ALERTS

New York Bankruptcy Court Awards Billions in Damages Arising from Corporate Spin-Off Avoided as Fraudulent Transfer

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A New York bankruptcy court, on Dec. 12, 2013, issued a 166-page decision after a 34-day trial, concluding that the spin-off of a highly profitable energy business constituted a fraudulent transfer intended to shield the business from massive environmental liabilities, and awarding damages of up to approximately $14.5 billion.[1] *Tronox Inc. et al. v. Kerr McGee et al. (In re Tronox et al.)* (Bankruptcy S.D.N.Y. Dec. 12, 2013) (J. Gropper).[2] The decision is significant because, among other things, the bankruptcy court (i) bucked the judicial trend of relying on market evidence of solvency (including a capital raise of unsecured debt and public equity) in favor of expert testimony; (ii) avoided asset transfers that began seven years before the bankruptcy filing even though the applicable fraudulent transfer law provides for a four-year reach-back period because the earlier transfers were part of a "single integrated scheme" culminating within the reach-back period; and (iii) awarded damages in an amount that far exceeds the amount of unpaid creditor claims. An appeal is certain to be filed.

Facts

Kerr McGee Corporation ("Old KM") was an energy and chemical company with a "wide range of operations and liabilities that accrued over the course of more than seventy years." In 2002, a strategic acquirer (Anadarko Petroleum Corp.), had "rejected an acquisition of [Old KM],

concluding that [Old KM] had more than 500 active pollution sites, had owned more than 1,000 such sites and that the annual costs of remediation 'eat[] up most of [Old KM's] free cash flow." After doing its diligence, Anadarko found the prospect of acquisition unattractive, given that Old KM's "future environmental liability was '$BILLIONS' and there was 'no end in sight for at least 30 more years." *Id.* at 8. Thereafter, Old KM began a "corporate reorganization" aimed at segregating its profitable oil and gas business (the "E&P Assets") from the rest of its holdings, which were comprised of a comparatively small chemical business along with nearly all of the corporate family's legacy environmental and tort liabilities. This reorganization was accomplished through "a series of 11 transactions" that began in 2002 and was completed in 2005. The transaction highlights are as follows:

1. *Separation of Chemical Business from E&P Business*. In 2002, Old KM (later renamed "Tronox") transferred to its newly-formed parent company ("NKM Parent") the equity of the subsidiaries that owned the valuable E&P Assets, leaving behind Tronox with the chemical business and "85 years and billions of dollars of legacy environmental and tort liabilities."

2. *IPO*. In 2005, Tronox incurred secured bank debt, issued unsecured bonds and issued equity in an IPO. Tronox transferred substantially all the proceeds of the financing (approximately $800 million) to NKM Parent. After the IPO, NKM Parent remained a majority shareholder of Tronox, with the remaining shares publicly traded.

3. *Spin-Off*. In March 2006, NKM Parent distributed its remaining shares of Tronox stock to NKM Parent's shareholders, effectively making Tronox a free-standing public company (as opposed to a majority-controlled subsidiary of NKM Parent). Tronox "began to struggle immediately after" the 2006 spinoff. At this point, it was essentially a one-product company, operating in a "cyclical" market, "dependent on the strength of the U.S. housing market" and faced with "increasing operating costs," "stagnant prices" and "thin margins." At the same time it was "struggling with poor cash flow," Tronox was obligated to fund the legacy liabilities left behind by NKM Parent.

4. *Anadarko Acquisition*. Three months later, in June 2006, Anadarko acquired NKM Parent (which owned the highly profitable E&P Assets formerly owned by Tronox) for approximately $18 billion in an all-cash transaction.

