LEVERAGED BUYOUTS AND LENDERS' RISKS

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I am John Jerome. I am the Chairman of the Bar Association Committee on Bankruptcy and Reorganization having succeeded the eminent Ed Cowan. . . . It is my pleasure this evening to introduce this illustrious panel headed up by Dick Lieb on the subject of leveraged buyouts. . . .

Mr. Richard Lieb:[1] I'd like you to meet our panel. On my left, . . . Wilbur Ross . . . . He's not burdened by a formal legal education; he's a financial advisor and an investment banker based here in New York. Barbara Houser, from Dallas, is a lawyer . . . . Jim Burns, another unburdened person, a member of Leventhal & Company, [is an] expert in accounting and bankruptcy matters. Judge Keith Lundin, from Nashville, Tennessee, [is] one of my favorites on the

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bench who has come a long way to be with us tonight. Robin Phelan is at the far right. I guess many of you know, and have heard Robin speak before. He is a practicing lawyer from Dallas and also travels quite a lot. That is what bankruptcy lawyers seems to do, they practice wherever. I remember the days when we first practiced bankruptcy law, in fact law in general, where local admission was critically important, and you never got past the boundary of the one state or district [that] you were admitted. All of that has changed, I guess hopefully for the better. . . .

Leveraged buyouts — what are they? What's going to happen to some of them? I heard some testimony before the House Judiciary Committee on March 1st of [1990], it was a House inquiry into the Drexel bankruptcy filing. During the testimony of one of the speakers, a congressman from Kentucky, said that leverage buyouts aren't much different than the old wild west, except there, they rode into town on their horses with their guns smoking, and now they ride out of town in their BMW's with the money bags jingling. That is the way he, for the folks back home, described leverage buyouts.

From your experience Wilbur, you might just give us a fill in, as a financial advisor on what you see as leverage buyouts. . . .

Wilbur L. Ross, Jr.:[2] Thank you, Dick. I would like to start by describing a little bit [about] how we got here, because nowadays so many discussions of leverage buyouts are looking backward that it reminds me of the story about the fellow whose doctor called him and said "I got your test results and I have bad news for you and even worse news." And the fellow thought "God what could that be?" The doctor said "do you want the bad news first?" And he said "yes." The doctor said "the bad news is you have twenty-four hours to live." The fellow said, "God if that's the bad news what could be the worse news?" The doctor said well actually I meant to call you yesterday. Dissecting the late 1980's on leverage buyouts is a little bit like calling him a day late, but since that's what we are here about, I will try to give a little perspective.

From 1985 through 1989, some 217 billion dollars of leverage buyouts were done — more than in the whole prior history of the world. Unlike the buyouts that had occurred earlier, which had been going on for generations, where a private person would sell it, get conventional bank or insurance company financing for whatever he could, and then perhaps take back a little paper, these were very different. They were [also] different conceptually. They were differ-

[2] Senior Managing Director, Rothschild, Inc., New York, New York.

ent in the way that they were implemented, and as a result, they are also having very different results in terms of failure rate. So I think it is not LBO's as such that have a problem, I think it is the particular way of doing LBO's that occurred in the late 80's that has brought the tremendous amount of problems upon us. Here's how I see the differences.

The old fashioned ones were meant to maximize return on equity by borrowing money at a lower rate than the return that you could earn on the assets you purchased, and using that excess to pay down principal on the debt. Eventually you would end up with an unleveraged asset, having made a big rate of return in between. By the late 80's, however, the real criterion for many people, for whether or not to do an LBO, was nothing more than financability. As long as they could do a deal with fairly nominal equity down, frequently no more equity than the front end fees to the investment bankers and the lawyers and the accountants, many deals closed. . . .

There were four basic differences, I think: First was that in the old days people generally did LBO's at more or less five or six times earnings before interest and taxes. That meant that you were getting somewhere between seventeen and twenty percent on your unleveraged purchase price. At those ratios, the thing did not have to grow particularly to provide you a positive return relative to your borrowing cost, and leave something left over in order to eventually repay the principal. However, by the late 1980's not only did the deals get bigger — which is one obvious difference where you had billion dollar deals done with great regularity and where single deals were more than had been done in the whole year previously — but you also had a different structure. The difference in the structure was that with the advent of high yield public markets, and especially with the acceptability during that period of non-cash pay instruments — instruments which were either zero coupon or payment in kind or increasing rate coupons all of which had two essential characteristics. The first was that they minimized the amount of cash throw-off that the venture needed in the early years because you didn't have the full interest burden of the debt load, and second, they resulted in a compounding of that problem later on. If you had a hundred million dollar problem in the beginning, where there was a hundred million of debt on which you could not pay a current coupon five years later that became a two hundred million dollar problem, if it compounded at fifteen percent.

So they had the two horrible characteristics of being inherent time bombs because at some point they became due or they went cash pay or something else happened, but second, they let people pay prices that would not have been sustainable in earlier times. Now deals were getting done at either nine or ten and sometimes twelve times earnings before interest and taxes (E.B.I.T.). If you did a deal at twelve times E.B.I.T., [which] really means that you are only getting an eight and one-half percent return on your unleveraged investment — combined with the non-cash pay instruments, meant that the companies had to grow at a very, very rapid rate, more or less every quarter from the time of the deal until eventual maturity, and if they didn't, you'd end up in a proceeding.

So it's not that there was anything inherently wrong with the general concept of LBO's, it is really that there were abuses of the concept . . . . I hope that's a useful beginning position for the discussions. . . .

Mr. Lieb: It is certainly an important foundation to have. I think really the question is "what is a leverage buyout" that we are talking about. Just structurally, is it something that involves a sale of a business, or the sale of an asset, or necessarily involves a change or a sale of control from one person or group to another?

Robin E. Phelan:[3] I think leverage buyouts, LBO's, have been around forever, and it is only in the 80's that the financial community and the financial press put a tag on it. It got popular in terms of being an identifiable financing technique. Everything Wilbur just said about LBO's is applicable to the savings and loan crisis, which we are more familiar with in our part of the world. Financability, the engine driving the S & L crisis was the fact that S & L's had dollars available to put into real estate. We've got a saying down in Texas: a developer, if you give him money, will build something whether it needs to be built or not.

What Wilbur said is the same thing that happened in the financial markets with respect to corporations. There was availability of financing, the original LBO's, the initial ones, were truly under valued situations and people went out and made a zillion dollars on them. So everybody else looked around and said "hey that guy made a zillion dollars, maybe I can too." The money was there chasing too few realistic deals, people start making projections that are unrealistic, overpaying for things and you end up with a crash.

The instruments that Wilbur talked about, the zero coupons, the negative amortization instruments, we got negative amortization deals in connection with the S & L real estate crisis, there were nega-

[3] Partner, Haynes and Boone, Dallas, Texas.

tive amortization mortgages. It's the same psychology, the same thing was involved — low rates of return. You had real estate projects being sold on the basis of either zero return, on a current basis, or very low returns, on current basis, and betting on the appreciation. It is the same type of psychology whether you apply it to a large corporation, apply it to a real estate deal or apply it to any business transactions. As Wilbur indicated, people bought and sold businesses a long time ago and they borrowed money to do it. A nickel down, a nickel a week. The money came out of the business. It is only when you've got lots of zeros on the end, and they start having a serious impact on the financial markets, that people start putting names on them like LBO's. We've got a problem now with the LBO's because they were predicated upon unsound business and financial practices.

Mr. Lieb: What we are talking about tonight, basically, is a transaction or a series of transactions. In a moment we will try to address whether . . . one thing or a whole series of separate things, in which the ownership of a business is changed from the present ownership group to a new ownership group, and the funds to achieve that come out of the credit and the assets of the so-called target company.

Probably, many of you have seen proxy statements that are written in connection with shareholder meetings to authorize a corporate step like a merger of two entities as part of the structure of a particular LBO. The question is whether an existing corporation with ten thousand shareholders, let's assume, are asked to vote on whether to have a cash out merger where they will get, for example, $50 a share, whereas prior to the proposal of the LBO the stock may have been trading at $15 or $20 a share. Of course, they will vote for that leverage buyout because they are going to get a pack of money in the transaction. When you read the proxy statement, the proxy statement may describe one or a series of complex corporate transactions that we have all been through, but somewhere it is going to say very clearly that the purpose of this transaction is to effect a transfer of ownership and control from the present group of shareholders, which may be thousands and thousands of shareholders, to a new group that may be five, ten, twenty or thirty individuals who basically put up little or nothing. Where the assets of the corporation are borrowed against by leverage buyout lenders, who put up the funds that are used in this transaction to pay the inducing cash price to the selling shareholders to get them to vote to go out of control and to transfer their ownership to another.

The question that really comes up is whether it makes any difference in examining one of these transactions when the target company shortly after leveraging up its debt may be twenty-fold, fifty-fold or one hundred or more fold from what it was the moment before the LBO, whether it matters whether there are two mergers, three mergers, a sale of assets or some other form to the transaction.

Barbara J. Houser:[4] Well I think, Dick, the answer to that question is probably not and it really depends upon where you are. You can look at the structures and there is any number of permutations that these transactions take, from the most simple structure where essentially a majority shareholder sells his stock back to the corporation for a note, some cash in a note secured by the corporation's assets. So you essentially have the minority, the form of minority shareholder owning one hundred percent of the stock, the majority shareholder or former majority shareholder coming out of the transaction with some cash and a note secured by the assets of the corporation, and you have a situation where the corporation, in that structure, got absolutely nothing. The shareholder has reversed the traditional priorities in a bankruptcy scheme and is taking value out of the corporation ahead of the creditors. That is a very simple form that many of the early LBO's took, and in that transaction, when you look at what the corporation got, the corporation got absolutely nothing.

You can go through the various more complicated and more sophisticated LBO structures where you have acquisition companies that get involved. You then have mergers of the target and the acquisition company, and, while the structure is cleaner and more complicated, the truth of the matter is that the same problems that you see in all of them continue to surface: those being that the shareholders have reversed typical priorities, the shareholders have taken substantial value out of the corporation, and the target company, the acquired entity, has really not received any benefit.

