Judicially Created Innocent Shareholder Defense to Constructive Fraudulent Transfer Liability in Failed Leveraged Buyouts

Michael L. Cook
Brad J. Axelrod
Geoffrey S. Frankel

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THE JUDICIALLY CREATED
"INNOCENT SHAREHOLDER" DEFENSE
TO CONSTRUCTIVE FRAUDULENT
TRANSFER LIABILITY IN FAILED
LEVERAGED BUYOUTS

MICHAEL L. COOK*
BRAD J. AXELROD**
GEOFFREY S. FRANKEL***

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* Partner, Skadden, Arps, Slate, Meagher & Flom, New York, N.Y. Mr. Cook is
  also an Adjunct Professor at New York University School of Law, teaching creditors'
  rights, debtors' protection, and bankruptcy. A.B. 1965, Columbia University; J.D. 1968,
  New York University.
** Associate, Skadden, Arps, Slate, Meagher & Flom, New York, N.Y.; A.B. 1985,
*** Associate, Skadden, Arps, Slate, Meagher & Flom, New York, N.Y.; A.B. 1986,
  University of Pennsylvania; J.D. 1991, The George Washington University, National Law
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I. **Introduction**

The corporate shareholders of a leveraged buyout (sometimes re-
ferred to as an LBO) target have long been viewed as the logical de-
fendants in any subsequent fraudulent transfer suit.¹ At least three
courts, however, have recently tried to narrow the scope of fraudulent
transfer law in the leveraged buyout context, limiting creditors' rights
against the old shareholders who were bought out.² We submit that
two of these courts have gone too far and have ignored the language of
the applicable statutes—the Bankruptcy Code,³ the Uniform Fraudu-

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(discussing the development of fraudulent transfer law and its application to LBOs).
² Kaiser Steel Corp. v. Pearl Brewing Co. (*In re Kaiser Steel Corp.*), 952 F.2d 1230 (10th Cir. 1991), cert. denied, 112 S. Ct. 3015 (1992); Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988).
³ Section 548(a) of the Bankruptcy Code provides:
   (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 obli-
   gation 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.

lent Transfer Act (UFTA)\(^4\) and the Uniform Fraudulent Conveyance

4. Section 4 of the UFTA provides:

§ 4. Transfers Fraudulent as to Present and Future Creditors
(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:

(i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.
(b) In determining actual intent under subsection (a)(1), consideration may be given, among other factors, to whether:

(1) the transfer or obligation was to an insider;
(2) the debtor retained possession or control of the property transferred after the transfer;
(3) the transfer or obligation was disclosed or concealed;
(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
(5) the transfer was of substantially all the debtor's assets;
(6) the debtor absconded;
(7) the debtor removed or concealed assets;
(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and
(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.


Section 5 of the UFTA provides:

§ 5. Transfers Fraudulent as to Present Creditors
(a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

(b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.
Act (UFCA). Only Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.), handed down by the Tenth Circuit on December 30, 1991, has a tenable statutory basis for insulating the target's public shareholders from liability. As we will show, however, the Kaiser Steel decision is distinguishable from other cases in which courts have concocted an innocent shareholder defense. In our view, the plain meaning, the underlying policy, and the legislative history of the relevant

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Id. § 5, 7A U.L.A. at 657.
5. Section 3 of the UFCA provides:
§ 3. Fair Consideration
Fair consideration is given for property or obligation,
(a) When in exchange for such property, or obligation, as a fair equivalent
therefor, and in good faith, property is conveyed or an antecedent debt is satisfied,
or
(b) When such property, or obligation is received in good faith to secure a
present advance or antecedent debt in amount not disproportionately small as
compared with the value of the property, or obligation obtained.
Section 4 of the UFCA provides:
§ 4. Conveyances by Insolvent
Every conveyance made and every obligation incurred by a person who is
or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.
Id. § 4, 7A U.L.A. at 474.
Section 5 of the UFCA provides:
§ 5. Conveyances by Persons in Business
Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.
Id. § 5, 7A U.L.A. at 504.
Section 6 of the UFCA provides:
§ 6. Conveyances by a Person About to Incur Debts
Every conveyance made and every obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.
Id. § 6, 7A U.L.A. at 507.
Section 7 of the UFCA provides:
§ 7. Conveyance Made With Intent to Defraud
Every conveyance made and every obligation incurred with actual intent,
as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.
Id. § 7, 7A U.L.A. at 509.
statutes do not even suggest the possibility of this defense. On the contrary, they confirm that, if the facts warrant such relief, the selling shareholders are and should continue to be liable for any fraudulent transfer to them of the target's assets. As Supreme Court Justice Scalia recently noted in *Union Bank v. Wolas,* a preference case, "[i]t is regrettable that we have a legal culture in which [legislative history and policy] arguments [even] have to be addressed (and are indeed credited by a Court of Appeals) [when] the plain text of [a] statute should [make] litigation unnecessary and unmaintainable."8

II. BACKGROUND

A brief summary of the current statutes and their statutory purpose will show why we believe that some courts have gone too far in protecting the selling shareholders from a fraudulent transfer attack after a corporate LBO fails. We will describe what a fraudulent transfer is, what the fraudulent transfer laws were intended to cover, and then discuss recent judicial developments in the LBO context.

III. DEFINITION

A fraudulent transfer "may be roughly defined as an infringement of the creditor's right to realize upon the available assets of his debtor."9 Thus, when a debtor transfers its assets to a third party with either actual or constructive fraudulent intent, those creditors who have been prejudiced may proceed against the transferred assets to satisfy their claims.

IV. PROHIBITION

Fraudulent transfer law "imposes a substantive prohibition: the debtor may not dispose of his property with the intent or the effect of placing it beyond the reach of his creditors."10 Creditors outside of the bankruptcy context and the bankruptcy trustee therefore have the right to undo or avoid a fraudulent transfer of the debtor's assets.11

8. *Id.* at 534 (Scalia, J., concurring).
10. VERN COUNTRYMAN, CASES AND MATERIALS ON DEBTOR AND CREDITOR 127 (2d ed. 1974).
11. See, e.g., 11 U.S.C, § 550(a)(1) (1988) (stating that the trustee may recover fraudulently transferred property from "the initial transferee of such transfer or the entity for whose benefit such transfer was made"); UNIF. FRAUDULENT CONVEYANCE ACT § 9(1)(a), 7A U.L.A. 578 (1985) (stating that the creditor may have the transfer "set
Courts look beyond the technical form of the challenged transfer and scrutinize its effect on the debtor’s estate. The Third Circuit recently focused on the potentially harmful effect of a leveraged buyout from the creditors’ perspective in Mellon Bank, N.A. v. Metro Communications, Inc. After describing the general substantive pattern of a leveraged buyout as the acquisition of a corporate entity “in which a substantial portion of the purchase price paid for the stock of a target corporation is borrowed and where the loan is secured by the target corporation’s assets,” the court stated:

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. . . . 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.

. . . . The target corporation, however, receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation. As legal scholars have noted, the target firm may not at all reflect the Elizabethan deadbeat [covered by the original sixteenth century fraudulent transfer law], but may in fact wind up as the sacrificial lamb.

