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Tronox v. Kerr-McGee: Game Changing Ruling on Fraudulent Transfer and Spin-Offs to Shed Legacy Liabilities

Navigating Complex Issues of Fraudulent Conveyance, Statute of Limitations, Stern v. Marshall Consent and Damages

TUESDAY, MAY 13, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Navigating Complex Issues of Fraudulent Transfers, Statutes of Limitations, Damages and Stern v. Marshall Consent

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SECTION I

History and Overview of Tronox v. Kerr-McGee

History and Overview of Tronox v. Kerr-McGee

- Tronox Incorporated ("Tronox") and 14 of its affiliates (the "Debtors") filed for bankruptcy protection on January 12, 2009.
- On November 30, 2010, the bankruptcy court (the "Bankruptcy Court") confirmed the Debtors' First Amended Joint Plan of Reorganization (the "Plan"), which, among other things, created a litigation trust (i.e., the Anadarko Litigation Trust or the "Trust") to pursue claims that three of the Debtors had brought against Anadarko Petroleum Corporation ("Anadarko") and several of Anadarko's subsidiaries, including Kerr-McGee Corporation (collectively, "Kerr-McGee" or the "Defendants").
- The beneficiaries of the Trust are public and private entities that have claims against the Debtors for damages for environmental response costs and tort liabilities. The beneficiaries include the United States, eleven states, the Navajo Nation, four environmental response trusts, and a trust for the benefit of tort plaintiffs. The beneficiaries had agreed to an allocation of the recovery in the lawsuit against Kerr-McGee.

History and Overview of Tronox v. Kerr-McGee (cont'd)

- The lawsuit was filed by three Debtors (the "Plaintiffs"): (1) Tronox Incorporated ("Tronox"), a holding company created in 2005 to hold the stock of the other members of the group; (2) Tronox Worldwide LLC ("Tronox Worldwide"), which is the successor to Kerr-McGee Corporation (formed in 1929 and also known as "Old Kerr-McGee"); and (3) Tronox LLC (formerly known as Kerr-McGee Chemical LLC, which is the successor to Old Kerr-McGee's chemical business).
- The Plaintiffs alleged that they were left with ***70 years and billions of dollars*** of legacy environmental and tort liabilities when the oil and gas assets of the group were transferred out and spun off; that the transfer was designed to "hinder, delay or defraud" creditors; that it left the Debtors insolvent and undercapitalized; and that these creditors can recover from the Defendants the value of the transferred oil and gas assets. These assets were acquired by Anadarko for $18 billion only a few months after they were spun off, and there is no dispute that they are worth billions more today.
- **Significance of lawsuit**: This lawsuit raises issues of first impression regarding the application of the fraudulent conveyance laws in the face of substantial environmental and tort liability.

Before the Separation: Profits Versus Liabilities

- By November 2005, Old Kerr-McGee had terminated all of its historical business except the oil and gas exploration and production ("E&P") business and the titanium dioxide business.
- By 2005, the E&P business had become wholly dominant, producing 2005 operating profits of approximately $1.8 billion as compared to the 2005 operating profits of $106 million for the titanium dioxide business. During the five years prior to 2005, the E&P business had produced cumulative operating profits of $5.2 billion as compared to $312 million for the titanium dioxide business.
- Despite the success of the E&P business, Old Kerr-McGee was burdened by enormous legacy environmental and tort liabilities.
  - Its portfolio of environmental sites numbered more than 2,700 in 47 states, including federal Superfund sites in Jacksonville, FL; Columbus, MS; Manville, NJ; Soda Spring, ID; West Chicago, IL; Milwaukee, WI; and Wilmington, NC.
  - It had incurred more than $1 billion in environmental response costs since 2000 and was spending an average of more than $160 billion annually on remediation.

