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APPLYING THE LAW OF FRAUDULENT CONVEYANCES TO BANKRUPT LEVERAGED BUYOUTS: THE BANKRUPTCY CODE'S INCREASING LEVERAGE OVER FAILED LBOs*

ANTHONY MICHAEL SABINO**

I. INTRODUCTION

> Today's financial age has become a period of unbridled excess with accepted risk soaring out of proportion to possible reward. Every week, with ever-increasing levels of irresponsibility, many billions of dollars in American assets are being saddled with debt that has virtually no chance of being repaid. Most of this is happening for the short-term benefit of Wall Street's investment bankers, lawyers, leveraged buyout firms and junk-bond dealers at the long-term expense of Main Street's employees, communities, companies and investors.
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> They forgo all significant covenant protection and ignore all warnings of "caveat emptor." Boom-time optimism, not thoughtful credit analysis, is their guiding light. *And in a bankruptcy, their holdings will almost certainly be wiped out.*[1]

As to the last statement, such were the quite prophetic words of Ted Forstmann, a founder and senior partner of Forstmann Little & Company, one of the nation's first, and most successful, leveraged buyout firms. His commentary above was memorialized as "The Spiel" in *Barbarians at the Gate*, the saga of the battle to take over RJR Nabisco, Inc. in a leveraged buyout.[2] And as the epilogue to that tome informs us:

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* The opinions expressed herein are solely those of the author.

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The author dedicates this writing to Mary Jane Sabino, Esquire, with deepest thanks for providing the inspiration for this article.

1. Theodore J. Forstmann, *'Leveraged to the Hilt' - Violating Our Rules of Prudence*, WALL ST. J., Oct. 25, 1988, at A26 (emphasis added).

2. *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE—THE FALL OF RJR NABISCO 258 (1990).

> The first eight months of 1989 saw $4 billion worth of junk-bond defaults and debt moratoriums, the most spectacular being the troubles of Canadian entrepreneur Robert Campeau's retail empire. Then, in October, the unraveling of a $6.79 billion buyout of United Airlines' parent prompted momentary panic on Wall Street, sending the Dow Jones Industrial Average down nearly 200 points and prompting fears of a new market crash.

Ted Forstmann, of course, felt thoroughly vindicated.[3]

It is therefore fitting that the zenith of the buyout craze of the 1980s also marked the day of a turning point in its own demise. On December 1, 1988, the financial press announced to the world that Kohlberg Kravis Roberts & Company had succeeded in its leveraged buyout bid to purchase RJR Nabisco, Inc., for the staggering sum of over $25 billion.[4] The RJR Nabisco transaction represented the pinnacle of leverage buyouts (LBOs). It was more than quadruple the size of the next largest LBO on record at that time, that of Beatrice Companies for over $6 billion. Indeed, it was a fitting climax to a year that witnessed LBO acquisitions totaling an astronomical $67 billion in value.[5]

Yet, while the mavens of Wall Street reveled in the glory of this megadeal, that same day a federal court in Illinois issued a decision representing a turning point in a series of judicial opinions dealing with a force even greater than the behemoth LBOs. That irresistable force was the Bankruptcy Code, particularly its laws on fraudulent conveyances, as applied to LBOs of companies which subsequently became bankrupt. That still-evolving clash of the titans is the subject of this writing.

As shall be demonstrated hereinbelow, while the world of high finance was gripped in its frenzy of leveraged buyouts, each one more spectacular and excessive than the last, tremendous forces in the law were working toward making their own startling appearance. Like a tidal wave, with its mammoth energy primarily submerged and thus unseen, various courts were quietly marshaling centuries-old law prohibiting conveyances in fraud of creditors, and were beginning to tentatively apply them to overleveraged buyouts that had subsequently filed bankruptcy.

Then, in a great onslaught that coincided with the flight of

3. *Id.* at 513.
4. WALL ST. J., Dec. 1, 1988, at p. 1, cl. 2.
5. *Id. See also* Colin P. Cross, *Intangible Assets: Extra Comfort for the LBO Lender*, MERGERS & ACQUISITIONS, Nov./Dec. 1988, at 50.

failed LBOs to the supposed shelter of the bankruptcy court, a large number of tribunals finally emerged, espousing the application of the ancient fraudulent conveyance law to the creations of Wall Street's *wunderkinds*. Thus began the great revolution in this realm, with case law advocating the unraveling of these failed LBOs, and a return of the massive payouts to the debtor for an eventual distribution to their creditors. The above view of the law, which puts existing and contemplated LBOs at risk of greater scrutiny, now generally prevails.

This view, however, is not without opposition. At least one circuit court has decided that failed LBOs need not be undone and the earlier payouts to shareholders may rest undisturbed.[6] While the result is diametrically opposed to the majority view, interestingly enough it has been founded upon a very different perspective of which precepts of law control here. Needless to say, the inter-circuit dichotomy is, at present, the most critical aspect of this issue, and may yet be addressed by the Supreme Court or Congress.

In any event, having posited the conflict between courts favoring the application of fraudulent conveyance law to LBOs and those who have not, this article shall proceed to analyze that schism, by first examining the basic underlying statutory provisions in force, as well as their medieval forebearers; tracing the genesis of the cases initially forging these principles; and then espousing in full the many recent decisions that have applied the law of fraudulent conveyances to failed LBOs, including the lone tribunal in opposition thereto. This writing shall conclude with a few thoughts for the future on this highly controversial subject.

II. TODAY'S WALL STREET VERSUS YESTERDAY'S ELIZABETHAN LAW

Looking to the long-standing laws of fraudulent conveyances, as enforceable under the modern Bankruptcy Code, creditors and bankruptcy trustees alike have attacked the transfers appurtenant to a leveraged buyout.[7] They have done so by claiming that the resulting transfers, among other things, were lacking in the receipt of fair consideration by the target in exchange for the bur-

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6. *See, e.g.*, *In re* Kaiser Steel Corp., 952 F.2d 1230, 1237 (9th Cir. 1991).

7. In reorganization cases proceeding under Chapter 11 of the Bankruptcy Code, the "debtor in possession [has] all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee . . . ." 11 U.S.C. § 1107(a) (1988). For that reason, the terms are virtually interchangeable, and, as shall be seen herein, it is just as often the debtor in possession that acts as plaintiff in these litigations.

den of the new LBO debt or, likewise, alleging the LBO transfer rendered the target insolvent.

While today's fraudulent conveyance action is prosecuted under the modern Bankruptcy Code, its history extends back far longer:

> The present law of fraudulent conveyances has ancient roots. Section 548 is derived from the Statute of 13 Elizabeth passed by Parliament in 1571. The statute was aimed at a practice by which overburdened debtors placed their assets in friendly hands thereby frustrating creditors' attempts to satisfy their claims against the debtor. After the creditors had abandoned the effort to recover on their claims, the debtor would obtain a reconveyance of the property that had been transferred. Such transactions operated as a fraud against the debtor's creditors because the debtor's estate was depleted without exchanging property of similar value from which the creditors' claims could be satisfied.[8]

Section 548 of the Bankruptcy Code specifies the circumstances under which a conveyance may be considered fraudulent, and thus avoidable. Section 548(a)(1) requires actual fraudulent intent, while § 548(a)(2) is a constructive fraud provision. Under this latter section, a transfer is conclusively presumed to be fraudulent when certain conditions are met.[9]

In many instances, a transaction cannot be challenged as a fraudulent conveyance under the Bankruptcy Code because it occurred more than one year before the bankruptcy case was

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8. Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 644-45 (3d Cir. 1991), *cert. denied*, 112 S. Ct. 1476 (1992).

9. In relevant part, 11 U.S.C § 548(a) reads as follows:

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily-

> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548(a) (1988). Generally, the trustee's ability to commence an avoidance lawsuit is subject to a two-year statute of limitations. 11 U.S.C. § 546(a)(1) (1988).

filed.[10] Accordingly, attention has traditionally been focused on state fraudulent conveyance law.[11] Section 544 of the Bankruptcy Code permits a trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under *applicable law* . . . ."[12] This is the avenue by which a trustee can invoke state fraudulent conveyance law.[13] While the trustee's powers to undo fraudulent conveyances are formidable, they are not absolute. The Bankruptcy Code has carefully carved out exceptions to the avoidance process. These exceptions were promulgated to preserve the finality of certain specified transactions. Pertinent to the instant discussion are the exceptions to the avoiding power created for so-called "settlement payments" made in securities transactions.

Although a tacit part of the Bankruptcy Code since its promulgation in 1978, these subsequent amendments enacted in 1982 are germane to this inquiry. Most importantly, one must consider the context of these amendments. At the time of their passage, Congress was concerned about the volatile nature of the commodities and securities markets and decided that certain protections were necessary to prevent "the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market."[14] As stated in legislative history:

> The Bankruptcy Code now expressly provides certain protections to the commodities market to protect against such a 'ripple effect.' One of the market protections presently contained in the Bankruptcy Code, for example, prevents a trustee in bankruptcy from avoiding or setting aside, as a preferential transfer, margin payments made

10. 11 U.S.C. § 548(a).

11. *In re* Revco D.S., Inc., 118 B.R. 468, 474 (Bankr. N.D. Ohio 1990).

12. 11 U.S.C. § 544(b) (1988) (emphasis added).

13. Ferrari v. Barclays Business Credit, Inc. (*In re* Morse Tool, Inc.), 108 B.R. 389, 389 (Bankr. D. Mass. 1989). The various individual codifications of fraudulent transfer law are generally modeled after either the Uniform Fradulent Conveyance Act (UFCA) or the Uniform Fraudulent Transfer Act (UFTA), provoking a substantial similarity among the fora. *See* N.Y. DEBT. & CRED. §§ 270 to 281 (McKinney 1990) (UFCA); N.D. CENT. CODE § 13-02.1-01 to 13-02.1-10 (1991) (UFTA); MINN. STAT. ANN. §§ 513.41 to 513.51 (West 1990) (UFTA); CAL. CIV. CODE §§ 3439 to 3439.12 (West 1971 & Supp. 1993) (UFTA). The Court of Appeals for the Third Circuit has noted that " '[t]he fradulent conveyance provisions of the Code are modeled on the UFCA, and uniform interpretation of the two states [is] essential to promote commerce nationally. . . .' " United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1299 (3d Cir. 1986), *cert. denied sub nom.*, McClellan Realty Co. v. United States, 483 U.S. 1005 (1987) (citing Cohen v. Sutherland, 257 F.2d 737, 741 (2d Cir. 1958)). *See Cohen*, 257 F.2d at 741 (the Bankruptcy Code's fradulent conveyance provision is the "federal codification" of the UFCA).

14. H. R. REP. NO. 420, 97th Cong., 2d Sess. 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583 [hereinafter HOUSE REPORT].

to a commodity broker.[15]

Yet Congress wanted to go further to protect margin payments and settlement payments made by and to participants in the securities market generally. Accordingly, it added a new subsection to § 546, subsection (e) of the statute.[16] As explicitly set forth in the legislative history, the thrust of this amendment was to extend protection to the securities market by ensuring that the avoiding powers of a bankruptcy trustee are not construed to permit settlement payments to be set aside, except in cases of fraud.[17] Notably, the explanation of the individual provision speaks of "a settlement payment made by a clearing organization . . . ."[18]

Almost by definition, an LBO acquisition is a financial mechanism that will inevitably collide head-on with the common law and statutes relating to creditors' rights, which trace their roots back to the 13th century, because it severely encumbers assets of a company to benefit transferring shareholders while revising downward the creditworthiness of the company for existing creditors. Existing creditors originally loaned money on one basis; the highly leveraged post-LBO company now presents a completely different credit risk to lenders.

