Bankruptcy Court Rules that Spinoff Was a Fraudulent Transfer

On December 12, 2013, in a 166-page opinion, Bankruptcy Judge Allan L. Gropper of the U.S. Bankruptcy Court for the Southern District of New York held that Kerr-McGee Corporation ("Kerr-McGee") was liable for between $5.1 and $14.5 billion in damages as a result of various fraudulent transfers occurring several years before Tronox Inc. and certain of its affiliates ("Tronox") filed for bankruptcy. *See Tronox Inc. v. Kerr-McGee Corp. (In re Tronox Inc.)*, Adv. Proc. No. 09-1198 (ALG), 2013 WL 6596696 (Bankr. S.D.N.Y. Dec. 12, 2013) (the "Opinion"). The fraudulent transfer claims, which were prosecuted by a litigation trust, related to the spinoff and separation of Kerr-McGee's chemical business from its oil and gas exploration and production business. Significantly, the Opinion addresses issues of first impression relating to environmental and tort liability in the context of a fraudulent transfer, provides guidance on the unique role that § 502(h)[1] of the Bankruptcy Code can play in fraudulent transfer litigation, and adds to a growing list of cases that address the safe harbors under § 546(e)[2] of the Bankruptcy Code.

Background

Kerr-McGee was formed in 1929. By 2000, it began planning for a potential spinoff or sale to separate the more profitable oil and gas exploration and production business ("E&P Business") from the titanium dioxide business ("Chemical Business"). Soon after, in 2002, Kerr-McGee engaged in an internal restructuring, forming a new corporation by the same name and separating the assets in the E&P Business and the Chemical Business into separate subsidiaries.

In 2005, the separation of the E&P Business from the Chemical Business was formalized through entry into a series of agreements, leaving Tronox with all liabilities related to all present or past Kerr-McGee operations except those "directly associated with the 'currently conducted' E&P operations," providing an "illusory" environmental liability indemnity by Kerr-McGee in favor of Tronox and resulting in Tronox's assumption of $442 million in pension obligations and $186 million in unfunded post-employment benefits that were not related exclusively to the Chemical Business. *Id*. at *5-6. According to the court, Kerr-McGee "dictated" the terms of separation, including the assumption of liabilities.

[1] Section 502(h) of the Bankruptcy Code provides that, "[a] claim arising from the recovery of property under section 522, 550, or 553 of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 502(h).

[2] Section 546(e) of the Bankruptcy Code provides that "[n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment. . ., or that is a transfer made by or to (or for the benefit of) a . . . financial participant . . . in connection with a securities contract. . ." 11 U.S.C. § 546(e).

In November 2005, Tronox incurred more than $500 million in debt, and was required to pay almost all of its cash (except $40 million), including proceeds from the debt financing, to Kerr-McGee. The final step in the spinoff was an initial public offering ("IPO") of Tronox Inc.'s stock in November 2005. Kerr-McGee remained in control of Tronox for several months, and a final split did not occur until March 2006, when Kerr-McGee distributed its Tronox stock to shareholders. Tronox filed for bankruptcy in January 2009.

The Decision

A. Fraudulent Transfer

The lawsuits alleged actual and constructive fraudulent transfer under Oklahoma's Uniform Fraudulent Transfer Act ("UFTA") and § 548(a) of the Bankruptcy Code. The court noted that the case presented an issue of first impression: "under what circumstances can an enterprise rid itself of its legacy environmental and tort liabilities by spinning off substantially all of its assets and leaving behind property incapable of supporting the liabilities." *Id*. at *22.

a. Collapsing Transaction Doctrine

Notably, the court collapsed a series of transactions from 2000 through 2005 into a single transaction on the basis that they were part of a single integrated scheme. *Id*. at *16. An important factor in this determination was "the transferee's actual . . . knowledge of the entire scheme." *Id*. By collapsing the transactions, the court was able to reach back to events occurring in 2000, notwithstanding a four-year statute of limitations under UFTA and a two-year statute of limitations under the Bankruptcy Code.