I think if you look to the *Wieboldt*[5] case and the *Gleneagles* cases[6] you will see that many of the courts — and it really comes down to, I think unfortunately, nothing more than the smell test. The more

[4] Partner, Sheinfeld, Maley & Kay, Dallas, Texas.

[5] Wieboldt Stores v. Schottenstein, 94 Bankr. 488 (N.D. Ill. 1988).

[6] United States v. Gleneagles Inv. Co., Inc., 565 F. Supp. 556 (M.D. Pa. 1983); 571 F. Supp. 935 (M.D. Pa. 1983); 584 F. Supp. 671 (M.D. Pa. 1984), *aff'd in part sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

egregious the facts and the more the parties participated in actual knowledge of the shape the corporation would be left in, vis-a-vis their other creditors, the courts do not like to look only to the form of the transaction. They want to get to the substance of what really happened, and in those two cases it is just an example of what happened in collapsing the multiple steps into one and concluding that a fraudulent conveyance occurred.

Mr. Lieb: You just heard about *Wieboldt* and probably most of you have heard about *Gleneagles* as well. *Wieboldt* is a leading case on the collapsing theory, Barbara. I guess, really, one of the basic legal questions that anyone is faced with in planning or challenging a leverage buyout in one form or another is whether a series of seemingly complex and sophisticated transactions, which usually involve a string of transactions each dependent upon the other — none are independent truly of the other and would not happen without all the other steps — whether the courts will perhaps look at one or more of them and stop there and sustain some part of the transaction, or whether the courts will, as *Wieboldt* did, collapse all of these different steps that are set up as protective mechanisms to sustain an LBO in the planning stage.

I think that there is probably some law that does not collapse it. But there is developing law, particularly this *Wieboldt* case is a very important one, that does look at the economic reality of what has happened, and did collapse the transaction and view it as one transaction that achieved a transfer of ownership by the present owners to new owners with the corporation — the target corporation, footing the bill.

Mr. Phelan: Dick, lest we take that as total gospel, I would like to posit the theory that in making that analysis one thing you should keep in mind is you have to look at, or you should look at, the perspective of the various parties, and Dick has very ably outlined the substance over form argument. However, a contra argument can be made that although a series of transactions might be one transaction from the standpoint of one of the participants, from the standpoint of any of the other participants in an LBO transaction, or a particular participant in an LBO transaction, his piece of the transaction is the only transaction.

Judge Keith Lundin:[7] This is the armadillo theory of law practice?

Mr. Phelan: No (laughter)

[7] United States Bankruptcy Judge, District of Tennessee, Nashville, Tennessee.

Judge Lundin: They live down in a hole in the ground?

Mr. Lieb: This is also known as the ostrich theory.

Judge Lundin: Or, after they get run over by a car, they put them in a can and eat them, in Texas.

Mr. Phelan: [Judge Lundin] raises a point indicating that he thinks it turns on knowledge, and there is some support for his position.

Mr. Lieb: Could you spell out the issue that he thinks just turns on knowledge?

Mr. Phelan: Well, . . . the *Kupetz*[8] case and some other cases, and *Wieboldt*, seem to indicate if for example a non-insider shareholder in connection with. . . .

Mr. Lieb: A public shareholder?

Mr. Phelan: A public shareholder — in *Kupetz* I don't even know if it was a public shareholder. A non-insider shareholder that just gets his check and sends his stock in that he is not going to get burned. I think also you have to look at the responsibility of each party in the transaction to the other parties in the transaction and to the creditors involved, and say does this party have a responsibility to insure that the funds that are being provided go to the parties that claim they should be protected. It is not always a clear situation, and I think an argument can be made that you have to look at the perspective of the individual party to the transaction.

Mr. Lieb: Robin, excuse me, let's get specific if we can. I think that quite a number of people here tonight represent banks or have feelings, or whose clients have positions, against banks. Let's talk about banks and lenders. . . . Let's take a bank that, so to speak, lends $100 million dollars to finance the buyout where twenty people end up with one hundred percent of the stock that five thousand shareholders owned before. They all vote for this LBO merger, and the public gets the $100 million dollars that the bank puts up. The bank gets a note and a mortgage on all the assets, and the target company is otherwise unaffected except that its got this enormous debt burden that is put on to it. Now, you know in the law we deal with purpose and intent, and we deal with effect of a transaction. Now, the bank made a loan and they evaluated the collateral; maybe they didn't evaluate the legal risk because they didn't know that some of the lawyers were going to look at it later when the projections were wrong.

[8] Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988).

Mr. Phelan: Maybe they did.

Mr. Lieb: Maybe they did.

Mr. Phelan: There is some of the evidence in *Gleneagles*. . . .

Mr. Lieb: Yes, maybe they did look at it, but. . . .

Judge Lundin: Oh, you know they did. Nobody makes a $100 million dollar loan without considering everything. . . .

Mr. Phelan: Yes, [I'll assume that] the bank knew absolutely everything that was going to happen.

Judge Lundin: And they went further than that. In their loan documents they said not only do I know everything about you but I am going to give you this $100 million dollars, and the only thing you can do with this $100 million dollars is to cheat the creditors of this company and give it to the shareholders. That is the only thing you can do with it.

Mr. Lieb: So why did you pay them out in cash?

Mr. Phelan: No, it was you who came to me and asked to borrow $100 million dollars, and I looked at your collateral and I looked at what I believed your cash flow to be because you warranted to me that it was your appropriate projected cash flow. You told me what you were going to use it for, and I said fine you can use it for that. I don't want to loan you the money to go off to Vegas and just throw it on the wheel. That is a perfectly legitimate thing to do.

Mr. Lieb: Well, you are postulating that as a case in which an LBO participant, the bank may get burned.

Mr. Phelan: Well, I am postulating it as a situation as to whether the bank should get burned which is still an open issue under the case law, and the position that I am taking. I can take the opposite position tomorrow . . . .

Mr. Phelan: . . . [T]he position I would take is real simple. I cannot tell my borrower — borrower comes to me and says I want to borrow the money — I do not have any legal duty or obligation to those creditors who are extending trade credit or to those old bondholders that didn't put a negative covenant in their indenture. So what did I do that was so evil, rotten, terrible and horrible? Am I supposed to say "Mr. Debtor, I think your projections are too optimistic and somebody else might get burned?" Or, do I just have to make a determination that I am adequately collateralized from my banking standpoint.

Ms. Houser: Robin, where do you think that it is not clear in the current case law? Because, unfortunately, there are cases just squarely against you on those issues. Where there is knowledge, the banks are being found liable in an LBO transaction.

Mr. Phelan: I agree, but I am just saying there is not a wide spread set of cases that have been actually litigated through trial. With few exceptions, they have either been settled or they are still in the litigation stage.

Mr. Lieb: I think it should be said that what is being said by these panelists is believed in part, and is otherwise to stimulate good conversation here. But I do think it is fair to say that the case law is, that there are certain cases that would hold such an LBO participant responsible. We will get to talk about what the potential remedies may be. But I think there is case law that would, whatever the restrictions, directions and directions for the use of money and so forth may be. . . .

Mr. Phelan: One more thing is that I think you have to look at this in the context of the substantive consolidation cases under section 105[9] of the Bankruptcy Code. Look at those cases and see if they fit with these theories and if the standards and criteria are met.

Mr. Lieb: There is no shortage of theory. I mean there is a very simple one that we all studied in the first days and weeks of law school. Here you have a target company which really, in a true pure leverage buyout, gets absolutely no benefit from the transaction, and although the papers are signed, and theoretically induce reliance by others, there simply is no consideration to the target company for the assumption of all of this debt. And if in one fashion or form or another there is some condition of financial weakness or difficulty that exists or results from the transaction, there seems to be something that the law would recognize as creating some infirmity with consequences perhaps for the participants. I think that before we get into the several basis and specific legal theories that the courts have drawn on in challenges to these LBO's and the different potentially responsible parties, we will go into some of the accounting aspects of a leverage buyout and how the accountants treat them and whether there are perhaps some points in the treatment of these transactions that may crystalize some thoughts about the economics of it.

Ms. Houser: Dick, before we do that can I ask Robin one quick question about something that was not clear?

9 11 U.S.C. § 105 (1988).

Mr. Lieb: Yes.

Ms. Houser: Are you suggesting, Robin, that the only time the courts should collapse the transactions, and look at them as one, is if in fact there is an alter ego as between the various entities?

Mr. Phelan: Not necessarily. I am suggesting that you have to take it on a case by case basis, that you have to factor those criteria that are set forth in substantive consolidation cases into your analysis and that you have to look at the perspective, because I agreed with everything that Dick said about ultimate responsibility and lack of consideration to the corporation. What I am saying is that you have to look at who is involved, what they did, and should they be liable.

Mr. Lieb: Those are all important questions and I am glad you agreed with me publicly Robin.

James J. Burns:[10] In order to deal with the fraudulent conveyance issues and solvency issues in an LBO that has been attacked, you really have to gain an understanding of the financial statement characteristics of an LBO. . . . [O]ne of the big ones is obviously a large reduction in common shareholders equity, and there is a large increase in debt, and what I call debt like capital, which is preferred stock and even common stock which has debt like characteristics. In addition, there is significant fees, that we talked about, and usually there is a restatement of assets and liabilities with a large amount of allocation of that restatement to good will.

There are certain accounting rules I will not spend much time on that allow a company to restate its assets and liabilities in an LBO. But some of the more important characteristics are that all of the outstanding stock of the old company must be acquired. There has to be a change of control. You cannot have a shareholder, a majority shareholder or a majority shareholder group acquire the minority interest. Also if you do not meet these requirements, it is just really a recapitalization where generally that would be a reduction in the outstanding stock which does happen in certain of these similar type transactions. And then what happened is there is a more detailed discussion of the specific requirements that were in this, what we call Emergent Issues Task Force 88-16,[11] but if the requirements are met for an adjustment of the assets and liabilities there are accounting rules that proscribe what should be done. The

10 Partner, Kenneth Leventhal & Company, certified public accountants, New York, New York.

11 Emerging Issues Task Force — Issue 88-16 — Bases in Leveraged Buyout Transactions.

basic rule is APB 16[12] that was issued in 1970 and then there was subsequent amendments, FASB 38[13] and FASB 96,[14] which all of these came about since I started in the profession so keeping up with them is a pain in the neck. But generally in an LBO acquisition the assets and liabilities are stated at fair value and are subject to certain modifications.

