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Ex Ante Review of Leveraged Buyouts

ABSTRACT. Under current bankruptcy law, a leveraged buyout (LBO) that leaves an acquired company insolvent, undercapitalized, or unlikely to be able to pay back its debts may be later avoided as a fraudulent transfer. This regime, intended to protect the target's creditors, requires a post-hoc valuation of the target long after the buyout and suffers from a number of practical, procedural, and policy problems. This Note proposes an alternative regime to supplant constructive fraudulent transfer litigation: an ex ante review of the proposed LBO by a neutral, third-party appraiser. This proposal ameliorates many difficulties inherent in the current regime.

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INTRODUCTION

In 1989, Kohlberg Kravis bought RJR Nabisco for $24 billion, using $19 billion in debt guaranteed by RJR Nabisco.[1] At the time, it was the largest leveraged buyout (LBO) in history.[2] After struggling to meet its debt burden for a decade,[3] RJR Nabisco was eventually broken up, and a large piece was sold off in 1999.[4] In 2003, it announced it would cut forty percent of its workforce and reduce its scope to just two brands.[5]

The financial community generally agrees that the massive debt load incurred in the LBO precipitated or at least accelerated the failure of RJR Nabisco.[6] Under current bankruptcy law, LBOs that eventually lead to bankruptcy may later be challenged and partially unwound as fraudulent transfers (sometimes called "fraudulent conveyances"). Such ex post review of buyouts seeks to determine whether, at the time of the transaction, the buyout left the target meeting any one of three standards of financial distress.[7] In short, ex post review asks whether the buyout was doomed to fail from the start.

Reviewing the LBO months or years after the transaction entails a number of problems, including hindsight bias, free insurance for creditors, misaligned monitoring incentives, and heavy litigation costs. This Note proposes a new solution: review LBOs for potential problems *before* the buyout takes place, rather than *after* the damage has already been done. I propose that LBOs be analyzed in much the same way and by the same standards of financial distress used in the current regime, but only at an earlier time. This would substantially ameliorate many of the problems with the current fraudulent transfer law (FTL) regime.

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1. Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1505-06 (S.D.N.Y. 1989).
2. Stephen Grocer, *Tracking the World's Biggest Buyouts*, WALL ST. J., May 7, 2007, http://online.wsj.com/public/resources/documents/info-buyouts0704.html.
3. *Id.*
4. Bryan Burrough, *RJR Nabisco, an Epilogue*, N.Y. TIMES, Mar. 12, 1999, http://www.nytimes.com/1999/03/12/opinion/rjr-nabisco-an-epilogue.html.
5. John Helyar, *RJR Goes from Ashes to Ashes: How a 15-Year-Old LBO Still Haunts a Once-Mighty Brand*, CNN MONEY (Oct. 13, 2003), http://money.cnn.com/magazines/fortune/fortune_archive/2003/10/13/350888.
6. *See, e.g.*, Burrough, *supra* note 4; Nancy W. Graml, *Bondholder Rights in Leveraged Buyouts in the Aftermath of* Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 29 AM. BUS. L.J. 1, 1-2 (1991); Grocer, *supra* note 2; Helyar, *supra* note 5.
7. 11 U.S.C. § 548 (2012).

This Note will begin with an overview of current FTL and how it applies to LBOs. It will then explore some of the problems with this current regime before proposing a new regime of ex ante review and detailing its implementation and procedure. Finally, it will detail some of the benefits of ex ante review and explore some possible criticisms of the proposed regime.

I. OVERVIEW OF LEVERAGED BUYOUTS AND FRAUDULENT TRANSFER LAW

An LBO is the acquisition of a target company financed by debt that is secured by the assets of the target company and paid with the target's future cash flows.[8] Put more simply: The acquiring company borrows money from the lending bank to purchase the target company. That loan is secured by the target's assets and future cash flows. The acquirer might also use some of its own capital for the purchase along with the borrowed funds.[9] The acquirer then uses these funds to buy the target from the target's current shareholders, often at a large premium, and the acquirer becomes the new owner.

The transaction leaves the target with a highly leveraged (or debt-heavy) capital structure, often close to a ninety percent debt-to-equity ratio.[10] Higher leverage generally disadvantages debt holders because it increases the risk that a firm will go into bankruptcy.[11] The transaction, then, may be harmful to the existing, unsecured creditors of the target, who gained nothing from the transaction but saw the value of their debt decrease as the risk associated with that debt increased.

The existing creditors face a real loss if the LBO is a failure and the highly leveraged target does in fact go into bankruptcy. In that case, the former shareholders lose nothing—they have already sold their interest in the company. But the unsecured creditors have to stand in line behind the secured lender in order to get their money.[12] Since the lender has a lien on all of the target's assets, there will be few (if any) unsecured assets left for the unsecured creditors to share.

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8. STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY JAFFE, CORPORATE FINANCE 905-06 (9th ed. 2010).

9. *Id.*

10. Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, *in* FOUNDATIONS OF CORPORATE LAW 194, 194 (Roberta Romano ed., 2d ed. 2010).

11. ROSS ET AL., *supra* note 8, at 520.

12. 11 U.S.C. § 1129 (b)(1).

The transaction looks a lot worse if the target was close to bankruptcy at the time of the LBO. The Bankruptcy Code uses an absolute priority rule to establish the order in which stakeholders receive money when a company goes bankrupt.[13] By this absolute priority rule, shareholders can get money only after creditors have been paid in full. The failed LBO described above subverts the absolute priority rule. It allows the shareholders to cash out in full – at a premium, no less – at the time of the acquisition, while the creditors get paid – if they get paid at all – months after the acquisition when the company finally enters bankruptcy.

Certain provisions of the Bankruptcy Code protect creditors against just such a transaction. FTL provides that if shortly before bankruptcy a debtor in financial distress gives away assets and does not get reasonable value in return, creditors can have that transaction avoided by the bankruptcy court.[14] These fraudulent transfer provisions have been applied to LBOs to avoid the lien that the target gave to the lender to finance the buyout.[15] If the lien is avoided in bankruptcy, the lender must stand in line with the unsecured creditors, or in some cases behind them, to get its money back from the bankrupt target.[16]

FTL applies to many fraudulent transactions and is not specific to LBOs. It applies to any fraudulent transaction that took place during or shortly before the debtor went into bankruptcy. Imagine an individual who, facing bankruptcy, knows her assets will soon be taken from her and divided up

13. *Id.* § 1129(b)(2).

14. *Id.* §§ 548, 550.

15. *See, e.g.*, Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787 (7th Cir. 2009); *In re* Iridium Operating LLC, 478 F.3d 452 (2d Cir. 2007); Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056 (3d Cir. 1992); Lippi v. City Bank, 955 F.2d 599 (9th Cir. 1992); Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635 (3d Cir. 1991); Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988); United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986); Zahn v. Yucaipa Capital Fund, 218 B.R. 656 (D.R.I. 1998); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988); Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989); Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175 (C.D. Cal. 1985); *In re* Charter Commc'ns, 419 B.R. 221 (Bankr. S.D.N.Y. 2009); *In re* Bay Plastics, Inc., 187 B.R. 315 (Bankr. C.D. Cal. 1995); *In re* Best Prods. Co., 168 B.R. 35 (Bankr. S.D.N.Y. 1994); *In re* O'Day Corp., 126 B.R. 370 (Bankr. D. Mass. 1991); *In re* Revco D.S., Inc., 118 B.R. 468 (Bankr. N.D. Ohio 1990); *In re* Vadnais Lumber Supply, Inc., 100 B.R. 127 (Bankr. D. Mass. 1989); *In re* Ohio Corrugating Co., 91 B.R. 430 (Bankr. N.D. Ohio 1988).

16. 11 U.S.C. § 1129 (b)(1). Again, the absolute priority rule will dictate that unsecured creditors share equally in the recovery. If the bank's lien has been equitably subordinated, the bank will stand behind the unsecured creditors.

amongst her creditors. She might be tempted to give away some assets – to a friend or relative, perhaps with the intention of later getting them back – before she actually files bankruptcy. This hurts her creditors, because it means there will be fewer assets left to satisfy her debts after she files for bankruptcy.

FTL prohibits such transactions made before or during bankruptcy or creditor workouts.[17] It provides for actions to avoid the fraudulent transfer and to recover the transferred property for the benefit of the debtor's estate.[18] FTL is codified in the Bankruptcy Code and in various state statutes, many of which incorporate the language of the Uniform Fraudulent Transfer Act. In defining fraudulent transfers, these statutes distinguish between *actual* and *constructive* fraudulent transfers based on the debtor's intent.[19] An actually fraudulent transfer is similar to the scenario described for the debtor above: a transfer made or obligation incurred by a debtor with actual intent to hinder, delay, or defraud its creditors.[20] A constructively fraudulent transfer hurts creditors in the same way as an actually fraudulent transfer – it reduces the assets available for distribution to creditors – but does not involve fraudulent intent on the part of the debtor. Such conveyances are defined as a transfer made or obligation incurred by the debtor without receipt of reasonably equivalent value and that either (1) leaves the debtor with unreasonably small capital, (2) creates a reasonable expectation that the debtor will be unable to pay its debts as they come due, or (3) is completed at a time when the debtor is insolvent or which leaves the debtor insolvent as a result.[21] The Bankruptcy Code includes additional provisions for fraudulent transfers to or for the benefit of insiders, which are outside the scope of this Note's analysis.[22]

If a transaction meets the definition of actual or constructive fraudulent transfer, that transaction may be avoided under § 548 of the Bankruptcy Code or under state law as permitted by § 544,[23] and the fraudulently transferred property or the value of such property may be recovered under § 550.[24]

Now I will return to the context of leveraged buyouts. The transactions involved in a failed LBO sometimes satisfy the definition of fraudulent transfer.

17. *Id.* § 548; UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 639 (1985).
18. 11 U.S.C. § 550.
19. *Id.* § 548; UNIF. FRAUDULENT TRANSFER ACT § 4.
20. 11 U.S.C. § 548(a)(1)(A); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1).
21. 11 U.S.C. § 548(a)(1)(B); UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2).
22. 11 U.S.C. § 548(a)(1)(B)(ii)(IV).
23. *Id.* § 544(b)(1).
24. *Id.* § 550(a).

The target is the eventually-bankrupt debtor, and the transfer we care about is the lien on the target's assets given to the lender, who is financing the LBO. In return for this lien, the lender gives capital. It lends that capital, however, not to the target, but to the acquirer, which then uses that capital to buy out the target's selling shareholders. Here's the key: the target receives nothing in return for issuing debt and granting a lien on its assets. And this is what makes a fraudulent transfer. The debtor gave away value (in the form of a lien) shortly before bankruptcy, thus hurting its creditors by reducing the assets available to satisfy its debts.