In finding the spinoff should be collapsed, the court relied upon evidence that the defendants were planning for the spinoff as early as 2000 with the express purpose of limiting the environmental liability of the profitable E&P Business. As support for this conclusion, the Opinion cited a presentation to the defendants' board in 2001 that identified a spinoff as the most effective way to rid the E&P Business of cumbersome environmental liabilities.

b. Actual Fraudulent Transfer

The court held that the transactions constituted an actual fraudulent transfer, made "with actual intent to hinder, delay, or defraud" a creditor within the meaning of § 548(a) of the Bankruptcy Code and § 116 of Oklahoma's UFTA, though it relied on the Oklahoma statute's longer statute of limitations.

In finding an actual fraudulent transfer, the court focused on the defendants' intent to "hinder or delay" creditors, noting that the intent to defraud is distinct from the intent to "hinder or delay." In light of other documentary evidence, the court viewed the defendants' testimony that the legacy liabilities played "no role whatsoever" in the separation as not credible and determined that the "principal goal" of the separation was to cleanse the E&P Business of every kind of liability. Moreover, the court found that the clear and intended consequence of the spinoff was that legacy creditors would have a smaller asset base against which to seek recovery. Accordingly, the court held that by imposing all legacy liabilities on Tronox, the defendants acted with the requisite intent to hinder or delay.

The defendants put forth three arguments against actual fraudulent transfer liability. First, they argued that they intended and believed that Tronox would be a successful solvent company. The court rejected this argument, stating that there was no documentary evidence that the defendants analyzed Tronox's ability to continue supporting its legacy liabilities following the spinoff. The defendants pointed to a solvency opinion obtained from a well-known advisor, but the court determined it had no probative value because the advisor did not perform an independent estimate of the environmental and tort liability estimates provided by the defendants. Second, the defendants argued that they had a "legitimate supervening purpose" for the spinoff, namely an attempt to maximize shareholder value. The court found this unpersuasive, explaining that even if that were the purpose, the defendants failed to provide a legitimate supervening purpose for the "*manner* in which the transfer was structured." *Id*. at *32 (emphasis added). Finally, the defendants argued that they were merely attempting to limit their overall liability. The court rejected this argument, stating that passing off liability to an entity ill-equipped to fulfill its obligations, without any analysis, constitutes an actual intent to hinder or delay creditors. Notably, the court highlighted an advisor's presentations and notes obtained in discovery that depicted a flower (Tronox) being choked by a weed (the legacy liabilities).

c. Constructive Fraudulent Transfer

Applying the UFTA, the court held that the transactions were a constructive fraudulent transfer, which generally requires a showing that the transferor or obligor received less than reasonably equivalent value and was insolvent or rendered insolvent (or had unreasonably small capital) at the time of the transfer.

The court first determined that the transfers were not made for reasonably equivalent value, relying on expert testimony to find that Tronox experienced a $14.5 billion net reduction in value as a result of the transactions without receiving reasonably equivalent value.

The court next found that Tronox was insolvent, in light of the significant environmental and tort liabilities. The court held that Tronox's potential liabilities were much greater than would be disclosed under Generally Accepted Accounting Principles, which require disclosure of environmental and tort liabilities only if they are "probable and reasonably estimable." In addition, the court determined that the market was not the appropriate measure of value given that the projections in the IPO were "inflated, sell side projections" imposed at the direction of the former parent. *Id*. at 39. Relying on the plaintiffs' experts' methodology (including an analysis of the net present value of environmental and tort claims), the court determined that Tronox had liabilities of $2.073 billion at the time of the IPO. Because neither side argued that the assets were valued at more than $2.073 billion, the court found Tronox to be insolvent.

B. Damages

In what proved to be the "most complex" issue in the case, the court considered the measure of damages. The court found that, based on the record, the net value of the property transferred out of Tronox as a result of the transactions was $14.459 billion. Under § 550 of the

Bankruptcy Code, the liquidation trust may recover the value of the property transferred. The defendants argued that several provisions of the Bankruptcy Code limit damages, including § 502(h), which provides that a recipient of a fraudulent transfer may share in estate distributions on the same basis as other creditors following the recovery of the avoided transfer by the debtor. The plan of reorganization (the "Plan") included an express provision, agreed to by the parties, to reduce the amount of any award from the fraudulent transfer litigation by the value of any claim that defendants might have under § 502(h), multiplied by the percentage recovery that general unsecured creditors received in the bankruptcy as determined by the Bankruptcy Court. The parties also reserved their rights with respect to the dilutive effect of an allowed § 502(h) claim.