Before the Separation: Profits Versus Liabilities (cont'd)

- Old Kerr-McGee also employed more than 40 professionals in its Safety and Environmental Affairs Group just to manage the active environmental sites.
- During the 6 year period ended in 2005, Old Kerr-McGee had settled approximately 15,000 claims of creosote tort liability for $72 million (plus $26 million in defense costs) and it was faced with an additional 9,450 pending claims and trial lawyers intent on prosecuting a wave of creosote claims.

Path to Separation: Project Titan and Project Focus

- As early as 2000, Old Kerr-McGee began to plan the transactions that restructured the company's E&P and chemical businesses and that are the heart of the issues in the lawsuit.
- In 2000, Lehman Brothers (one of Kerr-McGee's investment bankers) made a series of presentations to the top management and the board of directors regarding "Project Titan" and later "Project Focus." These "transactions" included the transfer of the E&P business assets, which were initially owned by subsidiaries of Old Kerr-McGee, to a new holding company known as Kerr-McGee Corporation ("New Kerr-McGee").
- The Plaintiffs contended that these steps were part of a general plan to split E&P assets from the titanium dioxide business, which was left with Old Kerr-McGee, along with all of the legacy environmental and tort liabilities.
- The Defendants insisted that the purpose of Project Titan and Project Focus was to rationalize the companies' two main businesses by organizing them into separate corporate groups and that sound business reasons justified having the two businesses as standalone entities.

Path to Separation: Project Titan and Project Focus (cont'd)

- The Bankruptcy Court found that the record was clear that a complete separation was the goal from the outset of Project Titan in 2000. In the fall of 2000, Lehman Brothers advised that the chemical business, which had recently been augmented by several acquisitions, had grown to a sufficient critical mass to separate altogether.
- The Bankruptcy Court also thought it was clear that freedom from Old Kerr-McGee's legacy liabilities was a central consideration in the decision to split the two businesses and in the structure that was devised. Moreover, the record showed that Lehman Brothers advised that absent a spinoff, alternative transactions would not isolate environmental liabilities and provide the complete separation necessary to rid the E&P business of the burden of the environmental liabilities.
- In 2001, Old Kerr-McGee retained law firm Simpson Thacher & Bartlett LLP ("Simpson") in connection with Project Titan. A Simpson partner testified that Kerr-McGee insisted that a transaction be devised that "would not have the E&P business bearing the legacy liabilities." Simpson advised Kerr-McGee that it could accomplish this goal through a spinoff.

Path to Separation: Project Titan and Project Focus (cont'd)

- The record demonstrated that the Defendants intended from the outset of Project Titan and Project Focus to divest the chemical business as soon as the market would permit it. It was also clear that management intended to free the valuable E&P assets from the legacy liabilities, especially where it prevented Kerr-McGee from being an attractive merger candidate.
- Anadarko (ultimate purchaser of the E&P business) considered the acquisition of Kerr-McGee in 2002 and performed due diligence on its environmental liabilities, but rejected the acquisition after concluding that Kerr-McGee had more than 500 active pollution sites, had owned more than 1,000 such sites and that the annual cost of remediation "eats up most of [Kerr-McGee's] cash flow."
  - Anadarko viewed Kerr-McGee's future environmental liability as "Billions" and there was "no end in sight for at least 30 more years."

Path to Separation: Project Titan and Project Focus (cont'd)

- The second stage of the separation of the chemical business came to be known as Project Focus, which was a series of 11 transactions that were approved by Kerr-McGee's board on September 10, 2002 and were deemed effective on December 31, 2002.
- In substance, a new holding company was formed (owned by New Kerr-McGee) and was called Kerr-McGee Worldwide Corporation. Ownership in the E&P subsidiaries were transferred from Old Kerr-McGee to Kerr-McGee Worldwide Corporation. Old Kerr-McGee formed a new wholly-owned subsidiary, Kerr-McGee Chemical Worldwide LLC and merged into it. Then Kerr-McGee Chemical Worldwide became Tronox Worldwide LLC (a plaintiff), which retained all of the legacy liabilities of Old Kerr-McGee, including every single legacy liability of every discontinued business that Kerr-McGee had engaged in over the prior 75 years.