A leverage buyout typically consists of the purchase of a corporation, the "target," from its shareholders by an investment entity, known as the "acquiror." The acquiror finances the purchase with proceeds from debt, loaned on the basis of the giving of the target's assets as collateral security, and a *de minimis* equity investment.[19] The fulcrum of the deal is the leveraging of all or most of the target's assets to secure the borrowing, the debt is typically massive in comparison to the equity put in by the acquiror; hence the term "leveraged."

The direct economic effect of the LBO on the acquired company is clear—after the LBO, the sum total of its assets is unchanged, but it is now heavily mortgaged. A huge debt must be serviced, but its beneficial proceeds were transferred not to the target, but to its former shareholders. In the eyes of creditors, the

15. *Id.* (citation omitted).

16. *See* 11 U.S.C. § 546(e) (1988). Originally, the clause was added as subsection (d) to § 546, but was renumbered when further amendments were promulgated in later years. Bankruptcy Act Amendments of 1982, Pub. L. No. 97-222, 96 Stat. 236 (1982), *reprinted in* 1982 U.S.C.C.A.N. 235, 236.

17. HOUSE REPORT, *supra* note 14, at 2, *reprinted in* 1982 U.S.C.C.A.N. at 583.

18. *Id.* at 3, *reprinted in* 1982 U.S.C.C.A.N. at 585.

19. *See* Matthew T. Kirby et al., *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27, 27 n.3.

target has been substantially weakened in terms of its creditworthiness. The general creditors now are confronted with a greatly diminished asset pool to look to for a recovery should the company fail. In addition, those creditors will stand behind the secured LBO lenders in any forced distribution. Obviously, the highly leveraged company represents a scenario in which no general creditor desires to be caught. Consequently, they have sought redress when an LBO target, unable to fulfill its increased financial burdens, succumbs to bankruptcy.

There exists a school of legal thought that failed LBOs in bankruptcy should never be subjected to the law of fraudulent conveyances. At least two leading academicians have staunchly advocated a more restrictive reading of the laws of the fraudulent conveyance today, in light of the modern financial world's degree of sophistication in both the legal and economic aspects of the debtor-creditor relationship.[20]

Pertinent here is the specific promulgation of the notion that LBOs are undeserving of attack under the historical concepts of fraudulent conveyances. "It is not clear," state Professors Baird and Jackson, "that permitting the debtor to engage in a leveraged buyout, for instance, is against the long-term interests of the creditors as a group."[21] Indeed, they assert that the buyout may bring about a more streamlined and effective organization, better able to service its debt.[22] Among other things, a privately-held entity has immediate savings by doing away with the necessity of complying with federal securities reporting requirements.[23]

The learned commentators claim that today's LBO is far different from the old "Elizabethan deadbeat who sells his sheep to his brother for a pittance."[24] In their view, the typical LBO simply lacks the element of genuine fraud from which the laws of fraudulent conveyances were designed to protect creditors.[25]

Lastly, in a "whipsaw" analogy, Professors Baird and Jackson cry out against any law that gives general creditors too much by insuring them against all less-than-satisfactory transactions into

20. Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

21. *Id.* at 833.

22. *Id.* at 853.

23. *Id.* (citing Jenny B. Wahl & Edward T. Wahl, *Fraudulent Conveyance Law and Leveraged Buyout: Remedy or Insurance Policy?*, 16 WM. MITCHELL L. REV. 343, 358 n.41 (1990)).

24. Baird & Jackson, *supra* note 20, at 852.

25. *Id.*

which a debtor may enter.[26] A just and proper application of fraudulent conveyance law in the context of LBOs would activate those provisions only where there were suspicious attributes to the transaction. Otherwise, the LBO is no different from any other business activity, with both the potential of risks and benefits to be borne by the company and its creditors alike.

Against this statutory and academic backdrop, we may now proceed to examine the evolution of the doctrine that has led to the acceptance of the applicability of fraudulent conveyance law to failed leveraged buyouts. Indeed, its formative beginnings tell us much.

III. THE PIONEERING DECISIONS

The decision to apply the law of fraudulent conveyances to today's LBOs was not easily reached. Early cases in this realm reflect judicial uncertainty as to how to deal with the modern dynamics of corporate finance, as represented by leveraged buyouts, when they clash with long established fraudulent conveyance law as applied in bankruptcy proceedings.[27]

In *Kupetz v. Wolf*,[28] the Ninth Circuit Court of Appeals affirmed the trial court's determination that the LBO of the debtor was not a fraudulent conveyance.[29] There, the acquiror incorporated with only *de minimis* capital and purchased all of the debtor's shares for $3 million.[30] The acquisition was financed with a $1.1 million loan and $1.9 million in letters of credit from its lender, and the target company's assets were pledged to the bank to secure those obligations.[31] Unable to service its debt, the company filed for bankruptcy protection under Chapter 7, slightly over two years after the acquisition.[32] Subsequently, the bankruptcy trustee filed a complaint alleging the underlying transac-

26. *Id.* at 843. *See, e.g.*, Ohio Corrugating Co. v. DPAC, Inc. (*In re* Ohio Corrugating Co.), 91 B.R. 430, 441 (Bankr. N.D. Ohio 1988) ("While transfers between a purchaser and the target company in an LBO ought to be subject to avoidance as a fraudulent transfer, a purchaser in an LBO transaction should not be required to be an insurer of the ultimate success of the purchased enterprise, except by legislative action determining public economic policy.")

27. The modern Bankruptcy Code was promulgated via the passage of the Bankruptcy Reform Act of 1978. Pub. L. No. 95-598, § 101, 92 Stat. 2549 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5807. Obviously, the Code itself was still in its infancy as LBOs began to take hold of Wall Street.

28. 845 F.2d 842 (9th Cir. 1988).

29. Kupetz v. Wolf, 845 F.2d 842, 850 (9th Cir. 1988).

30. *Id.* at 844.

31. *Id.*

32. *Id.*

tions were fraudulent conveyances.[33] The federal district court directed a verdict denying those claims and the trustee appealed.[34]

The appellate tribunal expressed its frustration with the issue from the outset, opining that "LBOs pose difficult issues when the purchased corporation becomes bankrupt. . . . As some of the acquired companies have failed, creditors have begun to assert that LBOs are fraudulent . . . ."[35] On that point, the panel pointed out that the application of fraudulent conveyance law to LBOs gives creditors the ability to "whipsaw" companies, taking advantage of successful LBOs and commencing a fraudulent conveyance lawsuit if the LBO fails.[36]

With this embryonic principle in mind, the court declined to apply the fraudulent conveyance laws in this context.[37] As its rationale, it first held there was no evidence of any intentional fraud worked by the selling shareholder on the target's creditors.[38] Second, these shareholders did *not* know the acquiror intended to finance his buyout via an LBO.[39] Third, the trustee was not representing the interests of pre-LBO creditors, who obviously lacked a full-fledged opportunity to evaluate the effect of the leveraged buyout on the target's creditworthiness.[40] Lastly, the form of the LBO represented a sale of stock to an entity other than the target itself, a critical distinction in the panel's view.[41]

Notably, the tribunal looked to various underlying facts in support of these holdings. The appellate judges found that the seller shareholders acted in good faith throughout the transaction and had sold their stock at a fair price.[42] The acquiror, albeit thinly capitalized, was backed by the substantial personal assets of its principal and a relationship with a substantially sound major money center bank.[43]

Most interesting was the panel's acknowledgment that a lack of intent does not necessarily bar a fraudulent conveyance claim

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33. *Id.*
34. *Kupetz*, 845 F.2d at 844-45.
35. *Id.* at 845-46.
36. *Id.* at 847 n.10.
37. *Id.* at 847.
38. *Id.* at 848.
39. *Kupetz*, 845 F.2d at 848. The court found the distinction set forth above significant because in many LBOs, the target buys back its own stock in an attempt to go "private" like RJR Nabisco.
40. *Id.* at 849.
41. *Id.* at 850.
42. *Id.*
43. *Id.*

because of the "constructive" fraud provisions of that law.[44] However, the tribunal backed away from that point, stating: "we hesitate to utilize constructive intent to frustrate the purposes intended to be served by what appears to us to be a legitimate LBO."[45] Furthermore, the court struck a cautionary note in adding: "[n]or do we think it appropriate to utilize constructive intent to brand most, if not all, LBOs as illegitimate. We cannot believe that virtually all LBOs are designed to 'hinder, delay, or defraud creditors.' "[46]

A sharp contrast to the preceding case is found in *United States v. Tabor Court Realty Corp.*[47] There, the Court of Appeals for the Third Circuit was compelled to examine an intricate leveraged buyout and decide whether the mortgages given in that transaction were fraudulent conveyances within the meaning of the intentional and constructive fraud provisions of the Pennsylvania Uniform Fraudulent Conveyances Act.[48] The panel noted that its decision was "the first significant application of the UFCA to leveraged buyout financing."[49]

In *Tabor Court*, the appellate court was greatly troubled by the nature of the LBO. The panel looked to the facts that: (1) the target's stock was purchased with large funds borrowed at an extremely high rate of interest;[50] (2) the assets of the target and its subsidiaries were mortgaged to secure those borrowings;[51] (3) the acquiring company was seemingly an empty shell, able only to perform the LBO on the strength of the massive aforementioned loan;[52] (4) the ominous presence of "secret partners" as the principals of the acquiror;[53] and (5) the existence of multi-million dollar liabilities on the books of the target at the time of the LBO.[54] Indeed, the court found this LBO to be "anything but unsuspicious."[55] The severe economic distress the target was put in, without a concomitant benefit, coupled with the lack of fair consideration to the debtor in this LBO, suggested the transaction was

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44. *See Kupetz*, 845 F.2d at 848.
45. *Kupetz*, 845 F.2d at 848.
46. *Id.*
47. 803 F.2d 1288 (3d Cir. 1986), *cert. denied sub nom.*, McClellan Realty Co. v. United States, 483 U.S. 1005 (1987).
48. United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1291 (3d Cir. 1986), *cert. denied sub nom.*, McClellan Realty Co. v. United States, 483 U.S. 1005 (1987).
49. *Id.* at 1291.
50. *Id.* at 1292.
51. *Id.* at 1292-93.
52. *Id.* at 1292.
53. *Tabor Court*, 803 F.2d at 1292.
54. *Id.* at 1293.
55. *Id.* at 1297.

not made in the ordinary course.[56]

Based upon the foregoing circumstances, the tribunal determined that the LBO was indeed a fraudulent conveyance because it rendered the target insolvent, as neither the target nor any of its subsidiaries received fair consideration in the transaction.[57] In so finding, the Third Circuit explicitly concluded that the law of fraudulent conveyances applied to this LBO. The court found that the "broad sweep" of the fraudulent conveyance law did not justify the exclusion of LBOs simply because they were innovative and complex.[58] The tribunal determined that any exemption for leveraged buyouts should be carved out by the legislature, not by the judiciary.[59]