Plaintiffs argued that because $14.459 billion represented a net transfer away from Tronox, no further reduction in the award was needed to satisfy the terms contracted for in the Plan. The defendants, however, argued that as a result of collapsing the transactions, the § 502(h) calculation should place the parties in the position that they would have been in if the transactions had been avoided entirely. In other words, the defendants asked for a valuation of their § 502(h) claim based on the value of the E&P Business assets after all the environmental and tort legacy liability had been paid off. The court found the defendant's argument persuasive and made "provisional" findings based on the record, valuing the § 502(h) claims at $10.459 billion ($14.459 billion less an assumed $4 billion of legacy liabilities). Applying the percentage recovery for unsecured creditors set forth in the disclosure statement, the court noted that the defendants would be entitled to offset $9.308 billion (*i.e.*, 89% of their $10.459 billion) from the plaintiff's damages of $14.459 billion, resulting in a net damages claim of $5.15 billion. As a result of the § 502(h) claim, the court suggested that the recovery percentage could be diluted from 89% to 2.8%, meaning that the value of the § 502(h) claim would be approximately $292.9 million, resulting in a net damages claim against the defendants in the amount of approximately $14.166 billion. Given the complexities of this formula, the dearth of relevant caselaw and the impact on the estate, the court requested the parties to submit briefs on the issue.

C. Safe Harbor Defenses

Defendants also raised the safe harbor affirmative defenses under § 546 of the Bankruptcy Code at the end of trial. The defendants argued that the relevant transactions were protected as "settlement payments," or in the alternative, that they were "financial participants" engaged in transfers in connection with a securities contract. Though finding that these affirmative defenses had been waived because the defendants failed to assert them in their answer as affirmative defenses or at trial, the court nevertheless addressed the merits.

The court explained that despite the broad construction of "settlement payments," the challenged transactions (including payments related to the inter-company internal restructuring and inter-company cash transfers) were not settlement payments within the meaning of § 546(e) and that this was not the type of transaction that § 546(e) was meant to protect.

The court then addressed the defendants' alternative argument that they were a "financial participant" and that the internal restructuring was a transfer involving a securities contract. The court found this argument without merit, stating that the 2005 inter-company agreements merely confirmed the allocation of assets and liabilities as contemplated in 2002 and that no consideration was paid for the "purchase, sale or loan of a security." *Id.* at *72.

<u>Significance of *Tronox*</u>

The Opinion is significant because it is the first time that an S.D.N.Y. bankruptcy court has addressed whether a transaction (or series of transactions) resulting in the assumption of significant legacy liabilities, including contingent environmental liabilities, can serve as the basis for a fraudulent transfer. Accordingly, the Opinion provides valuable insight to boards of directors and management considering transactions seeking to maximize shareholder value by limiting or controlling legacy liabilities. Courts following this approach in similar contexts may scrutinize carefully the company's decision making process, including presentations from advisors, to evaluate whether there was an integrated scheme that hindered or delayed creditors' recovery. Courts may also focus on whether the board or management adequately considered the impact of the transaction on the company retaining legacy liabilities.

This case is also significant because it adds to the nascent case law surrounding § 502(h) in the context of fraudulent transfers. While the parties in this case agreed in the Plan that the plaintiff's claim would be offset by the defendants' claims against the estate pursuant to § 502(h), they did not agree on damages. The court made provisional findings with respect to a potential approach for measuring damages, but the court has not yet adopted a final damage calculation. This will certainly be an issue of great significance to the parties and the market.

Finally, the court's discussion of § 546(e) is notable because the court addressed the merits even though it had a basis to dismiss them on waiver grounds. In reaching the merits, the court attempted to limit the scope of the safe harbors with minimal analysis or a reliance on policy issues. Given the procedural posture of the case, and the minimal discussion of the safe harbors, the impact of this part of the decision is uncertain.

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