Mr. Lieb: I did not think that when an LBO got put on to a balance sheet that fair values were stated. I thought they were overstated.

Mr. Burns: Well, we will go into that but some of the characteristics — many feel they are overstated but the accountants do not and I will explain why. Basically what happens is you look at the purchase price, any costs incurred, the fees incurred, the fair market value of any securities or debt issued and the liabilities assumed and that becomes the total purchase price. And the liabilities assumed are calculated at a present value of the debt. For example, if you bought a company that had six percent debt on the books, that would be discounted to a current interest rate of say eleven or twelve percent, depending on the priority. In the same fashion if you bought a highly leveraged company that maybe had twelve or thirteen percent debt on it, you might say well that is already an LBO, and you are the last piece of the LBO, like a recent transaction that I was involved with. You might ascribe a junk bond interest rate to that which would be sixteen or seventeen percent.

So now what we have is the total purchase price on one side and then what we do is we — there are other liabilities which you might pick up as contingent liabilities, unfavorable leases or any other types of unrecorded liability. If it is a merger you might accrue certain taxes as a result of the merger. The purchase price is allocated to the assets in general categories: receivables (long term receivables again are put on at fair market value which would mean a current discount rate or interest rate); marketable securities at the market prices; fixed assets, intangibles, trademarks and items like that would be at replacement costs or at appraised values; and one of the differences, like finished goods inventory, would be put on the books at the selling price less costs of disposal less selling profit, which is not gross profit. I will discuss that a little bit later on. Then what happens is you generally have a whole bunch of liabilities. You

[12] Accounting Principles Board Opinion No. 16 — Business Combinations.

[13] Statement of Financial Accounting Standards No. 38 — Accounting for Preacquisition Contingencies of Purchased Enterprises.

[14] Statement of Financial Accounting Standards No. 96 — Accounting for Income Taxes.

have assets but you have a missing asset, and basically what happens then that missing asset is to balance, which becomes goodwill.

[Referring to sample balance sheet[15]], basically what I did is I took Revco, and I took their balance sheet, which I estimated at the day prior to acquisition, and then I put it on what it was the day after the acquisition. So between old co. and new co. — and you see the adjustments I was talking about. One is inventory. There is a write-up of inventory because basically, in Revco, what you have is you have a lot of merchandise in the stores, so that all the costs to get it into the warehouse and delivered from the warehouse to the store, and a defined profit (what that is, is to leave a profit), which would only be the selling profit on the theory that if you allowed it to be put on a lower amount that the purchaser was really getting a higher profit in the future than the effort that they are entitled to under the circumstances. Because what they did is when they considered this acquisition, they considered that the inventory already being in place ready for sale as opposed to being back in the warehouse. Then if you take a look at some of the other major differences, the big one is in plant, property [and] equipment. If you look at their financials the main thing there is favorable leases. In other words, store leases that if the current market rate for a lease is say six dollars a square foot and you're paying two dollars, so what you do is you assign a value to that favorable lease to the extent that you are getting a benefit because you have a long term lease that benefits the company.

Mr. Lieb: Jim, as I understand it, are all these amounts, in this case at least, are write-ups of assets because of a change of control where there was no event or transaction that the target company itself had, or in its business, and where there really is a very substantial write-up of the assets, including a really big number for goodwill, simply because things happened outside the company, totally outside?

Mr. Burns: That is right. But the theory here is that there was a separate independent transaction that was done on a fair market value basis or an arms length basis, and that someone came in, looked at this company and paid X dollars for the company and assumed Y dollars of debt. Therefore, since there was a majority change in control that there should be a new basis of accounting for these assets and liabilities.

Mr. Lieb: The thing that makes it perhaps unique is that the party that agreed to assume the debt was a party that was controlled by

[15] *See* Appendix I.

people, by others, and that got absolutely nothing out of the transaction itself, except a big burden of debt. And that may be unique.

Mr. Burns: This is what is typical in an LBO. The other thing you see is other assets, where there were significant fees incurred in connection with the transaction. And of course looking down you see an increase in current debt, which is the debt assumed in the transaction, as well as the long term debt. And you see different categories of convertible preferred stock, which I defined before as debt like capital as opposed to real equity, and then you see a material reduction, from $409,000,000 to $23,000,000 of common stock, which is equity.

Judge Lundin: Jim, what is the effect of all of this on the great unwashed, on the general trade creditor who before and after this transaction all he sees is the same tube of toothpaste out there at the Revco store?

Mr. Burns: What happened is before you may have made a decision to sell merchandise to "a credit customer," or you might have been a landlord that signed a lease with Revco with $409,000,000 of equity and all of a sudden one day later its effectively got $23,000,000 of equity and maybe some other money type of equity. So there is a material reduction in the position . . . both the trade creditor and the landlord in this particular situation, and, of course, that happens in Federated and any other type of situation where you have a lot of retail stores and you have landlords.

Mr. Lieb: Jim, I would like to ask you a question. In an LBO, whether its the Revco or some other one, the goodwill really results from the dollar amount of the LBO transaction, and the dollar amount depends in these cases upon projections that companies and their financial advisors make — what they think it can stand. Now if the projections turn out to be wrong, then there is no goodwill, and the company is insolvent. So the whole thing really is kind of made out of whole cloth, isn't it?

Mr. Burns: With hindsight, yes, especially when one goes into the tank.

Mr. Lieb: Well that relates to the question whether there is anything good that can be said about LBO's — maybe there is. Does anyone have anything good to say about LBO's?

Mr. Phelan: Yes, Dick, it is not that simple. . . . The accountants are using a term called goodwill, which is really to some degree a misnomer. You could call it. . . .

Mr. Lieb: Bad will!

Mr. Phelan: Whatever you want to call it. The point is that all it boils down to is somebody bought that business, and that is an appropriate time under the accounting rules to determine what the stuff is really worth. So you take the assets, and you go down and you look at it and you say inventory; it was booked at cost under the accounting rules when it went into the warehouse, it is now out in the stores and it is worth more, we're going to write it up to what it is really worth. You go down the assets and you do that, you look at the liabilities and you say there is a six percent note out there, that is not really $10,000,000, that is really something less at a present value. Then you take the assets, subtract the liabilities and what the buyer paid more than that net number, that is goodwill, period. End of sentence.

Mr. Lieb: That is a legal term, says Barbara. Wilbur, did you have any comment on that?

Mr. Ross: I do not think the accounting is the issue. I think once you get over the mythology that the lefthand side and the righthand side have to balance, you inevitably get drawn into issues like goodwill. I think the true question, from a solvency point of view, is there any real economic value to the goodwill? Never mind the ribbon that is put on it — on the balance sheet. But is there real value there? I have at least a conceptual problem with the idea that if you had a situation where more than all of the net worth is represented by, let's say transaction fees, the front end fees paid to various parties, I have a hard time understanding how that is likely to be a realizable asset.

Mr. Lieb: Could you just spell that out a little. I am not sure that I understand the implication. Are you saying that in some of these LBO's, the upfront fees to professionals aggregated more than the book net worth of the enterprise?

Mr. Ross: More than the resulting book net worth — yes. That if one were to take the harsh view that whatever the merits or demerits of goodwill as such might be, leave the goodwill there, even though as you just heard it is really a balancing item. It is not anything that has a life of its own, but if you ignore that and you just say well what went in and what came out to me, cash that went in for equity but went back out for bank commitment fees, or went back out for investment banking fees or lawyer fees, is an asset that is hard to realize upon if you had to resell the entity.

Mr. Lieb: Before we get into legal bases of challenge to LBO's, Wilbur, could you just briefly speak about why LBO's fail. What goes wrong and how does that play out from a financial point of view in subsequent bankruptcy cases?

Mr. Ross: That is a lot of question.

Mr. Lieb: Just take any part you want.

Mr. Ross: They clearly did not fail as a matter of intent, but anytime you are lending money or you are borrowing money there will be a certain fatality rate. With LBO's there is what I feel is an infant mortality period of more or less two years to three years.

Mr. Lieb: An infant mortality period?

Mr. Ross: Generally speaking, if they can get through two to three years after the creation of the LBO, they are generally then fairly stable, other than if some exogenous factor. . . .

Mr. Lieb: Is that the period in which there is some debt burden and then [you] have to earn money to pay interest? What is the two year period?

Mr. Ross: Well, it is just a rule of thumb. The first thing that it usually means is that a lot of what was forecast to happen, did happen if there were divestitures, or achievement of some growth, or cash flow or even a little bit of debt paydown. So usually there has been some element of performance, some accretion of real net worth, not just book net worth over the time. So usually if they get through that period, the subsequent fatality rate is much lower than it is during the very beginning period. On that score, I think that people are greatly overestimating the sort of boom in fatalities because '88 was really the last very big year for LBO's. Eighty-nine, if you took out RJR [R.J. Reynolds-Nabisco] which I do not regard as particularly dangerous, if you took that out there was about sixty percent as much done in the way of LBO's in '89 as in '88 and '90, of course, was down a lot from that. Well, if the infant mortality theory is right, we are kind of taking care now of the classes prior to '88. Pretty soon we will be done with the class of '88, you will be then into '89 and '90 which are very much smaller classes and in general better underwritten than were the earlier ones.

Mr. Phelan: Doesn't it depend on the negative AMM on your instruments that you talked about earlier, Wilbur? The length of it?

Mr. Ross: It does, but a bond that was not sold cannot very well go into default. And there were far fewer sold in '89, and especially in '90, than earlier.