Notwithstanding the apparent misgivings expressed by the Ninth Circuit in *Kupetz*, it was the *Tabor Court* rationale of the Third Circuit that seemed to encourage the subsequent application of fraudulent conveyance law to failed LBOs. In *Ohio Corrugating Co. v. Security Pacific Business Credit (In re Ohio Corrugating Co.)*,[60] the creditors' committee brought an action alleging, among other things, that the transfer by the debtor of a security interest for purposes of a leveraged buyout was both an actual and constructive fraudulent conveyance under § 548 of the Bankruptcy Code and the UFCA.[61]

The defendants moved for summary judgment arguing, *inter alia*, that "as long as some entity received a reasonably equivalent value for the incurring of the loan obligation or the transferring of a security interest, Plaintiff's case must fail regardless of whether [the debtor] benefitted from the transaction."[62] Although the court granted summary judgment for the defendant on the actual fraud allegations, the court rejected the defendants' argument on constructive fraud in this fashion: "An analysis of an allegedly fraudulent transfer must be directed at what the Debtor surrendered and what the Debtor received, irrespective of what any third party may have gained or lost. The rationale of the fraudu-

56. *Id.*
57. *Id.* at 1296.
58. *Tabor Court*, 803 F.2d at 1297.
59. *Id. followed by* Moody v. Security Pac. Business Credit, Inc., 127 B.R. 958 (W.D. Pa. 1991). In *Moody*, District Judge Diamond held that the application of fraudulent conveyance law to LBOs "is mandated" by *Tabor Court*, and the Third Circuit's ruling therein was not meant "to encourage district court forays into legislating exceptions for some leveraged buyouts and not others." *Moody*, 127 B.R. at 989 n.7.
60. 70 B.R. 920 (Bankr. N.D. Ohio 1987).
61. Ohio Corrugating Co. v. Security Pac. Business Credit (*In re* Ohio Corrugating Co.), 70 B.R. 920, 923 (Bankr. N.D. Ohio 1987).
62. *Id.* at 927.

lent transfer provision of the Code is to preserve the assets of the estate."[63]

Other courts have found that improper payments made by a debtor either to selling shareholders or lenders in an LBO deal must be avoided. In *Vadnais Lumber Supply, Inc. v. Byrne* (*In re Vadnais Lumber Supply*),[64] a corporation purchased its own shares from four shareholders for $100,000 and paid an additional $300,000 for the selling shareholders' limited covenants not to compete.[65] The court held that the cash paid to the shareholders and the obligations for future installment payments incurred by the corporation were fraudulent conveyances under the Bankruptcy Code.[66] Therefore, the court discharged the debtor from all obligations to make future payments and allowed the estate to recover all the cash payments made at or after the closing.[67]

In *Ferrari v. Barclays Business Credit, Inc.* (*In re* Morse Tool, Inc.),[68] the court considered whether future creditors of the debtor had standing to assert a fraudulent conveyance action under the Massachusetts UFCA.[69] The tribunal examined a number of policy considerations raised by commentators and courts which have addressed the issue for not applying fraudulent conveyance laws to leveraged buyouts. Commentators argued that:

> [L]everaged buy-outs . . . will be discouraged if the courts apply fraudulent conveyance laws to them indiscriminately; that leveraged buy-outs are not the kinds of transactions that fraudulent conveyance laws (neither 13 Eliz. ch. 5 nor the Uniform Fraudulent Conveyance Act) were intended to deter and remedy; that creditors can protect themselves from leveraged buy-outs by . . . contracting to prohibit them; and that future creditors who extend[ ] credit knowing of the buyout should not be able to use fraudulent conveyance laws as insurance policies for failed LBOs.[70]

The *Ferrari* court concluded, however, that:

63. *Id.* (*citing* Martin v. Phillips (*In re* Butcher), 58 B.R. 128 (Bankr. E.D. Tenn. 1986)).
64. 100 B.R. 127 (Bankr. D. Mass. 1989).
65. Vadnais Lumber Supply v. Byrne (*In re* Vadnais Lumber Supply), 100 B.R. 127, 130 (Bankr. D. Mass. 1989).
66. *Id.* at 137.
67. *Id.* at 141.
68. 108 B.R. 389 (Bankr. D. Mass. 1989).
69. Ferrari v. Barclays Business Credit, Inc. (*In re* Morse Tool, Inc.), 108 B.R. 389, 389 (Bankr. D. Mass. 1989).
70. *Id.* at 390-91.

> These arguments have some merit, but so do the counter-arguments: for example, that not all leveraged buy-outs have social utility or benefit for creditors, and fraudulent conveyance laws may help deter or redress the worst of them; that few creditors have the bargaining power to prevent the debtor from engaging in an LBO; that many trade creditors and other future creditors do not and cannot, in the normal course of business, perform a solvency or cash-flow analysis of the debtor before extending credit; and that involuntary future creditors (such as taxing authorities and tort creditors) do not have freedom to decide whether to extend credit to the target of an LBO.[71]

Most recently, in *Aluminum Mills Corp. v. Citicorp North America, Inc. (In re Aluminum Mills Corp.)*,[72] United States Bankruptcy Judge Schmetter said that although a relatively small number of courts have written on the subject, they have uniformly held that transfers to and between debtors and their LBO lenders, controlling shareholders, and companies owned by those shareholders, are subject to both the Bankruptcy Code and state fraudulent conveyance statutes.[73] Judge Schmetter went on to state that "[t]here is no reason to go against this established precedent."[74] There, the court denied actions to dismiss fraudulent conveyance lawsuits by the unsecured creditors, thus allowing those actions to proceed. As opined by Bankruptcy Judge Bodoh in *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*:[75]

> The fact that fraudulent conveyance law originally did not envision its use to avoid LBOs is not important. The very essence of common law is its adaptability to unique situations and changing fact patterns. If the rights of creditors have been impaired, we see no reason to except LBOs from the operation of fraudulent conveyance law if the transfers otherwise fit within the statutory framework.[76]

71. *Id.* at 391. *See also* Anderson Indus., Inc. v. Anderson (*In re* Anderson Indus., Inc.), 55 B.R. 922 (Bankr. W.D. Mich. 1985).
72. 132 B.R. 869 (Bankr. N.D. Ill. 1991).
73. Aluminum Mills Corp. v. Citicorp North America, Inc. (*In re* Aluminum Mills Corp.), 132 B.R. 869, 885 (Bankr. N.D. Ill. 1991) (footnotes omitted).
74. *Id.*
75. 91 B.R. 430 (Bankr. N.D. Ohio 1988).
76. Ohio Corrugating Co. v. DPAC, Inc. (*In re* Ohio Corrugating Co.), 91 B.R. 430, 433 (Bankr. N.D. Ohio 1988).

Judge Bodoh added that any suggestion that LBOs should be exempt from such provisions "is largely a policy matter which is most appropriately left to the consideration of Congress and state legislatures."[77] Although the court found that the creditors suing on behalf of the debtor did not carry the evidentiary burden of proving that the LBO was a fraudulent conveyance, the court affirmed the notion that an LBO could still be scrutinized under the state fraudulent conveyance statutes.[78]

In sum, the Ninth Circuit in *Kupetz*, while not fully advocating the point, at least opened the door to the application of fraudulent conveyance law to failed LBOs. *Tabor Court* was by far the most influential case of its time, but since it was grounded upon such egregious facts, its future value as precedent was still unclear until further cases heightened its utility. Nevertheless, it did trigger a groundswell of support for its doctrine in the lower courts, and these decisions then helped define the parameters for what was yet to come. And come it did indeed.

IV. THE TURNING POINT

The seminal case which spearheaded this ground-breaking body of law, decided on the same day the world awoke to the "Mother of all LBOs," was *Wieboldt Stores, Inc. v. Schottenstein*.[79] Wieboldt, the debtor in a Chapter 11 reorganization proceeding, filed its complaint against 119 defendants alleging, among other things, that Wieboldt's leveraged buyout, by a specially formed acquisition corporation in 1985, constituted a fraudulent conveyance.[80] Specifically, Wieboldt contended that the LBO reduced the assets available to its creditors, increased its debt burden by millions of dollars, and left Wieboldt insolvent and without sufficient unencumbered assets to sustain its business and ensure the making of payments due unsecured creditors.[81]

The defendants in this case were grouped into three nonexclusive categories: (1) controlling shareholders, officers and directors; (2) the lenders who funded the leveraged buyout (the LBO lenders); and (3) other shareholders who owned more than 1,000 shares of Wieboldt and had tendered their shares in the LBO.[82] The instant matter came before the court on numerous

77. *Id.* at 434.
78. *Id.* at 440.
79. 94 B.R. 488 (N.D. Ill. 1988).
80. Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488, 493 (N.D. Ill. 1988).
81. *Id.*
82. *Id.*

motions by these defendants to have the complaint dismissed.[83]

As for the underlying LBO transaction itself, Wieboldt was a Chicago-based retail concern in declining financial health.[84] In January of 1985, unable to pay current obligations, Wieboldt agreed to be acquired via a tender offer made by WSI Acquisition Corporation. WSI intended to finance its leveraged buyout by pledging substantially all of Wieboldt's assets, particularly real property, which was already serving as collateral for obligations upon which Wieboldt was at least partially in default at the time.[85]

When the sale of Wieboldt's major piece of real estate did not generate sufficient funds to extinguish its pre-LBO obligations, WSI sought additional monies by selling the company's customer charge accounts, pledging all accounts receivable and subjecting the remaining real estate holdings to either first or second mortgages.[86] Notably, by the time of the buyout, the LBO lenders had full knowledge of the loan or credit commitments of WSI to each one of them.[87] Moreover, the board of directors of Wieboldt understood that WSI intended to pledge substantially all of Wieboldt's assets to fund the transaction, without using any of its own funds. The board also knew that the proceeds from the LBO lenders would not increase working capital. Nevertheless, the tender offer was approved, and by the end of 1985, WSI had acquired ownership of 99% of Wieboldt's stock.[88]

The following September, some of Wieboldt's aggrieved creditors commenced an involuntary liquidation proceeding against the company.[89] On September 24, 1986, Wieboldt filed a voluntary petition for reorganization under Chapter 11 of the Bankruptcy Code. Acting now as a debtor-in-possession, Wieboldt filed a lawsuit, alleging that the LBO had worked a fraud on its unsecured creditors.[90] The court in *Wieboldt* examined the precedents of *Tabor Court*, *Kupetz*, and others for guidance—surely a mixed lot of decisions.[91]

In deciding this case, District Judge Holderman rejected the assertion of the defendants that the law of fraudulent conveyances

83. *Id.* at 492.
84. *Id.* at 494.
85. *Wieboldt*, 94 B.R. at 494-95.
86. *Id.* at 495.
87. *Id.*
88. *Id.*
89. *Id.* at 496.
90. *Wieboldt*, 94 B.R. at 496.
91. *See id.* at 500-02.

did not apply to leveraged buyouts.[92] He did so based on primarily two grounds. First, the court found that the language of the Bankruptcy Code itself "in no way limits [its] application so as to exclude LBOs."[93] The definition of a "transfer" of property found in the Code and the statute invalidating a fraudulent transfer were both found to be very broad. Therefore, the court found no basis for finding an exemption for leveraged buyouts.[94] Second, the court looked to the rulings of its brethren and found that "those courts which have addressed this issue have concluded that LBOs in some circumstances may constitute a fraudulent conveyance."[95]

Having thus decided that a leveraged buyout can be deemed a fraudulent conveyance, Judge Holderman analyzed the Wieboldt buyout. The defendants claimed that this LBO was composed of "a series of interrelated but independent transactions," and that they were the transferees of the property of the acquiror, WSI, and not the debtor. Wieboldt, in turn, urged the court to consider WSI as a mere conduit of its property, and therefore collapse the LBO and treat it as one aggregate transfer to the defendants.[96] It was the latter view that the court adopted.[97]

Crucial in *Wieboldt* was the court's conclusion that the complaint alleged sufficient facts to demonstrate that the controlling shareholders entered into the transaction with the full knowledge that WSI was not using any of its own funds, that the leveraged buyout would result in the further encumbrance of already encumbered assets, and that Wieboldt was insolvent.[98] The LBO lenders were likewise implicated, said the court, because they had the same knowledge as the controlling shareholders, and they too "were well aware of each other's loan or credit commitments to WSI," which had financed the LBO.[99] Furthermore, the court agreed that WSI served "mainly as a conduit" for the transfer of

92. *Id.* at 499-500.