Proving fraudulent *intent* in such a transaction is difficult. The existing creditors would have to show that the selling shareholders conspired with the acquiring company to defraud the target's creditors. For this reason, most fraudulent transfer claims in the context of a failed LBO allege a *constructive*, rather than intentional, fraudulent transfer.[25]

To meet the definition of a constructive fraudulent transfer, the lien granted by the target to the lending bank must satisfy both prongs of constructive fraud. First, the debtor must have "*received less than a reasonably equivalent value*."[26] Recall that the target receives nothing in return for taking on new debt and granting a lien on its assets. Even if we collapse the steps of the transaction, the target still never sees the cash: we can follow the money from bank lender to the acquirer, and then to the selling shareholders when the acquirer buys out the stock of the target. In effect, the target is buying back its own stock—replacing equity with debt on its balance sheet. The target gets its own treasury stock, which is itself of no value to that company.[27] While some courts have recognized that an LBO *may* give the target reasonably equivalent value in the form of indirect benefits, such as "the ability to obtain substantial credit" or "the synergy expected to result from the combination,"[28] such a finding is the exception and not the rule; courts generally agree that the transfer of a lien in an LBO gives the target no reasonably equivalent value.[29]

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25. *See, e.g.*, Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 792 (7th Cir. 2009); Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175, 182 (C.D. Cal. 1985); *In re* Best Prods. Co., 168 B.R. 35, 60 (Bankr. S.D.N.Y. 1994).

26. 11 U.S.C. § 548(a)(1)(B)(i) (emphasis added).

27. "A transaction by which a corporation acquires its own stock from a stockholder for a sum of money is not really a sale. The corporation does not acquire anything of value equivalent to the depletion of its assets, if the stock is held in the treasury, as in this case." Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935).

28. Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 647 (3d Cir. 1991).

29. *See* Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488, 500 (N.D. Ill. 1988); *In re* Ohio Corrugating Co., 91 B.R. 430, 435 (Bankr. N.D. Ohio 1988).

For this reason, an LBO will nearly always satisfy this first prong of the constructive fraudulent transfer definition.[30]

The second prong of constructive fraud requires that the LBO meet one of three standards of financial distress.[31] Again, the LBO either (1) left the target company with unreasonably small capital, (2) created the reasonable expectation that the target would not be able to pay its debts as they came due, or (3) was completed at a time when the target company was insolvent, or left the target insolvent as a result of the LBO.[32] Satisfying one of these three standards requires a determination of the target company's value at the time of the LBO to determine its then-solvency and then-liquidity. The creditors trying to avoid the fraudulent transfer attempt to show that the LBO was doomed to financial failure from the start; the acquiring company and the lending bank try to show that the LBO was in fact financially sound at the start.

Since the first prong of the fraudulent transfer definition (no reasonably equivalent value) is essentially met by default, it is this second prong—evaluation of financial distress—that is the subject of costly ex post analysis during fraudulent transfer litigation. This is the review that I argue would be better undertaken before the LBO is finalized, rather than months after. When the LBO is proposed, we should ask then whether it is financially sound. We should not ask, months after the LBO failed, if it seemed like a good idea at the time.

If the fraudulent transfer action is successful, the trustee avoids the transfer under § 548 of the Bankruptcy Code. In the case of an LBO, this means that the lending bank loses its lien on the assets of the now-bankrupt target and stands in line with the other unsecured creditors for its share of the bankruptcy estate.[33] The court will sometimes grant other equitable remedies, discussed below,[34] such as subordinating the bank to the other creditors.[35] Section 550 additionally allows for the recovery of the property or value of property

30. *See Wieboldt Stores*, 94 B.R. at 500; *Ohio Corrugating Co.*, 91 B.R. at 435. *But see Mellon Bank*, 945 F.2d at 647 (noting that synergies resulting from the acquisition may constitute reasonably equivalent value).

31. 11 U.S.C. § 548(a)(1)(B)(ii).

32. *Id.*

33. *See, e.g.*, *Wieboldt Stores*, 94 B.R. at 500.

34. *See infra* Section II.G (explaining why these remedies are inadequate).

35. *See, e.g.*, *In re* O'Day Corp. v. Meritor Sav. Bank, 126 B.R. 370 (Bankr. D. Mass. 1991); *In re* Crowthers McCall Pattern Inc., 120 B.R. 279 (Bankr. S.D.N.Y. 1990).

fraudulently transferred.[36] In the case of an LBO, § 550 can sometimes be used to recover funds transferred to the target's selling shareholders.[37]

II. PROBLEMS WITH THE CURRENT REGIME

Attempting to evaluate an LBO months or even years after the transaction took place involves practical, logistical, and empirical difficulties, and also raises policy concerns, which include the risk of misaligning incentives. Over the last three decades, academics have explored many of these issues in critiques of the current regime. I will survey the problems most commonly discussed in the literature, as well as note others that ex ante review seeks to address.

A. *The Impact of FTL on the LBO Market*

FTL has a clear impact on the market for LBOs: it poses the danger that the transaction may later be unwound in a bankruptcy proceeding. Academics who believe that LBOs are value-creating tools criticize the current FTL regime as unfairly deterring buyouts with the threat of ex post litigation.

Indeed, the first wave of literature on this topic addressed the question of whether FTL should be applied to LBOs at all.[38] The seminal work in this debate was Douglas Baird and Thomas Jackson's 1985 article *Fraudulent Conveyance Law and Its Proper Domain*, which argues vehemently that FTL should not be applied to LBOs.[39] Baird and Jackson raise a number of

36. 11 U.S.C. § 550.

37. *See, e.g.*, *Wieboldt Stores*, 94 B.R. at 488.

38. For articles opposing the application of fraudulent conveyance law to LBOs, see Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); and Robert J. White, *Leveraged Buyouts and Fraudulent Conveyance Laws Under the Bankruptcy Code—Like Oil and Water, They Just Don't Mix*, 1991 ANN. SURV. AM. L. 357. For articles supporting its application, see William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92; Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165 (1995); Raymond J. Blackwood, Note, *Applying Fraudulent Conveyance Law to Leveraged Buyouts*, 42 DUKE L.J. 340 (1992); and Kevin J. Liss, Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491 (1987). *But see* Jenny B. Wahl & Edward T. Wahl, *Fraudulent Conveyance Law and Leveraged Buyouts: Remedy or Insurance Policy?*, 16 WM. MITCHELL L. REV. 343 (1990).

39. Baird & Jackson, *supra* note 38.

concerns, chief among them that these laws give creditors a sort of free insurance against the later failure of a buyout.[40] They further assert that LBOs are not necessarily harmful to pre-existing creditors.[41] In fact, they present a number of potential *benefits* accruing to creditors, including a more streamlined and efficient debtor, often with greater access to capital (through its new owner, in the case of a merger) than before the LBO.[42] In the case of an LBO in which the target is bought from public shareholders and taken private by the purchasers, the debtor-target is saved expenses by avoiding federal securities laws.[43]

Empirical studies have borne out these claims of the increased value of the debtor after a successful LBO.[44] More generally, LBOs facilitate the market for corporate control, disciplining management not only of the corporations that do become the target of a buyout, but also of those functioning under the threat of such a takeover.[45] Because a leveraged transaction allows the buyer to acquire the target without first amassing a large reserve of capital, more buyers can enter the market, putting more potential targets into play. Buyouts are also socially efficient when an acquiring company experiences synergistic gains with the acquired target.[46]

Other academics share Baird and Jackson's point of view; Barry Zaretsky interprets the Third Circuit's decision in *Mellon Bank* (in which the court recognized synergistic gains to the debtor as reasonably equivalent value) as a recognition that "risk does not necessarily increase in direct proportion to the obligation undertaken by the debtor."[47] An LBO could help existing creditors if the target was in poor financial health to begin with. If bonds were already trading at a substantial discount due to the debtor's risk of insolvency, the LBO

40. *Id.* at 840 ("If creditors always can undo transactions afterwards, they have every incentive to wait and upset only those transactions that turn out unfavorably from their perspective.").

41. *Id.* at 833 ("It is not clear that permitting the debtor to engage in a leveraged buyout, for instance, is against the long-term interests of the creditors as a group.").

42. *Id.* at 853.

43. *Id.*

44. Steven N. Kaplan, *Sources of Value in Management Buyouts*, *in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 95, 95-100 (Yakov Amihud ed., 2002).

45. Henry G. Manne, *Mergers and the Market for Corporate Control*, *in* FOUNDATIONS OF CORPORATE LAW, *supra* note 10, at 491, 492.

46. Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 647-48 (3d Cir. 1991).

47. Zaretsky, *supra* note 38, at 1185.

may be one of few possible outs for the ailing debtor.[48] Finally, defenders of the LBO transaction are eager to point out that for bonds issued after the Nabisco buyout and the other massive LBOs of the 1980s, creditors were on notice as to the possibility of an LBO; the lack of contractual protections against an LBO may have been ceded in exchange for a higher interest rate.[49] If this is the case, the creditors have no right to complain when a buyout does occur: the chance of its happening was priced in.

For these critics, the central problem of the current FTL regime is that it unduly restricts value-creating transactions. But for others, FTL is a necessary tool in restricting wealth-transferring buyouts. Recall that failed LBOs harm existing creditors: they reduce the assets available for distribution to creditors when the target eventually goes bankrupt. But an LBO can harm existing creditors before the target enters bankruptcy, or even if it never enters bankruptcy at all. It can harm them simply because of the increased *risk* of bankruptcy. This harm can take a number of forms: First, the highly leveraged company is less able to endure financial difficulty because of its debt load and is therefore more likely to fail.[50] Second, the increased riskiness of the debt can cause an immediate drop in its market value.[51] The 1988 RJR Nabisco buyout is one prominent example: some bonds plummeted twenty percent in value the day the buyout was announced.[52] These drops in market value may be accompanied by bond downgradings. In both the Unocal and Phillips Petroleum transactions, bond ratings fell drastically from AA to BBB.[53] John Coffee, reviewing an empirical study of changes to bond prices and ratings following LBOs, concludes that "downgradings by bond rating agencies are in fact associated with real losses to bondholders, although the loss may typically precede the downgrading."[54]

From an equity standpoint, the inherent unfairness in the LBO transaction lies in part in the subversion of the absolute priority rule: the shareholders get

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48. *See, e.g.*, *In re* Bay Plastics, Inc., 187 B.R. 315, 321 (Bankr. C.D. Cal. 1995) (confronting a situation where the existing creditor, enticed by the good credit of the purchaser in contrast to the poor credit of the target, gave up the security on its debt to facilitate the purchase).

49. *See* Baird & Jackson, *supra* note 38, at 835.

50. *See* Jensen, *supra* note 10, at 194.

51. Bratton, *supra* note 38, at 94.

52. *Id.*

53. *Id.* at 137.

