

THE LERNOU & HAUSPIE SAGA
BY
BERNARD HANOTIAU
MEMBER OF THE BRUSSELS AND PARIS BAR*

1. A Success Story

In 1987, Jo Lernout and Pol Hauspie formed Lernout & Hauspie, a company in Flanders, Belgium. Specialising in voice technology, its purpose was to create software to process and translate human speech in various languages. In practice, it would allow a Frenchman to telephone a Japanese colleague, allowing each to speak freely in their own language without substantial delay.

On December 1, 1995, L&H debuted on the NASDAQ at 4 USD per share.

In February 2000, L&H bought its American competitor Dragon, primarily through an exchange of shares. It then purchased Dictaphone, another American company, soon after.

In late March 2000, in a market bullish toward technological companies, L&H peaked at 72 USD. This valued the company at 120 times its profit, or 450 billion BEF (approximately 10 billion USD).

2. The Beginning of the End: The Revelations of the Wall Street Journal in August 2000

In August 2000, The Wall Street Journal published several articles expressing doubt over L&H's profit, and its Korean subsidiaries in particular.

The company was accused of fraudulent accounting practices. It was accused of falsely registering asset revenues originating from exchange agreements with other creators of software when no payment was made on either side. It was also accused of recording revenues linked to development works that should have been reported at a later stage. It was further suspected of registering sales before the contracts have been signed or even where clients were indefinite.

In the same month, Gaston Bastiaens resigned as CEO and was replaced by American John Duerden.

3. November 2000: The Descent to Hell

In November 2000, L&H shares were suspended on the NASDAQ and the EASDAQ. It continued to be transacted on a non-official market, known as the "pink sheet." The pink sheet market, a vestige from an early 1900's US stock exchange information sheet, is one which allows transactions of 'penny stocks,' or shares which are transacted for less than one dollar.

On November 17, 2000, John Duerden, Managing Director of L&H, went to Korea to ascertain why the L&H Korean subsidiary refused to release the 100 million USD in cash which appeared in its accounts. Given the increasing financial scandal, L&H needed these funds to thwart bankruptcy. Instead of having the money released, he discovered that the 100 million USD had disappeared, further evidence of the fraudulent accounting practices in L&H's operations.

On November 27, 2000, the five banks which had lent 430 million USD (nearly 20 billion Belgian francs) to L&H ended the credits. The loans had indeed been granted based on auditing figures that later turned out to be false.

In addition to heavy third quarter losses, management changes and the Korean debacle, the banks had not received a satisfactory business plan nor audit reports ordered from KPMG. The banks therefore requested reimbursement of the funds already disbursed. This request is synonymous with “*l'ébranlement des crédits*”, (when company can no longer access credit) a necessary step prior to “concordat” (composition with the creditors) or a bankruptcy.

In Belgium, when a company stands at the edge of the abyss and can no longer fulfil its financial undertakings, it may choose one of the two following paths:

- Concordat: when a recovery appears possible and the company in question acts in good faith, it may request authorisation of the tribunal to initiate a *procédure concordataire*. This procedure entails negotiation with the creditors to establish a plan for the company's recovery and payment (at least in part) of its debts. The resulting agreement must be approved by a majority of the creditors and subsequently by the court.

If successful, this procedure enables the company to regain its footing. Of course, allowing a company to temporarily freeze its debts affords it the opportunity to maximise its assets to better face existing financial obligations.

- Bankruptcy: when it appears from the beginning that recovery is impossible, that the company acts in bad faith, or where the “*procédure concordataire*” fails, the only remaining solution is bankruptcy, which must be declared by the Commerce Court. Once the bankruptcy is declared, a receiver in bankruptcy is appointed to liquidate the company: the assets are liquidated and distributed among the creditors according to their rank.

On November 29, 2000, L&H placed itself under the bankruptcy protection laws of the United States (Chapter 11). It also announced that it had filed a request for concordat in Belgium.