93. *Id.* at 499.

94. *Id.*

95. *Wieboldt*, 94 B.R. at 499 (citations omitted).

96. *Id.* at 500.

97. *Id.* at 502, *followed by* Moody v. Security Pac. Business Credit, Inc., 127 B.R. 958, 991 (W.D. Pa. 1991). *See* Murphy v. Meritor Sav. Bank (*In re* O'Day Corp.), 126 B.R. 370 (Bankr. D. Mass. 1991). Observing that "courts not infrequently 'collapse' the discrete steps employed by the parties" in structuring an LBO, Bankruptcy Judge Gabriel agreed to examine the substance of a failed LBO "as one transaction." *Id.* at 394. Moreover, the court acknowledged that while its fraudulent conveyance analysis may not be a simple task, when the target assumes liabilities or gives security interests and the LBO consideration is "immediately passed to target's shareholders or third parties then the lack of fair consideration may be equally evident." *Id.*

98. *Wieboldt*, 94 B.R. at 502-03.

99. *Id.* at 502.

Wieboldt assets to the controlling shareholders and the LBO lenders.[100]

Applying the principle espoused by other tribunals that "a court should focus not on the formal structure of the transaction but rather on the knowledge or intent of the parties involved," the court decided to collapse the LBO into one unified transaction.[101] "In sum," ruled Judge Holderman, "the formal structure of the transaction alone cannot shield the LBO lenders or the controlling . . . shareholders from Wieboldt's fraudulent conveyance claims."[102] For these reasons, the defendants' motions to dismiss the case were denied, and the fraudulent conveyance complaint was left standing for an eventual trial.[103]

In a later ruling, District Judge Holderman subsequently cut off another avenue of escape for various defendants in *Raleigh v. Schottenstein (In re Wieboldt Stores, Inc.)*,[104] in which he denied the motions of certain defendants to dismiss, or alternatively, for partial summary judgment.[105] These defendants had tendered their Wieboldt shareholdings in the LBO, and argued that the payouts they had received were "settlement payments" not subject to avoidance by a trustee under the Bankruptcy Code.[106] Their stake was not insignificant; these defendants had tendered nearly half a million of the debtor's shares to the buyout entity,[107] and benefitted by a payout of nearly $6.5 million from the LBO.[108]

The district court rejected the argument that the trustee was barred from avoiding these so-called settlement payments.[109] Commencing with the law itself, Judge Holderman found that "the language of the statute is not dispositive in determining

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100. *Id.* at 503.

101. *Id.* at 502.

102. *Id.* at 503.

103. *Wieboldt*, 94 B.R. at 503-04.

104. 131 B.R. 655 (N.D. Ill. 1991). The Wieboldt trustee, Thomas Raleigh, now stepped in to prosecute this action for the debtor. *Id.*

105. Raleigh v. Schottenstein (*In re* Wieboldt Stores, Inc.), 131 B.R. 655, 662 (N.D. Ill. 1991).

106. *Id.* at 663. *See* 11 U.S.C. § 546(e) (Supp. III 1991). The text itself reads:

> Notwithstanding sections 544, 545, 547, 548(a)(2), and 548(b) of this title the trustee may not avoid a transfer that is a margin payment, as defined in section 101(34), 741(5), or 761(15) of this title, or settlement payment, as defined in section 101(35) or 741(8) of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1) of this title.

11 U.S.C. § 546(e).

107. *Raleigh*, 131 B.R. at 663 n.7.

108. *Id.* at 665.

109. *Id.* at 663.

whether Section 546(e) bars the Trustee's claims."[110] Decrying the text of the provisions, describing it as having "circuitous verbiage" which "cryptically defines" the term " 'settlement payment,' " the court held that this "circular definition" lacked the " 'plain meaning' " the former stockholders urged would preclude further inquiry by this court.[111]

Instead, the court resorted to the legislative history of § 546(e),[112] and found that the lawmakers' chief concern in enacting the statute was that the clearance and settlement process of the securities industry remain unaffected when one of the linked parties filed for bankruptcy.[113] Drawing a critical distinction from that objective to the instant case, the court held that requiring these defendants to return any payments they received from the Wieboldt LBO "poses no significant threat to those in the clearance and settlement chain."[114] No intermediary in that linkage "would be meaningfully affected" if the court ordered an avoidance of the LBO transfers.[115]

In a historical postscript, *Wieboldt* was settled on the eve of the trial of the fraudulent conveyance action.[116] "[T]he principal shareholders who reaped profits in . . . and the directors who approved [the LBO] have agreed to return about $11.7 million to the bankrupt estate," said reported accounts.[117] *Wieboldt* was over, but it proved to be the watershed for the bringing of similar fraudulent conveyance suits on this issue.

V. THE CREDITORS GAIN ON THE LBOs

The next landmark decision in this realm was entered by the eminent District Judge Lasker in *Crowthers McCall Pattern, Inc. v. Lewis*.[118] The plaintiff was the subject of an LBO in 1987, and the defendants were its stockholders prior to that time.[119] In late

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110. *Id.*

111. *Id.*

112. *Raleigh*, 131 B.R. at 663-64.

113. *Id.* at 664.

114. *Id.* (footnote omitted).

115. *Id.* at 664-65. In composing his rationale, Judge Holderman concluded:

> Thus, although the legislative history of Section 546(e) is not dispositive *per se* of whether the section bars the Trustees [sic] claims, the section's legislative history, when combined with consideration of the system which Section 546(e) was designed to protect, convince this court that Section 546(e) does not bar the Trustee's claims against the [LBO] defendants.

Id. at 665 (footnote omitted).

116. Debra L. Moss, *Wieboldt's LBO Suit Settled*, A.B.A. J., Jan. 1992, at 31.

117. *Id.*

118. 129 B.R. 992 (S.D.N.Y. 1991).

119. Crowthers McCall Pattern, Inc. v. Lewis, 129 B.R. 992, 995 (S.D.N.Y. 1991).

1988, Crowthers was unable to pay its debts as they became due, and it filed for reorganization pursuant to Chapter 11 of the Bankruptcy Code.[120]

As summarized by the court at the outset, "[t]his case concerns the rights of creditors . . . to seek compensation from participants in the sale of the corporation when the debt assumed by that corporation as a result of the sale renders it unable to meets its financial obligations."[121] The creditor committee that filed the action on behalf of Crowthers alleged, *inter alia*, that the LBO was a fraudulent conveyance, and that the defendants had breached their fiduciary duties as directors of the company, along with committing various other transgressions of corporate law.[122]

The instant matter came before the court as a motion brought by certain defendants to dismiss the action as to them.[123] Essentially, Crowthers had alleged that the conveyances made and obligations incurred by it in connection with the LBO were actually and constructively fraudulent because the debtor did not receive fair consideration, was rendered insolvent or was left with an unreasonably small amount of capital as a result of the transaction.[124]

After a preliminary dismissal of the complaint against certain peripheral defendants due to the insufficiency of the pleadings made against them by the plaintiff,[125] the court turned its attention to one of the principal defendants, Bankers Trust.[126] The merchant bank had supplied a $15 million bridge loan to help finance the LBO.[127]

Bankers Trust defended its actions on the basis that it had not received any property or obligation from Crowthers that could be restored or annulled, and that the extension of its bridge loan constituted fair consideration to the debtor in the LBO. As to the fair consideration issue, the debtor retorted that the proceeds of the bridge loans, the liability which Crowthers assumed, went to the shareholders who sold their shares in the corporation and not to

Indeed, the defendant Lewis was none other than Reginald Lewis, one of the top dealmakers of the "Roaring Eighties," probably known best for his participation in the Beatrice Foods transactions.

120. *Id.*

121. *Id.* at 994-95.

122. *Id.* at 995. Such transgressions by the defendants included impermissible dividends, payments, and authorized redemption of stock. *Id.*

123. *Id.*

124. *Crowthers*, 129 B.R. at 995-96.

125. *Id.* at 996-97.

126. *Id.* at 997.

127. *Id.*

Crowthers.[128]

After briefly examining the laws of the forum defining fraudulent conveyances, Judge Lasker turned to *Wieboldt*,[129] and focused on its findings that 1) LBOs reduce the assets available to pay general creditors and 2) that the phases of an LBO should be "treated as one transaction."[130] Likewise citing the similar holding of the Third Circuit in *Tabor Court*, the district court in *Crowthers* characterized the instant LBO as "one integrated transaction, the ultimate result of which was to impose additional debt of $35 million on Crowthers . . . , for which Crowthers . . . received nothing in exchange."[131]

Refuting Bankers Trust's assertion that it was not liable because it made its loan to a nondebtor intermediary within the LBO's structure, the court found that the intermediary acted "essentially as a conduit" for funneling the loan proceeds to the divesting shareholders. The court concluded that while others did, Crowthers itself "did not receive the substantive benefits of the loan."[132] For all these reasons, the court refused to dismiss the fraudulent conveyance lawsuit against Bankers Trust and certain other defendants.[133]

At this juncture, it can be seen how the early cases of *Tabor Court* and its brethren gave birth to the breakthrough decision of *Wieboldt*, followed shortly thereafter by *Crowthers*. The latter

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128. *Id.*

129. *Crowthers*, 129 B.R. at 997.

130. *Id.*

131. *Id.* at 998 (citing United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986)).

132. *Id.* Judge Lasker opined:

> Under these circumstances, it would be inappropriate for the court in determining the rights of creditors of the corporation to turn a blind eye to the fact that the loan proceeds were merely passed through the corporation to the shareholders. In evaluating the applicability of fraudulent conveyance laws designed to protect creditors' rights, it is essential to view the transaction or transactions in question from the perspective of creditors. A leveraged buyout (i.e., the sale of a corporation in which at least part of the purchase price is obtained through debt assumed by the corporation) such as the one at issue here can harm creditors in exactly the way fraudulent conveyance laws are designed to prevent. Accordingly, under the fraudulent conveyance laws, a lender is required to make a reasonable determination that the buyout is consistent with the rights of creditors before advancing funds. Where, as here, it is alleged that the lenders knew that Crowthers Pattern would not receive the loan proceeds but would nevertheless assume responsibility for repaying the debt, and it is alleged that the eventual insolvency and bankruptcy of Crowthers Pattern was a foreseeable result of the leveraged buyout, the plaintiff has adequately pleaded a cause of action for fraudulent conveyance.

