economic effect and reality, namely that indebtedness is imposed on a target company without any benefit to it while the proceeds

¹⁰⁰ Baird and Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

¹⁰¹ 629 F. Supp. 175, 187-88 (C.D. Cal. 1986).

¹⁰² *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais)*, 100 Bankr. 127 (Bankr. D. Mass. 1989); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488 (N.D. Ill. 1988); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986) (*affirming United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983)), *cert. denied*, 483 U.S. 1005 (1987); *Ohio Corrugating Co. v. Security Pacific Business Credit, Inc. (In re Ohio Corrugating Co.)*, 70 Bankr. 920 (Bankr. N.D. Ohio 1987); *Anderson Indus., Inc. v. Anderson (In re Anderson Indus. Inc.)*, 55 Bankr. 922 (Bankr. W.D. Mich. 1985).

¹⁰³ See, e.g., *Wieboldt*, 94 Bankr. 488 (N.D. Ill. 1988).

of the debt are paid out entirely to the shareholders of the target company and for the fees for effecting the LBO. In the absence of benefit to the target, a key question in LBO/fraudulent conveyance or corporate distribution litigation is whether a financial "trigger" existed, such as insolvency of the target or the inadequacy of its capital.

The litigation of fraudulent conveyance claims arising out of an LBO is often complex for several reasons. First, the attorneys for the parties, who may be numerous, will be faced with a mountain of paper and witnesses, which necessarily entails lengthy pre-trial document production and discovery by means of depositions. Second, financial issues, such as "insolvency" or "insufficiency of capital," involve a number of aspects that are not governed by precise legal tests.

B. Impediment to Confirmation

So long as fraudulent conveyance and corporate distribution claims arising out of an LBO remain unadjudicated and not settled by the affected parties, it is difficult for a plan of reorganization to be confirmed in a chapter 11 case. A debtor in a chapter 11 case may have assets, which at a fair valuation approximate the amount of its debts, so that under the Code's definition of "insolvency" the chapter 11 debtor will not necessarily be insolvent.¹⁰⁴ If the debtor is actually insolvent due to an excess of debts above its assets, a plan of reorganization that extinguishes the equity interests may be confirmed over the dissent of the shareholders, because the shares of an insolvent company are considered to be valueless under bankruptcy law principles.¹⁰⁵ Where a debtor was the target in a pre-bankruptcy LBO, however, the fraudulent conveyance and corporate distribution claims that arise out of the LBO could be of great value and themselves render the debtor solvent.¹⁰⁶ Monetary recoveries may be effected, which could render the debtor solvent. There are, as well, remedies other than monetary recoveries that may be invoked if there has been a fraudulent conveyance or fraudulently incurred obligation. Voidable debt obligations may be set aside, or security interests given in violation or fraudulent conveyance laws may be avoided.

¹⁰⁴ 11 U.S.C. § 101(31) (1988).

¹⁰⁵ See *id.* at § 1129(b)(2)(C).

¹⁰⁶ See Preliminary Report of the Examiner in *In re Revco D.S., Inc.*, 118 Bankr. 468, 479 (Bankr. N.D. Ohio 1990), where the examiner stated that "the remedies for [LBO] causes of action could create a solvent estate". *Id.*

Contractual priorities among creditors may be reallocated by application of equitable subordination principles,¹⁰⁷ or LBO loans might be treated as equity investments, because the proceeds of such loans were in fact used for the purchase of stock from those who owned the stock at the time of the LBO.

Legal claims and causes of action constitute property of the estate. As assets, the debtor's LBO claims must be valued along with all of its other assets to determine whether the debtor is solvent. When appropriately and fairly valued, LBO causes of action may tip the scales and result in a condition of solvency for the debtor, thus precluding confirmation of a "cram down" plan that would extinguish equity interests.