54. John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1516 (1990).

paid before the bondholders. Baird and Jackson describe the LBO as the equivalent of a firm issuing new, senior debt and then disgorging the proceeds as dividends to existing shareholders.[55] Another commentator describes this scenario in terms of the option theory of the firm, under which shareholders own the firm along with a put option, written by the bondholders, for the value of the firm's debt.[56] If the firm goes bankrupt, the shareholders exercise this put option and the bondholders eat the losses.[57] LBOs increase the value of shareholders' put by increasing the likelihood of bankruptcy (and decreasing the assets available for distribution should bankruptcy occur).[58]

In addition to *transferring* value from creditors to shareholders, LBOs can also *destroy* value. As the court noted in *Mellon Bank*, a leveraged target is "less able to weather temporary financial storms because debt demands are less flexible than equity interest[s]."[59] The resulting increase in bankruptcies of otherwise healthy firms destroys wealth. Losses to employees are also a factor; buyouts often result in downsizing or terminations of pension plans.[60] And for ailing firms for whom a buyout is a gamble at resurrection, an eventual bankruptcy, because it occurred later rather than sooner, means lower payouts to creditors after the waste of running at a loss during the gamble.

Any proposed change to the regime of FTL, then, must take both these points of view into account. FTL should balance promoting value-creating LBOs against deterring those that are value-destroying.

B. The Problem of Free Insurance

Recall that from the ex ante position, a successful LBO can be in the interest of existing unsecured creditors—particularly if the target company was, as is frequently the case, inefficiently run and financially distressed. If the LBO is unsuccessful, however, the creditor is likely to receive less on the dollar for its debts than if the company had skipped the buyout and just entered bankruptcy sooner rather than later. Whether or not a creditor supports an LBO ex ante can depend on its view of the LBO's likelihood of success.

55. Baird & Jackson, *supra* note 38, at 853.

56. Terence C. Burnham, *Is Leverage an Invitation to Bankruptcy? Limits on Liability Actually Are What Invite the LBOs*, WALL ST. J., Feb. 1, 1989.

57. *Id.*

58. *Id.*

59. Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 647 (3d Cir. 1991).

60. *See* Coffee, *supra* note 54, at 1521.

The problem with the existing regime is that it allows a creditor to support an LBO ex ante, even if the LBO poses significant risk to the company, because that creditor carries implicit insurance in the form of FTL. If the buyout goes well, the creditor benefits from the target's increased creditworthiness. If it goes badly, the creditors can try to partially unwind the transaction through fraudulent transfer litigation.

In re Bay Plastics provides one example of this.[61] Bay Plastics, Inc., the target company, was in financial distress.[62] Milhous Corp. offered to purchase the ailing company.[63] One of Bay Plastics's suppliers and creditors, Shintech Corp., enticed by the good credit of the new purchasers, agreed to give up its first lien on Bay Plastics's assets so that the purchase could go through, financed with secured debt.[64] Fifteen months after the LBO, when Bay Plastics entered bankruptcy, Shintech was able to get the lending bank's lien avoided as a fraudulent transfer.[65]

Because of this implicit insurance, creditors are incentivized, in the case of a distressed debtor, to allow or encourage risky LBOs to go through; they are rolling the dice with the lending bank's money. Many of the scholars who argue entirely against the application of FTL to LBOs focus on this concept of free insurance, worrying that lenders and sellers become the guarantors of the buyout.[66] Courts have taken note of this argument, acknowledging the fear that FTL "gives creditors the ability to 'whipsaw' the debtor, taking advantage of the successful LBO and suing under fraudulent transfer theories if it is unsuccessful."[67] The court in *Credit Managers* similarly worried that

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61. 187 B.R. 315 (Bankr. C.D. Cal. 1995).

62. *Id.* at 320.

63. *Id.*

64. *Id.* at 321.

65. The court did note that Shintech, while in favor of the acquisition, was unaware that Milhous was not putting up any of its *own* capital to fund the purchase. *Id.* at 321. But the principle here remains the same: a creditor in favor of an LBO, perhaps even facilitating an LBO, carries implicit insurance against its failure.

66. *See generally* Baird & Jackson, *supra* note 38 (arguing that the "inability of parties to opt out" of fraudulent conveyance law should limit its reach); Anthony Michael Sabino, *Applying the Law of Fraudulent Conveyances to Bankrupt Leveraged Buyouts: The Bankruptcy Code's Increasing Leverage over Failed LBOs*, 69 N.D. L. REV. 15, 41-47 (1993) (discussing the *Kaiser* case, where the debtor alleged that payments to its former shareholders in connection with the LBO constituted a fraudulent conveyance). *But see* Wahl & Wahl, *supra* note 38, at 343 (concluding that the "absence of fraudulent conveyance remedies could under deter unjustified LBOs").

67. Kupetz v. Wolf, 845 F.2d 842, 847 n.10 (9th Cir. 1988).

> [i]f there is no limit on when a creditor can sue to set aside a transfer, fraudulent conveyance law becomes an insurance policy for creditors of companies that have gone private. Credit could liberally be extended to such companies regardless of their assets or cash flow with the knowledge that the buyout could always be attacked later if the company folded.[68]

C. *Reduced Monitoring Incentives*

Critics of applying FTL to LBOs similarly worry that such a guaranty arrangement reduces monitoring incentives.[69] Under the current regime, four parties are potential monitors to an LBO: the target, the purchaser, the lending bank, and the pre-existing creditors.

The target's selling shareholders have little incentive to restrain overly-ambitious LBOs; they simply want to get as much for their shares as possible, regardless of whether the company they leave behind is insolvent or likely to default on its debts. They need only discount for the possibility of later, successful fraudulent transfer litigation that manages to recover some funds from shareholders.

The purchasers, as we saw in *Bay Plastics*, rarely invest any significant amount of their own capital.[70] They have much to gain in the case of a successful LBO and too little to lose in the case of a failed one. They, too, have little incentive to avoid an overly risky, likely-to-fail LBO.

The lending bank would seem to have the greatest monitoring incentives—it needs to make sure that the target can pay back the loan from its future cash flows. The lender is also the cheapest cost avoider given its financial expertise and essentially unlimited negotiating leverage (that is, if the lender walks away, the deal falls through). But the bank's interest is limited to ensuring that the assets securing its loan are sufficient to cover the debts incurred for the buyout. That is, the bank is less interested in maintaining a proper capital cushion to cover future involuntary creditors or to pay back existing unsecured creditors in the case of bankruptcy—again, except insofar as they fear a later, successful fraudulent transfer action. Further, the lending bank profits from high interest rates and fees, which in an expected value calculation can offset the slight risk

68. Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175, 181 (C.D. Cal. 1985).

69. Baird & Jackson, *supra* note 38, at 840.

70. Zaretsky, *supra* note 38, at 1192.

of their lien being avoided in a successful fraudulent transfer action. Finally, lenders often sell off LBO debt to third parties, meaning they retain little interest in the target's long-term success.[71] So lenders, too, are insufficiently motivated to avoid a likely-to-fail LBO, even while that motivation is bolstered by FTL.

The existing creditors, then, have some interest in monitoring for themselves, but such an interest is mitigated by the "free insurance" of FTL discussed above.[72] As Baird and Jackson put it, creditors "have every incentive to wait and upset only those transactions that turn out unfavorably from their perspective."[73] Further, even to the extent the creditors *do* have an interest in monitoring, they suffer both from a collective action problem and from a poor monitoring position, since they stand outside of the deal.[74] Unlike the three groups discussed above (the target, the purchaser, and the lender), the pre-existing creditors are not party to the LBO. They have no good proxy inside the transaction to represent their interests.

D. Difficult Post-Hoc Valuations

While the first wave of literature focused on the problems with applying FTL to LBOs at all, the second wave critiqued the financial standards used to evaluate LBOs.[75] Recall that, to satisfy the second prong of a constructively fraudulent transfer, there is a post-hoc analysis of the company's value back at the time of the LBO. The creditors must show that the LBO left the target insolvent, unreasonably undercapitalized, or unlikely to be able to pay its

71. John H. Ginsberg et al., *Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts*, 19 AM. BANKR. INST. L. REV. 71, 76 (2011).

72. *See supra* Section II.B.

73. Baird & Jackson, *supra* note 38, at 840.

74. *See* Ginsberg et al., *supra* note 71, at 112 (noting that unsecured creditors have "no good proxy among the parties to an LBO").

75. *See id.*; Richard Lieb & Robert J. Feinstein, *LBO Litigation, Financial Projections and the Chapter 11 Plan Process*, 21 SETON HALL L. REV. 598, 606 (1991) (explaining that the past financial projections by which a failed LBO is evaluated are dependent on highly subjective assumptions fraught with "inherent difficulty"); Alemante G. Selassie, *Valuation Issues in Applying Fraudulent Transfer Law to Leveraged Buyouts*, 32 B.C. L. REV. 377 (1991); Robert J. Stearn, Jr., *Proving Solvency: Defending Preference and Fraudulent Transfer Litigation*, 62 BUS. LAW. 359 (2007).

debts.[76] The fraudulent transfer claim basically alleges that the acquirer paid too much for the target company, leaving it with debts greater than its value as a going-concern.[77] This is because the company goes into debt for the amount of the purchase price. If the purchase price is above the going-concern value of the company, then the company is left insolvent after the transaction, one of the three standards of financial distress necessary to show a fraudulent transfer. This very claim – that the purchasers paid too much – raises a difficult threshold objection to the creditor's argument: there are many possible ways to value a company, but one easy way to do it is to let market forces determine worth. That is, a company is worth what someone is willing to pay for it. Here, the creditors allege that the post-hoc, hindsight-biased calculation of their paid financial expert is more accurate than the price that the market was willing to pay for the company at the time of the LBO.

It is a difficult objection to overcome, made only more difficult by the inherent challenges of valuing a company at all on the basis of its balance sheet. As one bankruptcy court admitted:

> Valuation is a malleable concept, tough to measure and tougher to pin down without a host of explanations, sensitivities and qualifiers. Because point of view is an important part of the process, outcomes are also highly dependent upon the perspectives and biases of those doing the measuring. When it comes to valuation, there is no revealed, objectively viable truth . . . and consistency among valuation experts is rare.[78]

In other words, the court ends up refereeing "a battle between . . . hired guns [experts] for each side."[79]

The literature finds difficulty inherent in these standards of financial distress. The definition gives a disjunctive list of three standards, but nowhere specifies which valuation technique should be used in evaluating any of the three. Alemante Selassie finds that a court's choice of valuation method depends largely on its view of the underlying transaction and which parties it thinks should generally bear the risk of an LBO.[80] In an analysis of solvency,

76. 11 U.S.C. § 548 (a)(1)(B)(ii) (2012).

77. Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175, 188 (C.D. Cal. 1985).

78. *Id.* at 181.

79. *In re* Charter Commc'ns, 419 B.R. 221, 236 n.11 (Bankr. S.D.N.Y. 2009).