Crowthers, 129 B.R. at 998 (citation omitted). Notably, the court continued to borrow from the *Wieboldt* and *Tabor Court* "collapsed LBO" models in later finding that various other causes of action were sustainable. *Id.* at 999-1001.

133. *Id.* at 1003.

pair of cases exemplify a devastating one-two punch to failed LBOs, especially with respect to *Wieboldt*, where the court's ruling forced capitulation by the LBO participants. Yet the final knockout blows were yet to be delivered by the circuit courts. Fittingly, it proved again to be the Ninth and Third Circuits, who put the capstone on the legal dogma to which they had given birth in *Kupetz* and *Tabor Court*.

VI. THE CIRCUITS SPEAK

A. THE THIRD CIRCUIT—*METRO*

In *Mellon Bank, N.A. v. Metro Communications, Inc.*,[134] the debtor Metro was the target of a leveraged buyout financed by Mellon Bank.[135] The Court of Appeals for the Third Circuit ultimately reversed and remanded a lower court finding that the LBO constituted a fraudulent conveyance,[136] primarily because of a "sparse" record and the "surprisingly cavalier" rulings made below.[137] Nonetheless, the legal principles espoused by the tribunal in *Metro* represent its continued adherence to the embryonic precepts set forth in the seminal case of *Tabor Court*.

Writing for the court, Circuit Judge Rosenn found that the appeal, which was rooted "in the congenial climate of mergers and acquisitions that beguiled corporate America during the decade of the nineteen-eighties," raised vital questions regarding a bankruptcy trustee's power to avoid LBO transfers pursuant to the fraudulent conveyance provisions of the Bankruptcy Code.[138] The Third Circuit initially demonstrated some reluctance in making modern LBOs subject to attack pursuant to centuries-old fraudulent conveyance law.[139] Nevertheless, the tribunal forged ahead. Judge Rosenn opined:

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134. 945 F.2d 635 (3d Cir. 1991), *cert. denied*, 112 S. Ct. 1476 (1992).

135. Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 638 (3d Cir. 1991), *cert. denied*, 112 S. Ct. 1476 (1992).

136. *Id.* at 650, *rev'g and remanding*, 95 B.R. 921 (Bankr. W.D. Pa. 1989). *See also In re* Metro Communications, Inc., 135 B.R. 17 (Bankr. W.D. Pa. 1989) (amending 95 B.R. 921), *aff'd in part and rev'd in part*, 135 B.R. 15 (W.D. Pa. 1991).

137. *Metro*, 945 F.2d at 649.

138. *Id.* at 637-38.

139. *Id.* at 645. The court stated:

> At first glance, it seems difficult to reconcile the original purpose of the fraudulent conveyance laws with what has become a common, arms-length transaction—the leveraged buyout, or in business parlance, the LBO. Where there exists no intentional fraud, setting aside the security interest of a lender who has indisputably *given* reasonably equivalent value, cash for a promise to repay a loan, appears to be a patent anomaly.

Id. (emphasis in original).

Nonetheless, a thorough understanding of the typical LBO transaction reveals that there is a potential for abuse of the debtor's creditors, particularly those who are unsecured, when a company is purchased through an LBO.

* * *

The effect of an LBO is that a corporation's shareholders are replaced by secured creditors. Put simply, stockholders' equity is supplanted by corporate debt. The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio. This added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy. The lender, which normally assumes a senior, secured position vis-a-vis other creditors, is at risk only to the extent that the loan is under-collateralized. An LBO may be attractive to the buyer, seller, and lender because the structure of the transaction could allow all parties to the buyout to shift most of the risk of loss to other creditors of the corporation if the provisions of section 548(a)(2) were not applied.[140]

The tribunal astutely observed that virtually everyone benefits in an LBO: the selling stockholders cash out, usually at a premium for their shares; the acquiror achieves ownership of the target; and the lender profits by charging the higher interest rates and fees usually associated with leveraged buyouts.[141] But as for the target corporation, it receives no direct benefit to offset the great risk of now operating as a highly leveraged corporation.[142]

For these reasons, the Third Circuit held that the laws of fraudulent conveyances were available to avoid LBO transactions. The court found that:

> [B]ecause the fraudulent conveyance laws are intended to protect the debtor's creditors, a lender cannot hide behind the position, although sympathetic, that it had parted with reasonable value. The purpose of the laws is estate preservation; thus, the question whether the debtor *received* reasonable value must be determined from the standpoint of the creditors.[143]

140. *Id.* at 645-46.
141. *Id.* at 646.
142. *Metro*, 945 F.2d at 646.
143. *Id.* (emphasis in original).

Moreover, the tribunal found "no exception for the leveraged buyout transaction" in § 548 of the Bankruptcy Code.[144] The statute applied to any transfer, the circuit judges held, for the "definitional language is sufficiently broad to encompass a leveraged buyout transaction that falls within its terms."[145] By these words, the Third Circuit completed the evolution of its jurisprudence that now bridged the egregious facts of *Tabor Court* to an application of the laws of fraudulent conveyance to a modern failed LBO in *Metro* on this vital controversy.

B. THE NINTH CIRCUIT—*CITY BANK*

The Ninth Circuit Court of Appeals moved toward applying fraudulent conveyance law to LBOs in *Lippi v. City Bank*.[146] In *City Bank*, Russell decided to buy out his partners in a construction materials wholesaling business. The transaction was structured so that Russell and a shell corporation, created for purposes of the buyout, would purchase the shares of the selling owners.[147]

The bulk of Russell's funding was provided by City Bank, which secured the loan by taking a security interest in all of the debtor's assets. Importantly, the trustee asserted that it would seem that the creation of this new liability had the immediate effect of shifting the debtor's net worth from positive to negative.[148] It was also alleged that the parties knew that the LBO would devastate the debtor's net worth, an appearance that City

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144. *Id.*

145. *Id.* This proposition was cited with approval by the Third Circuit in Moody v. Security Pac. Business Credit, Inc., 971 F.2d 1056, 1064 n.10 (3d Cir. 1992) *rev'd on other grounds*, 127 B.R. 958 (W.D. Pa. 1991). "This conclusion" opined the panel, "is consistent with that reached by the other courts that have considered the applicability of the fraudulent conveyance provisions of the UFCA to leveraged buyouts." *Id.* (citing *inter alia*, *Crowthers* and *Wieboldt*).

Although the tribunal found the leveraged buyout in *Moody* not to be a fraudulent conveyance, it did so on very different facts which conclusively demonstrated that the debtor was not rendered insolvent in any sense by the LBO. *Id.* at 1074. Additionally, over ninety percent of the proof of claims filed by trade creditors in the case were for goods or services provided a year *after* the leveraged buyout was consummated. *Id.* "[W]e do not believe," opined Circuit Judge Scirica, "[the debtor's] insolvency was a natural consequence of the leveraged buyout." *Id.* at 1075-76.

Paramount to this analysis, the Third Circuit confirmed its view, as stated in *Metro*, that "leveraged buyouts present great potential for abuse. . . . Therefore, *we believe failed leveraged buyouts merit close scrutiny under the fraudulent conveyance laws*." *Moody*, 971 F.2d at 1073 (emphasis added). The tribunal repeatedly cited *Metro* and *Tabor Court*, leaving no doubt that those cases and the legal principles espoused therein retain their vitality in such controversies, and the instant case reached a different result solely by virtue of its unique facts.

146. 955 F.2d 599 (9th Cir. 1992).

147. Lippi v. City Bank, 955 F.2d 599, 601 (9th Cir. 1992).

148. *Id.* at 602.

Bank sought to avoid.[149]

A Chapter 7 bankruptcy followed, and the trustee commenced the instant adversary proceeding to recover the LBO payout as a fraudulent transfer.[150] The district court below granted summary judgment in favor of City Bank and certain other defendants. However, the district court, despite a jury verdict against Russell at trial, refused to enter an order of judgment voiding the LBO transfers.[151]

On appeal, the Ninth Circuit reversed and remanded.[152] Relevant to this discussion is the panel's conclusion that, should the finder of fact determine on remand that the various transfers constituted but one integrated transition, "the component transfers are also avoidable" as fraudulent conveyances.[153] Critical to the opinion was the comparison the court drew to *Tabor Court.*

As with the latter case, the Ninth Circuit found that the LBO lender was intimately involved with the formulation of the arrangement, whereby the proceeds of the City Bank loan were directed into the hands of the LBO participants.[154] The panel also cleared the way for recovery from the selling shareholders. Writing for the court, Circuit Judge Fletcher noted that the tribunal had previously held in *Kupetz* that the formal structure of an LBO should be respected.[155]

However, the appellate court opined that "where there is evidence that the parties knew of or should have known that the transaction would deplete the assets of the company, the court will look beyond this formal structure."[156] Indeed, the circuit judges gave tacit approval to the *Wieboldt* approach of collapsing the

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149. *Id.* at 602 n.3.

150. *Id.* at 603.

151. *Id.* at 604.

152. *City Bank*, 955 F.2d at 614.

153. *Id.* at 610.

154. *Id.* The tribunal also found that City Bank was an "initial transferee" of the loan repayments, within the meaning of § 550 of the Bankruptcy Code, and thus the trustee could recover from the lender if the transfer was avoided. *Id.* at 610-11. *See also* 11 U.S.C. § 550. Section 550 provides, in pertinent part, that:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a) (1988).

155. *City Bank*, 955 F.2d at 612.

156. *Id.*

LBO into one unified transaction for purposes of this analysis.[157] Given that the evidence adduced at the district court was conflicting, the appellate court ruled that the summary judgment order refusing to undo the LBO was improper since some evidence existed that the LBO might have to be collapsed.[158] The appellate court thereby opened the door to the application of fraudulent conveyance law.[159]

In sum, *Metro* and *City Bank* are the appropriate pillars of authority for the proposition that failed LBOs can be subjected to the laws of fraudulent conveyance in a bankruptcy case. These tribunals initiated the doctrine with *Kupetz* and *Tabor Court*, generating the landmarks of *Wieboldt* and *Crowthers*, and now brought all of it together with their two most recent decisions. It is this view which now predominates.

VII. OPPOSITION FROM THE TENTH CIRCUIT

Notwithstanding all the above, the instant controversy regarding the application of fraudulent conveyance law to modern LBOs remains unresolved. An internecine conflict has arisen, with an opposing vanguard coming from the Tenth Circuit. Taking a markedly different approach, that tribunal has not engaged the controversy frontally, but has instead flanked as if on a completely different basis. Rather than fully decide if failed LBOs are subject to unwinding by the law of fraudulent conveyances, this appellate court has reached inapposite results by relying upon a statutory protection that, in its view, makes payouts in an LBO virtually untouchable. The following discussion examines this contrary position.