Tronox filed for Chapter 11 protection in 2009. During the bankruptcy case, Tronox (as a debtor-in-possession) filed a lawsuit against NKM Parent (a subsidiary of Anadarko) and other defendants seeking to avoid, as fraudulent transfers, the "corporate reorganization" transactions and the transfer of the E&P Assets (collectively, the "Transaction") and sought more than $15 billion in damages. The court ultimately confirmed a Tronox reorganization plan pursuant to which environmental and tort plaintiffs agreed to accept the proceeds (if any) of the pending fraudulent transfer action as their plan distribution.[3] The trial was "hotly contested, consuming 34 days of trial at which 28 witnesses testified, 14 of who were qualified as experts. Over 6,100 exhibits and thousands of pages of deposition testimony of 40 witnesses were also admitted into evidence." *Id.* at 4.

"Reach-Back Period" and "Collapsing" the Transaction

As a threshold matter, the bankruptcy court had to address whether the 2002 transfer of the E&P Assets from Tronox to NKM Parent (which occurred seven years before Tronox's bankruptcy filing) could be avoided as a fraudulent transfer where the applicable fraudulent transfer statute had a four-year reach-back period.[4] The court found that the relevant transfer agreements had been backdated to 2002, but were not "finalized or executed" until 2005, thus falling within the four-year reach-back. *Id.* at 35. Relying on a well-established body of law allowing courts to "collapse" a series of transactions into one transaction, the court also found "overwhelming" evidence that the "[D]efendants devised, carried out and had complete knowledge that the . . . transfers in 2002 were part of a 'single integrated scheme' to create a 'pure play' E&P business free and clear of the legacy liabilities" *Id.* at 38. Thus, the 2002 transfer, the court held, was "part of an integrated scheme, known to the Defendants, that culminated only in the years 2005-2006." *Id.* at 39.

Actual Fraudulent Transfer

Plaintiffs alleged that the Transaction was undertaken with the actual intent to hinder, delay or defraud a creditor. The court distinguished between "intent to *defraud*" and "intent to *hinder or delay*" and determined that it was legally sufficient to impose fraudulent transfer liability where Defendants acted with "intent to *hinder and delay*." *Id.* at 52

(citing Supreme Court precedent (*seeShapiro v. Wilgus*, 287 U.S. 348 (1932)). Thus, the "scheme did not have to be undertaken for nefarious or malicious purposes but merely with the purpose of hindering or delaying creditors." *Id.* at 55. The court also noted that the word "intent" is "used to denote that the actor desires to cause consequences of this act, or that he believes that the consequences are substantially certain to result from it." *Id. at 55 (citing* Restatement (Second) of Torts).

Here, the court held, "there can be no dispute that [Old KM] acted to free substantially all its assets—certainly its most valuable assets—from 87 years of environmental and tort liabilities. The obvious consequence of this act was that the legacy creditors would not be able to claim against [the E&P Assets] and with a minimal assets base against which to recover in the future, would be accordingly hindered or delayed as a direct consequence of the scheme. This was the clear and intended consequence of the act, substantially certain to result from it." *Id.* at 55.[5]

The court also found evidence of so-called "badges of fraud," including (i) transfers among insiders; (ii) retention of control of the transferred assets; (iii) "ineffective and insubstantial" disclosure of the 2002 transfers in the SEC filings; (iv) that the transferor had been threatened with litigation regarding its environmental and tort liabilities prior to consummating the transactions in 2005; (v) the transfer was of all or substantially all of Tronox's assets; and (vi) as explained below, the transfer left Tronox insolvent and was not supported by reasonably equivalent value. *Id.* at 61-63.

To rebut the evidence of actual intent, Defendants asserted that the Transaction was consummated for "legitimate supervening purposes." *Id.* at 63. First, Defendants argued that they "intended and believed that Tronox was and would be solvent and able to pay its debts and a successful independent company." *Id.* at 64. The court disagreed. The question was not whether "Tronox was doomed to fail" or whether the Defendants "wanted Tronox to be a big success." Instead, the court stated, the "real question is whether the Defendants had a good faith belief that Tronox would be able to support the environmental and other legacy liabilities that had been imposed on it." *Id.* at 65. The court continued by observing that "the record on this point is extraordinary because it does not exist. . . . Thus, one of the most compelling facts in the enormous record of this case is the absence of any contemporaneous

analysis of Tronox's ability to support the legacy liabilities being imposed on it."[6] *Id.*

Next, Defendants argued that the primary purpose of the spinoff was to "unlock" the value of the chemical business and E&P Assets rather than evade legacy liabilities. Again, the court rejected this argument and found, in light of the magnitude of the legacy liabilities imposed upon a fraction of the total assets, that Defendants failed to prove a legitimate supervening purposes for "the manner in which the transfer was structured." *Id.* at 72 (internal citations omitted).