80. Selassie, *supra* note 75, at 410.

for example, the court has discretion to view the target as a going-concern or as in liquidation.[81] Even within those categories, the court makes further discretionary choices. If the court opts for a liquidation value, there are questions of timing – "immediate liquidation" or "reasonable time liquidation."[82] And if a going-concern value basis is chosen, the discount rates used and the reasonableness of projections made at the time of the LBO must be evaluated in retrospect.[83]

The "unreasonably small capitalization" standard is even more subjective than the insolvency standard. The term is not statutorily defined, and courts have interpreted it differently, either to mean a pledge of all assets (since doing so leaves the company no easy way to obtain further credit), or to mean a lack of the working capital needed for the debtor's particular business.[84] John Ginsberg et al. examine the case law and conclude that courts seem to agree that an "unreasonably small capital" definition "turns on some probability of insolvency," but disagree on just what that probability is: in some cases "likely," and in others, "giving rise to unreasonable risk."[85]

A quick example demonstrates the arbitrary nature of post-hoc valuations. In *Bay Plastics*, the bankruptcy court, noting that the bankrupt debtor was now in liquidation as a result of its failed LBO, concluded that "[t]his is a liquidation case" and removed goodwill from the balance sheet.[86] Without this going-concern value, the court easily concluded that the debtor was left insolvent by the leveraged transaction.[87] But without going-concern value, most if not all LBOs leave the target insolvent. As one scholar explained, "because LBOs are premised on the existence of hidden value not recognized in book values, using book values to measure solvency in LBOs would render almost every LBO target insolvent, effectively voiding every LBO challenged in court as a fraudulent conveyance."[88] This is also a perfect example of hindsight bias, which I will discuss next: the judge used the fact that the target was

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81. *Id.* at 395.

82. *Id.* at 392 (citing United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1304 (3d Cir. 1986)).

83. Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992).

84. Selassie, *supra* note 75, at 406-08.

85. Ginsberg et al., *supra* note 71, at 92.

86. *In re* Bay Plastics, Inc., 187 B.R. 315, 331 (Bankr. C.D. Cal. 1995).

87. *Id.*

88. Blackwood, *supra* note 38, at 369.

currently in liquidation to impose a liquidation value on the target months earlier when it underwent the buyout.

E. *Hindsight Bias*

Recent scholarship in the area of FTL applied to LBOs looks at the problem of hindsight bias inherent in failed LBO litigation.[89] One of the reasons valuation is so difficult is that the adjudication is tainted by hindsight bias. Creditors allege that the target was left too highly leveraged and too close to bankruptcy—and their proof is that, well, the target ended up in bankruptcy. The court is supposed to evaluate the transaction based only on the circumstances and information at the time of the LBO, but the evidence is inherently tilted in favor of the plaintiffs. Many scholars have expressed concern about this sort of "Monday morning quarterbacking."[90] After an extensive review of the empirical evidence of hindsight bias in legal decision-making, Simkovic and Kaminetzky note that valuation questions may be particularly prone to hindsight bias, since evidence can be "reconstructed to reveal arguable deficiencies in audit procedures."[91]

Some courts explicitly resist the bias. The court in *Credit Managers Ass'n of Southern California v. Federal Co.* stated that: "With 20-20 hindsight it is clear that [the target's] cash flows did not work out as projected, [but] the court's task in determining whether [the target] had sufficient capital . . . is not to examine what happened to [the target], but whether the projections . . . were prudent."[92] But other courts fall victim to hindsight. Earlier I discussed the bias in *Bay Plastics*;[93] *United States v. Gleneagles Investment Co.* is a second example of hindsight bias influencing the decision to use a liquidation standard, rather than the accepted going-concern value standard, in valuing the debtor for the purposes of the insolvency prong of the fraudulent transfer claim.[94] The facts in this case were particularly egregious—the insider shareholders appeared to

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89. *See, e.g.*, Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118.

90. Baird & Jackson, *supra* note 38, at 842.

91. Simkovic & Kaminetzky, *supra* note 89, at 155 (quoting Marianne M. Jennings et al., *Causality as an Influence on Hindsight Bias: An Empirical Examination of Judges' Evaluation of Professional Audit Judgment*, 21 J. ACCT. & PUB. POL'Y 143, 147 (1998)).

92. 629 F. Supp. 175, 186 (C.D. Cal. 1985).

93. *See supra* text accompanying notes 86-88.

94. 565 F. Supp. 556, 578 (M.D. Pa. 1983).

have intentionally looted the company at the expense of existing creditors, with little regard for the target's future. Some have argued that the related, *intentional* fraud claim surely spilled over into the constructive fraudulent transfer claim, coloring the court's valuation.[95]

Hidden hindsight bias is one lurking problem, but even explicit hindsight bias can be found where FTL is applied to failed LBOs. In *Moody v. Security Pacific Business Credit*, the court valued the target's accounts receivable based on the present fair saleable value *after* the leveraged transaction, at the time of the lawsuit, rather than the value set down at the time of the LBO.[96] In the *Moody* case, interestingly, the present fair saleable value of the target's accounts receivable was actually higher at the time of litigation than at the time of the LBO, which shows that hindsight bias can sometimes advantage the LBO participants at the expense of creditors.[97] Another example of this "reversed" hindsight bias is found in *In re Ohio Corrugating Co.*, where the bankruptcy court concluded that a target was not rendered insolvent by an LBO because of its demonstrated ability *after the buyout* to pay off its debts during "normal operating cycles."[98]

Whether hindsight bias works in favor of LBO proponents or against it, it makes for inaccurate analysis of fraudulent transfer claims. If buyouts are being evaluated by the wrong standards, then parties to an LBO account for that error ahead of time, and we see the wrong number of LBOs – probably too few, given that bias usually works against the transaction. This is one major problem with the current regime of ex post review.

F. Litigation Costs

Other problems with the current FTL regime as applied to LBOs have not been the focus of academic discussion, but are particularly relevant to my proposal for ex ante review. Litigation costs are one major disadvantage under the current regime that would be substantially eliminated by ex ante review.

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95. *See* Selassie, *supra* note 75, at 411.

96. Blackwood, *supra* note 38, at 371 (citing Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1066 (3d Cir. 1992)) ("The target corporation valued its receivables at $7.929 million at the time of the transaction . . . . Because the company was eventually able to collect $8.3 million of its accounts outstanding as of the time of the LBO, the court increased the reconstituted receivables up to $8.3 million – their value as actually collected.").

97. *Moody*, 971 F.2d at 1066 n.14.

98. 91 B.R. 430, 440 (Bankr. N.D. Ohio 1988).

Fraudulent transfer litigation is expensive. The bankruptcy court in *In re Best Products*, considering a proposed settlement, suggested that the debtor's special counsel's prediction of a five million dollar litigation was unrealistically optimistic.[99] "[T]here can be little doubt that the action would have taken a period of years to try to its conclusion," the court wrote, imagining "complex," "protracted" litigation including "extensive discovery, motion practice, and . . . interlocutory appeals" before trial.[100]

Litigating fraudulent transfers is a particularly elaborate matter due to the number of parties involved, the complexity of financing, and the inexactness of the standards of financial distress. A typical LBO can include many offerings of public and private debt, different security interests, and complex corporate structures.[101] It may also include additional unsecured, subordinated financing, the lenders of which may be defendants to the suit.[102]

The matter is further complicated by the fact that fraudulent transfer claims regarding an LBO will likely be brought during a larger bankruptcy proceeding. The court in *Best Products* observed that potential LBO fraudulent transfer claims were "lurking all the time" as the debtor attempted to organize a Chapter 11 plan of reorganization.[103] In fact, the analysis of the LBO claims required a stay of the pending plan confirmation process.[104] Wealth-destroying bankruptcy costs increase as fraudulent transfer litigation adds to uncertainty and holds up negotiation.

G. *Inadequate Remedy*

Inadequate remedy is another problem particularly relevant to a comparison of ex post versus ex ante review. When an LBO is found to have been a fraudulent transfer months or years after the transaction, the remedies available to creditors are often inadequate to restore them to their pre-LBO positions. One remedy is to avoid the lender's lien on the acquired company's assets, which leaves the lending bank on equal footing with the other

99. 168 B.R. 35, 60 (Bankr. S.D.N.Y. 1994).

100. *Id.*

101. Lieb & Feinstein, *supra* note 75, at 630-31.

102. White, *supra* note 38, at 386.

103. 168 B.R. at 44.

104. *Id.* at 35 ("I must resolve [these] cross-claims in the LBO action before I may consider confirmation of the plan.").

unsecured creditors for a share of the estate.[105] But since the money lent by the bank went out in large part to the selling shareholders, such a remedy still leaves unsecured creditors with a smaller piece of the pie than they could have expected before the LBO. To address this, some courts go further and equitably subordinate the lending bank's now-unsecured claim to those of pre-existing creditors.[106]

Another option is to use § 550 to try to recover some of the money paid out to the selling shareholders.[107] While recovering money from shareholders means a greater chance of making creditors whole, courts have largely limited the remedy to cases where the old shareholders were complicit in a scheme to loot the target company of value by means of the LBO.[108] And even when a court does allow recovery from the selling shareholders, tracking down what may be a dispersed group of shareholders and recovering that money is hardly straightforward.

Further complications specific to an LBO make unwinding the transaction a tricky endeavor. It is common for the target to sell off some assets after the LBO to reduce its debt load.[109] The cash proceeds from such a sale go to the LBO lender in service of the target's new debt, not to the pre-existing creditors. Additionally, recall that the LBO lenders may sell off some or all of the debt in the time between the transaction and the fraudulent transfer claim,[110] making equitable subordination a foggier matter.

In most cases, then, the pre-existing unsecured creditors are likely to receive less than they would have received absent the LBO. The company transferred a great deal of value to the selling shareholders – value which is in most cases unreachable by the time of bankruptcy months or years later. Further, value presumably has been lost in the interim as the company has been making interest payments to the lending bank and other expenditures in an attempt to overhaul what may have been a doomed company even from the time of the buyout. Because LBOs are examined and remedied so long after the

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105. *See, e.g.*, United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1306-07 (3d Cir. 1986) (setting aside a lien under state law, rather than federal bankruptcy law); *In re* Metro Commc'ns, Inc., 135 B.R. 15, 16 (W.D. Pa. 1991).

106. *See, e.g.*, *In re* O'Day Corp., 126 B.R. 370, 412 (Bankr. D. Mass. 1991); *In re* Crowthers McCall Pattern, Inc., 120 B.R. 279 (Bankr. S.D.N.Y. 1990).

107. *See, e.g.*, Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988).

108. *See, e.g.*, United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 585 (M.D. Pa. 1983).

109. White, *supra* note 38, at 377.

110. *Id.* at 390.

transaction, creditors often suffer losses even if successful in their fraudulent transfer actions.

A full recovery for creditors hurt by truly fraudulent LBOs may be further precluded by the statute of limitations. Under the federal Bankruptcy Code, plaintiffs may bring fraudulent transfer actions for transactions that occurred up to two years before the bankruptcy filing.[111] The Uniform Fraudulent Transfer Act allows for fraudulent transfer claims for up to four years after the transaction.[112] If the highly-leveraged target limps along for several years after the LBO before filing bankruptcy, FTL is of no help to the creditors.