A. *KAISER V. SCHWAB*

In a somewhat brief opinion, the Court of Appeals for the Tenth Circuit disposed of the LBO controversy on a rather limited ground in *Kaiser Steel Corp. v. Charles Schwab & Co.*[160] In *Kaiser*, the tribunal affirmed the district court's reversal of the bankruptcy court's denial of the defendants' motion for summary judgment.[161] The defendant Schwab claimed it was not liable because it was a

157. *Id.* at 611-12.
158. *Id.* at 613.
159. *Id.*
160. 913 F.2d 846 (10th Cir. 1990).
161. Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846, 847 (10th Cir. 1990). *See* Kaiser Steel Resources, Inc. v. Jacobs (*In re* Kaiser Steel Corp.), 110 B.R. 514 (D. Colo 1990), *rev'g* 105 B.R. 639 (Bankr. D. Colo. 1989).

"mere conduit" of the LBO payouts rather than a transferee, pursuant to the Bankruptcy Code's definition.[162]

Other moving defendants, stockbrokerages like Schwab, asserted that the LBO payments were exempt from avoidance as "settlement payments" under the statutory Code exception.[163] Notably, this fact led the Securities and Exchange Commission (SEC) to file a brief and participate in oral argument,[164] ostensibly to argue for the preservation of stability in the stock markets.[165]

The tribunal specified that it did not reach the conduit question raised by *Schwab*. Rather, it affirmed the district court solely on the "settlement payment" issue.[166] Writing for the panel, Circuit Judge Anderson began by noting that a trustee or debtor-in-possession cannot avoid a settlement payment.[167] The definition of a settlement payment,[168] while admittedly somewhat circular, is nevertheless extremely broad.[169] For that reason, the Tenth Circuit ruled that "it clearly includes anything which may be considered a settlement payment."[170] The transfer of the consideration in the Kaiser LBO was therefore a settlement payment under this pervasive definition.[171] The tribunal added that such an interpretation is consistent with the legislative intent to protect the nation's financial markets from any instability that might be caused by the reversal of concluded securities trades pursuant to a bankruptcy trustee's statutory avoiding powers.[172] Notwithstanding that "[n]either LBOs nor other exceptional transactions were ever mentioned" in the legislative history of the relevant Code provisions, the tribunal opined "it would be an act of judicial legislation" to establish such an exemption for a LBO transfer from the settlement payment definition now.[173]

Summarizing for the tribunal, Judge Anderson pointed out

162. *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 848 & n.2. *See* 11 U.S.C. § 550(a) (1988).
163. *Schwab*, 913 F.2d at 848 & n.2. *See* 11 U.S.C. § 546(e) (1988 & Supp. III 1991).
164. *Schwab*, 913 F.2d at 850 n.7.
165. *Id.* at 849-50.
166. *Id.* at 848.
167. *Id.* at 848 (citing 11 U.S.C. § 546(e) (1988)).
168. *See* 11 U.S.C. § 741(8) (1988).
169. *Schwab*, 913 F.2d at 848 (citing Bevill, Bressler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n (*In re* Bevill, Bressler & Schulman Asset Management Corp.), 878 F.2d 742 (3d Cir. 1989)). It must be noted that the "ultimate question" the Third Circuit decided was a controversy involving the transfer of federal government securities repurchase agreements with a defunct stockbrokerage under § 546(f), not a failed LBO, and not under the purview of § 546(e). *Bevill*, 878 F.2d at 743.
170. *Schwab*, 913 F.2d at 848.
171. *Id.*
172. *Id.*
173. *Id.* at 850.

that: "The LBO was a securities transaction. The transfer of money and preferred stock was the settlement of that transaction. Therefore, the transfers to Schwab were exempt from avoidance under section 546(e) as 'settlement payment[s] . . . to a . . . stockbroker.' "[174]

As stated previously, the Tenth Circuit's approach left certain questions, such as the "conduit" question, explicitly unanswered. Left implicitly unanswered was the question of the application of fraudulent conveyance law to leveraged buyouts. That was not to be for long, however, as the panel was soon compelled to return to this very same proceeding.

B. *KAISER V. PEARL*

In *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*,[175] the inevitable question presented was the one the Tenth Circuit left unresolved in *Schwab*: "whether consideration paid to shareholders for their stock in connection with a leveraged buy out is exempt from the avoiding powers of a trustee . . . as 'settlement payments . . . .' "[176] The *Kaiser* caption was a virtual indictment of Wall Street, naming practically every brokerage firm in the Western World,[177] followed by an equally lengthy list of their respective counsel.[178] Moreover, the SEC again filed a brief and participated in the oral argument of the case.[179]

As introduced by the court, this case involved "a leveraged buy out gone bad."[180] The debtor now sought to retrieve the monies paid to its former shareholders in connection with the LBO by making "the relatively novel yet increasingly popular claim that these payments constitute[d] a fraudulent conveyance."[181]

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174. *Id.* (footnote omitted). Indeed, the appellate court also refuted the debtor's assertion that its shares were not securities, because the LBO entailed a delisting of Kaiser shares from the New York Stock Exchange. *Id.* at 850 n.8. The panel reasoned:

> The shares were securities when the parties agreed to the LBO. A technical change in how Kaiser regarded them after the merger should not obscure the more sensible interpretation of the transaction: that the owners of Kaiser Steel sold their common stock for cash and preferred stock. That LBOs of publicly-traded companies are securities transactions is shown by the fact that they are within the purview of the Securities and Exchange Commission.

Id.

175. 952 F.2d 1230 (10th Cir. 1991), *cert. denied*, 112 S. Ct. 3015 (1992).

176. Kaiser Steel Corp. v. Pearl Brewing Co. (*In re* Kaiser Steel Corp.), 952 F.2d 1230, 1235 (10th Cir. 1991), *cert. denied*, 112 S. Ct. 3015 (1992).

177. *Id.* at 1230-32.

178. *Id.* at 1233-35.

179. *Id.* at 1235 n.1.

180. *Id.* at 1235.

181. *Kaiser*, 952 F.2d at 1235.

Nonetheless, posed Circuit Judge Anderson, writing for the tribunal again, "[t]he current battle is much more narrow," as it pertains solely to the construction of a bankruptcy law statute that prohibits a debtor from avoiding settlement payments "made by or to stockbrokers, financial institutions, and clearing agencies."[182] In *Pearl*, both the defendants and the SEC agreed that this exemption "encompasses amounts paid to the shareholders in the LBO and accordingly prevents Kaiser from unwinding their transaction."[183]

Describing the LBO itself, the opinion relates that in late 1983, the Kaiser board of directors in fact agreed to the LBO. Under the plan, the Kaiser Steel Corporation would be merged with a new entity that was owned by a group of outside investors. Upon the effectuation of the merger, all of the outstanding shares of Kaiser common stock would be converted into the right to receive two shares of preferred stock and twenty-two dollars—the LBO consideration—in the surviving entity. The source of funding, which amounted to $162 million, was to come from Kaiser's cash reserves and from a $100 million loan from a financial institution. The $100 million loan was secured by the target corporation's assets.[184]

The proposed LBO was approved by the shareholders on January 18, 1984. As of February 29, 1984, the effective date of the merger, the former Kaiser common stock shareholders were required to tender the shares they held to Kaiser's disbursing agent, Bank of America, in order to receive the cash and preferred stock. The stock was delisted by the New York Stock Exchange the following day.[185]

The Depository Trust Company (DTC), a securities clearing agency acting as depository, was in possession of most of the common stock. Following the merger, DTC received the payments of the LBO consideration upon tendering the stock certificates to Bank of America. DTC subsequently transferred these payments to the accounts of its participants, which included brokers and other financial intermediaries. In turn, these intermediaries either retained the payments if they themselves were the beneficial owners, or disbursed the payments to their customers, who were the beneficial owners of Kaiser stock. A number of shares were

182. *Id.*
183. *Id.* at 1236.
184. *Id.* at 1235-36.
185. *Id.*

exchanged through securities clearing agencies other than DTC, and since DTC stopped trading in Kaiser shares prior to the date the LBO became effective, some beneficial owners and financial intermediaries were required to tender their shares to Bank of America directly.[186]

Kaiser filed for bankruptcy under Chapter 11 of the Code in 1987 and filed the instant fraudulent conveyance action, seeking to recover the $162 million. The test case of *Schwab* followed. Pending the *Schwab* appeal, in consolidated proceedings before the district court, other financial intermediaries moved for summary judgment on the basis of the § 546(e) settlement payment exemption.[187]

The district court granted summary judgment, dismissing all of the claims asserted against the financial intermediaries, and on its own motion, dismissed the claims asserted against the remaining defendants. The remaining defendants included the beneficial shareholders of Kaiser stock, as well as brokers trading on their own account.[188]

In light of the decision in *Schwab*, Kaiser abandoned all the claims against the defendants in the case insofar as they had functioned in conduit/financial intermediary capacities. Therefore, all the defendants remaining before the circuit court were either brokers or shareholders that were the beneficial owners of the Kaiser shares tendered in connection with the LBO.[189]

Positing the precise issue before the tribunal, Judge Anderson wrote that the Tenth Circuit was called upon to decide if its holding in *Schwab* should be extended to provide protection for payments made to beneficial shareholders.[190] The debtor insisted that first, the LBO payments were not true settlement payments, and second, that even if they were, the statutory exception of § 546(e) protected a recipient only to the extent it was a participant in the securities clearance and settlement system—in other words, a stockbroker, clearinghouse or the like.[191] A true shareholder was not protected by the statutory exception, asserted Kaiser.[192]

The Court of Appeals for the Tenth Circuit could not accept

186. *Id.* at 1236.
187. *Id.*
188. *Kaiser*, 952 F.2d at 1236.
189. *Id.*
190. *Id.*
191. *Id.*
192. *Id.* at 1236-37.

the debtor's argument. Its analysis began with the statutory language itself:

> Section 546(e) refers to section 741(8) for the definition of "settlement payment." Section 741(8), in turn, defines "settlement payment" as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or *any other similar payment commonly used in the securities trade*."[193]

The court noted that a natural reading suggested that the definition of settlement payment was "extremely broad."[194] Moreover, the court found that the law's "clear aim" was to be all encompassing in setting forth what constituted a settlement payment.[195]

The tribunal's task, opined Judge Anderson, was to apply the Bankruptcy Code terminology "according to its plain meaning."[196] In this particular context, the court added, it "must interpret the term 'settlement payment' as it is plainly understood within the securities industry."[197]

By way of explanation, the court described that, with respect to the routine purchase and sale of a security, the opportunity for settlement occurred on at least two occasions. The first, a "street-side settlement," occurred between the brokers and the clearing agency during the clearance and settlement process. The brokers' transactions are matched and compared upon submission. Confirmed contracts are submitted to the clearing agency's accounting functions. The obligations produced under the individual trades are netted to determine each clearing member's "settlement obligations." The second opportunity for settlement is on the "settlement date," generally five days after the trade date. The brokers and the clearing agency, which have interposed themselves between the buying broker and the selling broker, will deliver securities and receive payment. " 'Settlement payments' are those payments made in discharge of a party's settlement obliga-

193. *Kaiser*, 952 F.2d at 1237 (citing 11 U.S.C. § 741(8)) (footnotes omitted) (emphasis in original).