Finally, the court rejected Defendants' argument that it was appropriate for Old KM to contain or limit environmental exposure of the corporate group. It found this argument unacceptable from a policy perspective, for if such a defense were allowed to stand, all enterprises with substantial existing environmental liability "would be encouraged to do exactly what Defendants did—manage the liabilities so as to leave them attached to a fraction of the assets unable to bear them." *Id.* at 72. As a result, the court found that Defendants acted with intent to hinder and delay the creditors.

Constructive Fraudulent Transfer

To succeed on their constructive fraudulent transfer claim, Plaintiffs had to prove that Tronox (i) received less than reasonably equivalent value ("REV") and (ii) was insolvent, inadequately capitalized, or unable to pay its debts as they became due.

Reasonably Equivalent Value

Plaintiffs' REV expert testified that Tronox transferred property worth $17 billion (most notably the E&P Assets) and received only $2.6 billion in return.[7] *Id.* at 76. Defendants did not dispute these figures, but raised three objections, each of which the court rejected.

First, the court rejected Defendants' view that the transfer of the E&P Assets should be excluded from the REV analysis because those assets were transferred seven years before the bankruptcy and, therefore, outside the four-year reach-back period. *Id.* at 77. Second, Defendants argued that the waiver of an intercompany claim of $378 million owed by Tronox to NKM Parent should be valued at its face amount and treated as additional consideration from NKM Parent to Tronox. Defendants,

however, "never provided sufficient evidence" of the intercompany claim's existence and, even if it existed, the court stated that it would have treated the claim as an equity contribution rather than debt. *Id.* at 78. Third, the court dismissed Defendants' claim that the REV analysis must be performed on a strict entity-by-entity basis. The court reasoned that because Tronox operated its businesses, handled environmental liabilities, and marketed the IPO on a consolidated basis, and because no creditor had relied on the separate identity of the Tronox entities, it would inappropriately elevate form over substance to consider the Tronox entities individually. *Id.* at 78-82.

Insolvency — Market Evidence

Relying on the recent trend of cases that favor market evidence of solvency over expert testimony, Defendants argued that Tronox's solvency was well established by market evidence—namely, in the form of a successful IPO and a private equity firm's ("PE Firm") offer to purchase the chemical business. Indeed, the court noted that Tronox's ability to "sell into the market $350 million in [unsecured] bonds and $224.7 million in stock" in the IPO was "Defendants' strongest indication of solvency based on the market." *Id.* at 85-87.[8] The court found that Plaintiffs successfully rebutted the market evidence of solvency "by demonstrating that the financial statements on which the market relied were false and misleading." *Id.* at 87 ("IPO projections were unrealistic when compared with Tronox's historical performance"; "financial statements omitted certain critical contingencies and potential liabilities"; "no disclosure of the risks related to [a certain] land sale contract").[9] On this issue, Plaintiffs' expert "convincingly demonstrated that the projections on which the IPO was based were inflated, sell-side projections, and that key numbers were imposed at the direction of [NKM Parent's] chief financial officer." *Id.*

As additional market evidence of solvency, Defendants relied on the offer by the PE Firm and argued that the PE Firm's "valuation of the Chemical Business was ultimately and powerfully manifested in its November 20, 2005 fully-funded and signed offer for $1.3 billion, which the record shows as final and binding." *Id.* at 96. The court rejected the significance of the offer, noting that it contained many open items and requested large indemnities for environmental and tort liabilities, which were rejected as frustrating the "clean break" from the legacy liabilities that NKM Parent demanded. *Id.* at 96. (In the end, NKM Parent went forward with the IPO

and never even brought the bid to the attention of its board. *Id.* at 97.) The court also afforded little weight to the PE Firm's valuation of environmental liabilities because its analysis was limited to "known environmental sites" (for which a third party had filed a claim) and thus "materially underestimated . . . [the] total exposure for the purposes of a valid solvency analysis." *Id.* at 99. As a result, the court rejected Defendants' reliance on market evidence of solvency in determining that the Transaction rendered Tronox insolvent.