H. Ex Ante Uncertainty

Finally, the uncertainty created by the specter of future fraudulent transfer litigation, compounded by the unpredictability of court valuation methods and the subjectivity of the Bankruptcy Code's standards of financial distress, means that parties to an LBO must heavily discount the expected profits of the transaction with the negative expected value of future liability.[113] This complicates not only the decision of whether to go forward with the transaction in the first place, but also the financing and the structuring of the deal, as parties try to find ways to shield themselves from eventual litigation.[114] Lenders don't know which of the three standards the court will focus on, which method of valuation it will use, and whether or not the court will collapse the transaction, consolidate the parties involved, or perform other analytical acrobatics in the name of equity.

III. PROPOSAL FOR EX ANTE REVIEW

Many of the problems discussed thus far exist because LBOs are reviewed and potentially avoided only months or years after the transaction in question has gone through. A process for reviewing LBOs *before* the transaction is finalized would minimize many of these difficulties, as well as confer other advantages. As detailed below, ex ante review would be tied to later presumptions of constructive fraud, would be performed by an independent

111. 11 U.S.C. § 548(a) (2012).

112. UNIF. FRAUDULENT TRANSFER ACT § 9, 7A U.L.A. 639 (1985).

113. Robert A. Fogelson, *Toward a Rational Treatment of Fraudulent Conveyance Cases Involving Leveraged Buyouts*, 68 N.Y.U. L. REV. 552, 553 (1993).

114. *Id.*

third party, and would provide opportunity for opposition from existing creditors. Ex ante review would supplant constructive FTL claims; that is, LBOs greenlit in the review stage could not later be avoided as constructively fraudulent transfers. However, actual fraudulent transactions would not be protected by ex ante review, and would still be subject to ex post litigation.

A. Implementation

Under the current FTL regime, the power to avoid fraudulent transfers lies in §§ 548 and 544 of the Bankruptcy Code. Recall that § 548 defines fraudulent transfers and gives the court the authority to avoid them; § 544 incorporates state FTL in addition to federal. Ex ante review could be implemented through a statutory amendment to both of these two sections. First, the amendment would carve out a safe harbor for LBOs that have passed ex ante review: these transactions would not be subject to constructive fraudulent transfer litigation. To encourage parties to undergo the review, a second provision would provide that LBOs that did not undergo ex ante review are presumed to be constructively fraudulent. By building off the existing framework of §§ 548 and 544, ex ante review thus implemented requires no additional statutory authority. It becomes functionally necessary (because of the consequence of a presumptively fraudulent transaction) without the additional authority required to make it actually mandatory. This sort of "double-edged" safe harbor is functionally equivalent to both requiring ex ante review and supplanting FTL.

If an LBO does not undergo review and later enters bankruptcy, creditors will enjoy the presumption of constructive fraud. That is, the transaction is presumed to have failed one or more of the standards of financial distress. Parties to the LBO will have a chance to rebut this presumption with financial data, but will have hindsight bias and the presumption working against them.

Given this rebuttable presumption of constructive fraud, the burden of proof would be on the debtor to show that the LBO did not leave the firm failing one of the three prongs of financial distress. This shifts the burden of proof from the current system of ex post review, where the creditors must show one of the three prongs. The debtor would meet its burden by presenting the financial models used to project the LBO's success at the time of the transaction. Of course, the debtor faces a difficult inquiry here: if the transaction was sound, why did you fail to submit it for ex ante review? Debtors could further bolster their case by showing that unexpected, intervening causes, rather than inherent financial instability, led to the bankruptcy.

The presumption should be sufficiently difficult to rebut to prevent repeat players from strategically bypassing ex ante review, preferring to roll the dice than to risk having the transaction stopped ahead of time. But while selling shareholders or managers may be incented to take the risk, the lending bank certainly is not—it has the most to lose if the LBO later fails and the parties face a rebuttable presumption of constructive fraud. From the lender's perspective, ex ante review is just one more step in the diligence process; it ensures, with an objective, third-party stamp of approval, that they're lending into a financially stable deal. Selling shareholders would be hard-pressed to convince a lending bank to conspire with them to strategically bypass review; there is simply not enough in it for the banks.

The amendment to the Bankruptcy Code would further need to define "LBO" to specify which transactions can reach the safe harbor through ex ante review (and, correspondingly, which must undergo review to avoid the presumption of constructive fraud). The definition should be expansive but also flexible, capturing the type of creditor-harming transactions that this Note has already explored. A flexible definition gives judges some latitude as to when to apply the double-edged safe harbor should the question arise ex post in a bankruptcy proceeding following a failed LBO. Judges would be looking for substance—is this the kind of LBO that shifted wealth from creditors to shareholders?—over the form that a technical and rigid definition would require. With little to lose and much to gain, if ex ante there were any doubt as to whether an LBO fit the flexible definition, parties to an LBO would be inclined to err on the side of caution and undergo review. After all, one of the advantages of ex ante review is that it confers a stamp of confidence on the transaction. Refusal to submit to ex ante review—even on the grounds that the transaction might squeak by outside the technical definition of LBOs—may weaken the confidence of the lending bank. If the transaction is sound, the parties have no reason to try to escape review.

A flexible, working definition of an LBO should involve a conjunctive list of requirements that captures all the features of the potentially creditor-harming transactions discussed thus far. First, the buyout substantially increases the debt-to-equity ratio of the target. This eliminates buyout transactions in which the company is already highly leveraged, as well as acquisitions financed with equity and not debt (that is, when the acquiring company uses its own cash to buy the target). In neither of these cases does the risk of existing debt increase significantly as a result of the transaction. Second, the transaction involves the creation or transfer of a control block of shares, as is the case in the going-private LBOs. This eliminates non-buyout transactions in which a company issues additional debt to raise capital (and therefore increases its debt-to-equity

ratio, perhaps substantially, but without a change in control). Since the double-edged safe harbor is meant to apply to *buyout* transactions, it should not overreach to interfere with standard debt issuances. After all, one of the main justifications for protecting LBOs from ex post fraudulent transfer attack is that they facilitate the market for corporate control; such a justification does not extend to debt issuances. Third, the transaction does not offer to redeem all pre-existing debt. This eliminates buyout transactions that protect creditors by giving them a chance to cash out their debt (or renegotiate for new interest rates commensurate with the additional risks of leverage) before it increases in risk and drops in value. These creditors do not need the protection of ex ante review to ensure that the buyout is sound.

B. Procedural Details

Parties to an LBO – that is, the selling shareholders, the acquirer, and the lending bank – would file for review with an independent third party which could take the form of a court-appointed examiner, auditor, or valuation expert. The most natural choice for a reviewer seems to be an accountant, since the standards that an LBO must pass in ex ante review all relate directly to the financials of the target company. Because those parties are properly incentivized to have the transaction reviewed, existing creditors need not take action to initiate review. Parties to the LBO would file for review of their own accord knowing that, if they do not, the double-edged safe harbor will render their transaction presumptively constructively fraudulent should the target enter bankruptcy at a later date.

The acquirer and lending bank need only to turn over to the reviewer the extensive due diligence they have already performed regarding the firm's assets, liabilities, and projections of future cash flows. Before lending into a buyout, a bank examines the target's financials, creating pro forma schedules of assets and liabilities, obtaining statements of assurance from the target's CFO, and using discounted cash flow projections to estimate the target's debt-earnings ratio post-buyout.[115] A number of consultants take part in the process, including accounting firms, investment banks, valuation experts, and lawyers.[116] Under the current regime, investment bankers and valuation experts sometimes hesitate to issue strong solvency opinions, in large part

115. Christian C. Day et al., *Riding the Rapids: Financing the Leveraged Transaction Without Getting Wet*, 41 SYRACUSE L. REV. 661, 736-38 (1990).

116. Matthew T. Kirby et al., *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27, 40 (1987).

because of the potential liability associated with a future fraudulent transfer claim.[117] With the specter of such litigation eliminated, experts can more fairly evaluate the prospects of the target company. Any solvency opinions still have to pass muster under the eye of the reviewer, but valuators need not discount for the possibility of hindsight bias or other complications in a future bankruptcy litigation. Rating agencies sometimes participate in the review process, too, as parties to an LBO often structure the transaction with the intention of achieving a certain debt rating in the target's post-LBO debt.[118] Since the acquirer and the lending bank already complete all this due diligence for their own purposes, submitting to ex ante review by turning over that material does not impose large additional information-gathering costs on the transaction.

If the target wants the LBO approved, it is incentivized to cooperate in turning over its financial information to the reviewer. In the case of a hostile takeover, management of the target may resist turning over information to the reviewer if they are certain the information would help the LBO pass ex ante review; this would indeed be another weapon in management's arsenal against the desires of its shareholders to sell. The public security filings of publicly traded companies, however, may be sufficient, particularly when supplemented by the diligence work of the lending bank.

The reviewer would then use all of the submitted information to analyze the proposed LBO under the same three standards of financial distress used to evaluate transactions under current FTL. That is, the reviewer would ask whether the transaction would leave the target insolvent, inadequately capitalized, or unlikely to be able to pay its debts as they came due. Under a regime of ex ante review, there is no change to the standards of evaluation—only to the timing. While the three standards of financial distress would still suffer from the subjectivity and indeterminacy already discussed,[119] the analysis is relieved of the burden of hindsight and the other difficulties of ex post review. Valuation difficulties aside, an analysis of the transaction's feasibility at the time of the LBO is best completed at the time of the LBO.

One modification for ex ante review, however, would be to drop the third standard of financial distress. As discussed earlier, "unreasonable capitalization" is arguably the most subjective standard,[120] one with no

117. Blackwood, *supra* note 38, at 374.

118. Ginsberg et al., *supra* note 71, at 94.

119. *See supra* Section II.D.

120. *Id.*

statutory definition and a history of inconsistent interpretation in the courts.[121] While Congress found the standard sufficiently firm to impose on failed LBOs, imposing it on proposed LBOs is admittedly a different matter. Since the very nature of an LBO is to leave a firm highly leveraged – that is, with a small capital cushion – we might see too many of what below[122] are labeled Type I (false negative) errors if we impose this standard ex ante. We could reduce these Type I errors by implementing ex ante review with a modified scheme of only the first two standards – insolvency and inability to pay debts as they come due.[123]

While creditor action is not required to initiate ex ante review, creditors would have the opportunity to oppose the buyout by submitting their own materials to the reviewer – for example, valuations from their own hired expert that contradict the valuations submitted by the acquirer and lender. The reviewer would then consider the data and arguments of both sides in his evaluation of the transaction. Indeed, even under the current regime, there seems to be nothing stopping creditors from suing to enjoin a pending LBO before it is finalized.[124] Such intervention would likely play out in the same kind of dueling-experts valuation battle that we currently see under fraudulent transfer litigation, only with the advantage of settling the valuation question before and not after it's too late. In order to give full opportunity to creditors to participate in the process, an additional requirement of submitting for ex ante review would be to notify all creditors of such submission.