Path to Separation: Project Titan and Project Focus (cont'd)

- After the transfer of the E&P assets in 2002, Kerr-McGee continued to operate as a consolidated entity. Until it finally spun off the E&P assets and the separation was complete, Kerr-McGee continued to pay its creditors and fund all of its operations (including its legacy liability expenses) out of its central cash management system without regard to the ability of the subsidiaries to pay the expenses on their own.
- One group of creditors (holders of approximately $2 billion in bonds that Old Kerr-McGee or a predecessor in interest had issued pursuant to three indentures) were contractually protected against the transfer of the E&P assets out of Old Kerr-McGee. Old Kerr-McGee had covenanted with the bondholders in the indentures that it would not divest itself of substantial assets unless the transfer involved "substantially all" of its assets and the recipient of those assets assumed its obligation under the bonds.

Path to Separation: Project Titan and Project Focus (cont'd)

- To induce the indenture trustees of the bonds to accede to the transfer, Kerr-McGee represented that Old Kerr-McGee had "distributed substantially all of its assets to its parent" through Project Focus. This representation was backed up by internal analysis showing that assets transferred out accounted for 86.4% of Old Kerr-McGee's assets, 83.2% of its revenues and 112.6% of its net income as of December 2001.
- Although the transactions regarding the severance of the chemical and E&P assets were initiated at the end of December 2002, the split of the chemical and E&P businesses was not completed until 2005.
- In 2005, New Kerr-McGee and Old Kerr-McGee entered into a series of agreements that documented the terms of the separation, including several 2005 transactions.

Path to Separation: Project Titan and Project Focus (cont'd)

- In an Assignment, Assumption & Indemnity Agreement ("A, A & I Agreement") and a related "Assignment Agreement," New Kerr-McGee and its wholly-owned subsidiary, then known as Kerr-McGee Chemical Worldwide LLC (later to become Tronox Worldwide LLC) agreed on a formal split of their properties.
- The A, A &I Agreement also confirmed that the chemical company was solely responsible for all of the legacy liabilities of the terminated businesses of the group, including those associated closely with the E&P business (e.g., Kerr-McGee's historical contract drilling business and refining and petroleum product manufacturing and marketing business). In turn, the only liabilities assumed by the E&P business would be those directly associated with the "currently conducted" E&P operations.
- The A, A & I Agreement and the Assignment Agreement were finalized and signed in 2005 but were backdated to December 31, 2002, which the Defendants argue was the date of the "closing" of Project Focus.

Path to Separation: Project Titan and Project Focus (cont'd)

- A Master Separation Agreement ("MSA") was executed on November 28, 2005 between Kerr-McGee, Tronox Worldwide, and Tronox Incorporated.
  - The terms of the MSA were dictated by Kerr-McGee and governed the separation as well as Tronox's future administration of the liabilities that had been allocated to it.
  - For example, Tronox was left with $40 million in cash for its business, and New Kerr-McGee took the rest.
  - Tronox was forbidden for 7 years from changing existing company environmental remediation and administration practices.
  - The MSA also contained an ostensible $100 million, 7 year indemnity running from New Kerr-McGee to Tronox for the legacy environmental liabilities; however, the evidence at trial showed that the indemnity was illusory.

Path to Separation: Project Titan and Project Focus (cont'd)

- The indemnity covered only 50% of Tronox's environmental remediation costs and in order to access it, Tronox had to spend $200,000 more than the existing environmental reserve at each individual site. Tronox, which started its existence with a mere $40 million, never had enough cash to trigger the reimbursement obligation. As of March 2009, after the bankruptcy filing, Tronox had received less than $5 million from Kerr-McGee under the MSA.
- In 2005, New Kerr-McGee also required Tronox to take responsibility for $442 million in pension obligations and $186 million in unfunded OPEB benefits. There is no explanation as to why these liabilities were assigned to Tronox (other than that Tronox was assigned all the other liabilities that New Kerr-McGee did not want).