194. *Id.* (citations omitted). *See also Schwab*, 913 F.2d at 848.

195. *Id.* (citations omitted).

196. *Id.* This comports with the Supreme Court's recent edicts that the bankruptcy statutes be given their plain meaning when under judicial review. *See* United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 242 (1989), *followed by* Connecticut Nat'l Bank v. Germain, 60 U.S.L.W. 4222 (U.S. March 9, 1992).

197. *Kaiser*, 952 F.2d at 1237. *See* Shell Oil Co. v. Iowa Dep't of Revenue, 488 U.S. 19, 25 (1988); McCarthy v. Bronson, 111 S. Ct. 1737, 1740 (1991) (stating that "statutory language must always be read in its proper context.").

tions."[198] Additionally, a " 'customer-side settlement' " also occurs between the customer and its broker.[199] Logically, the term "settlement payment" can be used to describe those payments made to settle a customer's account with its broker as well.[200]

As pointed out by the court, none of the parties argued that a shareholder could never make or receive a settlement payment with regard to routine securities purchases.[201] Rather, the debtor had argued that the Bankruptcy Code's usage of the term applied to shareholders exclusively for normal securities purchases and sales, "not an extraordinary securities transaction like the leveraged buy out."[202]

The panel, as it had in *Schwab*, agreed that Kaiser's position was not without merit. "However, we continue to note," wrote Judge Anderson, "that while Congress might have chosen otherwise, neither section 546(e) or [sic] section 741(8) is on its face limited to 'securities contracts,' as defined by the Code . . . ." Indeed, the court remarked that Congress had previously demonstrated "itself capable of restricting the counterparts of § 546(e) to a particular type of transaction."[203]

The panel set forth its *raison d'etre* as follows:

> Given the wide scope and variety of securities transactions, we will not interpret the term "settlement payment" so narrowly as to exclude the exchange of stock for consideration in an LBO. As the appellees and the SEC have urged, there is no reason to narrow the plain concept of "settlement" to a single type of securities transac-

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198. *Kaiser*, 952 F.2d at 1237-38 (citations omitted). *See* DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION, THE OCTOBER 1987 MARKET BREAK 10-5 (1988) (hereinafter SEC REPORT); Dale A. Oesterle, *Comment on the Harris Paper*, 74 CORNELL L. REV. 943, 944 (1989) ("Settlement payments refer to the final payment of funds between clearing house [members] for trade[s] registered up to a specific point in time.").

199. *Kaiser*, 952 F.2d at 1238. *See* SEC REPORT, *supra* note 198, at 10-2, 10-10 to 10-11. Settlement is defined as the " '[c]onclusion of a securities transaction when a customer pays a broker/dealer for securities purchased or delivers securities sold and receives from the broker the proceeds of a sale.' " *Kaiser*, 952 F.2d at 1238 (quoting NEW YORK STOCK EXCHANGE, LANGUAGE OF INVESTING GLOSSARY 30 (1981)). JERRY M. ROSENBERG, THE INVESTOR'S DICTIONARY (1986) (defining settlement day as "the deadline by which a purchaser of stock must pay for what has been bought and the seller must deliver the certificates for the securities that have been sold.").

200. *Kaiser*, 952 F.2d at 1238.

201. *Id.*

202. *Id.* at 1238-39 & n.7.

203. *Kaiser*, 952 F.2d at 1239 n.8. *See* 11 U.S.C. § 546(f) (1988) (referring to settlement payments "made by or to a repo participant, *in connection with a repurchase agreement* . . . .") (emphasis added); 11 U.S.C. § 546(g) (1988 & Supp. III 1991) (referring to "transfer[s] made by or to a swap participant, *in connection with a swap agreement* . . . .) (emphasis added).

> tion. The Code has been expanded to explicitly cover five different types of financial transactions, all of which, with the exception of swap agreements, involve "settlement payments" of one form or another. In fact, the definition of "settlement payment" found in § 741(8) also applies to payments made in connection with a repurchase agreement, which is not a "trade" entered into on an exchange, and which involves a completely different settlement process.
>
> While the leveraged buy out may not be a "routine" securities trade, at least as viewed by Kaiser, we cannot deny what in substance took place here. The LBO was a securities transaction, varying only in form from the various other ways in which a shareholder's equity interest can be sold. The former Kaiser Steel shareholders effectively sold their equity interests to the new investors in exchange for money and a continuing stake in the new entity as preferred shareholders. In settlement of that transaction, the Kaiser Steel shareholders tendered their shares and received payment. These payments were "settlement payments."[204]

Moreover, the tribunal found that it also achieved an equitable treatment for all shareholders of Kaiser, both pre- and post-LBO:

> [T]hose shareholders who tendered their shares one day after the LBO and received the LBO consideration are treated just the same under the Code as shareholders who sold their shares in the market one day prior to the LBO and received a settlement payment reflecting the market value of the LBO consideration. Neither type of investor will be forced to disgorge the payments several years later.[205]

The Tenth Circuit added parenthetically that "this symmetry of treatment" for public shareholders was justified by "the plain notion of 'settlement,' " as well as the Congressional policy of pro-

204. *Kaiser*, 952 F.2d at 1239-40 (citations omitted).

205. *Id.* at 1240 (footnote omitted). *See also* Jonas v. Resolution Trust Corp. (*In re* Comark), 971 F.2d 322 (9th Cir. 1992). Just as the Third Circuit in Bevill, Bressler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n (*In re* Bevill), 878 F.2d 742 (3d Cir. 1989), the Ninth Circuit was dealing strictly with "reverse repo" transactions and not suprisingly, reached the same result as to the interpretation of the term "settlement payment" found in § 741 of the Code.

moting speed and finality in commercial transactions, a view particularly espoused by the SEC in the instant proceedings.[206] To be sure, according to the panel, the "public" shareholder includes a brokerage firm trading for its own account.[207]

Lastly, the tribunal looked to the "by or to" argument made by Kaiser, that § 546(e) only protects a settlement payment made by or to a party in the clearance and settlement system, and not ordinary shareholders.[208] Again, the circuit judges rejected the debtor's argument:

> On its face the statute is clear. The statute exempts payments made "*by or to*" a stockbroker, financial institution, or clearing agency. Again, unless there is some reason to believe the clear application is absurd or otherwise unreasonable, we can leave our inquiry at that.[209]

Of greater import was that the panel's plain language rationale for the holding above was the significant policy concern it alluded to:

> Certainly, we cannot say that the clear application is absurd, given the fact that disruption in the securities industry—an inevitable result if leveraged buy outs can freely be unwound years after they occurred—is also a harm the statute was designed to avoid. Accordingly, we must reject Kaiser's argument.[210]

Clearly, the paramount concern implicit in this conclusion was the disruption of the stock exchanges by the subsequent bankruptcies of companies that had previously been the subject of leveraged buyouts. In dispensing a passing glimmer of hope, the Tenth Circuit added that, while its holding was broad in its application, and certainly foreclosed Kaiser's prayer for relief as made herein, remedies by way of suit for damages against specific individuals or institutions for unlawful acts were still available.[211]

C. SUPREME COURT REVIEW—AN UNFULFILLED NEED

The denial of certiorari in *Kaiser* has exposed a wide rift in the circuits, surely one destined to plague an already troubled bankruptcy court system in these recessionary times. Lack of review

206. *Kaiser*, 952 F.2d at 1240 n.10.
207. *Id.*
208. *Id.* at 1240.
209. *Id.* (emphasis in original).
210. *Id.* at 1241 (citation omitted). *See Schwab*, 913 F.2d at 848-49.
211. *Kaiser*, 952 F.2d at 1241.

by the high court has left unanswered the many questions raised by the *Kaiser* appellants, which are in fact some of the very open issues that have plagued this interaction between the Bankruptcy Code and LBOs.

The petition for *certiorari* asserted that the Tenth Circuit effectively turned the Bankruptcy Code on its head by preferring equity for debt. Section 546(e) was intended to address other concerns, and it was a novel interpretation indeed for the appeals court to apply it to forbid the trustee from avoiding transfers made as part of an LBO pay out.[212] By thus absolving the securities industry of liability, the appellant argued, the Tenth Circuit has " 'license[d] corporate raiders . . . to plunder corporate assets.' "[213] Indeed, such a crucial point should not go without a response from the nation's highest court.

Pointing to, *inter alia*, the fact that the text of the law did not explicitly name equity shareholders therein, the petitioners had contended that settlement payments did not include one-time redemptions of stock or cash mergers where assets are distributed to stockholders. In short, § 546(e) was designed to protect the chain of facilitators in security trades, rather than to prevent the recovery of improper corporate distributions made to shareholders.[214]

Raising a telling public policy argument, of which the Supreme Court is the ultimate arbiter, the appellants charged that the Tenth Circuit's decision condones similar excesses in other failed LBO bankruptcies. If left standing, petitioners contended that the tribunal's ruling would insulate profiteering shareholders from liability while the debt-ridden companies they created fail, leaving numerous creditor constituencies foundering. Among others, the losers in this exchange include retirees, health plan beneficiaries, and the Pension Benefits Guaranty Corporation, along with ordinary creditors. At their significant expense, it was argued, the LBO participants gained handsomely while leaving in their wake a decrepit company unable to meet its obligations. The problem will only worsen if this incorrect view of the law is not corrected, claimed the petitioners, and recovery from the beneficiaries of LBO transfers are permitted to go forward pursuant to

212. *Trustee Should Be Allowed To Avoid Distribution Made In Kaiser Steel LBO*, 4 BANKR. L. REP. (BNA) No. 19, at 560 (May 7, 1992).
213. *Id.*
214. *Id.* at 561.

the laws governing fraudulent conveyances.[215] Only time will tell if the petitioner's dire forecasts will come true. In any event, the lack of a clear resolution is disquieting and will only foment more litigation on the bankrupt LBO issue.

In brief, the Tenth Circuit avoided addressing the instant controversy in the manner undertaken by the courts in *Wieboldt* and *Crowthers*, as well as the Third and Ninth Circuits in *Metro* and *City Bank*, respectively. Rather, the *Kaiser* panel has espoused two opinions which operate in the limited range of "settlement payments," and the statutory exemption from the trustee's avoiding powers supposedly ends the query. It leaves one to wonder if such holdings by that tribunal would have withstood substantive scrutiny from the Supreme Court. Moreover, the salient fact remains that the *Schwab* and *Kaiser* decisions represent a tremendous break from the persuasive majority of courts which have considered the issue of failed LBOs in the context of bankruptcy proceedings. It is regrettable that the high court chose not to test the holdings of the Tenth Circuit.

VIII. ANALYSIS

Considering the state of the decisional law today, it is apparent that the courts have established a clear trend in proceeding on this issue. It would seem a foregone conclusion that leveraged buyouts shall be considered susceptible to attack under the Bankruptcy Code and the laws of fraudulent conveyances. Except for the Tenth Circuit, no tribunal seems willing to carve out an exception which addresses the problem and bring all LBOs out from under the penumbra of those statutory provisions.