The review process could be iterative; that is, if the reviewer rejects the proposed transaction, the interested parties could re-work the transaction and submit again for another review. For example, if the reviewer finds that the sale leaves the company too highly leveraged, parties could reduce the purchase price, or the purchasing group could contribute equity alongside the lender's loan. These two possible features of the review process – the opportunity for creditors to litigate ex ante and the opportunity for parties to the transaction to resubmit for subsequent review – might functionally turn the process into a negotiation between the creditors and the LBO proponents, with the reviewer

121. Selassie, *supra* note 75, at 406-08.

122. *See infra* Section IV.C.

123. What this conversation really requires is a proper review of all three standards of financial distress, and an exploration of whether better alternatives exist. This would require an empirical study of the financials of failed LBOs at the time of the transaction, alongside parallel data from successful LBOs, to see which standards best predict bankruptcy, and thus would best distinguish ex ante between likely-to-succeed and likely-to-fail transactions.

124. Ginsberg et al., *supra* note 71, at 106.

acting on behalf of the creditors to ensure that the transaction does not leave the target in financial distress. This addresses both the collective action and sophistication concerns that normally arise where the interests of a group of unsecured creditors are involved.

Under the proposed regime, the acquiring company would be responsible for paying the costs associated with third party review. In practice, these costs might very well be passed on to—or at least shared by—the selling shareholders, in the form of a lower purchase price paid. Recall, however, that the shareholders are often paid a premium for their shares in a leveraged buyout. Part of the criticism of LBOs is that they involve a wealth transfer from debt holders to shareholders. Since ex ante review protects debt holders, but is paid for by shareholders, it works in the opposite direction as that wealth transfer. Shareholders might walk away with a lower premium, but creditors are protected against unsound transactions that greatly reduce the value of their debt.

IV. ADVANTAGES OF EX ANTE REVIEW

A. *Hindsight Bias*

Since review is performed before the LBO instead of after, it isn't tainted by the same kind of hindsight bias we see under the current regime. The reviewing party need not pretend it doesn't know the LBO eventually failed in order to determine if it was likely to fail months earlier. The questions presented for valuation are best answered with contemporaneous data—the target's present financial information—rather than old figures that are subject to manipulation based on eventual outcomes. The question of whether an LBO was a good idea *at the time* is best decided, well, at the time.

It is illuminating to compare the benefits of ex ante review to another proposal addressing the hindsight problem. Michael Simkovic and Benjamin S. Kaminetzky propose that, to escape hindsight bias, bankruptcy courts look at the spreads of the target's credit default swaps in the time leading up to the LBO to determine whether, according to the market, the target was already headed for bankruptcy before the buyout took place.[125] This way, they argue, courts can sidestep some of the hindsight bias inherent in ex post analysis.

Ex ante review, like Simkovic and Kaminetzky's proposal, seeks to remedy hindsight bias, but with a different solution. It departs from existing

125. Simkovic & Kaminetzky, *supra* note 89.

scholarship in this area by proposing that LBOs be evaluated for financial distress *before they ever take place.* Ex ante review would generate enormous cost savings: wealth-destroying transactions would be precluded, rather than remedied; litigation costs would be minimized if not entirely removed. Unlike Simkovic and Kaminetzky's proposal, it would work for all target companies, not only those with widely traded credit default swaps. Also, unlike the credit default swap solution, it would entirely remove hindsight bias, rather than adding a piece of unbiased data to the mountain of biased evidence before the court. Ex ante review would even make it easier for parties to engage in wealth-creating LBOs, since they would no longer need to discount for the probability of fraudulent transfer litigation in the wake of an unexpected downturn.

B. Improved Valuation

Absent ex ante opposition by creditors, a neutral, third-party appraisal takes the "dueling hired guns" problem out of LBO analysis. It gives the final say on valuation to one financial expert, rather than to a court faced with conflicting testimony from two biased and conflicting hired experts. Of course, if creditors do choose to oppose the LBO with valuation data of their own, the dueling guns problem returns. However, such ex ante opposition is not required under the proposed regime, and, unlike ex post litigation, review can take place without it.

One problem with having one expert instead of two is that it might reduce the accuracy of the valuation. Importantly, opponents to ex ante review might suggest that the accounting firm or other reviewer appointed to review is incentivized to approve the LBO so that it gets more work in the future. But accounting firms, investment banks, and other firms already face these conflicts in all areas involving valuation; we simply rely on these firms to protect their long-term reputations at the expense of increased short-term business.

C. Discrimination Between LBOs that Will Fail the Standards of Financial Distress and LBOs that Will Pass Them

When lenders and purchasers discount for all of this uncertainty, they decline to undertake some LBO opportunities that, but for the risks presented by fraudulent transfer litigation, have a positive expected value. The parties to the transaction have to discount both in the case of likely-to-pass LBOs and likely-to-fail LBOs, for a number of reasons: a hindsight-biased court might impose liability for a once-likely-to-pass buyout that, for unforeseeable

reasons, went badly; creditors may later be able to extract settlement value even if the fraudulent transfer claims are weak; and courts may interpret the Bankruptcy Code's unpredictable standards of financial distress in some unanticipated way. The discounting imposed by the current regime falls on good and bad transactions alike.

An ex ante review, by contrast, distinguishes between likely-to-pass LBOs and likely-to-fail LBOs, encouraging the former and chilling the latter. Review encourages the former because parties to the transaction rest safe in the knowledge that the buyout, if deemed now to pass the standards of financial distress, cannot later be unwound after some series of unforeseen events. It chills the latter because it sets out an extra procedural hurdle for the transaction to clear before going forward. It puts more scrutiny – and more importantly, disinterested scrutiny – on the deal. Negotiating parties, knowing this ahead of time, may even be less likely to put such likely-to-fail LBOs up for review in the first place, further reducing wasteful transaction and review costs.

Jenny and Edward Wahl consider a similar view of LBOs in the context of Type I and Type II errors.[126] A Type I error occurs when a likely-to-pass LBO is barred, while a Type II error occurs when a likely-to-fail LBO is allowed to go through to completion.[127] This is a useful framework for analyzing the issue. While removing LBOs from the arena of FTL would eliminate Type I errors, it would do so only by increasing the number of Type II errors. Ex ante review, on the other hand, works by decreasing both Type I *and* Type II errors, for precisely the reasons discussed above: fewer likely-to-fail LBOs are put up for review in the first place, and more scrutiny is attached to them, reducing Type II errors; LBO proponents no longer need to discount likely-to-pass LBOs for fraudulent transfer avoidance, reducing Type I errors.

Further, scholars worry that the cost of capital for an LBO is made unnecessarily high by the risk of fraudulent transfer litigation, as the lender increases interest rates to compensate for the negative expected value of having its lien on the target's assets avoided.[128] Since ex ante review eliminates this future risk to the lender, we might expect the lender to pass on those savings to the purchaser and the target company. This makes an LBO more affordable, from the perspective of the post-LBO company, increasing the number of potential purchasers and resulting in a general boost to the market for corporate control.

126. Wahl & Wahl, *supra* note 38, at 364-66.

127. *Id.*

128. Zaretsky, *supra* note 38, at 1200.

D. *Sharing the Benefits of an LBO: Turning Kaldor-Hicks-Optimal Buyouts into Pareto-Optimal Buyouts*

The distinction between likely-to-pass and likely-to-fail buyouts raises a question: what exactly constitutes a successful LBO? The question is not only whether the transaction constitutes a wealth *transfer* from bondholders to shareholders, but also whether the transaction is wealth-*creating* in sum.

Empirical studies have examined the losses to bondholders and the gains to shareholders in LBOs and concluded that stockholder gains tend to far exceed bondholder losses.[129] The Nabisco buyout provides one example.[130] The purchaser paid stockholders $109 for shares that, before announcement of the buyout, were trading at $55.[131] Met Life estimated after the deal that it would have cost the purchasers an average of $4 per share to make bondholders whole again for losses in the bond trading values after announcement of the buyout.[132] Coffee argues that it is equitable to demand such compensation.[133] First, investors are not all evenly invested in equity and debt, which means some investors consistently lose while others consistently win in a wealth transfer from bondholders to shareholders.[134] Second, insofar as some of the losers in the transaction, like employees, are geographically concentrated, "a regulatory mismatch is created," with small, local parties unable to fight the interests of the parties on the other side (e.g., lending banks).[135]

We can analyze the distinction between wealth-transferring and wealth-creating transactions from the standpoint of Pareto efficiency versus Kaldor-Hicks efficiency.[136] A transaction is Pareto efficient if it makes some parties better off while making no party worse off.[137] An LBO that yielded gains to shareholders and no losses to bondholders, employees, or involuntary creditors

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129. Bratton, *supra* note 38, at 123 (citing Robert A. Taggart, *The Growth of the "Junk" Bond Market and Its Role in Financing Takeovers*, *in* MERGERS AND ACQUISITIONS 5, 6-11 (Alan J. Auerbach ed., 4th ed. 1988)).

130. Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

131. Coffee, *supra* note 54, at 1544 (citing Barbara Franklin, *Met Life Looks for Help*, N.Y. L.J., May 11, 1989, at 5, col. 5).

132. *Id.*

133. *Id.* at 1544 n.176.

134. *Id.*

135. *Id.* at 1548.

136. *See* Jules Coleman, *The Normative Basis of Economic Analysis: A Critical Review of Richard Posner's* The Economics of Justice, 34 STAN. L. REV. 1105, 1106 (1982).

137. *Id.* at 1107.

would be Pareto efficient. A transaction is Kaldor-Hicks efficient if it results in net gains to the parties involved.[138] An LBO that earned shareholders a $20 million premium on their shares and cost bondholders $15 million in losses would be Kaldor-Hicks efficient. One way of looking at a Kaldor-Hicks efficient transaction is to say that, by rearranging the gains among the different parties, Pareto optimality could be attained.

Contractual solutions like poison puts, discussed in the next Section,[139] under which the acquirer in an LBO must buy out all existing debt at face value, ensures that a proposed LBO is at least Kaldor-Hicks efficient. The acquirer will not attempt to make the bondholders whole if, after doing so, there is not also enough profit leftover for the acquirer to keep for itself. In other words, by buying out existing debt, acquirers turn a Kaldor-Hicks efficient transaction into a Pareto efficient transaction. At least, they do so as far as the parties of bondholders and equity holders are concerned; whether employees, future creditors, or involuntary creditors should also be compensated is another question. Indeed, others have proposed, in the context of an LBO, similar compensatory wealth transfers: pre-funding certain obligations of the target,[140] compensating employees terminated as a result of the buyout,[141] or increasing the interest rates of existing creditors.[142]

In the negotiation induced by ex ante review, existing creditors, purchasers, and selling shareholders can analyze the proposed LBO through the lenses of Pareto and Kaldor-Hicks efficiency.[143] Through changes in the purchase price, or through offers to redeem debt, wealth created by the buyout may be allocated to one party or another to turn Kaldor-Hicks LBOs into Pareto LBOs. This ensures that all parties are made better off—or at least no worse off—by the transaction. It also puts additional roadblocks—third party review, creditor opposition—in the way of wealth-destroying LBOs that benefit selling shareholders at the expense of creditors.