Sale/Spin Alternative

- After the transfer of the E&P assets in 2002, but before the terms of the separation were set in 2005, the Defendants created a structure for the split, which was considered a continuation of Project Titan.
- However, economic conditions in 2003 and the first half of 2004 were not favorable for a split.
- In September 2004, Lehman Brothers advised that there was a "window of opportunity" to separate the companies in light of a "hot" market for chemical companies and high demand and prices for TiO_2. Lehman Brothers also advised that the company embark on a "dual-track [spin/sale] process" to "[c]apitalize on [the] open 'window' in [the] equity markets and chemicals sector" and that a "100% Spin-Off/Split-Off" would permit Kerr-McGee to achieve the benefits of a "pure play" valuation of the businesses and a "cleaner separation of Titan liabilities." However, Lehman Brothers warned that the "separation of [the] Titan liabilities" would have "to be negotiated" in a sale or leveraged buyout as opposed to a spinoff.
- In February 2005, lawyers at Covington & Burling LLP, Kerr-McGee's new environmental and litigation lawyers, spent over 96 days researching fraudulent transfer litigation in other failed spinoffs.
- In July 2005, Lehman Brothers prepared a draft board presentation on the advantages and disadvantages of a sale and a spin, concluding that (i) an advantage of the spin would be a cleaner "[s]eparation from legacy liabilities" but (ii) this would be "Complicated under bankruptcy scenario." The chief executive officer and general counsel instructed Lehman Brothers to delete the words "Complicated under bankruptcy scenario."

Potential Sale

- There was no indication that Kerr-McGee ever seriously considered the sale of the chemical business to a third party.
- Nonetheless, Lehman Brothers prepared for a potential sale by, among other things, identifying 60 potential purchasers.
- After management presentations were made to potential buyers, in April 2005, Lehman Brothers narrowed the field to four, Apollo Investors, Bain Capital, JP Morgan Partners, and Madison Dearborn Partners, all of which were given access to a virtual data room containing information on the business being sold, which included not only the chemical business but included approximately 27,000 documents relating to environmental liabilities at more than 300 sites.
- Three of these four finalists dropped out, largely because of reasons relating to the environmental liabilities, or offered conditional bids to avoid the environmental liabilities which were rejected by Kerr-McGee.

Potential Sale (cont'd)

- In June 2005, Apollo made a "final offer" to purchase Kerr-McGee Chemical Worldwide LLC, which provided for a purchase price of $1.6 billion "plus the assumption of certain environmental liabilities [then valued according to a] 3/31/2005 balance sheet at approximately $225 million" but excluded certain liabilities, including all "liabilities related to Wood Treatment facilities."

- These terms were unacceptable to Kerr-McGee because it wanted a "cleaner" separation from the liabilities.

- On the eve of the spinoff, Apollo sent Kerr-McGee a signed, revised "final version" of a Purchase and Sale Agreement, which provided for a purchase price of $1.3 billion, as well as $300 million in indemnities from New Kerr-McGee for environmental liabilities being assumed and an additional $200 million indemnity for breaches of representations and warranties.

The Separation: Spin and Initial Public Offering

- The transaction that finally closed was a spinoff and initial public offering for Tronox. It consisted of a number of steps, leading to the final spinoff of the E&P and chemical businesses.
- First, documentation for the separation of the chemical business from the E&P business was completed and top management decided who would be employed by the respective businesses.
- Then Kerr-McGee arranged for Tronox's financing. After considerable negotiation, Tronox became indebted for an advance of $200 million and a revolving line of credit of $250 million that was provided by a group of lenders on a secured basis. Tronox also issued unsecured notes of $350 million at an interest rate of 9.5%. Net cash proceeds were $537.1 million, after expenses. Eventually, Tronox was required to pay almost all of its cash over to New Kerr-McGee, keeping only $40 million.