Before examining the Belgian judge's decision, it is useful to note that a court receiving a request for concordat may reach one of three decisions :

- First, the tribunal may either decide immediately on the validity of the request or it may postpone its decision ;
- If the court finds the company's plan of recovery to be credible, and finds that the financial partners and the banks also approve, the company is granted a provisional stay of six to nine months ;
- However, if the court believes that the conditions for the concordat are not met, it must reject the request. In this case, the company will normally default to bankruptcy.

4. The Request for Concordat : 27 December 2000

On December 5, 2000, the Commerce Court of Ypres declared that its decision on the request would be reached on December 8. The three-day extension was due to the complexity of the matter.

A few notable clarifications were made during the hearing:

- L&H's lawyer declared that the 100 million USD which disappeared in Korea had been used to reimburse clients. He also explained that in the United States a bridge credit of 20 million USD had been granted by General Electric's Capital (a financial subsidiary of the American conglomerate) ;
- Attorneys representing the banks requested a stay of two months, arguing that the standard period of six months was too long. They contended that the L&H group lost approximately 20 million USD per month.

On December 8, 2000, the Commerce Court of Ypres refused the request and rendered a judgement with stringent terms for L&H:

- The court first concluded that it was not in a position to determine whether the financial situation of the company might be righted, given the absence of sufficiently clear (or accurate) figures. The court also criticised KPMG auditors for refusing to communicate various working documents to the internal audit committee, for which KPMG had cited professional secrecy requirements. The lack of definite figures therefore undermined the credibility of the six month provisional plan presented with the request for concordat.
- The tribunal also found that the measures of recovery presented by L&H were not convincing. It pointed specifically to its belief that a reduction in salaries would impose a restructuring far from obvious for a company which bases its development on the technological know-how of its personnel.

The court also concluded that the sale of certain assets, including a translation company, was equivalent to a liquidation and was of such a nature as to generate non-recurrent income which gives no guarantee for the recovery of the company.

However, the tribunal decided not to declare L&H in bankruptcy. Instead, it gave L&H the opportunity to file a new request for concordat based on reliable figures.

On December 12, 2000, the Chairman of the Commerce Court of Ypres appointed a panel of three temporary directors (*administrateurs provisoires*). Their mission was to take all necessary measures to preserve the assets of L&H and assist L&H's board of directors in their search for a solution to avoid L&H's bankruptcy.

This decision was made following a unilateral request filed by Déminor, a company specialised in defending the interests of minority shareholders. They represented nearly 17,000 shareholders of L&H injured by its fraudulent practices.

The consequence of this appointment was that no transfer of assets could be decided by the board of directors without authorisation from these three director-experts. In this respect, they had access to all documents relating to the company's financial, legal, administrative or accounting positions, at the same level as the other board members.

Seemingly, the court suspected a conflict of interests within the management of L&H capable of adversely affecting the interests of the Belgian creditors. The lawyers for the banks and the representatives of Déminor indeed wondered whether following the Belgian judicial route was not useless: the new American director, John Duerden, could decide to take the American judicial route, considerably less favourable to the Belgian creditors, in order to save the US assets (the companies Dictaphone and Dragon).

On December 19, 2000, an internal audit was made public. The report revealed the details of the accounting irregularities. It pointed out that L&H in two and a half years could have accounted for false revenues amounting to 277 million USD (12.55 billion Belgian francs).

The audit was performed by two law firms. Interestingly, one of them was one of the firms representing L&H. They recommended that L&H's management pursue disciplinary sanctions against the former management. The presentation of this internal audit to the board on November 8, 2000 had already resulted in the dismissal of the two founders, Jo Lernout and Pol Hauspie, from daily operations.

The audit report revealed fraud in all fields of activity in which the company engaged: suspicious sales practices in the United States and Belgium, inaccurate accounting reflecting false growth in the start-ups, and a debt of 106 million USD in Korea.

In a particularly illustrative example of their behaviour, L&H financed the cost of research development for 24 new start-ups. The money paid to these new start-ups was accounted as turnover representing sales of software, which in fact it did not. The money they received was in fact money paid directly by L&H.

On December 27, 2000, L&H filed a new request for concordat. The court of Ypres had expressly ruled in its initial judgement that L&H could reintroduce a request on the basis of more serious and accurate figures. While L&H could have appealed the ruling, it decided it would be more expeditious and efficient to file a new request.