The non-prosecution of LBO causes of action and their treatment by principal parties in interest in a chapter 11 case may have a significant impact on whether and when a plan of reorganization may be confirmed. In some cases, the debtor's management will set its sights on completing the chapter 11 process as early as possible by satisfying the creditor constituencies on the terms of a plan of reorganization for the treatment to be accorded the various debt claims. Where the debtor was the product of an LBO, corporate management may try to work out the terms of reorganization with the creditor groups by agreeing with them that the debtor will not pursue its LBO causes of action, thereby gaining the support of the creditors who were the LBO lenders. Obviously, creditors who are being sued to set aside their LBO collateral arrangements and debt obligations will not readily agree to the major changes in their debt claims that are necessary for a realistic settlement of the LBO claims against them. A realistic settlement would require a reduction in the amount of the LBO loan claims, which approximates the value of the LBO claims against the LBO creditors.

The hope for a quick reorganization in chapter 11 may lead a debtor's management not to pursue its LBO claim, and management may even oppose the efforts of others to pursue them derivatively. That is precisely what happened in *Allegheny International*.¹⁰⁸ The court there pointed out that very early in that case the court itself recognized the importance of the claims

¹⁰⁷ See Appeal of United States (*In re Virtual Network Servs. Corp.*), 902 F.2d 1246 (7th Cir. 1990), where the court concluded that creditor misconduct is not a prerequisite for equitable subordination under § 510(c) of the Code. *In re Virtual Network*, 902 F.2d at 1249 (citing 11 U.S.C. § 510(c) (1988)).

¹⁰⁸ 118 Bankr. 282 (Bankr. W.D. Pa. 1990).

of the debtor against a bank group that received prepetition prepayment of \$400 million, for invalidation of their liens to secure other loans approximating \$220 million, for the recovery of \$500,000 of fees paid pre-petition to the bank lenders in connection with granting an extension of time for payment, for the recovery of preferential transfers to insiders, and for equitable subordination. The court stated that very early in the case "the court recognized that this litigation would have a crucial role in the bargaining related to any plan of reorganization" and that "[w]hen the debtors decided not to pursue these causes of action, this court invited the Creditors' Committee to pursue them."¹⁰⁹ Massive claims against banks and other lenders as well as other potential defendants were also identified in the Examiner's preliminary report filed in the *Revco* chapter 11 case, which was followed by a court directive to a committee to file an LBO action derivatively when the debtor itself failed to do so.¹¹⁰

If major fraudulent conveyance claims have not been adjudicated, and thus are uncertain as to the liability and remedy when confirmation of a plan is requested, the question is whether the existence of the debtor's lawsuits in that condition stands in the way of confirmation of a plan of reorganization. One approach, which has been followed to avoid the problem, is to seek a "settlement" of the fraudulent conveyance claims against major creditor constituencies through the vehicle of a plan of reorganization. Settlements may be effected in bankruptcy cases only with the approval of the court, either through the process of a court-approved compromise and settlement under Bankruptcy Rule 9019(a)¹¹¹ or by means of the confirmation of a plan of reorganization which contains a settlement of the controversy. A settlement is a permissive provision of a plan of reorganization under section 1123(b)(3)(A) of the Code.¹¹² Specifically, section 1123(b)(3)(A) authorizes the inclusion in a plan of a settlement "of any claim or interest belonging to the debtor or to the estate."¹¹³ Under that provision, if a fraudulent conveyance claim is a claim "belonging to the debtor" rather than to others, then a

¹⁰⁹ *Id.* at 308. In the *Revco* chapter 11 case, the court also directed an official committee for unsecured creditors to file a derivative LBO lawsuit, but did not do so until approximately 2-1/2 years after the chapter 11 case was filed, when the statute of limitations was about to run. See *In re Revco D.S., Inc.*, 118 Bankr. 468 (Bankr. N.D. Ohio 1990).

¹¹⁰ 118 Bankr. at 477-529.

¹¹¹ See FED. R. BANKR. P. 9019(a).

¹¹² 11 U.S.C. § 1123(b)(3)(A) (1988).

¹¹³ *Id.*

settlement of that claim may be effected by the confirmation of the plan of reorganization if the terms of settlement pass legal muster.