Insolvency — Contingent Liabilities

"[T]he amount of Tronox's environmental and tort liabilities," the court observed, "is what this case is all about." *Id.* at 103-04. Although Plaintiffs and Defendants both retained environmental liability experts, Plaintiffs' expert conducted the only comprehensive valuation of Tronox's environmental liabilities. *Id.* at 105. In what the court characterized as a "major failure of proof," Defendants did not provide a comprehensive environmental liability analysis of their own. *Id.* at 106. Instead, Defendants' experts only offered criticism of the report submitted by Plaintiffs' expert. *Id.* Additionally, the extremely low estimate of future environmental liability provided by Defendants' experts—approximately the same amount that NKM Parent had recently paid in reclamation over a two-year period—did "not pass the common sense test." *Id.* at 107. The Court essentially adopted the low-end of the estimate provided by Plaintiffs' expert, finding $1.5 billion in environmental liability as of the IPO date. *Id.* at 111.

Defendants' expert on tort liability hardly fared better than their environmental liability expert. Once again, the court noted that Defendants' expert did not provide an independent analysis and instead limited his testimony to a critique of Plaintiffs' expert report. *Id.* at 112. Furthermore, Defendants' expert provided an extremely low liability estimate, testifying that Tronox had no future tort liability relating to the chemical creosote, even though at least 9,450 claims were pending at the time. *Id.* at 113. In the court's view, this testimony "wholly undermined his credibility." *Id.* Finding Plaintiffs' expert far more credible, the court once again essentially adopted the low range of Plaintiffs' figures, settling on $257 million in tort liability as of the IPO date. *Id.* at 114. Combining Tronox's $1.27 billion in legacy liabilities ($1.757 billion minus $484.4 million in reimbursements) with $803 million in additional, undisputed liability, the court valued Tronox's total liabilities at slightly above $2 billion. *Id.* at 114.

Insolvency, Inadequate Capitalization, and Inability to Pay Debts

Plaintiffs and Defendants both retained experts who calculated Tronox's business enterprise value using three methods: discounted cash flow analysis, comparable company analysis, and comparable transaction analysis. *Id.* at 114-15. Finding the valuation performed by Plaintiffs' expert to be more reliable, the court concluded that Tronox was insolvent as of the IPO date by approximately $850 million. *Id.* at 120. The court also found that Tronox was unreasonably undercapitalized in light of its legacy liabilities, and that Defendants reasonably should have believed that it would be unable to pay its debts as they became due. *Id.* at 122-29.[10]

Measure of Damages

The court determined that the net value of the property fraudulently transferred was equal to $14.459 billion, but deferred ruling on the precise measure of damages on a final basis. *Id.* at 135. At an earlier stage in the case, Defendants argued that section 550(a) caps Plaintiffs' recovery on their fraudulent transfer claims at the amount of unpaid creditor claims in the range of $2-6 billion.[11] The court, however, rejected the imposition of a damages cap, concluding that a ceiling would unfairly value Plaintiffs' agreement to give up their rights to a pro rata distribution of estate property and instead take limited cash and an uncertain litigation recovery.[12]

Before the court makes a final determination on damages, Defendants will be able to file a section 502(h) claim—pursuant to which any claim arising from the recovery of property under section 550 becomes a prepetition claim entitled to a share of recovery from the estate on the same basis as all other prepetition claims. Thus, Defendants will be able to assert a section 502(h) claim in the amount of $14.459 billion. According to the terms of the confirmed plan, the distribution on account of Defendants' 502(h) claim could be used to "discount and/or otherwise reduce any judgment" in the fraudulent transfer action. *Id.* at 145 (internal citation omitted). The open issue, which the parties will brief, concerns competing interpretations of the plan's provisions. Under one interpretation, the offset constitutes more than $9.3 billion, thereby reducing the damage award from $14.4 billion to $5.1 billion. Under the interpretation advanced

by the Plaintiffs, the offset should be valued at only about $300 million, thereby reducing the damage award from $14.4 to $14.1 billion.