Mr. Lieb: I think too Wilbur, don't a lot of people equate just junk bond issuances that could go into default long after the two year period we are speaking about with LBO's? I think there is a lot of fall out left down the road, perhaps not so much due to LBO's themselves. I think that is your point.

Mr. Ross: Yes, I think what has provoked the big newspaper headlines has mostly been a very different kind of insolvency or financial problem from what we used to have. We used to have things come to us that would be a lousy business wrapped up in a lousy balance sheet. So you had a whole bunch of problems to fix. Many of the failed LBO's are halfway decent businesses, maybe even very good businesses. It is just that they are drowning in the balance sheet. The balance sheet is too big for them to absorb because the business did not know that the day after the deal it had to live with all this so-called goodwill.

Mr. Lieb: When an LBO comes front and center, Barbara, what are the legal approaches that have been brought to bear when the judicial microscope, or the lawyers microscope, comes to inspect them?

Ms. Houser: You mean the companies run out of goodwill?

Mr. Lieb: I guess the companies bad will is showing its colors.

Ms. Houser: Well there is really two approaches essentially: an offensive and defensive approach. The offensive approach would be to file an affirmative action against the alleged bad doers in the LBO transaction, whether that be the lenders, the selling shareholders, the purchaser or whomever in the litany of targets that get sued in those, actually to bring an adversary proceeding under section 548 of the Code,[16] in order to set aside or recover the property that was actually transferred. If you have a fraudulent conveyance or you think you have a fraudulent conveyance, if you look to section 550 of the Code,[17] the remedies are set forth in an affirmative recovery situation. The Code specifically contemplates that you can recover the property transferred including liens that have been given as a part of that transaction, or, alternatively, you can attempt to recover the value of the property transferred. Actually [you] get a monetary judgment against the participants for the value of the property which was transferred to them. So, from that standpoint the debtor in possession or trustee can seek out actually an affirmative recovery of either the property or the value of the property transferred.

16 11 U.S.C § 548 (1988).

17 11 U.S.C § 550 (1988).

Mr. Lieb: Subjecting the property to a lien would be a transfer or the incurrence of a debt could be involved as well to avoid that.

Ms. Houser: That is right. The alternative approach is really done in the context of a claim objection under section 502 of the Code.[18] Section 502(b)(1) says that the court shall disallow any claim that is unenforceable against the debtor or property of the debtor under any agreement or applicable law for a reason other than the fact that the claim is contingent or unmatured. So your other applicable law theory would be, of course, state fraudulent conveyance laws and you could then object to the claim under section 502(b)(1). And finally in the claim objection category, I think you could look to section 502(d), which says that the court *must* disallow a claim of a creditor who has received, among other things, a preference or a fraudulent conveyance and fails to return that property to the estate. So I think you can look at it under either one of those two, and essentially get to the same spot.

Mr. Lieb: The *Gardinier*[19] case . . . is an interesting variation of this.

Mr. Phelan: What Barbara just mentioned can lead to some tactical maneuvering in the context of the chapter 11 case because, unless you have an allowed claim, you cannot vote for the plan. If there is an objection then, under Rule 3018,[20] it is the affirmative obligation of the creditor to go in and have his claim temporarily allowed for voting purposes. The question then becomes, if the claimant is the subject of an objection as a result of the fraudulent transfer, to what extent does the court have to go in determining whether in fact there was a fraudulent transfer, and whether the claim will be allowed at the time of the determination as to whether this claim should be allowed to vote or not. The cases go both ways on that, depending on the facts and circumstances of the situation, it is easy for an objecting party to just throw out an objection. On the other hand, there are situations where there are specific determinations, specific facts that do lead to an inevitable conclusion that there is a fraudulent transfer involved, in some manner, shape or form, and that the claim should not be allowed for voting purposes.

Judge Lundin: Robin, do you think a bankruptcy court is a good place to squeeze the goodwill out of an LBO?

Mr. Lieb: Don't answer that question Robin.

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18 11 U.S.C § 502 (1988).

19 *In re* Gardinier, Inc., 55 Bankr. 601 (Bankr. M.D. Fla. 1985).

20 FED. R. BANKR. P 3018.

Mr. Phelan: No, it depends. It really does depend. We have a jurisdictional problem under *Granfinanciera*[21] with respect to a fraudulent transfer, and whether a claim was filed. You get into the entire *Granfinanciera* problem of whether the bankruptcy court has jurisdiction to determine fraudulent transfer claims, particularly if the other party requests a jury trial.

Ms. Houser: But Robin, how do you ever have, in the context of a 3018 motion for temporary allowance, a meaningful resolution by the judge of whether or not there really is a good fraudulent conveyance claim?

Judge Lundin: I think every resolution by a judge is meaningful.

Ms. Houser: I said that specifically for your benefit. But, I mean, you have a situation where normally in the context of a case where there may be substantial creditors involved, I mean the temporary allowance hearings, I mean they are five minutes a pop if you are lucky. In what sort of sense can you ever really determine the validity of those? And what do you think the courts are going to do in the context of numerous claimants, some of which will be some of the most substantial claimants in the case.

Mr. Lieb: Probably what a lot of banks rely on as their salvation.

Mr. Phelan: In most of the situations that I have seen, the courts have really leaned towards allowing the claims. . . . Most of the actual situations that you see, I think courts are very reluctant to prevent somebody from voting in connection with the plan. They view that more as a confirmation issue, and look at the confirmation in the context of whether they ought to confirm the plan of reorganization. Also, I think they are going to look at it a little like they have to look at it in the context of section 502(C),[22] which allows courts to estimate claims. Dick, I think you believe that estimation under section 502(C) is confined to voting purposes. I think that it may be a little broader than that. The case law, I think, is not fully developed.

Mr. Lieb: I think you've been very fair about that one, Robin.

Mr. Phelan: There has been a wide variance of the types of hearings the courts have held in connection with section 502(C), and in connection with a determination of allowance for purposes of voting, ranging from a couple of days of mini-trial to, as Barbara indicated, a five minute argument on just argument.

Mr. Lieb: Well, what I think this really illustrates is that the holder

[21] Granfinanciera, S.A. v. Nordberg, 109 S. Ct. 2782 (1989).
[22] 11 U.S.C § 502 (1988).

of a substantial claim that arises out of a failed LBO can be in for somewhat of a rocky road procedurally, and substantively in the ensuing bankruptcy, which just leads me to comment as to what I had learned a chapter 11 or a reorganization case is supposed to be about: namely, consensual bargaining. When you have the potential of substantial LBO claims or objections to claims that the debtor may file or any party in interest, be it an individual shareholder or individual creditor, the parties are supposed to get to the table. After measuring their respective strengths and weaknesses and to try to come up with a plan by consent that will resolve these issues and reflect a fair and reasonable settlement in the reorganization that is worked out.

Mr. Phelan: That only happens when you have "wimpy" judges. Set her down for trial and go for it.

Mr. Lieb: Well, that is one way to do it. . . . The trouble is that in some jurisdictions, in the east and the far west, there is something known as discovery.

Mr. Phelan: Everybody knows what happened. Just stand up and make your argument. You are going to decide whether to collapse it or not. . . .

Mr. Lieb: There is one other interesting feature of the Bankruptcy Code — chapter 11 has a division which mandates the appointment of a bankruptcy personage known as an examiner, if debts, with certain exceptions, aggregate $5,000,000 or more, which is usually every leveraged buyout that gets into bankruptcy. Some courts read that provision as permissive, ducking all around it, and the Sixth Circuit in the *Revco* case reversed the lower courts and held that it was mandatory. An examiner has reported in that case, and laid out in his report, a number of theories, helping perhaps to point the way for where courts are going in that rather visible LBO case. But the process is an interesting one, which is supposed to be by consent, not with a short or long litigation. I think, Robin, you might turn to some analysis . . . on who the targets, the so-called targets, are in LBO litigation, after one of these things fails. . . . [U]nsecured lenders — how would they be targets?

Mr. Phelan: The unsecured lenders that are part and parcel to the transaction can be targets basically on the same theories that you mentioned before, Dick. The unsecured lenders that are part of the transaction, the loan money for the LBO, are subject to the same types of attack that were previously articulated with respect to the secured lenders. They knew what was going on, the debtor did not get anything at all, the transaction is collapsed and, by God, they were a participant in the transaction and they should be liable just like everybody else.

Mr. Lieb: So I suppose we are also talking about directors at the time who authorized a transaction — professional advisors who advised parties at the time.

Judge Lundin: Why directors Dick?

Mr. Lieb: Why not directors, they are the ones who set it all in motion, Judge.

Judge Lundin: If the director is a shareholder also, so that the director receives some of this goodwill distribution that we were talking about, I would understand that. But why would a director be a defendant if the director was not also a shareholder?

Mr. Lieb: That is a good question.

Ms. Houser: If there was fraud in connection with the transaction, under a breach of fiduciary duty theory, the director could be held liable to the creditors.

Mr. Phelan: Because the directors have more fiduciary duty than the bank I was talking about.

Judge Lundin: Those would be causes of action that the corporation might have against its directors; those would not be causes of action of a creditor.

Mr. Lieb: The current chairman of a sponsoring committee here tonight said "what about redemptions of stock?" Of course, state statutes will create a cause of action expressly against directors who authorize a dividend or distribution in the absence of adequate surplus as well as against all shareholders who receive an improper distribution.

Mr. Phelan: Almost always that is determined on a book surplus as determined by the auditors of the corporation, and in most of the states the directors . . . . [P]utting aside for the moment your fraudulent transfer law, under state corporate law those directors are generally going to be protected, unless they knew there was something wrong with the financial statement, and the book surplus was inadequate.

Mr. Lieb: Yes, but every proxy statement tells you what is wrong. I think we will hold that just for a minute. We are going to get to, briefly, to the elements of a cause of action be it under a fraudulent conveyance law or the similar theories of state redemption laws. I think basically what is being said is that any material or significant participant in a leveraged buyout has some problem — how the law is going to come out we are not sure — but does have a problem as an active participant, and potential responsibility, which should be a matter of concern: be it a director at the time, inside shareholders, public shareholders, professionals, underwriters who participated and so forth. I think, Robin, you had some special matter you wanted to talk about [regarding] successors who purchased these deals from some of the current regulators that are selling bank assets.