The Separation: Spin and Initial Public Offering (cont'd)

- The final step in the spin was an initial public offering ("IPO") of Tronox's stock to the public on November 28, 2005. In the IPO, Tronox issued 17.5 million shares of Class A common stock at $14 per share, yielding net proceeds after expenses of $224.7 million, which were paid over to Kerr-McGee and resulted in an aggregate transfer of $761.8 million to Kerr-McGee from the spin off.
- The Class A Tronox stock issued to the public, however, had only 11.3% of the combined voting power of all outstanding issues. Kerr-McGee still held all of Tronox's Class B and 88.7% of the combined voting power. Tronox continued to be controlled by Kerr-McGee until March 30, 2006 when Kerr-McGee distributed to its shareholders its holdings of Tronox's Class B stock and several New Kerr-McGee executives resigned from Tronox's board of directors.

Post-Separation: Faltering Chemicals Business

- The business that was left behind when the E&P assets were divested entailed the manufacture and sale of titanium dioxide, an industrial chemical used to whiten paints, paper, plastic and other products.
- Starting in 1998, Kerr-McGee began to acquire plants in Europe and a plant in Savannah, Georgia to become the second or third largest producer of titanium dioxide.
- According to the Plaintiffs, the European and Savannah acquisitions were economic disasters that were pursued by Kerr-McGee's management only to bulk-up the titanium dioxide business so that it could stand on its own once the E&P assets were divested.
- Following the spin-off, Tronox was basically a one-product company as titanium dioxide sales represented more than 90% of its revenues.

Tronox: Unable to Function as an Independent Company

- Tronox continued to be unprofitable on a net revenue basis after the spinoff, losing $199.7 million from November 2005 through the third quarter of 2008.
- Due to its cash position, Tronox began cutting costs almost immediately after the spinoff.
  - Tronox developed 40 cost-cutting programs within six weeks of the spin-off and by 2008 had undertaking more than 280 cost-cutting initiatives.
- Tronox began drawing on its line of credit in June 2006, two months after Kerr-McGee distributed its Tronox stock to shareholders.
- Although Tronox paid back lenders from time to time, it continued to draw on its revolver until its bankruptcy filing, when more than $212.8 million was outstanding to secured lenders.
- A sale of land in Henderson, Nevada to a company known as Centex for $515 million, which was anticipated to bolster Tronox's financial position, fell through after it was discovered that the land contained ponds of ammonium perchlorate waste and Centex walked away from the contract for $2 million.

Tronox: Unable to Function as an Independent Company (cont'd)

- At the same time Tronox was struggling with poor cash flow, Tronox was obligated to fund the legacy liabilities Kerr-McGee had left behind.
  - Tronox was only able to fund $90 million per year, net of reimbursements.
  - The cost of these legacy liabilities amounted to 56% of Tronox's 2006 EBITDA and 95% of its 2007 EBITDA.
- Tronox's cash position continued to deteriorate through 2006 and 2007.
- In 2007 and 2008, Tronox obtained various waivers of covenants in its secured loan agreements to avoid defaults.
- In September 2007, Tronox entered into an accounts receivable securitization facility, selling its receivables in return for immediate cash.
- After retaining restructuring specialists and counsel in or shortly after May 2008, Tronox filed its chapter 11 petitions in January 2009.