Conclusion

The Tronox decision is significant given the impact it may have on the way market participants evaluate the front-end fraudulent transfer risk of any transaction, including LBOs, asset divestitures, dividend recapitalizations, and spin-offs. We will continue to share our insights on this case with our clients and friends.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] As explained below, there will be further proceeding to determine the impact of the Defendants' section 502(h) claim against the Tronox estate, which will reduce the damage award from approximately $14.5 billion to either $5.1 billion or $14.1 billion depending on the interpretation of certain plan provisions.

[2] Click here for the decision.

[3] The plan established a litigation trust to act as plaintiff to prosecute action for the benefit of the environmental and tort creditors.

[4] The court applied Oklahoma law.

[5] The court relied heavily on *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 375 (S.D. Tex. 2008) (finding actual fraudulent intent to hinder, delay, or defraud creditors where a parent corporation transferred to itself its subsidiary's "crown jewel" assets and attempted to isolate them "from risk of exposure to the government and other creditors.")

[6] A solvency opinion was obtained in connection with the transactions but the court found that the opinion failed to scrutinize the "critical issue" of contingent liabilities independently, and instead relied wholly on Defendants' representations. *Id.* at 67.

[7] The $2.6 billion received by Tronox in connection with the IPO consisted of approximately $2 billion in debt that was assumed by NKM

Parent, $285 million in chemical assets, $100 million in environmental reimbursements, $140 million in pre-paid insurance policies, and a $41 million indemnity for environmental liabilities. *Id.* at 77.

[8] The court gave no weight in the solvency analysis to Tronox's ability to issue $450 million in senior secured debt because "the sophisticated lenders who bought this debt well knew they would come first in any bankruptcy or liquidation of the enterprise." *Id.* at 86.

[9] In addition, the court emphasized that financial statements do not report on contingent liabilities in a manner that is necessarily useful when determining solvency. *Id.* at 91-93. According to generally accepted accounting principles ("GAAP"), contingent liabilities must be reported only when "probable and reasonably estimable." *Id.* at 91. Determining solvency, however, requires assigning a fair value to each contingent liability, even those which are not necessarily probable. Because financial statements may underestimate contingent liabilities, the court concluded that they "are of *no probative value* in a solvency analysis." *Id.* at 92 (emphasis added).

[10] Defendants asserted an affirmative defense under section 546(e), which the court rejected because (i) it was not timely raised; and (ii) Defendants failed to adduce any evidence that (a) "the change of ownership of the stock of the E&P subsidiaries from [Old KM] to [NKM Parent] constituted a settlement payment," (b) Old KM was a "financial participant" and (c) changes of ownership were not made in connection with a "securities contract," each as defined in the Bankruptcy Code. *Id.* at 156-58. Additionally, the court rejected Defendants' argument that it lacked jurisdiction to enter a final order pursuant to the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011). The court held that the Defendants failed to timely raise this issue and that they had consented to entry of a final order. The court acknowledged that the issue of whether consent is sufficient to empower a bankruptcy judge to enter a final order is an issue where the circuit courts are split and on which the Supreme Court is expected to rule in 2014. *SeeExecutive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency)*, 702 F.3d 553 (9th Cir. 2012), *cert. granted*, 2013 U.S. LEXIS 4727 (June 24, 2013) (No. 12-1200) (consent sufficient to confer jurisdiction).

[11] In its disclosure statement, Tronox valued tort and environmental claims in the case at between $1.9-6.2 billion. The Defendants asserted

that such claims were “worth no more than $2 billion.” *In re Tronox*, 464 B.R. 606, 611 (Bankr. S.D.N.Y. 2012).

[12] *In re Tronox, Inc.*, 464 B.R. at 609.

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