138. *Id.*

139. *See infra* notes 155-160 and accompanying text.

140. *See* Burnham, *supra* note 56.

141. Coffee, *supra* note 54, at 1548 (explaining that "losers" in a takeover include employees while "winners" include shareholders, and suggesting that future policy consider forcing "winners" to compensate "losers").

142. Graml, *supra* note 6, at 37.

143. Coffee, *supra* note 54, at 1548 (suggesting that social policy should consider moving us from a Kaldor-Hicks analysis to a Pareto analysis, and leaving such policy as "the topic for another article").

E. Risk Sharing and Monitoring Incentives

A regime of ex ante review puts more eyes on the buyout, including those of a neutral third party. Giving the creditors the opportunity to object to the transaction before it takes place means that those creditors no longer get free insurance at the expense of lending banks; it shifts the monitoring responsibility to the party whose interests are served by monitoring, and whose monitoring efforts generate the fewest externalities. Given that unsecured creditors face a collective action problem outside of bankruptcy, it is central to the proposed regime that skipping review carries the penalty of the presumption of constructive fraud; in this way, review is not contingent on opposition from the unsecured creditors (even though they are still afforded the opportunity to object and to participate in the review process).

Some may object that the bank is still in the best position to monitor the deal – it is the cheapest cost avoider[144] – and thus the bank, not the creditors, should be responsible for monitoring. A third-party financial expert, though, provided with all the information available to the bank, is just as capable a monitor as the lending bank, but without the bank's self-interest. The *creditors* may not be in the best monitoring position, yes – but the regime provides them with a champion to monitor on their behalf.

F. Remedy and Costs

As discussed above,[145] the current regime of ex post review leaves inadequate remedies for the parties damaged by a constructively fraudulent transaction. Under ex ante review, by contrast, likely-to-fail LBOs are enjoined beforehand, preventing the damage rather than trying to undo it after the fact. For ailing companies for which an LBO was tantamount to a rescue, that might mean a bankruptcy now instead of later – but before time and money are expended in the rescue. Ex ante prevention, rather than ex post avoidance, also saves the creditors the high costs of fraudulent transfer litigation.

G. Assimilation of Fraudulent Transfer Law into Fraud Tort Law

By taking constructive fraudulent transfer claims out of the creditor arsenal, the proposed regime would filter many more LBO challenges into the

144. Selassie, *supra* note 75, at 429.

145. *See supra* Section II.G.

arena of actual fraud. The issue at litigation becomes not whether the target company was left undercapitalized or insolvent or unable to pay its debts, but rather whether the target company fully and accurately disclosed all of its financial information to the purchasers, lending bank, creditors, and third-party appraiser. In other words, creditors are not left without ex post recourse for LBOs later revealed to be manipulative. Questions of fraud and full disclosure are much better suited to ex post litigation than is the issue of valuation; that more information has come to light *helps* the court determine the question before it, rather than obscuring that question with hindsight bias. Essentially, as far as LBOs are concerned, the proposed regime assimilates the controversial and, as many have argued, outdated[146] FTL into the better-suited law of fraud.

V. POTENTIAL CRITICISMS OF EX ANTE REVIEW

A. *Why Don't Creditors Just Protect Themselves?*

One obvious criticism of any regime that protects creditors against overly risky LBOs is this: Why don't the creditors protect themselves contractually? Bond covenants could impose a ceiling on the debtor debt-to-equity ratio that effectively precludes an LBO; contingent rate-shifting bonds could compensate creditors if a debtor takes action to increase bond risk.

Scholars have posed a number of possible answers to this question.[147] In the case of the massive LBOs of the mid-1980s like the RJR Nabisco buyout,

146. Commentators object that fraudulent conveyance law, deriving from English law that stopped consumer creditors from nominally transferring assets before bankruptcy with the intent of taking them back after, has no place in the arena of corporate buyouts. Baird and Jackson, in their seminal argument against fraudulent transfer law as applied to LBOs, referring to the original English case from which the law derived, noted succinctly that 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." Baird & Jackson, *supra* note 38, at 852.

147. *See generally* Coffee, *supra* note 54, at 1502-03 (exploring the possibility that bondholders earn higher interest in return for the lack of covenants; that risk was so low it was not worth protecting against; that bondholders believed the law already protected them; and that bondholders relied on an implicit agreement with managers); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 45 (1986) (suggesting that perhaps proper protective mechanisms had not yet developed); Graml, *supra* note 6, at 13-14 (noting that bondholders believed that management was constrained from opportunistic behavior by the knowledge that such behavior would prompt the imposition of restrictive covenants on future bond issuances).

an easy answer is that creditors never anticipated such a transaction, or thought the law would protect against this type of wealth transfer.[148] To this point, creditors in *Nabisco* argued (unsuccessfully) that the debtor's management violated the implied standard of good faith and fair dealing by cashing out equity at the expense of pre-existing debt.[149]

But this explanation is less satisfying for bonds issued *after* the 1980s, when creditors were aware of the danger of over-leveraging subsequent to a bond issuance. Still, even in the 1990s, scholars posited that the probability of an LBO was too low to warrant bondholder concern.[150]

Another possibility is that creditors give up contractual protections against levering up in exchange for a higher interest rate. In this way, the risk of an LBO is already priced in. Coffee explores the possibility that negative covenants are not reliable protections against all levering transactions; when investors cannot distinguish between strong indentures and weak ones, a market for lemons develops in which debtors cannot expect lower interest rates by credibly committing to covenants precluding risky leveraged transactions.[151] Further, given the tax advantages to the corporation of higher debt levels, it may be difficult to distinguish between "opportunistic" leveraging and leveraging done for good "business purposes."[152]

Additionally, Coffee suggests that creditors may be free-riding on the known risk aversion of managers, who have too much undiversifiable human capital invested in the firm to take such large risks.[153] If managers are risk-averse, however, it seems they wouldn't object to covenants limiting the leverage of the company. Coffee also argues that there may just be too many ways for managers to increase firm-specific risk for creditors to attempt to circumscribe all such behavior via contractual covenants.[154] In the case of LBOs, however, a leverage-limit covenant seems to cover all bases.

One contractual provision *does* attempt to protect bondholders against losses associated with an LBO: the "poison put," which is triggered at the occurrence of both a designated event, such as a change in control or an all-

148. Coffee, *supra* note 54, at 1503.

149. Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1507-08 (S.D.N.Y. 1989).

150. Fogelson, *supra* note 113, at 594 ("An LBO is not a typical occurrence and cannot be compared to . . . typical risks. . . . It is doubtful that creditors contemplate the complete replacement of equity with huge amounts of senior debt.").

151. Coffee, *supra* note 54, at 1511.

152. *Id.* at 1508.

153. Coffee, *supra* note 147, at 8 n.16.

154. *Id.*

asset sale, and a downgrade in bond rating.[155] If both these conditions are met, a poison put allows the bondholder to redeem his bond early and at full face value.[156]

For a number of reasons, however, poison puts are inadequate to address the problem of wealth transfers from bondholders to shareholders in an LBO. First, redemption at face value could still amount to a loss to bondholders, relative to their position before the triggering event, if interest rates have risen since the debt was issued. Second, the condition of a downgrade by Moody's or Standard & Poor's will not necessarily be met immediately upon announcement by the firm of an LBO, even if that announcement resulted in a decline in the market value of the bonds.[157] Bond ratings are retrospective, and often the change in a targeted company's rating does not occur until four or five months after the announcement of the buyout.[158] Third, poison puts generally only last for ten years, even for bonds of longer duration, because the market is not willing to pay for protection further out in time.[159]

Graml further offers procedural reasons that contractual provisions like poison puts have not supplanted FTL. Bond contracting is not typical arms-length bargaining taking place between individual creditors and debtors.[160] Instead, underwriters negotiate the contract with the debtor on behalf of the eventual creditors. To the extent that the underwriter is not able to exhaustively communicate to the future creditors the value of each covenant negotiated – perhaps because of a lack of sophistication on the part of bond buyers – such covenants in turn hold less value for the underwriter. This may be the reason that restrictive covenants in indenture contracts are "boilerplate provisions" that are never negotiated.[161] By nature, the contract is an adhesive one for the eventual creditor. Other scholars agree that creditors "do not have the bargaining power to protect their claims from . . . subordination [to creditor claims in an LBO] in advance."[162]

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155. Graml, *supra* note 6, at 34.

156. *Id.*

157. Coffee, *supra* note 54, at 1510 n.51.

158. *Id.*

159. Graml, *supra* note 6, at 37 (citing Peter Heberling, *Event Risk Provisions Protect Bondholders Against Takeovers*, NAT'L LAW. J., June 5, 1989, at 22).

160. *Id.* at 16.

161. *Id.* at 16-17.

162. Fogelson, *supra* note 113, at 594.

For all these reasons, creditors do not protect themselves contractually under the current FTL regime. This would likely remain the status quo under the proposed regime, as well, for all the reasons discussed above: creditors give up covenants for higher interest rates; they rely on manager's implicit risk-aversion; they cannot distinguish between opportunistic and efficient leveraging; and bondholders do not negotiate for themselves for bond provisions.

Further, ex ante review is superior to a contractual solution in a number of ways. First, ex ante review would be a single, centralized process. The debtor would not individually negotiate with each creditor, nor would the creditors be required to overcome any kind of collective action problem or holdout incentive, as they would in a bond redemption negotiation.

Imagine a distressed debtor whose bonds are trading below par due to the market's assessment of its default risk. If the creditors were protected by bond covenants, rather than by a regime of ex ante review, the debtor could negotiate with individual bondholders for a redemption price at which the bondholder and the target share the potential benefits of the LBO (e.g., increased access to capital from the new lenders, synergistic gains with the new owner, etc.) while sharing the risk of increased leverage. Multiple negotiations with dispersed creditors impose costs in time and money, compared to the centralized process of ex ante review.

Similarly, a requirement of bond redemption at face value, or a poison put, is both overprotective and underprotective of the creditors. It may be underprotective if interest rates have fallen since the bonds were issued. It may be overprotective and confer a windfall to bondholders if the bonds were trading below par before the announcement of an LBO, either because of firm-specific default risk or because interest rates had risen since the bonds were issued. Such overcompensation of the bondholders means that some likely-to-pass LBOs will be precluded by artificially high costs of the transaction. Finally, even if a poison put neither under- nor over-compensated bondholders, it still substantially increases the capital required to complete the leveraged transaction.