SECTION II

Overview of State Law vs. Bankruptcy Code Fraudulent Transfers

Overview of State Law vs. Bankruptcy Code Fraudulent Transfers

- Debtors in possession have the authority to avoid certain transfers (or obligations fraudulently incurred by the debtor) under section 548 or 544 of the Bankruptcy Code.
- Section 548 provides two types of fraudulent transfer actions:
  - Actual fraudulent transfer actions, and
  - Constructive fraudulent transfer actions.
- Section 544 (i.e., the trustee's strong-arm powers) incorporates state law remedies and actions.
- Most states have adopted the Uniform Fraudulent Transfer Act ("UFTA") or Uniform Fraudulent Conveyance Act ("UFCA").
- Although specific requirements vary, both the UFTA and UFCA provide remedies for actual and constructive fraudulent transfers or conveyances.
- In Tronox, the parties did not dispute that the law of Oklahoma was applicable. Oklahoma has adopted a version of the UFTA.

SECTION III

Fraudulent Transfer Statutes of Limitation Issues

Statutes of Limitations

- Section 548 of the Bankruptcy Code only applies to avoid transfers that occurred 2 years before the filing of the bankruptcy petition.
  - Thus, the Tronox Plaintiffs would only be permitted to avoid, at most, a few conveyances that took place after January 12, 2007 under section 548.
- In order to use a longer statute of limitations, a debtor must rely on section 544(b) of the Bankruptcy Code, which provides:

> ...the trustee [including a debtor in possession such as Tronox] may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim...

- The Oklahoma UFTA provides a 4 year look-back period for fraudulent transfer claims.
  - A 4 year look-back period from the date of Tronox's petition in January 2009 would encompass the IPO in November 2005 and the final spinoff in March 2006—but not the 2002 transfers—if they are considered separate, complete transfers.

Collapsing Transactions

- The Bankruptcy Court noted that fraudulent transfers must be reviewed for substance, not form.
- "Where a transfer is only a step in a general plan, the plan must be viewed as a whole with its composite implications." Orr v. Kinderhill Corp., 911 F.2d 31, 35 (2d. Cir. 1993) (internal quotations omitted).
- "It is well established that multilateral transactions may under appropriate circumstances be 'collapsed' and treated as phases of a single transaction under the UFCA." In re HBE Leasing Corp., 48 F.3d 623, 638 (2d Cir. 1995).
- "'In deciding whether to collapse the transaction and impose liability on particular defendants, the Courts have looked frequently to the knowledge of the defendants of the structure of the entire transaction and to whether its components were part of a single scheme.'" In re Best Products, 168 B.R. 35, 56-57 (Bankr. S.D.N.Y. 1994) (quoting In re Best Products, 157 B.R. 222, 229 (Bankr. S.D.N.Y. 1993)).
- The Bankruptcy Court found that the Tronox transactions should be collapsed.
- The Bankruptcy Court reasoned that the Defendants "devised, carried out and had complete knowledge that the 'Project Focus' transfers were part of a 'single integrated scheme' to create a 'pure play' E&P business free and clear of legacy liabilities."

Collapsing Transactions (cont'd)

- The Bankruptcy Court also rejected the Defendants' arguments that there was an independent valid business reason for segregating the chemical and E&P businesses, finding this fact irrelevant to the determination of whether there was a single integrated scheme.
- The Bankruptcy Court also found that the limitations period could not be measured from 2002 as a matter of policy.
  - Specifically, the Bankruptcy Court found that the "Defendants' view of the law would permit a shrewd and unscrupulous enterprise to divest itself of 'substantially all of its assets,' as Kerr-McGee represented it did, continue to satisfy environmental liabilities from the cash flow of the combined entity until the statute of limitations period had run and the divestiture was ready for completion, and then split the good assets from the bad. If the architects of such a scheme could claim that the statute of limitations had already run by virtue of the first step in the scheme, they would have free reign to hinder and delay creditors so long as they could do it in two steps several years apart (at least four years under Oklahoma law)."
  - Additionally, "there would be no recourse whatsoever for legacy creditors if, as in this case, there was minimal disclosure of the first phase of the internal corporate reorganization and no disclosure whatsoever of its effect on creditors."