That raises a number of crucial questions. The first is determining the legal standard that applies to test whether the settlement embodied in the plan will be approved. The second is whether confirmation of the plan operates to preclude others, such as individual creditors or shareholders, from pursuing the LBO claims that have been settled or from pursuing their Code section 502 objections interposed to the proofs of claim filed by the creditor-defendants whose LBO liabilities would be settled under the plan.

C. Standard For Settlement

While each creditor individually possesses fraudulent conveyance causes of action to set aside a debtor-transferor's pre-bankruptcy transfers or fraudulently incurred obligations, the commencement of a bankruptcy case in essence operates to transfer those claims to the debtor in possession or bankruptcy trustee, if one has been appointed. A plan proponent will obviously seek to gain the support of the major creditor constituencies for the proponent's proposed plan. Because the major creditors, who were LBO lenders, are themselves potential defendants in fraudulent conveyance litigation, any hope of gaining their support is likely to be dependent upon reaching a settlement with them of the fraudulent conveyance claims against them, which is then embodied in the plan.

The approach in this context would be to negotiate a meaningful reduction in the amount of the otherwise allowable claims of the lender-creditors who are among the LBO defendants. This could take the form of (1) elimination or a reduction in the amount of the post-petition interest payments that may have been received by the lenders as "adequate protection" pursuant to section 364(d)(1)(B) of the Code¹¹⁴ to enable a senior lien to be created as security for post-petition financing, or (2) a reduction in the principal amount of the lenders' pre-petition LBO loan claims.

Obviously, any settlement must be "fair and equitable" to the parties who have an interest in the estate.¹¹⁵ Unless the settlement produces a return or benefit for the estate that bears a

¹¹⁴ *Id.* at § 364(d)(1)(B).

¹¹⁵ *Id.* at § 1129(b).

direct relationship to the value of the claims that the estate would release, the settlement should not be approved. As stated in *Allegheny International*, a "court has discretion to approve a settlement as part of a reorganization plan. Even so, there are limits to a court's discretion in approving a settlement."¹¹⁶ The standard for settlement was first articulated in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*,¹¹⁷ which requires that a compromise be fair and that the benefits received by the estate be within the range of high and low values of the causes of action to be released under the compromise.¹¹⁸ It is thus essential "to compare the terms of the compromise with the likely rewards of litigation."¹¹⁹

The factors to be considered in a court's evaluation of a settlement were enumerated in *In re Texaco, Inc.*,¹²⁰ where the court stated that the following factors should be given consideration: the likelihood of success by each of the parties to the litigation, the concrete present benefits of the settlement as compared with the future benefits of a successful litigation, an analysis of the extent to which the numerous beneficiaries of the litigation support or object to the proposed settlement, and the extent to which the settlement is the product of arms length bargaining following the vigorous development and pursuit of the claims in the litigation so as to make them ripe for settlement.

In *Allegheny International*,¹²¹ the court approved a settlement of a lawsuit against a defendant bank group, under which the banks agreed to return approximately eighteen million dollars of post-petition interest payments they already received in cash as "adequate protection," and also to forego further post-petition interest payments that would have accrued thereafter at the rate of approximately two million dollars per month until the end of the chapter 11 case. The court mentioned several significant factors in addition to the substantial dollar proceeds generated for the debtor estate by the proposed settlement. First, the plan at issue provided a distribution for the three classes of equity secur-

¹¹⁶ *In re Allegheny Int'l, Inc.*, 118 Bankr. 282, 309 (Bankr. W.D. Pa. 1990).

¹¹⁷ 390 U.S. 414 (1968).

¹¹⁸ See *id.*; Appeals of Koch Refining Co. (*In re Energy Coop., Inc.*), 886 F.2d 921, 927 (7th Cir. 1989); LaSalle Nat'l Bank v. Holland (*In re American Reserve Corp.*), 841 F.2d 159, 161 (7th Cir. 1987); Martin v. Kane (*In re A&C Properties*), 784 F.2d 1377, 1382 (9th Cir. 1986), *cert. denied*, 479 U.S. 854 (1986).

¹¹⁹ *TMT Trailer*, 390 U.S. at 425.