Wieboldt and its progeny, particularly the circuit cases, exemplify an emerging school of judicial thought that refuses to exempt LBOs from the laws of fraudulent conveyances and subsequent attack in bankruptcy proceedings. In fact, these courts speak correctly, for no exemption for LBOs exists in any reasonable interpretation of the law of fraudulent conveyances—be it in the Bankruptcy Code or in any state codification of the UFCA or its ilk. True to the plain meaning of these statutes, these courts have dutifully applied them for no defensible position exists for doing otherwise.

Moreover, these tribunals have rejected the arguments that exalt form over substance as a reason not to impose fraudulent

215. *Id.*

conveyance law upon failed LBOs. To say a leveraged buyout is a complex financing mechanism is to woefully understate the case. But judges need not fear LBOs for this reason, and if the substance demands that their many strata be collapsed into one unified transaction, then so be it. The letter of the law insists upon it.

Lastly, the evolution of this line of cases has been a measured one. From the first exploratory steps of *Kupetz* and the overwhelmingly special circumstances of *Tabor Court*, court after court gradually built upon the theories espoused previously, and carefully applied them to the increasingly evident problems peculiar to failed LBOs. This has led to the breakthroughs of the *Wieboldt* and *Crowthers* landmarks, as well as other contemporary cases.

It could very well be that it was not mere happenstance for the Third and Ninth Circuits to revisit the controversy in *Metro* and *City Bank* and thereby put the crowning decisions in place. One thing is surely evident—as sophisticated as LBOs are, the jurists unraveling their misfortunes in a subsequent bankruptcy have been more than up to the task. For this we should be grateful.

Standing in counterpoise, the pair of decisions from the Tenth Circuit in the *Kaiser* bankruptcy are sorely lacking in terms of persuasiveness. First, as a matter of legal philosophy exemplified therein, that tribunal has twice refused to grapple with the issue as did its sister circuits in *Metro* and *City Bank*. This writing does not fault the worthy panels for deciding the issues as put before them by the litigants. Nevertheless, the approach taken was simply too facile, given the magnitude of the problem.

Second, the appellate court's constricted vision of the "settlement payments" exception does not serve the best interests of either that statutory provision, or the laws of fraudulent conveyances, be they companions in the Bankruptcy Code or relations of state law. The panel committed several errors. It accorded plain meaning to a statute that is anything but plain. The law has surely been resoundingly criticized as circular and obtuse. Surely the plain meaning doctrine loses its positive qualities when applied in such a blanket fashion.

Given such, the dogma of statutory construction demands an examination of the law's legislative history. Here the Tenth Circuit errs again, for the legislative history contains absolutely no indicia of how this narrow exception should interface with LBO transactions. The court could have taken judicial notice that the

dilemma of failed LBOs was simply not an issue at the time, thus making it highly unlikely that Congress intended to address it. In fact, the record clearly shows that Congress' simple aim was to promulgate a general law designed to protect intermediates in the securities industry's clearance and settlement process. There is nothing apparent in those well-expressed concerns that could possibly be expanded upon to claim that Congress intended this statutory exception to immunize LBO transactions from attack as fraudulent conveyances.

For additional precedent, the Tenth Circuit relies heavily on the *Bevill, Bressler* case for its own expansive definition of "settlement payments" and the scope of the exception. However, as noted hereinabove,[216] the Third Circuit in *Bevill, Bessler* was factually distinguishable in that the court was: a) dealing with federal government securities "repo" agreements, not payouts to the selling shareholders of an LBO target company; b) confronted with a defunct brokerage, not a failed LBO under attack as a fraudulent conveyance; and c) most importantly, the Third Circuit explicitly decided its proceeding under a different exception to the trustee's avoiding powers. The *Schwab* and *Kaiser* rationales are therefore seriously misplaced in terms of the common law they both prominently relied upon.

Third and last, the decisions of the Tenth Circuit simply cannot withstand the pressure of the great weight of authority that has ruled differently. From *Tabor Court* to *Wieboldt* to *Metro* and *City Bank*, and all the cases in between as passed upon by bankruptcy, district, and circuit judges alike, the law as it exists today demands that failed LBOs in bankruptcy proceedings may be avoided under federal and state fraudulent conveyance laws. The crushing onslaught of contrary holdings simply discredits the minority view of the Tenth Circuit. While this is certainly enough on its own, it is nevertheless unfortunate that the Supreme Court declined to review the Tenth Circuit's holding in order to finally resolve the controversey. One can only hope for the high court's review via a different appellate trail.

To be sure, the creation of a "safe harbor" for LBOs by way of statutory revision does not appear to be on the horizon. In fact, in the recent past, anti-leveraged buyout sentiment flared to levels close to inciting legislative reform that would have *encouraged* fraudulent conveyance lawsuits in failed LBO bankruptcies.

216. *See* text accompanying *supra* note 169.

For instance, prominent bankruptcy judges, among them Judge Bodoh, the author of the two *Ohio Corrugating* decisions,[217] urged the Subcommittee on Economic and Commercial Law of the House Judiciary Committee to extend the existing one-year "reach-back" period[218] to at least two years, if not longer.[219] Repeating the battle cry of the *Wieboldt* era, that the 1980s' LBOs are the 1990s' bankruptcies, the jurist urged that the change be made to conform the federal provisions with the majority of state fraudulent conveyance laws. As Congress could not have anticipated the " 'corporate feeding frenzy of LBOs' " when it promulgated the Bankruptcy Code in 1978, it should act now in view of today's realities, said Judge Bodoh.[220]

Certainly, any political movement is relatively quiet these days, but the sleeping giant can easily be stirred into action. One must remember that not long ago the Senate Banking Committee had requested the Treasury Department, the Securities and Exchange Commission and other regulatory agencies to conduct an analysis of, among other things, "[w]hether banks that participate in LBO loans conduct appropriate credit analysis and whether they are obtaining enough information from borrowers."[221] The SEC, among other agencies, was actively considering legislative and rulemaking proposals relating to the regulation of LBOs.[222] A reactivation of these endeavors is not beyond the realm of possibility in the present politically charged environment.

In view of all of the foregoing, the "players" in the high-stakes game of leveraged buyouts must now confront the dark reality of legal intervention. *Wieboldt*, *Metro*, and *City Bank* portend the day of reckoning for LBOs, as "critics have long complained that these deals serve little economic purpose beyond enriching management, underwriters, and lenders, and that the companies have become so prodigiously leveraged with debt that they could not withstand a financial storm."[223] The majority of courts are follow-

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217. *See* Ohio Corrugating Co. v. Security Pac. Business Credit (*In re* Ohio Corrugating Co.), 70 B.R. 920 (Bankr. N.D. Ohio 1987); Ohio Corrugating Co. v. DPAC, Inc. (*In re* Corrugating Co.), 91 B.R. 430 (Bankr. N.D. Ohio 1988).

218. *Two Bankruptcy Judges Urge Changes To Deal With LBO-Related Problems*, 22 Securities Regulation & Law Report (BNA) 767, 767-68 (May 18, 1990).

219. *Id.*

220. *Id.* at 768.

221. Letter from Senator Riegle, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, to Chairman Ruder, Securities and Exchange Commission, at 3 (Jan. 6, 1989).

222. Letter of Chairman Ruder, Securities and Exchange Commission, to Representative Dingell, Chairman of the House Committee on Energy and Commerce (May 1, 1989).

223. Carol J. Loomis, *LBOs Are Taking Their Lumps*, FORTUNE, Dec. 7, 1987, at 63.

ing the *Wieboldt* rationale in taking the offensive in vindicating the rights of general creditors injured by the subsequent bankruptcy of an LBO company. Moreover, the presence of such unwanted scrutiny looms even larger, as the threat of judicial action is coupled with the uncertainty inherent in an application of law that has yet to find completely firm footing.

For these reasons, parties who participated in or are contemplating involvement in a leveraged buyout, especially lenders making substantial investments of their capital, should presume significant risks are present. Those with LBOs still in formative stages should diligently strive to build a record to validate the transaction as legitimate in order to fend off an attack that may come in a bankruptcy court at some future date.

For potential LBO participants, *Wieboldt* and its predecessors may also signify that it is time to intensify preventive measures designed to insulate them from a subsequent attack should the target company later slip into bankruptcy. Such procedures would entail the construction of an extensive pre-LBO record, evidencing careful scrutiny of issues such as the target's solvency, capital maintenance, cash flow and asset dispositions.

Prospective LBO lenders should in particular assure that the financial information and projections relating to the target be as accurate and conservative as possible.[224] This task is more difficult because of the decree of the American Institute of Certified Public Accountants that accountants may not issue written assurances regarding a target's solvency or related matters to an LBO lender.[225]

As pointed out by one commentator, the virtue of such diligent inquiry is that it compels prospective LBO lenders to evaluate the economic impact of the transaction, and then enables them to refuse to participate if it appears the buyout will run afoul of the Bankruptcy Code and fraudulent conveyance law. Given the likelihood that the lender who finances a leveraged buyout is in a superior position to evaluate it, that party thus assumes the risk of subsequent litigation if the LBO exceeds the parameters of a sound transaction. An LBO lender would then take on risk in equal proportion to the questionable nature of the leveraged

224. David A. Murdoch et al., *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles*, 43 BUS. LAW. 1, 21.

225. Interpretation of Attestation Standards: Responding to Requests for Reports on Matters Relating to Solvency, *codified at* 1 AICPA Professional Standards (CCH) AU 2012.01-.05 (May 1988).

buyout, but without the imposition of the absolute liability that would, in effect, make that lender the insurer of the transaction.[226]

IX. CONCLUSION

In this last decade of the twentieth century, it would seem that the highly leveraged buyout is in its nadir. However, we have yet to crest the wave of failed LBOs and the carnage that they bring to the bankruptcy court. For this reason, the treatment that such transactions are accorded in the aftermath of their demise is a vitally important issue for bankruptcy law today.

There are those who argue that the ultra-modern financing mechanism of a leveraged buyout should not be subjected to arcane law that was devised centuries before to deal with improper transfers of cattle and sheep by agrarian debtors to avoid the claims of their merchant creditors. Reaching the same result, but in a totally different way, is the view espoused by a single tribunal that resolves the matter via a questionable interpretation of a statutory exemption, originally conceived to address a totally different concern.

Nevertheless, it is clear that the majority and better view is that failed LBOs in bankruptcy proceedings are subject to the full weight of the laws of fraudulent conveyances. The bulk of the courts that have decided this vital issue have not uncovered a reason to except such transactions from subsequent attack under either federal or state fraudulent conveyance laws. Instead, they have decreed that LBOs can be scrutinized, collapsed into one transaction, and basically undone, with the massive payouts appurtenant thereto reversed and the returned funds made available to all creditors in a uniform distribution.

This interpretation and application of the law is more than just a trend. The sole dissenting circuit court is heavily outnumbered, notwithstanding that the Supreme Court declined to grant review. Little legislative activity is in the offering, and what was once considered was decidedly anti-LBO. Thus, no change is anticipated on that front. For all these reasons, any party presently contemplating a leveraged buyout has tremendous legal ramifications to ponder. As for an existing LBO already embroiled in bankruptcy or sliding in that unfortunate direction, be fore-

226. Emily L. Sherwin, *Creditors' Rights Against Participants In a Leveraged Buyout*, 72 MINN. L. REV. 449, 493-96 (1988).

warned that here, the law of fraudulent conveyances under the Bankruptcy Code has all the leverage.