This excerpt concisely shows why fraudulent transfer law is relevant to a failed LBO.

aside . . . to the extent necessary to satisfy his claim”); UNIF. FRAUDULENT TRANSFER ACT § 8(b), 7A U.L.A. 662 (1985) (“[T]o the extent a transfer is voidable in an action by a creditor . . . , the creditor may recover judgment for the value of the asset transferred . . . or the amount necessary to satisfy the creditor’s claim, whichever is less.”).

12. Meister v. Jamison (In re Jamison), 21 B.R. 380, 382 (Bankr. D. Conn. 1982) (“[A]nalysis 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.”) (citing Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 992 (2d Cir. 1981)); GLENN, supra note 9, § 195, at 262 (“The test is the effect of the conveyance . . . .”).


14. Id. at 645.

15. Id. at 645-46 (citing Jenny B. Wahl & Edward T. Wahl, Fraudulent Conveyance Law and Leveraged Buyouts: Remedy or Insurance Policy?, 16 WM. MITCHELL L. REV. 343, 353 (1990)).
V. CODIFICATION OF FRAUDULENT TRANSFER LAW

A. Statute of Elizabeth

Anglo-American fraudulent transfer law originated with the Statute of Elizabeth. It deemed "void" any conveyance made with intent "to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debts." The Statute of Elizabeth is still "part of the common law or statutory law of every American jurisdiction."

B. Uniform Fraudulent Conveyance Act

Ten jurisdictions retain the Uniform Fraudulent Conveyance Act that was first promulgated in 1918. It not only codifies the Statute of Elizabeth, but also deems voidable those transfers that are constructively, rather than actually, fraudulent. In practice, there is little difference between the application of fraudulent transfer law under the Statute of Elizabeth and under the UFCA. States that have not adopted the UFCA have established similar presumptions and rules by which a court may infer intent.

C. Uniform Fraudulent Transfer Act

The National Conference of Commissioners on Uniform State Laws approved the UFTA in 1984 as a replacement for the UFCA. To date, twenty-nine states have adopted the UFTA, and additional states should adopt it in the near future. As the statute becomes even more widely adopted, it also should have a significant impact on leveraged buyouts. The UFTA has borrowed heavily from the Bankruptcy Code and contains important changes from the UFCA, both in structure and in substance. The most important changes that are relevant to leveraged buyouts include the following: The introduction of provisions making transfers to insiders voidable, generally enhanced creditors' remedies against transferees, the inclusion of a uniform statute of limitations, a new and more objective definition of insolvency than the one

16. 13 Eliz., ch. 5 (1571) (Eng.).
17. Id.
18. 4 Collier on Bankruptcy ¶ 548.02[3], at 548-31 (Lawrence P. King et al. eds., 15th ed. 1991) (citing James A. McLaughlin, Aspects of the Chandler Bill to Amend the Bankruptcy Act, 4 U. Chi. L. Rev. 369, 386 (1937)).
contained in section 101(32) of the Bankruptcy Code, and certain new defenses for fraudulent transfer defendants.

D. Bankruptcy Code

Section 548 of the Bankruptcy Code establishes a federal law of fraudulent transfers and enables the trustee to avoid these transfers if made within one year of bankruptcy. Section 548 is derived from the UFCA and resembles it closely enough that case law under one statute is often applicable to the other. Like the UFCA, the Bankruptcy Code classifies fraudulent transfers as actually fraudulent (i.e., made with actual intent to hinder, delay, or defraud), or constructively fraudulent (i.e., made under specific circumstances deemed fraudulent by law). The most important limitation on the trustee’s power to assert claims under section 548 is the one-year reachback, a material element of the claim. If, for example, a fraudulent transfer was made two years prior to bankruptcy, the trustee would not be able to rely upon section 548 to recover the property transferred.

Section 544(b) of the Bankruptcy Code gives the bankruptcy trustee additional powers in an appropriate case to pursue fraudulent transfers made prior to the one-year reachback contained in section 548. "But whether a particular transfer . . . may be avoided, and under what circumstances, are matters upon which the trustee must look to the appropriate state or federal law as incorporated by section 544(b)." This section “contains no original substantive provisions to determine when the transfers . . . are voidable.” Thus, section 544(b) gives the trustee at least the avoiding powers that an unsecured creditor with an allowable claim might have under applicable law, such as the UFCA or UFTA, where adopted, and any other state fraudulent transfer law. As a practical matter, therefore, state fraudulent transfer law is relevant not only to creditors outside of bankruptcy, but also

24. Id. § 548(a)(2).
25. Id. § 544(b).
26. 4 COLLIER ON BANKRUPTCY, supra note 18, ¶ 544.03[1], at 544-16.
27. Id.
28. Id. at 544-15.
29. Id. at 544-19. A trustee may avoid an entire transfer for the benefit of the debtor’s estate and is not limited to the recovery of any single creditor. Moore v. Bay, 284 U.S. 4 (1931); see also H.R. REP. No. 595, 95th Cong., 1st Sess. 370 (1977).
to trustees in federal bankruptcy cases. Indeed, although trustees may not be able to avoid a transfer under section 548, they may be able to attack the transfer under applicable state law as a result of section 544(b) of the Bankruptcy Code.

VI. APPLICATION OF FRAUDULENT TRANSFER LAW TO LEVERAGED BUYOUTS

Courts and commentators recently debated whether fraudulent transfer law should be applied to leveraged buyouts.\(^3\) Although there seems little doubt today that fraudulent transfer law does apply, that hardly means every leveraged buyout is voidable as a fraudulent transfer.

The Third Circuit recently put the issue in its proper perspective and held that creditors or bankruptcy trustees may avoid a leveraged buyout so long as the facts fit within the statutory requirements.\(^3\)

[T]he statutory language provides no exception for the leveraged buyout transaction. Section 548 [of the Bankruptcy Code] applies to "any transfer of an interest of the debtor in property." The definitional section of the [Code] states that transfer means "every mode, direct or indirect; absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property." This definitional language is sufficiently broad to encompass a leveraged buyout transaction that falls within its terms.\(^3\)

Despite its willingness to apply fraudulent transfer law to a leveraged buyout, the Third Circuit held that the plaintiff creditors' committee had "failed to satisfy its burden of proof in showing that [the debtor] failed to receive reasonably equivalent value . . . and that the

30. See, e.g., Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 645 (3d Cir. 1991) (holding that although the leveraged buyout under consideration was not a fraudulent transfer, "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"), cert. denied, 112 S. Ct. 1476 (1992); Baird, supra note 1, at 139-48 (discussing the application of fraudulent transfer law to LBOs). But see Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175, 179 (C.D. Cal. 1986) (noting that because leveraged buyouts did not exist when fraudulent transfer laws were first enacted, it is problematic to "apply a law with its origins in 16th century England to a financial transaction which did not exist on a large scale until the 1980's") (footnote omitted); see id. (citing Douglas G. Baird & Thomas H. Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 VAND. L. REV. 829, 852 (1985) ("A firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance.").
31. Metro Communications, 945 F.2d at 644-46.
32. Id. at 646 (citation omitted).
loan [in question] rendered it insolvent under section 548(a)(2)." In short, according to the Third Circuit, a leveraged buyout may be voidable as a fraudulent transfer, but the plaintiff must still prove its case. It quite properly found that not every leveraged buyout is voidable per se.