Mr. Phelan: Let me just mention a couple of things real quickly in connection with that. The public shareholders we mentioned — there at least have been a couple of cases that said public shareholders should be left off the hook. In certain circumstances, some of the shareholders that are even non-insider shareholders can be identified, and you may want to sue them in a defendants class action law suit under Rule 7023.[23]

Mr. Ross: In most cases you could in fact find them because most companies at the time the LBO's are done, if you added up the amount of institutional ownership, the amount of arbitrage ownership and the amount of inside ownership, it is frequently half to three-quarters of the total stock. So it isn't Aunt Nellie with 200 shares that you have to track down. There is usually a much greater concentration at that point than I think people give credit for.

Mr. Phelan: Another problem that you can run into is, in this day and age, if the lending institution, the bank, that has the really deep pockets in the transaction, gets taken over by the FDIC; what the FDIC does or the S & L — and S & L's financed a lot of these LBO transactions — if the S & L or the bank gets taken over by the Receiver or the Government's Receiver, the Government then does a couple of funny things. They turn around generally and they will take all the assets, and either transfer those to the FDIC as the corporate entity, not as the Receiver, or they will transfer the assets to a third party successor institution, either a federal savings bank or a bank one or an NCNB or somebody that is going around buying these things up. They will transfer the assets to that institution, that institution will assume the deposit liabilities, they will get a chunk of assistance from the governmental agency, and the FDIC, in its corporate capacity, will keep the bad assets. The Receiver, the guy that took down the bank, the entity that took down the bank, has *nothing*,

[23] FED. R. BANKR. P. 7023.

and is protected by what is called the Dengadoom doctrine, which basically says unless a commitment which is in the bank's files, has been approved by the board of directors, it is not enforceable against the government.

There is also what is called the government's holder in due course doctrine, which is a misnomer. They do not have to be a holder in due course in the sense that you have to jump through the hoops under the Uniform Commercial Code, but they are protected like a holder in due course. As a result, it is extremely difficult to go through these entities wearing their various hats and achieve any recovery. With respect to the fraudulent transfer under section 550,[24] you can recover from the initial transferee, even if it is for value and in good faith. You cannot recover from that initial transferee because the initial transferee is the FDSIC as receiver. Everybody else is protected by the federal holder in due course doctrine, Dengadoom, or the fact that they are immediate, or an intermediate, transferee, and you are going to have a lot of trouble recovering from them.

Mr. Lieb: Let's talk about just simply the elements of a fraudulent conveyance action.

Ms. Houser: The elements of a fraudulent conveyance action under the Code really go in one of two directions. You can have actual fraudulent conveyances or constructively fraudulent conveyances. Actual fraudulent conveyances are fraudulent conveyances that occur [with] the actual intent to delay or defraud creditors. Now you may ask yourself well how do you prove actual intent. I mean, rarely do you find someone so silly to put a memo in the file that says, "[B]oy this would be really great, we are really going to defraud all these people as a result of the transfer that is being made or the obligation that is being incurred." So, that is remote, and the case law has developed to identify certain, what the courts call, "badges" of fraud. Those are articulated in some of the cases that . . . we talked about previously, but the badges of fraud are used in lieu of ever having any direct evidence or the unusual circumstance of ever having any direct evidence of an actual intent to hinder, delay or defraud creditors. The more common attacks, or at least those that are more frequently successful, are the constructively fraudulent conveyances. Those occur if the debtor received less than a reasonably equivalent value *and* the debtor was either insolvent, or rendered insolvent, or the property remaining with the debtor was

24 11 U.S.C § 550 (1988).

unreasonably small capital, or the debtor intended to incur or believed it would incur debts beyond its ability to pay.

Mr. Lieb: So any one of those financial triggers in that category would satisfy one of the two elements?

Ms. Houser: That is right.

Mr. Lieb: The other is reasonably equivalent value in exchange. Is there any objective definition of reasonably equivalent value?

Ms. Houser: Not under the Code unfortunately. The state laws, which the bankruptcy trustee or debtor-in-possession can also use, . . . essentially have two variations. All states have adopted one of the two. You have the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act; they are substantially similar. One uses the words fair consideration; the other uses the same terminology as the Code: reasonably equivalent value. But most of the cases where people hang up are on the triggers under a constructively fraudulent transfer.

Mr. Lieb: If we can just divert for a moment to state laws regulating or limiting dividends and distributions. . . . I think basically state laws, which in former times, state corporate laws, in former times were basically geared to limitations against distributions of capital or capital surplus almost on a balance sheet test basis. By and large I think they have been amended to get to definitions that are fairly close to solvency or insolvency as used on the fair value, actual fair value test, which is the test under section 548 of the Bankruptcy Code[25] for fraudulent conveyances. So that while the two laws may be geared to protecting different constituencies, creditors or shareholders who are injured, the financial test is getting pretty close to the same. . . .

Ms. Houser: I think that is exactly right, but those are essentially the elements that have to be proven. There is obviously difficulty in proving numerous . . . allegations, although in the LBO context the insolvency issue is often a very easy one to prove. The company is usually left so highly leveraged that it is not within its abilities to pay its debts. So that is often times a conceded stipulated fact in the context of the litigation.

Mr. Lieb: Who can be a plaintiff, Robin? Who can assert one of these claims?

Mr. Phelan: The cause of action to void a fraudulent transfer, which

[25] 11 U.S.C § 548 (1988).

under state law would belong to an individual creditor, becomes collectivized and becomes property of the debtor. So certainly the debtor in a chapter 11 case or a trustee in a chapter 7 or 11 could bring the cause of action. The problem is that in many instances the debtor is reluctant to do so either because it's controlled by parties that would be targets: the acquiring individuals or entities. It has relationships with its lender, it needs . . . the debtor-in-possession financing from its bank or its lender party, and is willing to concede what . . . it may appear to be a worthless or troublesome cause of action in order to get the cash from the lender that it needs to keep the doors open. That is a high priority at the beginning of the case. So the debtor may not be the right party or not be the party that wants to bring the cause of action. Now certainly under the Bankruptcy Code, and under the case law . . . *E.F. Hutton*,[26] and *Louisiana World Exposition*[27] and other cases, the bankruptcy court can authorize a creditors' committee, or indeed an individual creditor, to bring a cause of action on behalf of the corporation after a demand is made. If the debtor unreasonably or unjustifiably refuses to bring the action and if it is a legitimate cause of action, it can be pursued by the creditors' committee or by an individual creditor on behalf of the estate after court approval.

Mr. Lieb: If a fraudulent conveyance is to be set aside, is it set aside only to take care of creditors that specifically prove injury or does it get set aside totally, avoided totally for all purposes, to benefit all creditors and the equity interests as well?

Judge Lundin: It is one of the wonderful penalties of unwinding a failed LBO in bankruptcy court, as opposed to doing it somewhere else, is that you run right into a doctrine from an old Supreme Court case back in the 30's called *Moore v. Bay*.[28] Essentially in one page, Justice Holmes says in this case that if you have a creditor that was hurt you can undo the whole transaction. You get the whole asset. So if you transferred a $5,000,000 asset and it hurt a $1,000,000 creditor, you recover the $5,000,000 asset.

Mr. Lieb: I think you told me that no one should be reluctant to read that opinion because Holmes did it in literally one page. Well, all is not lost if someone is sued. There are some good faith savings provisions for an LBO recipient at least under the Federal Bankruptcy Code who acted in good faith. The only trouble with that is

26 *In re* E.F. Hutton Southwest Properties II, Ltd., 103 Bankr. 808 (Bankr. N.D. Tex. 1989).

27 Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233 (5th Cir. 1988).

28 284 U.S. 4 (1931).

there probably are one thousand to two thousand reported bankruptcy cases dealing with the meaning of good faith as used in the various ways that the Bankruptcy Code uses it. The trouble is that some of those cases say that if the recipient claiming good faith knew that the party had financial problems at the time of the transaction then that is evidence of a lack of good faith. Anyone who deals with someone in a transaction knows that everyone has financial difficulties, and that really reads good faith out of the law. There is a great deal of difficulty in applying the savings provision and how far it goes and how far it really protects.

[There is some question as to] directors who participate in leveraged buyouts and what their protection is if they rely on counsel, the judge, whether they are protected if they rely on counsel and whether their duties after a leveraged buyout fails, whether their duties really do not require them to go all the way with these claims to try to maximize the estate.

Judge Lundin: It is one of the areas among all of the attacks we have been talking about tonight, about how you attack the participants in an LBO that fails. One that is down about number three or number four or five on the list is you can always sue the directors. Suing the directors is not worth a whole lot in most situations. If you are in the *Revco*[29] case and you are looking at one point. Something billion dollars worth of uncovered general credit, what good does it do to sue this guy over here who sits on the board.

Mr. Ross: There usually is [officer and director] insurance.

Judge Lundin: There isn't any in *Revco*. That is one of the things the examiner found out is that there isn't any insurance there to cover the directors.

Mr. Ross: No, I'm saying in a more general sense.

Judge Lundin: Well, the actions against the directors are not worth a whole lot, but there is at least a theoretical basis for it. If a director authorizes a company to take all of its net worth and pay it to the shareholders and leave the creditors without anything to realize on for their claims, then the directors violated a duty under state law. There is under most state corporation statutes very broad protection for reliance on counsel, if you are a director. So you do all of the due diligence stuff, that many of the people in this room who are shaking their heads up and down right now have been doing for years. The lawyer goes into the meeting of board of directors and

29 *In re* Revco D.S., Inc., 898 F.2d 498 (6th Cir. 1990).

says "we are going to nail our creditors but I am telling you on the advice of counsel go ahead and do it." And you write it all up in the minutes real well, you make it documented and then you appoint an outside committee of directors as well. You get this separate outside committee to give you the same good advice, and it has the sort of bizarre outcome under state law in many states that you actually protect the directors with sort of hocus pocus. It is not a very good cause of action in the first place because most of the state corporation statutes were written by corporation lawyers who saw this fraudulent conveyance stuff coming before the bankruptcy lawyers did, and those statutes about surplus and insolvency under state corporation law are a lot better protection than the Bankruptcy Code is.