¹²⁰ 84 Bankr. 893, 902 (Bankr. S.D.N.Y. 1988).

¹²¹ *In re Allegheny Int'l, Inc.*, 118 Bankr. 282 (Bankr. W.D. Pa. 1990).

ity holders, even though it was unreasonable to expect that the litigation could gain a sufficient amount to support full payment to creditors and a further distribution to the shareholders.¹²² Second, while the shareholders would benefit under the proposed plan, the Equity Committee in that case was the only entity that opposed confirmation. That opposition was interposed even though it was in conflict with the expressed view of two of the three classes of equity security holders represented by that committee and possibly the third represented equity class as well.¹²³ Third, the lawsuit against the banks had already been extensively litigated in the derivative action initiated by the Creditors' Committee at the invitation of the court.¹²⁴ The litigation was conducted in a way that was "clearly adversarial." Special counsel for the plaintiff had already requested \$1.7 million in fees to conduct the litigation. It was clear that the claims in suit had been substantially developed and litigated, that they were ripe for a settlement, and that all major constituencies, including virtually all of the equity interests, supported the settlement embodied in the plan of reorganization. By contrast, however, a settlement agreed to at the beginning stage of a major litigation may lack the reliability that results from one reached after a period of vigorous prosecution of the claims in suit. Finally, a settlement that does not provide a meaningful and identifiable financial benefit to the estate will fail the test for court approval.

Traditionally, there has been a unity of interest between management of a corporation and its shareholders. While the advent of bankruptcy triggers express fiduciary duties on the part of a debtor's management to the creditors, the management continues to have fiduciary duties to the owners of the equity. Management, therefore, is subject to restraints in reaching settlements of fraudulent conveyance and similar claims in the chapter 11 context if the proposed settlement would leave little or nothing for the owners of the equity. The desire of management to emerge from chapter 11 is appropriate, but the rights of the equity interests should not be disregarded in a hasty effort to settle LBO litigation. To do so would likely generate litigation that may delay or stand in the way of confirmation of a plan. Therefore, courts have recognized that the settlement of disputes of this type on a basis that provides for all parties in interest on a

¹²² *Id.* at 314.

¹²³ *Id.* at 313.

¹²⁴ *Id.*

fully consensual basis is the wisest course, and that a settlement on such a basis may be the only means of achieving confirmation of any plan of reorganization. As stated by the court, in respect of the settlement embodied in the plan in *Allegheny International*, without "settling this litigation . . . it might be impossible to consummate any plan of reorganization."¹²⁵ Indeed, the fabric of chapter 11 is to encourage the negotiation of a fully consensual plan rather than to seek confirmation through protracted and costly litigation.

D. Other Uncertainties of Litigation

Fraudulent conveyance claims are asserted in the chapter 11 context by the debtor in possession or bankruptcy trustee, if appointed, or derivatively by an official committee or other entity authorized by the court to do so. That is, however, not the sole manner in which fraudulent conveyance claims may be asserted in the chapter 11 context where the potential defendant is itself an entity that has filed a proof of claim against the estate, such as an LBO lender. Two provisions of the Code are applicable. First, section 502(b)(1) requires that a claim, proof of which has been filed under section 501 of the Code, be disallowed by the court to the extent that "such claim is unenforceable against the debtor, and unenforceable against property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured."¹²⁶ If and to the extent that a proof of claim is filed with respect to an LBO debt claim, such debt may be voidable under state fraudulent conveyance laws, and the creditor's filed proof of claim may then be subject to mandatory disallowance on the ground that the claim is unenforceable under applicable law within the meaning of section 502(b)(1) of the Code.

Section 502(d) contains a provision parallel to section 502(b)(1), but provides for a remedy other than permanent disallowance of the claim. Under section 502(d), if a creditor who has filed a proof of claim has received a fraudulent transfer, the proof of claim of the creditor-transferee must be disallowed by the court unless the creditor-transferee has returned the fraudulently transferred property.¹²⁷

If there is an unadjudicated objection to a filed proof of

¹²⁵ *Id.* at 313.