VII. RECENT DEVELOPMENTS IN FRAUDULENT TRANSFER LITIGATION OVER FAILED LEVERAGED BUYOUTS

The Tenth Circuit recently noted that fraudulent transfer attacks on leveraged buyouts are "relatively novel yet increasingly popular." Within the past year alone a number of significant fraudulent transfer attacks have been made on leveraged buyouts. Although some commentators have generalized that courts are hostile to these attacks, we believe that courts are, for the most part, deciding each case on its facts. The Metro Communications case represents an example of a balanced application of the law. One commentator recently stated that the decision "strongly favors the secured lender," and "reflects clear judicial hostility to the application of fraudulent conveyance theory to LBO transactions." We do not, however, read the case that way. In our view, the court properly emphasized the fact-intensive nature of fraudulent transfer litigation, particularly when the material issues are reasonably equivalent value, adequate capitalization, and insolvency.

A brief summary of the most recent cases shows just how fact-intensive this litigation can be. For example, the district court in Moody v. Security Pacific Business Credit, Inc. rejected the trustee's claim that a 1981 leveraged buyout of Jeannette Corporation was a fraudulent transfer under the Pennsylvania version of the UFCA and section 548 of the Bankruptcy Code. After finding that the transaction before it was not "intentionally fraudulent," the court also dismissed the trustee's constructive fraud claims, reasoning as follows:

While we find that the transaction was without fair consideration to Jeannette [the corporate target whose assets secured the acquisition debt], we conclude that Jeannette was not rendered insolvent by it. Similarly, we conclude that Jeannette was not engaged in a business

33. Id. at 650.
36. Id. at 3.
38. Id. at 964.
for which the capital remaining in its hands after the July 31, 1981, transaction was an unreasonably small capital.49

According to the court, the corporate target’s financial problems were the result of a continuing recession, intense competition, and mismanagement.

The court also found no requirement that “participants in a leveraged buyout . . . become insurers of the company’s ultimate success,”46 but that statement is hardly a blanket condemnation of fraudulent transfer attacks on failed leveraged buyouts. Like Metro Communications, Moody confirms that creditors or a bankruptcy trustee must prove insolvency or inadequate capitalization when those facts are a material element of the claim.

In Murphy v. Meritor Savings Bank (In re O’Day Corp.)41 the bankruptcy court found no actual fraud, but permitted the trustee to avoid an LBO as a constructively fraudulent transfer because the debtor did not receive reasonably equivalent value before it became obligated to repay the LBO indebtedness. The acquisition loan proceeds had been immediately transferred to the selling shareholder. According to the court, new management or a new revolving credit facility did not constitute “fair consideration.”42 The Murphy court also found that the corporate target was rendered insolvent and was inadequately capitalized as a result of the LBO. According to the court, the target would have been left with no working capital at all unless it had deferred the payment of trade payables.43 Indeed, the court found that from the outset of the transaction, the acquisition lender had intended that the corporate target would stretch its accounts payable past their due dates.44

Applying the balance sheet approach to determine insolvency, the court valued each asset of the corporate debtor on an individual basis. After giving effect to the LBO, the court found that the target was insolvent.45

The court’s finding of inadequate capitalization also was based on the factual record. The corporate target had been unable to meet its business projections because their earnings assumptions greatly ex-

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40. Id. at 1000.
42. Id. at 394-95. But see Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 647 (3d Cir. 1991) (rejecting the bankruptcy court’s analysis as “flawed” and holding that the “ability to borrow money has considerable value in the commercial world”), cert. denied, 112 S. Ct. 1476 (1992).
43. Murphy, 126 B.R. at 384.
44. Id. at 384, 408.
45. Id. at 402-07.
ceeded "the actual average experienced over the period of reference." Because the debtor's business was cyclical in nature and because the "projections prepared by the Bank had no cushion, no room for error," the debtor was left with an unreasonably small capital as a result of the LBO.

Moody and Murphy were decided after trial, with an intensive review of the facts. Although there now seems little doubt that fraudulent transfer law should be applied to a failed LBO, courts have properly scrutinized the facts to determine whether the target’s creditors were prejudiced by the target’s assuming the acquiring shareholder’s acquisition obligation. In short, the ultimate result will often turn on the substantive economic effect of the LBO.

VIII. MAJOR EXAMPLES OF JUDICIAL CREATIVITY

Some important courts recently have stretched to insulate the selling shareholders in an LBO from fraudulent transfer liability. In two of these reported decisions, Kupetz v. Wolf and Wieboldt Stores, Inc. v. Schottenstein (Wieboldt I), shareholders argued that the LBO's formal structure should be respected, not collapsed so as to hold them liable. In two other decisions, Kaiser Steel Corp. v. Charles Schwab & Co. (Kaiser I) and Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.) (Kaiser II), shareholders claimed that payments for their shares constituted "settlement payments" under section 546(e) of the Bankruptcy Code and therefore were exempt from the trustee's section 548 avoiding power. We will examine each of these decisions critically to see how far some courts have strayed from the text of the relevant statutes to reach a desired result.

46. Id. at 407.
47. Id. at 412.
49. 845 F.2d 842 (9th Cir. 1988).
50. 94 B.R. 488 (N.D. Ill. 1988).
51. 913 F.2d 846 (10th Cir. 1990).
A. Kupetz v. Wolf

1. Facts

The Ninth Circuit in Kupetz v. Wolf\textsuperscript{54} refused to collapse or go behind the formal structure of an LBO to impose fraudulent transfer liability on the two selling shareholders of a closely held corporate debtor.\textsuperscript{55} In July 1979, two fifty percent owners of Wolf & Vine, a mannequin manufacturing company, sold their shares for three million dollars ($1.1 million in cash and $1.9 million in installments over two years) to Little Red Riding Hood, a Wisconsin corporation formed for the purpose of acquiring Wolf & Vine. Little Red Riding Hood financed its acquisition with a $1.1 million loan and $1.9 million in letters of credit from Continental Illinois National Bank, and Wolf & Vine pledged its assets to secure the financing. Wolf & Vine subsequently was unable to service its debt and sought bankruptcy relief in December 1981.\textsuperscript{56}

The trustee alleged that on these facts payments to the selling shareholders were voidable both as fraudulent conveyances under the then applicable sections 4 and 5 of the California UFCA and as payments made within one year of bankruptcy under section 548 of the Code.\textsuperscript{57} Specifically, the trustee asserted that the shareholders were paid without giving fair consideration or reasonably equivalent value to the corporate debtor at a time when the debtor had been rendered insolvent or inadequately capitalized.\textsuperscript{58} The district court had granted summary judgment and dismissed the claims based on insolvency because it found that "there was no creditor whose claim was in existence on the date of the [LBO], July 31, 1979."\textsuperscript{59} It therefore "directed a verdict in favor of the selling shareholders on the remaining claims."\textsuperscript{60} Significantly, the court emphasized that "[t]here was no evidence" in the record that the selling shareholders "knew how the purchase of their stock was to be financed."\textsuperscript{61}