5. January 2001: The Court Grants the Concordat

On January 5, 2001, the court of Ypres granted a provisional stay to L&H.

The concordat procedure includes two phases:

- In the first phase, a provisional stay of six months (stays average between 6-9 months) is granted to the company. During this period, the management is to prepare a plan for recovery (*plan de redressement*). This plan is to include a new financial blueprint as well as propose payment percentages for the reimbursement of creditors (*abattements de créance*).
- At the close of the first period, the company is to then make its plan public and invite the creditors to vote on it. If approved by a majority, it is to be accepted by the tribunal which grants a final stay (*sursis définitif*). At this point, the company has two years to perform the plan and if successful, the company may start a new life without the weight of its past debts.

In this particular case, the company was granted five months, i.e., until June 5, to propose a credible rehabilitation plan. The decision of the court was based on the fact that the accounts had been corrected following the internal audit report and that a very valuable technology was at stake.

The court appointed a panel of three temporary administrators (*commissaires au sursis*) and provided that they had to give their approval for any sale of assets deemed necessary for the performance of the rehabilitation plan. Further, it required the management to convene a general assembly of the shareholders with the following agenda: an explanation to the shareholders as to how they intended to redress the company's situation, a presentation of the accounts by the KPMG auditors to explain where control had been deficient, and a discussion of the board's liability.

At this point, the panel of temporary administrators valued the assets of the company at approximately 1.27 billion EURO, and valued the debt at 796 million EURO. The solvency was therefore considered satisfactory. Nevertheless, L&H had cash-flow problems and was not in a position to reimburse the credits previously terminated by the banks in November.

Realising the potential of the provisional stay, the company believed it would be able to generate an operational profit (prior to factoring interest and depreciation) in 2002, as well as a positive cash flow beginning the second trimester of 2001.

To finance itself during the five month provisional stay, beyond its normal revenues, L&H intended to use a 20 million dollar line of credit granted in the United States, as well as applying for new credits. The company also intended to terminate 20% of its personnel (1,200 employees, of whom only 100 were in Belgium). L&H was further prepared, if unable to obtain additional credit in the United States, to sell several peripheral companies. Among these, a translation company based in Brussels, Mendez (valued at 150 million USD), Medical Solution Inc. (purchased for 60 million USD in May 2000) and a company that manufactures Dictaphones in Florida.

On January 16, 2001, Philippe Bodson, retired Managing Director of another leading Belgian group, Tractebel, was named Managing Director of L&H.

6. February 2001: Déminor Files a Complaint

On February 2, 2001, Déminor, the aforementioned company that defends minority shareholders, filed a complaint against X with the district attorney of Ypres in the name of 4000 L&H shareholders. Déminor acted in concert with Test-Achat (TA), the leading private company of consumer defence in Belgium. The complaint was based on various criminal offences: forgery, embezzlement, insider trading, violation of accounting rules, and manipulations of shares.

For Déminor and TA, the complaint's purpose was to reveal the following:

- The role and potential wrongdoings by various counsellors, consultants, and auditors, in particular those of KPMG ;
- Potential insider trading. According to the Wall Street Journal, four managers of L&H would have sold their shares immediately after the Securities & Exchange Commission announced an inquiry into the financial conditions of the company. They would have made profit of 8.9 million USD ;
- The role of FLV Fund. Set up in 1995 by Jo Lernout and Pol Hauspie, this fund was created to invest in companies specialising in voice recognition and synthesis technologies. From the beginning, many investors were interested in the fund, among them Microsoft, who invested 3 million USD in 1997. The fund consequently invested in small companies. Today, the FLV Fund is accused being one of the instruments which increased the turnover of L&H. Indeed, FLV was systematically used to financially support companies that became clients of L&H. Essentially, the money transferred from the FLV was invested in these small companies which, by way of orders, sent it back to L&H.