¹²⁶ 11 U.S.C. § 502(b)(1), § 501 (1988).

¹²⁷ *Id.* at § 502(d).

claim which is grounded on the creditor-claimant's receipt of or participation in a fraudulent conveyance, the pendency of the unresolved objection may affect the goal of confirmation. The pendency of the objection may itself preclude the creditor from voting on a proposed plan of reorganization. The reason is that under section 1126(c) of the Code, the majority of a class of creditors required to constitute acceptance of a proposed plan by that class is governed by the vote of the holders of "allowed" claims who have accepted or rejected the proposed plan.¹²⁸ Under section 502(a), a claim is deemed "allowed" unless there has been an objection to the claim by a "party in interest,"¹²⁹ which in a chapter 11 case, includes any creditor or shareholder under the inclusive language of section 1109(b) of the Code.¹³⁰ If there is an unadjudicated objection filed by a creditor or shareholder, the claim that is subject to the objection is not deemed "allowed" and the vote on that claim does not count for determining whether the class has accepted the plan. It is noted, however, that Bankruptcy Rule 3018(a) permits the court temporarily to allow a claim for voting purposes.¹³¹ But the validity of that rule is doubtful because, in conflict with section 1126(c), it would permit a claim to be voted despite the fact that it is not an "allowed" claim.¹³²

Assuming that a settlement of major LBO claims against various creditor-defendants has been effected by means of confirmation of a plan of reorganization, which releases the creditor-defendants, based on a ruling by the court that the settlement has passed the legal test for such approval, the question remains whether a section 502 disallowance of the creditor-defendant's claim filed against the estate may nevertheless be ordered after confirmation of the plan in the proceeding arising from the filed objection to the claim, which was unadjudicated at the time of confirmation. If creditor-defendants continue to be subject to the disallowance of their claims despite the confirmation of a plan of reorganization, which by its terms released the creditor

¹²⁸ *Id.* at § 1126(c).

¹²⁹ *Id.* at § 502(a).

¹³⁰ *Id.* at § 1109(b).

¹³¹ FED. R. BANKR. P. 3018.

¹³² See *In re Gardinier, Inc.*, 55 Bankr. 601, 604 (Bankr. M.D. Fla. 1985); see also *In re American Solar King Corp.*, 90 Bankr. 808 (Bankr. W.D. Tex. 1988) (determining that the purpose of Rule 3018 is to foster consensus); *In re Amarex, Inc.*, 61 Bankr. 301 (Bankr. W.D. Okla. 1985) (finding no persuasive authority on Rule 3018 and concluding that a court should exercise its equitable powers regarding disallowance or allowance of claims throughout the case).

from liability on fraudulent conveyance claims, it is less likely that creditor-defendants will vote in favor of a plan, because it would not establish allowance of their claims and their clear entitlement to receive distributions under the confirmed plan.

The key question is whether the order confirming the chapter 11 plan that contains a settlement of fraudulent conveyance claims is entitled to *res judicata* effect and thus would constitute a bar to the objectant's further litigation of the proceeding seeking the disallowance under section 502 of a creditor-defendant's proof of claim. Confirmation should not operate as such a bar to the individual claims of the objectant. A judgment has *res judicata* effect in a later proceeding only if the issue adjudicated in both the first and later proceedings are the same.¹³³ It is clear that the issue with respect to the settlement of fraudulent conveyance claims in the proceeding for confirmation of a plan of reorganization is not the same as the issue in the proceeding for determining whether a creditor-defendant's proof of claim should be disallowed under section 502. Accordingly, the order confirming a plan of reorganization containing a settlement should not bar the objectant's prosecution of its objection to a claim after confirmation of the plan to the extent that it is based on the objectants' own rights. Since fraudulent conveyance claims belong to creditors before the bankruptcy filing the question remains whether the debtor can release the claims of the individual creditors.