2. Holding

The Ninth Circuit affirmed the trial court's refusal, on these facts,

\textsuperscript{54} 845 F.2d 842 (9th Cir. 1988).
\textsuperscript{55} Id. at 847.
\textsuperscript{56} Id. at 844.
\textsuperscript{57} Id. at 844-45.
\textsuperscript{58} Id. at 844.
\textsuperscript{59} Id.
\textsuperscript{60} Id.
\textsuperscript{61} Id. at 843.
to impose fraudulent transfer liability on the selling shareholders.\textsuperscript{62} Although the acquisition lender, a bank, and the acquiror previously had settled with the trustee,\textsuperscript{63} the court found no evidence that the selling shareholders actually intended to defraud Wolf & Vine's creditors.\textsuperscript{64} The court therefore reasoned that it would be inappropriate to apply the constructive fraud provisions of section 548: "Although lack of fraudulent intent does not bar a fraudulent conveyance claim under a constructive intent provision of the law, we hesitate to utilize constructive intent to frustrate the purposes intended to be served by what appears . . . to be a legitimate LBO."\textsuperscript{65} As discussed below, the premise of this conclusion—the lack of evidence of actual intent by the shareholders—is irrelevant.

3. Reasoning

The court explained that "the selling shareholders neither knew nor had reason to know that [the buyer] planned a leveraged acquisition of [the debtor target]."\textsuperscript{66} Although the court recognized that, in some cases, selling shareholders have a duty to investigate the nature of a buyout transaction,\textsuperscript{67} it did not find that the shareholders in \textit{Kupetz} had breached such a duty.\textsuperscript{68}

\textsuperscript{62} Id. at 847.
\textsuperscript{63} Id. at 844. The trustee's complaint asserted claims against the lender and acquiror based on civil conspiracy.
\textsuperscript{64} Id. at 848.
\textsuperscript{65} Id.
\textsuperscript{66} Id.
\textsuperscript{67} Id. at 848 n.12 ("In some circumstances . . . controlling shareholders . . . are obligated to make certain that the business's creditors are not harmed by transactions in which the business enters.") (citing Pepper v. Litton, 308 U.S. 295, 306-07 (1939); Brown v. Presbyterian Ministers Fund, 484 F.2d 998, 1005 (3d Cir. 1973)).
\textsuperscript{68} In Lippi v. City Bank, 955 F.2d 599 (9th Cir. 1992), the Ninth Circuit reaffirmed this analysis, but found that the insider selling shareholders may still be subject to fraudulent transfer liability because of their actual or constructive knowledge of the leveraged nature of the transaction. The bankruptcy trustee in \textit{Lippi} sought to recover as fraudulent transfers the consideration paid to two insider shareholders in a leveraged buyout of the debtor.

The district court had granted the shareholders' motion for summary judgment, finding that "they received their transfers in good faith and for value and thus came within the safe harbor of section 550(b)(1)." \textit{Id.} at 611. The Ninth Circuit reversed. It found that genuine issues of material fact existed about "what [the selling shareholders] knew or should have known as controlling shareholders." \textit{Id.} at 614. Specifically, the court found that "[t]he materials submitted at summary judgment indicate that the selling shareholders in this case fall somewhere along the spectrum between the 'innocent' \textit{Wieboldt} shareholders and the controlling shareholders who were aware of the financial condition of the company and of the nature of the LBO and its effect on the company." \textit{Id.} at 612. Accordingly, the court reversed the district court's judgment that, as a matter
Clearly there was a screening of prospective purchasers. Several purchasers were rejected outright as not being financially sound enough to make the acquisition. Of greater importance is the fact that [the selling shareholders] knew that [the purchaser] was backed by [a bank] which had agreed to issue a letter of credit to back the transaction.\textsuperscript{69}

To bolster this finding, the court emphasized the "unchallenged evidence that [one of the two selling shareholders] did not know that" the buyer had leveraged the debtor's assets, but retreated somewhat by acknowledging that "it was not clear from the record" what the other selling shareholder knew.\textsuperscript{70}

The Ninth Circuit further reassured itself by noting "the absence of presently existing creditors with claims that arose prior to the LBO."\textsuperscript{71} In effect, the court found no one with standing under section 4 of the UFCA to complain of a fraudulent transfer because "all existing creditors had the opportunity to gain the knowledge of Wolf & Vine's financial status and its heavy debt structure prior to extending credit to it."\textsuperscript{72} Finally, after emphasizing the structure of the Wolf & Vine LBO, the court reiterated that it found no evidence that the selling shareholders acted in bad faith or that they took unfair advantage of the corporation.\textsuperscript{73} Because the acquirer paid more than one third of the purchase price at the closing and the bank's irrevocable letter of credit secured the remainder,\textsuperscript{74} the LBO supposedly "bore the indicia of a 'straight' sale rather than the marks of a serial redemption by Wolf & Vine of its own stock."\textsuperscript{75} Again, the court emphasized that it might have considered the payments made to the selling shareholders fraudulent transfers "had the 'selling' shareholders known, or should have known, that their stock was being paid for by an asset depleting transfer by Wolf & Vine."\textsuperscript{76} Because the terms of the transaction seemed fair, at least among the buying and selling shareholders, the Ninth Circuit affirmed the district court's decision not to impose fraudulent transfer liability on the selling shareholders under state law or the

\textsuperscript{69}Kupetz, 845 F.2d at 848 (citation omitted). The Ninth Circuit apparently concluded that the selling shareholders, who knew that they were being paid, in part, with bank letters of credit, were not on notice that the transaction was leveraged.

\textsuperscript{70}Id.

\textsuperscript{71}Id. at 849.

\textsuperscript{72}Id.

\textsuperscript{73}Id. at 850 ("As already mentioned, we are influenced by the formal structure of this LBO.").

\textsuperscript{74}Id.

\textsuperscript{75}Id.

\textsuperscript{76}Id.
Bankruptcy Code.\textsuperscript{77}

4. Critique

The reasoning of \textit{Kupetz} may have superficial appeal as a matter of policy. But can \textit{Kupetz} be reconciled with the language of the UFCA and the Bankruptcy Code? We submit that it cannot. Will other courts follow \textit{Kupetz}? Only if they ignore the text of the relevant statutes and impose their own policy views, as one district court did seven months later in \textit{Wieboldt I}. Simply stated, the Ninth Circuit's reasoning in \textit{Kupetz} will not withstand careful scrutiny.