B. Type I Errors in Ex Ante Review

As discussed above,[163] Type I errors are false negatives. In the context of ex ante review, that means LBOs that would have been successful but were barred

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163. *See supra* Section IV.C.

by ex ante review. One strong criticism of an ex ante regime is that ex post litigation applies only to bankrupt firms; ex ante review, however, applies to all LBOs, and thus might result in a significant number of these Type I errors.

Consider the LBO, however, that fails ex ante review: to do so, it must meet one of the three standards of financial distress. Congress decided that these standards marked the point at which the wealth transfer through risk-shifting from shareholders to bondholders becomes unacceptable. An LBO that meets one of the standards of financial distress is not a sound transaction. It represents the shareholders and the lending bank gambling with the creditors' money. In an equitable analysis, such a gamble should be stopped – even if that gamble later turns out to be successful. It is no defense for the shareholders to argue that their gambling with the creditors' money is acceptable just because that gamble happened to pay off.

Putting equity aside and considering only efficiency, transactions that meet one of the standards of financial distress are likely to be wealth-destroying in net. Consider the three standards: the target is left with unreasonably small capitalization; the target is unlikely to be able to pay its debts as they come due; or the target is left insolvent. All three of these standards mean a likelihood of eventual bankruptcy, which entails enormous costs to all parties involved.

For this reason, we need not worry about the LBOs that would have succeeded but for being barred by ex ante review. Those LBOs are, by the very definition of the standards of financial distress, the great minority.

One way, however, to mitigate this concern would be to alter the standards of financial distress to a more lenient form. This proposal suggests importing the same standards from ex post review; but perhaps ex ante review calls for lesser standards. After all, one might object, the nature of an LBO is to place a firm in a near-bankrupt state. The nature of the LBO is a gamble. While this Note takes the position that the current standards would be as apt for review ex ante as they are ex post, a softer form of this proposal may better allay concerns that too many transactions will be barred. The standards could be changed in degree without being changed in substance; for example, a modified insolvency standard might require that the debtor be left insolvent with no reasonable chance of achieving solvency in the foreseeable future.

Several issues are at stake in the question of how best to discipline constructively fraudulent LBOs. Excessively rigid standards unduly restrict the market for corporate control, weakening an important tool for keeping corporations efficient. Excessively loose standards, on the other hand, allow shareholders to extract wealth from creditors too easily, which in turn could drive up interest rates to compensate for additional risk. The current standards imposed by the Bankruptcy Code reflect Congress's line-drawing, and

that line may need to be re-drawn if all LBOs, not just those that fail, are disciplined by it.

C. *Information and Transaction Costs*

The proposed regime involves some additional ex ante costs for finalizing an LBO. The target must provide extensive information to the third-party reviewer, as well as putting on notice all of its current creditors, who, under the proposed regime, are given the opportunity to participate in the review process by actively opposing the LBO. As discussed,[164] however, the target, purchaser, and lending bank already engage in extensive due diligence during the negotiation and preparation of a buyout.[165] Under the notification portion of this proposed regime, this work is simply made public and subject to additional monitoring by the other parties with a stake in the transaction.

While turning over information to the reviewer requires little additional work, the process of review itself will impose a more substantial cost on the transaction. The acquirers are paying for the reviewer's time and expertise. If creditors fight the buyout by submitting their own valuations and projections, then the acquirers also pay bankers or valuation experts to analyze this data and oppose it. That imposes additional costs on the creditors, who pay to hire their own expert to challenge the financial picture painted by the acquirers. Given the collective action problem that creditors face, it seems unlikely that any small stakeholders would be willing to foot such an expense. If this is the case, the ability to litigate ex ante could be criticized as fair in theory while unrealistic in practice. Still, creditors with large stakes in the company, or sophisticated investors who are able to collaborate, may find opposing the buyout to be in their interests.

For any single buyout, the procedural costs of ex ante review are likely still dwarfed by the enormous magnitude of full-blown fraudulent transfer litigation in the midst of a bankruptcy proceeding. The criticism of ex ante review, however, is that these costs are imposed on *every LBO*, while ex post litigation occurs only in a handful of cases. Reviewing every proposed LBO sounds wasteful. If a transaction passes review, in some sense that review represents the wasted cost of a double-check on a sound transaction. From this perspective, Simkovic and Kaminetzky's approach of using credit default swap prices leading up to the buyout in order to evaluate a failed LBO is superior to

164. *See supra* notes 117-119 and accompanying text.

165. Day, *supra* note 115, at 736-37.

ex ante review: it beats hindsight bias, but still limits review to those transactions that have actually failed. Comparing the two regimes, the question, then, is whether the procedural costs of ex ante review are less than the expected value of the costs of ex post litigation, when such litigation is discounted by the probability of bankruptcy.

But in fact we can go further in this cost comparison. It is inequitable to allow shareholders to gamble unreasonably with bondholder money even if that gamble ultimately pays off. It is no equitable defense of a prohibited wealth-transfer for the shareholders to argue that it all worked out in the end. Likely-to-fail buyouts are not only wealth-transferring, but wealth-destroying. The goal should be to stop all likely-to-fail buyouts – that is, all the buyouts that fail the standards of financial distress – not just the ones that ultimately do fail. When we add this consideration to the cost equation, we reduce the net costs of the proposed regime.

D. Restricting Market Forces

Imposing external review on the market for corporate control also feels like an undue restriction of market forces. Mergers and acquisitions are private, contractually-governed transactions; it is generally left up to the parties involved to protect themselves through negotiation, and up to market forces to determine proper pricing. Further, without extensive regulatory reach, there seems to be little authority to place such an umbrella-like restriction on one type of corporate transaction.

FTL, however, recognizes a particular time when one party – namely, creditors – are entitled to protection beyond what they negotiate for themselves through contract. In this peculiar intersection of a large corporate transaction and a particular piece of the Bankruptcy Code, Congress has found it warranted to interfere with market forces. If we accept that failed LBOs get this special kind of attention after the fact of failure, then perhaps it makes sense to impose a limited check on the market before the fact. Externalities justify regulation, and the externalities of LBOs, in which shareholders extract value from creditors, are abundantly clear. Contractual solutions have failed to solve the problem of wealth-extracting LBOs, and FTL already recognizes as much. Further, the existence of FTL as codified in §§ 544 and 548 of the Bankruptcy Code create a convenient opportunity to provide a system of review without the regulatory authority required to *mandate* review. Without these provisions, a system of ex ante review seems a mammoth undertaking and unlikely proposition. For this reason, it is not surprising that ex ante review has not yet been proposed.

E. Bad Faith Objections and Disclosure Timing

The proposed procedure does increase the amount of time the LBO is in negotiation, and the purchasers and lenders may worry that the review process would be subject to abuse by other interested purchasers. For example, a competitive bidder may find a way to use the objection and review process to hold up the original bidder's deal and to get a peek at the intricacies of the proposed transaction, the better to marginally best the offer currently on the table.

But friendly bidders making tender offers or structuring mergers face the same issue. Parties to these deals find ways to ward off competitive bidders using exclusive dealing and good-faith negotiation arrangements.[166] Under the proposed regime, for example, the purchaser, lender, and target company could finalize and commit to the LBO deal—subject to the approval of ex ante review—before sending notice out to the target's creditors and before undergoing the process of review.

The process of ex ante review should also be timed appropriately late in the process in order to guard against the possibility that changes in the target's financial condition occurring after review but before finalization render the findings of the review inaccurate. In *In re O'Day Corp.*, for example, the court rejected the projections of the target's future cash flows because they were based on long-range historical data and did not incorporate a downturn in profits that occurred shortly before the buyout.[167]

F. Risk Externalities and Imperfect Adjusters

The most forceful criticisms of ex ante approval of LBOs are likely to come from those eager to protect creditors and skeptical of LBOs generally. In the long debate over whether FTL should be applied at all to LBOs,[168] one of the strongest justifications for its use is that an LBO creates risk externalities

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166. WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 577 (4th ed. 2012).

167. 126 B.R. 370, 405 (Bankr. D. Mass. 1991).

168. *See generally* William C. Rand, *In re* Kaiser Steel Corporation*: Does Section 546(e) of the Bankruptcy Code Apply to a Fraudulent Conveyance Made in the Form of an LBO Payment?*, 19 FORDHAM URB. L.J. 86 (1991) (exploring whether or not § 546(e) of the Bankruptcy Code, which precludes the application of FTL to settlement payments made to certain financial parties, should apply to LBO payments); Sabino, *supra* note 66 (analyzing the schism between courts that have applied FTL to LBOs and scholars who have opposed such application); White, *supra* note 38 (exploring the technical applicability of FTL to LBOs).

within the firm.[169] An LBO shifts risk from selling shareholders to current and future creditors, as well as to firm employees impacted by the firm's increased risk of bankruptcy.[170] When external parties can adjust to the increased risk—by charging higher interest rates, for example—there is little policy reason for policing the risk-shifting, unless that adjustment process involved high transaction costs. In the case of LBOs, however, a number of the parties with increased risk cannot adjust for it: existing creditors, employees, and future involuntary creditors (e.g., tort victims or tax authorities). The three-pronged criteria of FTL attempt to protect these imperfect adjusters with a minimal cushion shielding against bankruptcy. Giving the green light ex ante and shielding negotiating parties against later fraudulent transfer litigation limits these protections. It provides a mechanism by which creditors give up their future litigation rights and thus limits the bargaining tools that creditors have in any pre-LBO negotiations. In the case of ex ante review, under which creditors have an opportunity to litigate against the financial projections used to approve the LBO, the creditors of an ailing company who are desperate for a fix, even a risky one, may be coerced out of objecting.

The answer to this set of objections is that a process of ex ante review does not generally tip the scales in favor of the target and lenders and against the creditors. That is, it should not make it easier for LBO participants to extract value from creditors through an overly-risky transaction—and that is because of the review's discriminatory effect on likely-to-pass and likely-to-fail LBOs. By imposing an extra layer of scrutiny on an LBO before it proceeds, LBO participants looking merely to extract value may be less inclined to propose the transaction in the first place. And those who do will be ferreted out by the process of external review. If the ex ante review spurs pre-transaction negotiations between interested parties, it can increase only the number of Pareto-efficient LBOs and decrease the number of overly-risky or wealth-destroying transactions.

CONCLUSION

The current regime of constructive fraudulent transfer litigation suffers from problems of hindsight bias and inadequate remedy, adds great uncertainty to potential transactions, and creates poor monitoring incentives regarding buyouts. The solution proposed in this Note attempts to remedy

169. *See* Ginsberg et al., *supra* note 71.

170. *Id.*

many of these difficulties. The strength of this proposal turns on its ability to do what the current regime does not: distinguish between different types of LBOs. Ex ante review of LBOs makes likely-to-pass or "good" LBOs safer for the parties involved, while making likely-to-fail or "bad" LBOs tougher to execute in the first place. With such ex ante review in place, any ex post litigation over LBOs would turn not on a second-guessing of projections made at the time of the transaction, but on the completeness and honesty of the target's disclosure of its financials—a question much better suited to ex post analysis than are questions of valuation.