The release given to the creditor-defendant under the confirmed plan should not have a greater effect than the order of confirmation that in essence approved the settlement. In that connection, it is noted that section 1123(b)(3) authorizes a plan of reorganization to "provide for . . . the settlement or adjustment of any claim . . . belonging to the debtor or to the estate."¹³⁴ The release given as part of a settlement contained in a plan cannot release more than the claims "belonging to the debtor or to the estate."¹³⁵ An entity's objection to a filed proof of claim is itself interposed by the objectant in the exercise of an independent statutory right conferred by section 502(a) on each party in interest. A settlement effected on the authority of section 1123(b)(3)(A) may not deal with or extinguish the independent claim that a party in interest has under section 502(a) to object to any proof of claim.

¹³³ 50 C.J.S. *Judgments* § 648 (1947).

¹³⁴ 11 U.S.C. § 1123(b)(3) (1988).

¹³⁵ *Id.*

The substantive difference between the issue adjudicated in a proceeding for confirmation of a plan that includes a settlement and grants a release, on the one hand, and the merits of an objection to the claim based on a fraudulent conveyance, on the other, is evidenced by the particular and narrow issue addressed in the plan and settlement context. The function of the court in passing on a settlement is not to decide the merits of the claim, but rather to determine whether the settlement is fair and equitable. As stated in *In re Energy Cooperative, Inc.*:

Our function, however, in reviewing the court's approval of a settlement agreement is not to decide the merits of individual issues. "[I]t is not the function of this court to determine the merits of a single contested issue but rather to determine whether the plan as a whole is equitable and fair in light of all of the issues which have been contested."¹³⁶

Creditor-defendants in fraudulent conveyance litigation may be exposed to still other risks at the plan confirmation stage. If the holders of claims that arose in an LBO acquired their claims at discount prices that prevailed after the debtor's financial troubles became public knowledge, it is possible that a plan may be structured by a proponent that involves separate classification for creditors who acquired their securities at deep discount prices and provides distributions less favorable to those classes than other creditor groups.¹³⁷

VI. CONCLUSION

Litigation arising in chapter 11 cases out of LBOs and other leveraged financial transactions is complex because of uncertainty as to resolution of the financial issues posed by such dis-

¹³⁶ 886 F.2d 921, 927, n.6 (7th Cir. 1989) (citations omitted). See *Huddleston v. Nelson Bunker Hunt Trust Estate*, 117 Bankr. 231 (Bankr. N.D. Tex. 1990) (court affirmed an order of confirmation granted by the bankruptcy court of a chapter 11 plan of reorganization that settled and released derivative claims against bank lenders). Derivative claims are "property of the estate," which may be released if the terms of settlement are fair and equitable. Derivative claims are distinguishable from individual or class claims. The latter do not constitute property of the estate, but are owned by individual injured parties. The court recognized in the *Nelson Bunker Hunt* case that non-derivative claims are not barred by a debtor's settlement with the defendants in which the individual claimants have not joined.

¹³⁷ See *In re U.S. Truck Co.*, 800 F.2d 581, 583-87 (6th Cir. 1986) (discussing classification of creditors under the Code); *In re Four Seasons Nursing Centers of Am., Inc.*, 472 F.2d 747, 750 (10th Cir. 1973) (holding that individuals who purchased shares after filing of petition for reorganization were not entitled to participate equally with prior shareholder); *In re Aztec*, 19 B.C.D. 1826 (Bankr. M.D. Tenn. 1989).

putes and the extensive documentation of such transactions leading to protracted discovery, motion practice, trials and appeals. Such litigation is costly, protracted and uncertain in its outcome. Fraudulent conveyance and similar litigation has a significant impact on the chapter 11 confirmation process. The valuation of LBO causes of action is an important issue for adjudication when confirmation of a cram down plan extinguishing the equity interests is sought. Uncertainty also exists as to whether a particular settlement of fraudulent conveyance litigation will qualify for court approval and, even if it does, whether confirmation of such a plan will provide a safe harbor to the creditor-defendants from the post-confirmation adjudication of objections to their filed proofs of claim. The only sure answer to the elimination of delay and risks to confirmation as well as to post-confirmation litigation is a plan that gains the support of every major creditor and shareholder constituency.