First, neither section 4 of the UFCA\textsuperscript{78} nor section 548(a)(2) of the Bankruptcy Code\textsuperscript{79} makes intent of the transferor or transferee an element of the trustee's claim. Rather, these two substantively similar provisions focus exclusively on objective facts: (a) the debtor's insolvency, and (b) the debtor's receipt of "reasonably equivalent value"\textsuperscript{80} or "fair consideration."\textsuperscript{81} By relying on external criteria, these statutes enable courts to impose liability based on the transaction's harmful effect on creditors rather than the parties' subjective intent.\textsuperscript{82}

The Ninth Circuit in \textit{Kupetz} conveniently sidestepped section 548 of the Bankruptcy Code, concluding that there were no "creditors with claims that arose prior to the LBO."\textsuperscript{83} Although it is true that only creditors with claims arising prior to the challenged transfer may bring a fraudulent transfer claim under section 4 of the UFCA,\textsuperscript{84} section 548

\begin{flushright}
\textsuperscript{77} Id. At the beginning of the opinion, the court explained its rationale for applying the same analysis to the state and federal fraudulent transfer claims. "Inasmuch as the purpose of California fraudulent conveyance law in no way differs from that of Bankruptcy Code § 548, the discussion applicable to the first disposits of claims under the latter as well." \textit{Id}. at 845 (footnote omitted). As discussed below, however, the court failed to grasp a material difference between the statutory claims after bankruptcy ensues. \textit{See infra} text accompanying notes 84-86.

\textsuperscript{78} \textit{See supra} note 5 and accompanying text.

\textsuperscript{79} \textit{See supra} note 3 and accompanying text.


\textsuperscript{81} \textit{UNIF. FRAUDULENT CONVEYANCE ACT} § 4, 7A U.L.A. 474 (1985).

\textsuperscript{82} \textit{JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY} § 236, at 271 (1956) ("Section 5 [of the UFCA] sets up external standards in relation to a transfer without a fair consideration, leaving the transferor with an unreasonably small capital for his business. Section 4 [of the UFCA] sets up a purely objective standard of a transfer without fair consideration rendering the transferor insolvent if he is not already insolvent."); \textit{see also UNIF. FRAUDULENT CONVEYANCE ACT} prefatory note, 7A U.L.A. 640 (1985) ("Both Acts [the UFCA and the newer UFTA] render a transfer made . . . without adequate consideration to be constructively fraudulent—\textit{i.e.}, without regard to the actual intent of the parties . . . .")

\textsuperscript{83} \textit{Kupetz} v. \textit{Wolf}, 846 F.2d 842, 849 (9th Cir. 1988).

\textsuperscript{84} Under § 4 of the UFCA conveyances made without fair consideration are fraud-
does not refer to, or depend on the existence of, preexisting creditors. The bankruptcy trustee has the independent power to avoid fraudulent transfers under section 548 regardless of whether pre-LBO or post-LBO creditors exist. By using the same analysis that is applicable to section 4 of the UFCA, however, the Ninth Circuit simply read section 548(a)(2) out of the Bankruptcy Code.85

The court’s flawed analysis becomes more serious when it confronts section 5 of the UFCA, on which the trustee also relied in Kupetz. That section enables creditors that existed at the time of the LBO and “other persons who become creditors during the continuance of [the debtor’s] business”86 to attack a transaction if the other elements of a claim exist (i.e., inadequate capitalization and lack of fair consideration). As the Ninth Circuit acknowledged, “[t]he California courts do not seem to have doubted the plain language of the statute that later-arising creditors may attack conveyances that meet the other requirements of the statute.”87 Nevertheless, the court overrode or modified the terms of section 5 of the UFCA because “[f]uture creditors [either] knew or could easily have found out about the transaction.”88 Reasoning that it “would not be just”89 to apply the terms of the statute, the court explained that “[i]n the context of this well-publicized LBO, this court will not permit later-arising creditors to attack an LBO purchase transaction . . . under section five of the UFCA.”90

Aside from improperly ignoring California law,91 the court rested its modification of the UFCA on policy grounds, something other courts have properly refused to do.92

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85. The trustee was relying on § 548(a)(2) of the Bankruptcy Code to recover “the 1981 payments [as] fraudulent transfers” because they were made within one year of bankruptcy. Kupetz, 845 F.2d at 845. The selling shareholders received almost $1.6 million during this period. Id. at 844.


87. Id. at 849-50 n.16.

88. Id. at 850.

89. Id. at 850 n.16.

90. See Butner v. United States, 440 U.S. 48, 55 (1979) (holding that state law concerning security interests must be respected and stating that “[u]nless some federal interest requires a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding”); Justice v. Valley Nat’l Bank, 849 F.2d 1078, 1084 (8th Cir. 1988) (“[S]tate laws are suspended only to the extent of actual conflict with the federal bankruptcy system.”) (citing Johnson v. First Nat’l Bank, 719 F.2d 270, 273 (8th Cir. 1983), cert. denied, 465 U.S. 1012 (1984)).

91. See Butner v. United States, 440 U.S. 48, 55 (1979) (holding that state law concerning security interests must be respected and stating that “[u]nless some federal interest requires a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding”); Justice v. Valley Nat’l Bank, 849 F.2d 1078, 1084 (8th Cir. 1988) (“[S]tate laws are suspended only to the extent of actual conflict with the federal bankruptcy system.”) (citing Johnson v. First Nat’l Bank, 719 F.2d 270, 273 (8th Cir. 1983), cert. denied, 465 U.S. 1012 (1984)).

92. See United States v. Tabor Court Realty Corp. (Gleneagles), 803 F.2d. 1288,
Finally, the court's reliance on the supposed good faith of the selling shareholders is irrelevant to the trustee's fraudulent transfer claims. The defendants in Kupetz apparently conceded that they gave no consideration to the debtor in exchange for the payments they received; no mention of such a defense is made in the court's opinion. Because "'[g]ood faith' is a defense to a fraudulent [transfer] attack only to the extent of fair consideration" to the debtor, the Ninth Circuit merely added to the confusion by throwing in its irrelevant discussion of good faith.

B. Wieboldt I

1. Facts

A few months later, in Wieboldt I, the United States District Court for the Northern District of Illinois selectively applied fraudulent transfer law to certain selling shareholders in an LBO. On December 20, 1985, WSI Acquisition Corporation (WSI), a corporation formed for the purpose of acquiring Wieboldt Stores, Inc. (Wieboldt), purchased ninety-nine percent of Wieboldt's outstanding shares through a so-called tender offer. WSI had financed the acquisition with three loans that were secured by substantially all of Wieboldt's real estate holdings. The loan proceeds went directly from the lenders to WSI and then to the tendering shareholders. Subsequently, on September 24, 1986, just nine months later, Wieboldt filed a petition for relief under Chapter 11 of the Bankruptcy Code.

2. Reasoning

The court first grouped the selling shareholders into two categories: (1) insider and controlling shareholders, and (2) other shareholders who owned and tendered more than one thousand shares. The

1297 (3d Cir. 1986) ("If the UFCA is not to be applied to leveraged buy-outs, it should be for the state legislatures, not the courts, to decide.")}, cert. denied, 483 U.S. 1005 (1987).