Mr. Lieb: You know, the treatment of the LBO difficulties when one fails and the attitudes of debtors in possession in reorganization cases differs vastly. There are some in which the debtors (I am talking about large debtors as well as medium or small ones) aggressively go after their pursued leveraged buyout causes of action under federal and state law and some have effected large recoveries. Others have tried to avoid getting into LBO litigations and tried to avoid it like the plague as if somehow it would poison the business problems worse than they really are, which is kind of a strange reaction for directors who have a fiduciary duty to make the most out of the estate.

Ms. Houser: Well, do you really think this? Because in a mid size company in many instances as an example (the dilemma that you have is if you start off biting the hand that feeds you so to speak) I mean typically the lender who was the LBO lender when the debtor first files is the likely source of post-petition financing. If you start off talking about the great fraudulent conveyance suit you are going to file and win; their enthusiasm for participating in the case wanes pretty quickly.

Mr. Lieb: Well it may actually enhance their appetite for it. I am not sure which way it will go.

Ms. Houser: I think it only does, though to the extent that initially in those size of cases I think the parties try and see if there cannot be a consensual accommodation and a resolution of the LBO issues through some sort of a consensual plan where those that might be the target take some sort of haircut, and a consensual plan is put in place to avoid the expense of the litigation. I think in some instances the minute those kinds of claims get pursued, it is a death for the case, and it essentially just evolves into nothing but litigation.

Mr. Lieb: I think you hit the nail on the head, and that is that there are surely uncertainties to costly and protracted litigation.

Mr. Ross: I think you are going to see a lot more designing around the problem because right now the problem is the financial reorganization of the bankrupt company which is kind of held hostage potentially to the protracted litigation. I think you are going to start finding lawyers and financial advisors designing ways to unhinge the two and let the litigation have a life separate from the reorganization.

Mr. Lieb: You mean create a trust of some sort. Put the causes of action into a trust, confirm a plan and let suit follow later.

Mr. Ross: In the *Griffin* case there was some causes of action, fraudulent conveyance actions, against Trump and his organizations that were preserved. They were funded with the $5,000,000 litigation kitty from the estate, and embodied in what I guess you would call litigation participation certificates so that there could actually be a market.

Mr. Lieb: Doesn't that violate some sort of ancient law against champity to have a trading security in a cause of action that is publicly marketed? I do not know.

Mr. Phelan: Federal supremacy.

Mr. Lieb: Federal supremacy overcomes state champity laws. Robin, that is very good. You know Wilbur, that is fine, but if the principal targets of LBO suits are also principal creditor constituencies, they are going to want a release in order to allow the claims to go into a trust. In some cases that will work and in some cases they are not going to have a release available. So if you have a settlement, as Barbara says with a haircut, which may be more than a haircut, it may be a close shave around the neck, Robin, how do those work out, how can you prove the — don't you have to prove the fairness of the settlement under the *TMT Trailer Ferry*[30] line of cases?

Mr. Phelan: The answer is yes. Under *TMT*[31] . . . and *Aweco*[32] — (which is a Fifth Circuit case which basically stands for the proposi-

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30 Protective Comm. for Independent Stockholders of TMT Trailer Ferry v. Anderson, 390 U.S. 414 (1968).

31 *Id.*

32 *In re* Aweco, Inc., 725 F.2d 293 (1984), *reh'g denied*, 732 F.2d 941 (1984).

tion that in approving a settlement be it in the context of a plan of reorganization or otherwise) the court has to abide by the absolute priority rule and the requirements of section 1129.[33] The court has to make some type of inquiry into whether the release that is embodied in the plan of reorganization constitutes a fair settlement. As a practical matter, there is a railroad train effect. You get everybody standing up in the courtroom saying I want this plan confirmed, the fraudulent transfer action is really a piece of garbage and as you indicated, Dick, you are not going to get a six week trial in there on that. The court is going to have and hold, . . . an evidentiary hearing; is going to hear some testimony probably from some of the lawyers that are handling the case, conceivably from the examiner that has been appointed. That certainly is a tactical maneuver that the party opposing the settlement should employ, is to ask for an examiner, and as indicated in *Revco*,[34] I read the code the way the court did there: that it is mandatory under those circumstances that are set forth in the code.

Mr. Lieb: You agree with the Sixth Circuit Court of Appeals?

Mr. Phelan: I agree. Every once in a while I don't.

Mr. Ross: Robin, could you imagine a cram-down[35] occurring under those circumstances?

Mr. Phelan: Yes, I sure do. What will happen is the appointment of an examiner, even if it is mandatory, the statute provides great flexibility for the court to determine what the role of the examiner is and the time frame in which the examiner can complete his task. And it is very consistent with the — at least the literal language of the Code — and under those circumstances, say a pre-packaged plan like they did in *Republic Health Care* or *Crystal Oil*, for the court to say yes I am going to appoint an examiner, and you have got a month to come back and tell me what your report is vis-a-vis this LBO transaction because I am going to have a confirmation hearing in a month. You are going to testify as to what your report has found and the debtor is going to put on its testimony, and the supporters of the plan as to why this is a lousy cause of action. Anybody that wants to object can put on (oh, maybe an hour or two of) testimony supported by whatever evidence they want in a summary fashion to show why it is a lousy cause of action and I will make findings. My findings, of

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33 11 U.S.C § 1129 (1988).

34 *In re* Revco D.S., Inc., 898 F.2d 498 (6th Cir. 1990).

35 A "cram-down" is a term referring to the final attempt by the court to force a settlement upon the reorganization investors. *See* 11 U.S.C. § 1129(b).

course, coincidentally in my Order of Confirmation, my findings are that I have examined everything from every which way, I have looked at all the evidence, I have looked at the affidavits, the examiner had a whole month to look at it, his report says this and I am going to confirm the plan because I think it is a fair settlement.

Mr. Lieb: I think there is another side of the story that Wilbur wants to discuss.

Mr. Ross: Take the off chance that the examiner came out favorably that there was a fraudulent conveyance. How then, pray tell, would a cram-down work over the examiner's report?

Mr. Phelan: Same way. It depends on what the examiner's report is. If he says it is a slam dunk, — you got these guys nailed cold; it is going to cost $23.06 for the filing fee and they are going to roll over and play dead because it is accepted law from the Supreme Court decision in 1898 — then maybe you would not confirm it . . . . But as a practical matter, what is going to happen is the examiner is going to come in with the kind of report you saw in *Revco* where he says "yes, maybe there is a cause of action here, and gee golly it's going to cost a lot of money to pursue it, and yet there are some holes in it and there are some other people I did not get to talk to," and it is going to be like anything else. The court has got to make an evaluation and determination as to whether the benefits of pursuing the litigation, whether the risks involved, whether the costs involved, whether the detriment to the debtor and the creditors by keeping this company in a chapter 11 for an additional two, three, four or five years, outweighs the potential discounted present value of the recovery that might be expected from the parties that you are suing and whether they are going to be collectable at that point in time.

Mr. Lieb: There is another focus on this Robin. There are other approaches to working these things out in a plan that you might consider. . . . Classification in chapter 11 is kind of a complex subject for any of you that have worked in it.

Mr. Phelan: Dick, can I have ten seconds. . . . That has been done in a recent pre-package case. The scenario that I just outlined.

Mr. Lieb: Oh, I think that is potentially possible. I think it depends on a number of factors, whether it is workable or not. What you are really talking about is what I call the confirmation locomotive, and that is when people flex their muscles and want to put a plan into place it is like a locomotive going down the road and it is hard to sidetrack it unless and until you can get to the circuit to do justice. I think that it just depends on where it is going.

Judge Lundin: Isn't the confirmation process in a chapter 11 case ideally suited to sort out just what kind of competing things that you are describing, you and Wilbur, everyone has been talking about tonight, I mean it works. . . . In what other forum can you go and get protection for the lender who may be the defendant in this law suit that he has been describing. The shareholders can end up with some kind of a claim left — wherever it is — both the old ones and the new ones. The general creditors will get paid because everyone is going to have to make them happy along the way, and the company stays in business. Isn't that just what it is about? That is why they are ending up in chapter 11.

Mr. Lieb: I think that those who wrote the Bankruptcy Code, and chapter 11 in particular, in the 1970's — I don't know whether they realized the simple beauty that they created — but . . . chapter 11 does provide, as Keith said, a mechanism to deal with a great number of complex shareholder and creditor claims and interests. It provides a forum for the negotiation of these things when the parties are not totally insane, as they sometimes are in chapter 11 cases, and for the resolution of disputes in a meaningful and fair way in a rather amazing process much of which should, and most often does, take place out of court, with all due deference, rather than in court, as Congress deemed it to be primarily a consensual process with the courts as the backup for when the parties were unable to reach agreement.

Mr. Phelan: A court setting is probably the best stimulus I know to a consensual plan.

Mr. Lieb: It is also probably the best stimulus to the truth. . . . I think we are going to conclude our banter now, and we will stay as long as you want so long as we do not wear out any questions you may have. . . .

Question -

Mr. Lieb: I think the question is what we think of the *Kupetz*[36] case, number one, which tends not to apply fraudulent conveyance laws to a leveraged buyout; and, secondly, whether post-petition creditors are in a more inferior position under fraudulent conveyance laws than . . . pre-LBO creditors.

Mr. Ross: I think in the *Federated*[37] case the judge did give leave for the pre-petition, the antecedent debt on the Allied side, to bring a

36 Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988).