On Tuesday February 20, 2001, the bankruptcy court of New Jersey authorised a credit of 60 million USD (66 million EURO) to L&H by Cerberus Capital Management LP. This credit was granted subject to Cerberus' status as a priority creditor (placing them first in line should L&H default on the loan).

7. April 2001: Further Initiatives

On April 6, 2001, KPMG filed a complaint against all those who impeded its inquiry into L&H, namely those who refused to supply information or intentionally supplied incorrect or incomplete data.

The complaint targeted L&H's former managers, namely Gaston Bastiaens, Nico Willaert, Pol Hauspie and Jo Lernout.

Of all the claims made against L&H in these proceedings, the Commerce Court of Ypres recognized 335 declarations of claims against L&H. Of these, the court ruled against L&H on 216 claims, 183 of which L&H had contested. The 216 claims amounted to approximately 2.5 billion EURO. Factored against L&H's assets, its total debt amounted to 562 million EURO.

On April 25, 2001, the Korean subsidiary of L&H filed for bankruptcy. A report by Pricewaterhouse Coopers confirmed that nearly all the Korean division's sales were fictitious. A criminal complaint was filed against the Korean management, including the Managing Director, John Seo.

On April 26, 2001, Jo Lernout, Pol Hauspie and Nico Willaert were interrogated by the Federal Police. This hearing was the result of an investigation opened a few months earlier to determine the existence of criminal offenses. Pending trial, these three were imprisoned. They were charged with forgery and manipulation of stock prices (*manipulation des cours*).

On April 27, 2001, L&H called an extraordinary general assembly which had been required in January by the President of the Commerce Court of Ypres. CEO Philippe Bodson explained that the sale of certain assets like Mendez appeared to be extremely difficult, that the valuation of technological companies had undergone a serious decline, making sales of L&H patents more difficult. Further, he argued that the group confronted

a high level of personnel departure. Finally it was reported that according to a report of the three temporary administrators, the value of the assets equaled the total debts of the company, i.e., approximately 600 million EURO.

8. The Rehabilitation Plan: May 2001

On May 21, 2001, approximately 100 shareholders of L&H filed an action against KPMG. They claimed 1 BEF in damages on a provisional basis, arguing that KPMG was negligent in its accounting for L&H and that this caused considerable loss. According to their attorneys, L&H shares were worthless; but if KPMG had acted responsibly, L&H's managerial negligence would have been discovered and the shares would not have been suspended. This case is currently pending.

The same day, L&H submitted their rehabilitation plan to the court. It considered two alternatives:

- The sale to or merger with similar companies of all the activities of L&H.
- The transfer of the voice technology into a new company, Newco, whose shares would be held by the creditors of L&H at the prorata of their claims.

9. June 5, 2001 : approval of the Plan by the creditors

On June 5, 2001, 179 out of 203, or 88%, of L&H's creditors approved the alternative of the Plan, under which the company would sell nearly all its assets to repay its debts. The creditors that voted in favour of the Plan account for 99% of the money owed by L&H. Before L&H could begin to implement the Plan, however, the Commerce Court of Ypres had to sign off on it. A court hearing was scheduled for June 20.

The Belgian judge's approval would only allow L&H to sell its non-US assets. The company also needs approval from a US bankruptcy judge to proceed with the disposal of its US assets.

10. June 20, 2001: Refusal of the Plan by the Commerce Court

Mid June, Gaston Bastiaens, former CEO of L&H, was arrested in the United States and transferred to Belgium where he was jailed.

On June 20, 2001, the Commerce Court of Ypres refused to approve the Plan because it would violate public policy, i.e., lack of transparency or clarity on various issues and non-compliance in various respects with the principle that the (authorised) difference of treatment between various categories of creditors may not be arbitrary, unreasonable or unjustified. The Court requested the Plan to be adapted in accordance with its directives and to be filed with the Commerce Court no later than September 10, 2001. It extended the temporary stay until September 30, 2001 and fixed a hearing on Tuesday September 18, 2001 for the (eventual) final approval of the adapted Rehabilitation Plan.

(Footnotes)

*Derks Star Busmann Hanotiau, Brussels. Starting September 1, 2001, Hanotiau & van den Berg, Brussels.