93. BAIRD, supra note 1, at 143.
94. 94 B.R. 488 (N.D. Ill. 1988).
95. Id. at 500.
96. Id. at 495.
97. Id. at 495-96.
98. Id. at 496. On that very day certain creditors had filed an involuntary Chapter 7 petition against Wieboldt, id., but that petition was superseded by the Chapter 11 petition under 11 U.S.C. § 706(a).
99. Id. at 493. The lenders who financed the tender offer were also defendants, but the claims against them are beyond the scope of this Article. For more on this subject,
court then considered the alternative views of an LBO transaction for the purpose of applying the fraudulent transfer laws. On the one hand, as the shareholders contended, the transfer of funds from a lender to the acquisition corporation WSI and then to the tendering shareholders constituted one transaction, while the hypothecation of the assets of the debtor Wieboldt to the lender in exchange for financing constituted a distinct transaction. The court noted that "[u]nder this view, [the shareholders] did not receive the debtor's property during the tender offer but rather received [the acquisition corporation's] property in exchange for their shares." On the other hand, as the debtor in possession argued, the entire LBO transaction could be "collapsed" into one "aggregate transaction" in order to impose fraudulent transfer liability on the selling shareholders:

This approach requires the court to find that the persons and entities receiving the conveyance were direct transferees who received "an interest of the debtor in property" during the tender offer/buyout, and that WSI and any other parties to the transactions were "mere conduits" of Wieboldt's property. If the court finds that all the transfers constituted one transaction, then defendants received property from Wieboldt and Wieboldt has stated a claim against them.

At this point in its reasoning, the court made no distinction among the various defendant selling shareholders.

Relying on the Ninth Circuit's decision in Kupetz v. Wolf and the Third Circuit's decision in United States v. Tabor Court Realty Corp., the court collapsed the entire LBO transaction to impose fraudulent transfer liability only on the insider and controlling shareholders. The complaint clearly alleged that these participants in the LBO negotiations attempted to structure the LBO with the requisite knowledge and contemplation that the full transaction, tender offer, and LBO be completed.

Important to the court, based in part on the flawed analysis in Kupetz, was "the knowledge or intent of the parties involved in the transaction." The court was unwilling, however, to "collapse" the

see Baird, supra note 1, at 145-48.
100. Wieboldt I, 94 B.R. at 500.
101. Id.
102. Id.
103. Id.
104. 845 F.2d 842 (9th Cir. 1988).
106. Wieboldt I, 94 B.R. at 502-03.
107. Id. at 502.
108. Id. Although Kupetz is consistent with Tabor Court to the extent that both purported to apply fraudulent transfer laws to LBOs, the Ninth Circuit's further distinc-
transaction to find that payments to the noncontrolling shareholders were fraudulent.109 Wieboldt does not allege that [these] shareholders were aware that WSI's acquisition encumbered virtually all of Wieboldt's assets. Nor is there an allegation that these shareholders were aware that the consideration they received for their tendered shares was Wieboldt property. In fact, the complaint does not suggest that [these] shareholders had any part in the LBO except as innocent pawns in the scheme.110

The court asserted that its conclusion was consistent with the underlying "purpose" of fraudulent transfer laws111—explaining that payments made to the noncontrolling shareholders either constituted, or were analogous to, transfers made to "subsequent transferees" under section 550(b) of the Bankruptcy Code112 because the noncontrolling shareholders received the payments "in good faith, for value, and without knowledge that the original transfer was voidable."113 "[T]he [noncontrolling] shareholders are not direct transferees of Wieboldt property. From their perspective, WSI was the direct transferee of Wieboldt property and the shareholders were merely indirect transferees because WSI was an independent entity in the transaction."114 Accordingly, the court denied the insiders' and controlling shareholders' motions to dismiss, but dismissed Wieboldt's fraudulent transfer claims against all other shareholders.115

3. Critique

The Wieboldt I court's partial focus on the substance of the LBO, rather than its form, was sound.116 However, its reliance on Kupetz's knowledge and good faith test to exonerate the public shareholders—the purportedly "innocent pawns in the scheme"117—has no basis in the applicable statutes. To insulate the public shareholders from liability, the court exalted form over substance when it asserted that WSI,

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109. Id. at 503.
110. Id.
111. Id.
113. Wieboldt I, 94 B.R. at 503.
114. Id.
115. Id. at 504.
116. "The court in Wieboldt captured one of the most important features of fraudulent conveyance law: What matters is the substance of the transaction, not its form." BAIRD, supra note 1, at 144.
117. Wieboldt I, 94 B.R. at 503.
not Wieboldt, was the source of their cash payments. Indeed, on the same page of its opinion, the court found that "WSI served mainly as a conduit for the exchange of assets and loan proceeds between LBO lenders and Wieboldt and for the exchange of loan proceeds and shares of stock between the LBO lenders and the insider and controlling shareholders." There was also no reason for the court to view the LBO from the public shareholders' "perspective." Fraudulent transfer law provides creditors with the remedy of avoidance when the debtor transfers its property "with the intent or the effect of placing it beyond the reach of his creditors." As in Kupetz, the court created by judicial fiat a new defense for the selling shareholders in an LBO. Practical limitations may exist on a trustee's pursuit of thousands of diverse public shareholders, but none of the applicable statutes grants them a safe harbor based on innocence, lack of knowledge, or good faith.

C. Kaiser I and Kaiser II

1. Facts

The leveraged acquisition of Kaiser Steel Corporation (Kaiser) has generated protracted fraudulent transfer litigation in the context of Kaiser's bankruptcy reorganization case. In 1984 Kaiser's shareholders approved a plan to sell all of Kaiser's outstanding shares to an acquisition group, which would then merge with Kaiser. Shares of Kaiser were converted into the right to receive both cash and shares in the postmerger corporation. Financing for the acquisition came in part from Kaiser's cash reserves and in part from a bank loan secured by Kaiser's assets.

Kaiser's shareholders included customers of Charles Schwab & Company (Schwab), a brokerage firm. The Depository Trust Company, a securities clearinghouse, had possession of the shareholders' stock certificates. It tendered the shares to Kaiser's disbursing agent in exchange for cash and shares in the postmerger corporation. After receiving this consideration from the Depository Trust Company, Schwab credited its customers' accounts. When Kaiser subsequently sought bankruptcy reorganization relief in February 1987, it sued as a Chapter

118. Id.
119. Id.
120. Id.
121. COUNTRYMAN, supra note 10, at 127.
122. BAIRD, supra note 1, at 145.
124. Id.
11 debtor in possession to recover these payments as fraudulent transfers on behalf of its creditors.\textsuperscript{125}

2. Reasoning

In Kaiser I\textsuperscript{126} the Tenth Circuit held that the payments to Schwab, a stockbroker, were "settlement payments," as defined in section 741(8) of the Code,\textsuperscript{127} and therefore were insulated from a fraudulent transfer attack under section 546(e) of the Code.\textsuperscript{128} The court noted that "[t]he definition [of settlement payments] in section 741(8), while somewhat circular, is 'extremely broad' in that it clearly includes anything which may be considered a settlement payment."\textsuperscript{129} Moreover, the court found that its interpretation of section 741(8) was "consistent with the legislative intent behind § 546 to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions.' "\textsuperscript{130} Finally, the court stated that "interpreting 'settlement payment' to include the transfer of consideration in an LBO is consistent with the way 'settlement' is defined in the securities industry. Settlement is 'the completion of a securities transaction.'"\textsuperscript{131} Accordingly, the Tenth Circuit affirmed the district court's dismissal of the fraudulent transfer claim against Schwab.\textsuperscript{132}

During the pendency of Schwab's appeal to the Tenth Circuit, other financial intermediaries, also fraudulent transfer defendants, moved for summary judgment in the district court, arguing that the payments made to them also constituted settlement payments under section 546(e).\textsuperscript{133} During oral argument on the defendant financial intermediaries' motions, Kaiser apparently conceded that if section 546(e) insulated a broker from liability, it also would insulate the broker's customers.