37 *In re* Federated Dept. Stores, 114 Bankr. 501 (Bankr. S.D. Ohio 1990).

fraudulent conveyance action. So, in the Federated Department Stores, the Campeau matter, I believe Judge Aug recently authorized the bondholder committee of antecedent debt in the Allied Stores side to bring such an action. So you may very well have an adjudication. At least as a lay person I think that is pretty important because it is one thing to say that the bank or some other participant had knowledge did not have knowledge, for them at least, it was a voluntary act. For the antecedent bondholder it was not a voluntary act. He never got to vote on it, never got to say no, never got to do anything, just got dragged along, and I think to the degree that one views it as a matter of equity or fairness, it is a little hard not to be sympathetic to the party who had no voice in the event at all.

Judge Lundin: You have asked a really good question because *Kupetz* — if you are going to go home and read one case after this meeting you might read that one. I want to tell you that *Kupetz* probably is going to end up standing off on the side by itself in another couple of years. The only reason I say that is I run around with bankruptcy judges a lot, and we end up being wrong most of the time, but we are all laughing at that case. It is a court of appeals doing what we get accused of all the time. The court of appeals is always saying to the bankruptcy judges you are letting your policy arguments overcome a literal reading of the statute. Read the law, here is what the law says. The Ninth Circuit let its attraction to an economic theory by a couple of fellows who wrote a law review article get in the way of reading the statute on its face. I think that the Third Circuit's *Gleneagles*[38] case, that has been talked about a couple of times, is going to end up being the mainstream of this furrow we are cutting here, and that *Kupetz* is going to be over here. Because, read literally, *Kupetz* says that only the actual intent kind of fraudulent conveyance is going to be available to undo an LBO because an LBO is some sort of important and legitimate undertaking. That is an odd reading of the statute.

Mr. Lieb: I would just like to supplement one thing to your answers and that is that there is even one statute, one of the state law fraudulent conveyance provisions, which expressly is for the benefit and protection of *subsequent creditors*, . . . those who were not creditors at the time of the challenged transaction.

Judge Lundin: In *Kupetz*, the Ninth Circuit looks at that. That is the

[38] United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (affirming United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983)).

provision that says that if you do not get fair consideration, and it leaves the company with unreasonably small capital, then you are in trouble. *Kupetz* looked at that, and then cited an ambiguous California decision, which was off on another issue all together, and said we are not going to apply the unreasonably small capital provision to LBO's.

Mr. Lieb: They legislated.

Judge Lundin: That is one of those where all you can do is pick your jaw up and say, "all right, not in the Ninth Circuit."

Mr. Phelan: I think the answer is they should not be if you read the statute literally, but they probably will be to some degree. Read literally, and I think if you are going to follow the statute, I think you come to the conclusion that if there is unreasonably small capital, and there was lack of consideration, that creditor is exactly what the statute was designed to protect. If you follow *Moore v. Bay*,[39] which I think, as Keith indicated, should still be good law, that is the logical conclusion that you come to. Also, I am not sure I make a real distinction in favor of the pre-LBO creditors that Wilbur does. Because, it seems to me that, for example, that bondholder that you were talking about, Wilbur, he could have protected himself when the indenture was drafted for his bond back when. He could put in there "if you are going to collateralize anybody, you are going to collateralize me." That is not an uncommon provision in indentures and in bond instruments. There were means of protecting themselves that were available at the time those instruments were issued. The problem was that nobody ever thought ten years ago big companies were going to go [bankrupt]. That there was going to be a large wave of availability of finance driven LBO's or acquisitions that would result in the problem. So it was not negotiated into the deal. So to some degree you can have that sympathy for the pre LBO creditor, but if you read the statutes they should apply across the board.

Mr. Ross: Right. Well, Robin, you know the "equal and ratable" clause doesn't really protect against an LBO anyway because if there is not enough collateral to go in — if there is not enough value — it is slim help that you have a piece of it.

Mr. Phelan: As a practical matter, though, the lender probably would not have made the loan if he was going to have to share the collateral with the pre-existing bondholder.

[39] 284 U.S. 4 (1931).

Judge Lundin: I think this person back here who has asked the question is making another point too that ought to be said. These are smell test cases. They really are. It is what the thing smells like. In a way result oriented, result driven, opinions like *Kupetz* come out because the facts are bad or good depending on which side you are on in the case. If you come into a court with a fraudulent conveyance action where your only plaintiff is a five hundred dollar post-LBO vendor of flowers, the judge's law clerk is going to be looking for some reason to go the other way.

Mr. Lieb: You know there is another part that — part of the smell test — which I think is really very important, Keith. That is that in some of these deals, particularly where you have securities that trade in public markets, you get some of these junk bonds that trade at very, very deep discounts. By the time bankruptcy comes, they may be trading at ten cents on the dollar or twenty cents on the dollar, and that poses a certain reaction: Why should these speculators, who buy up a lot of this stuff, who may be happy if they quickly get out for forty cents on the dollar, drive a reorganization to that level whereas original investors at much higher prices would lose out desperately at that level. That creates certain approaches and certain issues. For example, it may be and there are not many cases that have done this, and, notably, it started with the *Four Seasons* case out in the Tenth Circuit, about twenty years ago, where a plan was confirmed that created two different classes for holders of common stock. One class was the holders who bought before the chapter filing at legitimate prices, so to speak, and then a second class was created for those who were the speculators — the court called them speculators — who bought after bankruptcy at deep discounts but a minor fraction of what the others paid, and that second class was given as its distribution in the chapter 11 case only a small fraction of what the pre-bankruptcy security holders paid. That was sustained and if you translate that into some of the bondholder cases, and there are none yet on the junk bond issues, although there is some authority . . . that deals with this in other contexts, it may be that there will be classification to deal with deep discount buyers of bonds in terms of not having cram-down available under the Bankruptcy Code against junior classes of debt or shareholders despite the Supreme Court's ruling many years ago that [for] distribution purposes in the *Becker* case it is the face amount that governs, not the discount price that was paid. . . . There are issues like that on speculators that I think are going to be developed in the courts as time goes on in some of these cases.

Mr. Phelan: *Speculators*? What is this Czechoslovakia or someplace, it is un-American to be a speculator?

Mr. Lieb: No, I think that it is not a word of a program in our society, on the other hand, a speculator does not invest any money in the enterprise to make it better or more wholesome.

Mr. Ross: I think that the speculators do perform some socially useful functions, in that I do not think that it facilitates the process to imprison a trade creditor for three years of a proceeding when sometimes you can have more than half the guys net worth tied up in a given receivable. I think, if anything, the sad thing is that it is not easier to trade claims rather than to make it harder to trade the public paper.

Mr. Lieb: I think trade claims, should be traded and freely tradeable. Putting aside the question of whether the securities laws really should apply to trade claims, it becomes securities because the nature of the trade claim changes when a chapter 11 case is filed. Putting that aside, the question is not whether they should be traded, but at what value should they be recognized when they try to wipe out junior classes of securities.

Mr. Phelan: If you take out all the profit, they are not going to be traded. If there is no opportunity to make a profit. . . .

Mr. Ross: The problem is that who you are really punishing is the original holder, the pre-petition holder, who for whatever reason needs to realize on his investment. He is the guy you are punishing because if you say that a post-petition buyer can only get fifty cents on the dollar, he will peg his bid off the fifty cents instead of off par.

Mr. Lieb: I do not know why I find myself on the wrong side of this debate, but I will say two things. There are two cases that say courts are not concerned with the supposed legitimacy of the availability of a public market in this kind of stuff. One is the *Gleneagles*[40] case in the Seventh Circuit Court of Appeals, and the other — a favorite at this end — is the [original issue discount] case *Chateaugay*[41] which you might want to talk about briefly, Robin.

Ms. Houser: Dick, why should lower classes or more junior classes essentially get a windfall. Because that is what your theory gives them as if it was held by the original holder of the claim they would be "penalized" to the full extent of claims senior to them. So if you do not allow a speculator to use the full value, or the face value of

[40] United States v. Gleneagles Invest. Co., 565 F. Supp. 556 (M.D. Pa. 1983).
[41] *In re* Chateaugay, 109 Bankr. 51 (Bankr. S.D.N.Y. 1990).

the claim amount, essentially the junior classes are getting a windfall.

Mr. Lieb: I do not know that there is a windfall. Really the question is only participating in relative values, and it is recognizing the reality that the original holder did transfer the claim to somebody else. The original party had it then the event would not have happened. It's the transfer to be recognized. I think there are two sides to it.

Mr. Ross: Yes. I think there are two sides to it.

Mr. Phelan: Dick, the *Chateaugay* case, which you mentioned which is better known as LTV, created a real problem in connection with the exchange offers that are utilized in an out-of-court workout. By the way, *Chateaugay*, if you have all been reading the papers about the Mohawks, that is up there at Chateaugay and that was what that boat was named after and ended up being the key name in the LTV case.

Mr. Lieb: I thought that was what gave jurisdiction over that case in the Southern District of New York.

Mr. Phelan: It is. Chateaugay was a company that was headquartered in New York that gave jurisdiction to this district up here, and Chateaugay Corporation was named after a boat which is the only asset of the Chateaugay Corporation, which is a boat. . . .

Mr. Phelan: . . . . [T]he concept is that when a company's bonds are selling at a discount and the corporation wants to effectuate an exchange offer to put off the day of reckoning. . . . Mr. Lieb: This is before bankruptcy?

Mr. Phelan: Before bankruptcy, pre-bankruptcy. What happened there is, for example, bonds are selling at sixty cents on the dollar. The debtor, pre-bankruptcy, says "look sixty cents bondholder, I will give you a new par bond for your old bond that is selling at sixty cents that has a face value of par of one hundred cents, and I will alter the terms and give you better terms and put off the day of reckoning." Somebody exchanges, that is what happened. What the court said was this — the issue was raised but look — under the Bankruptcy Code you do not get paid for unmatured interest.

Mr. Lieb: Is there a section number on that? 502 something or other?

Mr. Phelan: 502. Under section 502[42] unmatured interest is not an allowable claim in the case. You paid for your par bond the one that

42 11 U.S.C. § 502 (1988).

we just issued in the exchange offer, you only paid sixty cents for it because the bonds you gave us [were] only worth and that is just the same as if you had only paid sixty cents for it. I am going to treat that essentially as a zero coupon bond is treated, and the interest just accrues at the rate that takes it to par by maturity date. Since this bankruptcy was filed not too long after the exchange offer, you have only got a claim in the case for sixty-two cents. That is what Judge Lifland held.