\textsuperscript{125} Id. at 848. A Chapter 11 debtor in possession has "all the rights, . . . powers, . . . and duties . . . of a trustee." 11 U.S.C. § 1107(a) (1988).
\textsuperscript{126} 913 F.2d 846 (10th Cir. 1990).
\textsuperscript{127} Id. at 846 (10th Cir. 1990).
\textsuperscript{128} Id. at 846 (10th Cir. 1990).
\textsuperscript{129} Kaiser I, 913 F.2d at 846 (quoting Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n (In re Bevill, Bresler & Schulman Asset Management Corp.), 878 F.2d 742, 751 (3d Cir. 1989)).
\textsuperscript{130} Id. (quoting Kaiser Steel Resources, Inc. v. Jacobs (In re Kaiser Steel Corp.), 110 B.R. 514, 522 (D. Colo. 1990), aff'd sub nom. Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846 (10th Cir. 1990)).
\textsuperscript{131} Id. at 849 (quoting ALLAN H. PESSIN & JOSEPH A. ROSS, WORDS OF WALL STREET: 2000 INVESTMENT TERMS DEFINED 227 (1983)).
\textsuperscript{132} Id. at 860.
\textsuperscript{133} Appellees Consolidated Brief and Reply to Order to Show Cause at 6, Kaiser I (No. 90-1078).
"If by chance this court rules today that these payments were payments to a stockbroker, therefore barring a suit by Kaiser against the stockbrokers, those very same payments are payments by a stockbroker to the beneficial interest . . . .

....

[W]e have thought long and hard about how you could differentiate between the payment to the stockbroker and the payment by a stockbroker.134

Apparently as a result of this concession, the district court announced that it would consider, sua sponte, whether to dismiss Kaiser's claims against the selling shareholders on the ground that payments made to them were settlement payments. After oral arguments on that issue, the court dismissed Kaiser's fraudulent transfer claims against the selling shareholders.138

In Kaiser II138 the Tenth Circuit affirmed the district court's dismissal of fraudulent transfer claims against the Kaiser selling shareholders. Initially, the court reiterated its conclusion in Kaiser I that section 741(8)'s definition of settlement payment is "'extremely broad.'"137 As the court stated, "'[t]he clear aim of the definition is to encompass all 'settlement payments' commonly used in the securities trade.'"138 According to the court, payments made to selling shareholders in an LBO are "'customer-side settlements,'" as that term is understood in the securities industry.139 The court therefore considered itself bound to apply section 546(e) to these payments because they constituted "'settlement payment[s]' as [that term] is plainly understood within the securities industry."140 The court's conclusion is based

134. Id. (quoting Transcript of Oral Argument for Motion for Summary Judgment at 34-35 (July 24, 1990)).


137. Id. at 1237 (citing Kaiser I, 913 F.2d at 848 (quoting Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n (In re Bevill, Bresler & Schulman Asset Management Corp.), 878 F.2d 742, 751 (3d Cir. 1989))).

138. Id. (citing Kaiser I, 913 F.2d at 848). The court cited the congressional hearings concerning § 741(8) in support of this conclusion. Id. (quoting Bankruptcy of Commodity and Security Brokers: Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary, 97th Cong., 1st Sess. 372 (1981) ("'This new section is added to provide a definition for the term "settlement payment" to include the several types of settlement payments commonly used in the securities industry.'"). This is not the only instance when the court departed from its otherwise orthodox statutory construction in favor of supporting legislative history. See infra notes 145-46 and accompanying text.

139. Kaiser II, 952 F.2d at 1238.

140. Id. at 1237 (citing McCarthy v. Bronson, 111 S. Ct. 1737, 1740 (1991); Shell Oil Co. v. Iowa Dep't of Revenue, 488 U.S. 19, 25 (1988)).
on a literal reading of the relevant statutory language. For example, the court rejected Kaiser’s argument that Congress intended that section 546(e) apply only to settlement payments made in routine securities transactions, and not in the unusual context of an LBO. Applying a familiar canon of statutory construction, the court held that Congress’s failure to include this exception in sections 546(e) and 741(8) must be presumed to be purposeful.\textsuperscript{141} Accordingly, the court refused to find an exception to section 546(e) for settlement payments made in LBOs. “While the leveraged buy out may not be a ‘routine’ securities trade, . . . 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.”\textsuperscript{142}

The court likewise rejected Kaiser’s assertion that the omission of equity security holders from the parties that are listed in section 546(e) reflects Congress’s intent to exclude payments “‘by or to’” selling shareholders from protection.\textsuperscript{143} The court stated that “Kaiser has given us no reason to replace the unambiguous language of the provision with clues garnered from the legislative history.”\textsuperscript{144} Although its decision is grounded in section 546(e)’s plain language, the court apparently could not resist mentioning why, in its view, its conclusions were consistent with section 546(e)’s legislative policy. “For the public customer, [treating payments made to all selling shareholders, including shareholders who sold in an LBO] is justified . . . by Congress’ policy interests in promoting finality and ‘in promoting speed and certainty in resolving complex financial transactions.’”\textsuperscript{145} Similarly, the court found support for its conclusion, as it pertained to a “broker trading on its own account,” in “Congress’ policy of promoting the health of the clearance and settlement system, which by all accounts is one of the fundamental aims of the 546(e) exemption.”\textsuperscript{146}

\textsuperscript{141} Id. at 1239 (“[W]hile Congress might have chosen otherwise, neither § 546(e) or § 741(8) is on its face limited to ‘securities contracts,’ as defined by the Code, or to ‘trades,’ as defined by Kaiser.”) (citing Gozlon-Peretz v. United States, 111 S. Ct. 840, 846-47 (1991) (“[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.”) (brackets supplied by court) (quoting Russello v. United States, 464 U.S. 16, 23 (1983))).

\textsuperscript{142} Id. at 1239-40.

\textsuperscript{143} Id. at 1240 (quoting 11 U.S.C. § 546(e) (Supp. II 1990)).

\textsuperscript{144} Id. at 1240-41 (citing Miller v. Commissioner, 836 F.2d 1274, 1283 (10th Cir. 1988)).


\textsuperscript{146} Id. (citing Kaiser I, 913 F.2d 846, 848-49 (10th Cir. 1990)).
3. Critique

The Tenth Circuit's reasoning in Kaiser I and Kaiser II is consistent with section 546(e)'s plain language, which provides no exception for payments made to selling shareholders. The court's refusal to delve into section 546(e)'s murky legislative history in the hope of finding support for a favored outcome, therefore, was a proper exercise of statutory construction.147

There are, to be sure, persuasive policy arguments against the Kaiser II result. For example, insulating payments that are made to public shareholders from fraudulent transfer attack arguably does nothing to promote stability in the securities industry's clearance and settlement process.148 Recovery of these payments, therefore, would not appear to threaten the integrity of upstream brokerages. The plain language of section 546(e) does not, however, give effect to this argument. Thus, the Tenth Circuit's holding in Kaiser II represents a judicially responsible result.

D. Wieboldt II

1. Reasoning

The district court in Wieboldt II149 refused to extend the protection of section 546(e) to selling shareholders who received payment from certain securities clearinghouses. As a threshold matter, the court reasoned that "the language of the statute is not dispositive in determining whether Section 546(e) bars the Trustee's claims."150 The court also found that section 741(8)'s definition of settlement payment is "circular" and "cryptic[]."151

The court therefore looked to the relevant legislative history.

Congress exempted settlement payments in the commodities (and later the securities) industry out of concern that the bankruptcy of one party in the clearance and settlement chain could spread to other parties in that chain. . . .

In the instant case, however, requiring the [selling shareholders] to return to the Trustee payments they received from WSI through

147. See Union Bank v. Wolas, 112 S. Ct. 527, 531 (1991) ("The fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning.") (citing Toibb v. Radloff, 111 S. Ct. 2197 (1991)).


150. Id. at 663.

151. Id.
[WSI's disbursing agent] poses no significant threat to those in the clearance and settlement chain. Neither [the disbursing agent] nor any other financial intermediary purportedly involved in the clearance and settlement process would be meaningfully affected by such a judicial order.\footnote{195}

Accordingly, the court denied the selling shareholders’ motion to dismiss.\footnote{163}

2. Critique

The court’s refusal to apply section 546(e) to payments that are made to selling shareholders is understandable, if not defensible, in view of the Bankruptcy Code’s treatment of settlement payments. On the one hand, section 546(e) provides a relatively straightforward mandate that settlement payments are exempt from fraudulent transfer attacks.\footnote{164} The court might, therefore, have concluded that it, like the Third Circuit in \textit{Tabor Court}, was duty-bound to apply the statute literally.\footnote{165} Instead, the court found that section 741(8)’s somewhat ambiguous definition of settlement payment invited a review of the legislative history behind section 546(e)’s plain language. In its analysis of that history, the court drew heavily from a student note which argued that payments made to selling shareholders were never intended to be deemed settlement payments.\footnote{166} As the note accurately pointed out, the congressional hearings concerning section 546(e) reveal a desire to protect the securities and commodities industries’ clearing and settlement process from the instability that might result if margin and settlement payments could later be attacked under the Bankruptcy Code.\footnote{157} The note concluded that protecting payments made to selling shareholders simply does not advance this policy. “The inviolability of payments to shareholders is simply not basic to the operation of the clearance and settlement systems. Those systems will be only incidentally affected, if at all, if former shareholders are required to return payments they received in an LBO.”\footnote{158}

Although this analysis seems persuasive—indeed, it persuaded the court in \textit{Wieboldt II}—it overlooks a part of the relevant legislative history that suggests a contrary intent. The congressional comments ac-

\begin{footnotes}
\footnote{152. \textit{Id.} at 664-65 (citation omitted) (footnotes omitted).}
\footnote{153. \textit{Id.} at 669.}
\footnote{154. 11 U.S.C. § 546(e) (Supp. II 1990).}
\footnote{155. \textit{See supra} note 92 and accompanying text.}
\footnote{156. \textit{See} Garfinkel, \textit{supra} note 52, at 65-68.}
\footnote{157. \textit{Id.} at 61-65.}
\footnote{158. \textit{Id.} at 66-67.}
\end{footnotes}
companying section 362(b)(6), which Congress considered contemporaneously with section 546(e), suggest that payments made by or to a selling shareholder are settlement payments, at least for purposes of section 362(b)(6)'s setoff provision. In the Senate's consideration of section 362(b)(6), Senators Mathias and Dole stated:

Mr. MATHIAS: I too am concerned about achievement of these market protection functions. Accordingly, my question is whether a settlement payment owed to a customer with respect to a commodity contract, forward contract, or securities contract is property held by a commodity broker, forward contract merchant, or stockbroker to guarantee or secure the customer's other contracts within the meaning of [proposed section 362(b)(6)], and may therefore be offset against a margin or settlement payment owed by the customer with respect to that or another contract.

Mr. DOLE: Yes.

Neither the court in *Wieboldt II*, nor the note on which it relied, considered why the term "settlement payment" should not be given the same meaning in section 546(e) that Congress apparently intended it to have under section 362(b)(6). Indeed, section 362(b)(6) expressly refers to section 741(8)'s definition of "settlement payment," the same definition relied on by section 546(e).

Section 546(e)'s legislative history, therefore, is hardly dispositive as to whether payments to selling shareholders may be settlement payments. Accordingly, *Wieboldt II*’s reliance on that legislative history is misplaced.

IX. CONCLUSION

Fraudulent transfer litigation is inherently fact-intensive. Recent

159. Section 362(b)(6) provides that the filing of a bankruptcy petition does not operate as a stay:

- of the setoff by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761(4) of this title, forward contracts, or securities contracts, as defined in section 741(7) of this title, that constitutes the setoff of a claim against the debtor for 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, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by or due from such commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts.


case law in the LBO context confirms that the primary fact issues will continue to be the target's insolvency, the adequacy of its capitalization, and whether the target received adequate consideration. Because the target's actual fraudulent intent usually is not a material issue and because the factual inquiry in constructive fraudulent transfer suits is objective, some courts have mistakenly relied on the defendant shareholder's knowledge or state of mind as a defense.

The Tenth Circuit, in Kaiser II, is one of the few courts to sustain a purely legal defense to a constructive fraudulent transfer attack on a leveraged buyout. Although the court's analysis is based on a tenable, but literal reading of the Bankruptcy Code, at least one other court and a student commentator have reached a contrary conclusion based on their (mis)reading of a murky legislative history. The type of statutory analysis in Wieboldt II is currently in disfavor, particularly when the relevant legislative history could support a contrary reading of the Bankruptcy Code. Most courts have rejected the other purely legal attack that is based on the purported inapplicability of fraudulent transfer law to leveraged buyouts. Some courts, however, continue to resist applying fraudulent transfer law in the LBO context. That resistance is based on a misunderstanding of the law rather than on any careful statutory analysis. We submit that the Third Circuit's Metro Communications decision represents the proper reading of the applicable statutes. Metro Communications also confirms that a fraudulent transfer attack can be defeated with a proper factual showing.