Mr. Lieb: So you reduced your claim by exchanging from 100 cents, the face amount, to sixty-two cents.

Mr. Phelan: Right. And those bond holders that did not exchange, they still have a one hundred cent claim.

Mr. Lieb: Didn't Judge Lifland talk about the impact on the public market, and he did not care.

Mr. Phelan: He mentioned the impact on the public market and said who cares, that's not my problem.

Mr. Ross: I do not know if its good law or bad law, the Appellate Court will decide that. . . . It is on appeal. It is bad business, though, because it rewards the wrong people. In an exchange offer out of court, it is already very difficult because it is invariably true that the non-consenting holder, the fellow who just sits with the paper he originally had, always gets a better economic return than the fellow who exchanges. So what happens now, if Judge Lifland's decision holds up, is not only will the consenting party who is trying to help the company get an initially inferior economic deal, he will also get his head handed to him if there should be a subsequent chapter 11. . . .

Mr. Lieb: That will discourage a lot of exchange offers where it may have an impact.

Mr. Ross: It is already making a problem. Right now, most of the exchange offers that we are involved with which, Lord knows these are quite a few, are going to turn out to be so-called pre-packaged chapter 11's, or may be just regular chapter 11's. So unless the bankruptcy courts view [original issue discounts] as some sort of a marketing thing to draw more cases in, I think it is going to be counterproductive because it will provoke some companies going in.

We have a situation now that will be sort of nameless. The bonds are trading at twenty cents on the dollar. So if someone took an exchange, as I understand the way Judge Lifland's ruling works, he would have an eight hundred dollar original issue discount per one thousand dollar bond. . . . Net-net effect would be in the chapter 11, if and when it came, two things would have happened. The fellow who was a holdout who kept the one thousand dollar bond that got reinstated would still have a one thousand dollar claim. So that is one problem. But the other curious thing is the net beneficiary of the IOD would be the equity holder. So the court in effect is endorsing the direct transfer of wealth from the exchanging bondholder to the equity holder. That cannot be a logical consequence of a bondholder wishing to help a company, and tried to help, solve the financial problem. It seems at least in my primitive mind counter-intuitive that should be a result that anybody would wish to incur.

Mr. Phelan: There is a worse problem than that is that nowhere in the Bankruptcy Code does it say that bondholders should be treated any different than any other holder of claims. There is no distinction between holders of claims. When you go in, debtor, and renew that bank note, . . . the bank may very well have the same problem the bondholder as a creditor does because there is no distinction under the Bankruptcy Code between bondholders and banks.

Mr. Lieb: The Bankruptcy Code will accommodate that if appropriate, we know that, in classification. . . .

Mr. Phelan: You say appropriate classification. Nowhere in the Bankruptcy Code does it say that it is not unfair discrimination to separately classify those two types of creditors. When you walk in with your worthless note because you are deadbeat, and want to renew it at my bank, and I renew it, you can show up the same way that the bondholder or the debtor showed up in the LTV case with your expert testifying that he would have only bought your note for twenty cents on the dollar because you were such a deadbeat, and I have got an eight hundred dollar discount as the bank. You look at the *Four Seasons*[43] case, and you have got to look at the facts of that case. The old shareholders had securities law claims that are now subsumed within section 510(b)[44] that did not exist at the time the *Four Seasons* case was decided. They had claims, the post-shareholders that they were talking the other class, I think it was a class E creditor, did not have the same kind of claim. So you were not unfairly discriminating by separately classifying them. You go take a

[43] *In re* Four Seasons Nursing Centers of America, Inc., 472 F.2d 747 (10th Cir. 1973).

[44] 11 U.S.C § 510(b) (1988).

bank that has an unsecured claim, and a bondholder that has an unsecured claim, and I think you have got a real problem if you separately classify them, and then discriminate unfairly under section 1129[45] by paying one more than the other.

Mr. Lieb: That is the nature of our work. We deal with difficult problems, Robin, and you know that. Listen, the hour is getting late. We will take one or two more questions.

Question: Take a small corporation, somebody comes along and says, I like your company. I will give you a million dollars for it. . . . There are thirty-four stockholders involved. He does not discuss the financing. . . . They like his balance sheet. They say fine, let's do the deal. . . . Meanwhile, he has gone to the bank and he has financed [the deal] with a third party. . . . He finances [the deal] with a different bank. . .than the company was using. . . . Are those selling stockholders vulnerable to the fraudulent conveyance statute, and, if they are, do they have a crossclaim against the buyer?

Ms. Houser: The answer is, if you are in the Ninth Circuit, they are not vulnerable because that is essentially the *Kupetz* case, but I think the answer has to be yes in most places; you would be vulnerable. That is Robin's armadillo theory according to Judge Lundin.

Mr. Phelan: Did I hear the assertion that the debtor's assets, the corporation's assets are pledged against that new bank loan or not?

Mr. Lieb: Yes. . . . The answer to your contribution question is there is one case that deals with that and rules against the availability of contribution for a guilty party. It is a tough position to be in.

Judge Lundin: There is one other aberration that may help you in your close corporation situation that you are describing. Look at a case called *Knox Kreations*[46]. . . . In *Knox Kreations* they had a close corporation and the district judge there, who has since passed away, ruled that consideration to a sole shareholder is sort of like consideration flowing to the corporation itself because he *is* the corporation. Now I am not going to defend the theory, but that he accepted that theory and then passed away.

Mr. Lieb: Yes, last question.

Question: What are the responsibilities of the seller's attorney?. . .

Mr. Lieb: You have got a very real problem. If you write to your

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45 11 U.S.C § 1129 (1988).

46 *In re* Knox Kreations Inc., 474 F. Supp. 567 (1979), *aff'd in part, rev'd in part*, 656 F.2d 230 (1981).

client, you are going to make the problem worse for your client. And you know you put confidential and all of that. When it comes to discovery the judge says I want to peek at it so I can rule whether you gave him legal advice, and whether its privileged so you know what the label means. . . . If you do not write it to your client, then you have got a problem when you get sued for not giving the right advice. It is a very practical thing.

Judge Lundin: The seller's lawyer has another kind of exposure too, and that is that the seller's lawyer may personally be the recipient of a fraudulent conveyance, if the seller's lawyer's fees are paid from the money generated by leveraging the assets of the target because the target does not get anything for these legal services. Yet, the target typically pays those legal services. So there is another sort of hook in there.

Mr. Lieb: The answer is yes it is a problem. In *Wieboldt*[47] which we have referred to several times, professional's lawyers moved to dismiss the complaint against them as did a whole bunch of other classes of defendants. In a long opinion, the district court sustained the complaint. [The court ruled] if you prove what you allege, plaintiff wins.

Ms. Houser: Keep in mind *Wieboldt* — I think the important thing to remember there is its all decided in the procedural context of a motion to dismiss. So from a substantive standpoint, it does not get into the issues, but essentially views all of these questions in the context of: did they plead a case if there is evidence to support the allegations.

Mr. Ross: The examiner report in *Revco* also addresses that.

Mr. Lieb: I think *Wieboldt* is just a little stronger than that. Question . . . One of the favorite devices, particularly with a small corporation, is that the selling shareholder takes back an employment contract for several years. . .[Does] the employment contract fall within the context of a potential fraudulent transfer?

Mr. Lieb: My view is that such a contract is a serious problem. I think that they are infirm, and there are any number of cases in bankruptcy that have declined to enforce them at all.

Judge Lundin: Dick, there is a case that is pretty close. . . . It is called *Vadnaise Lumber*[48]. . . . It is a Massachusetts case that Judge Quenan wrote. The essence of it was . . . clever lawyers in an effort

[47] Wieboldt Stoves v. Schottenstein, 94 Bankr. 488 (N.D. Ill. 1988).
[48] *In re* Vadnaise, 100 Bankr. 127 (Bankr. D. Mass. 1989).

to disguise some of this distribution of good will, we have been talking about, built it in as a non-compete contract, not an employment contract, but an agreement that the outgoing principal of the business would not compete with the business. That is how they were going to pass all this wealth to him and sort of disguise it. [Judge] Quenan looked at the deal, and said, look the corporation already had a right that its principal would not compete with it. So acquiring that right was worthless to the company after the LBO. If it has a right of employment, and other rights you are going to run into the same kind of argument that the corporation is not getting anything for this contract.

Mr. Lieb: All right. We thank you all for being here with us tonight. I want to thank each member of the panel: Wilbur and Jim for taking time after a long and arduous day in their offices, and Robin and Barbara for traveling from Dallas to New York, just to be with us here tonight, and Keith Lundin who works very hard, all kidding aside, on a big bench in Nashville for traveling especially here to be with us tonight. I was very privileged to be your moderator for this occasion. Thank you.

APPENDIX I
Revco D.S. Inc.
Consolidated Balance Sheets
(Millions)

	Oldco*	Newco
	December	
Assets	29,1986	30,1986
Current assets		
Cash	$ 32	$ 87
Accounts receivable	90	87
Notes receivable	24	24
Inventories	581	674
Prepaid expenses	27	27
Total current assets	754	844
Property plant, equipment and leasehold costs	262	508
Goodwill	14	541
Other assets	34	111
Total assets	$ 1,064	$ 2,004
Liabilities and Stockholders' Equity		
Current liabilites		
Current portion of long-term debt	4	123
Accounts payable	234	234
Other including current portion of restructuring reserve, at December 30, 1986	74	101
Long-term debt	303	1,214
Deferred income taxes	40	—
Restructuring reserve		40
Redeemable preferred stock		
Convertible		85
Exchangeable		131
Junior		30
ANAC Common Stock and common stock puts		3
ANAC Common Stock subject to put options		10
Common shareholders' equity	409	23
	$ 1,064	$ 2,004

*Estimated by James J. Burns