SECTION IV

Fraudulent Transfer Analysis

Actual Fraudulent Transfers

- The Plaintiffs alleged that the transfers that culminated in the spinoff were made "with actual intent to hinder, delay, or defraud" a creditor within the meaning of section 548(a)(1)(A) of the Bankruptcy Code and the Oklahoma Uniform Fraudulent Conveyance Act, which are substantially similar.
- Section 548(a)(1)(A) provides for the avoidance of a transfer if the debtor "voluntarily or involuntarily – (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted."
  - The Oklahoma UFTA speaks of intent to hinder, delay or defraud "any creditor of the debtor." OKLA. STAT. tit. 24, § 116(A)(1).
  - The Bankruptcy Court noted that the Plaintiffs needed to rely on the Oklahoma UFTA, not section 548, due to the statute of limitations issues.
- Actual fraud is generally difficult to prove.

Actual Fraudulent Transfers (cont'd)

- The Plaintiffs rested their case primarily on the provisions of Oklahoma UFTA that proscribed actual intent to "hinder and delay" creditors.
- The Bankruptcy Court noted that although there was no disclosure of the scheme in December 2002 and disclosure in March 2003 was minimal and ineffective, the Defendants made it clear in the S-1 registration statement that Tronox was being left with all of the legacy liabilities.
- By 2005, the Defendants' plan to impose the legacy liabilities on Tronox was known to the United States environmental authorities. In 2005, the US Environmental Protection Agency sent a demand letter to Kerr-McGee regarding the remediation at the Manville, New Jersey site. Kerr-McGee's response was to deny liability and to insert a clause in the Assignment Agreement whereby Tronox was obligated to indemnify New Kerr-McGee for any environmental expenses that Tronox failed to satisfy and that was imposed on New Kerr-McGee.
- The Bankruptcy Court noted that the Defendants did not disclose that Tronox would not be able to support the legacy liabilities that were imposed on it; in any event, even if the Plaintiffs cannot prove fraud, disclosure of a scheme is no defense.

Actual Fraudulent Transfers (cont'd)

- The Bankruptcy Court found the intent to delay or hinder key to finding actual intent:
  - "The intent to defraud is something distinct from the mere intent to delay or hinder." Quoting In re Braus, 248 F. 55, 64 (2d Cir. 1917); In re Duncan & Forbes Dev., Inc., 368 B.R. 27, 34 (Bankr. C.D. Cal. 2006).
  - Liability is imposed for an "intentional fraudulent conveyance" where the fact and purpose of a conveyance may have been known to creditors in whole or in part, but the transferor intended to hinder or delay them.
  - The Supreme Court in Shapiro v. Wilgus, 287 U.S. 348, 354 (1932), stated that "[a] conveyance is illegal if made with an intent to defraud the creditors of the grantor but equally it is illegal if made with an intent to hinder and delay them." The Supreme Court did not take issue with the contention there that the debtor believed he could satisfy all creditors if given more time, nor with the fact that his scheme was widely disclosed, nor with the fact that most of his creditors went along. The Supreme Court concluded that the defendant's conveyance of assets to a corporation was made "to divest the debtor of his title and put it in such a form and place that levies would be averted."

Actual Fraudulent Transfers (cont'd)

- The District Court in ASARCO LLC v. Americas Mining Corp., 396 B.R. 278, 386 (S.D. Tex 2008), observed that while a few courts have held that "the intent required must be an intent to harm creditors. Other courts have held that a transfer may be made with fraudulent intent even though the debtor did not intend to harm creditors but knew that by entering the transaction, creditors would inevitably be hindered delayed or defrauded."
- The ASARCO court went on to conclude that "[m]any fraudulent transfer cases cite to the Restatement (Second) of Torts for the definition of 'intent' under the UFTA . . . According to the Restatement, '[t]he word 'intent' is used . . . to denote that the actor desires to cause consequences of his act, or that he believes that the consequences are substantially certain to result from it."
- In Tronox, the Bankruptcy Court stated that "there can be no dispute that Kerr-McGee acted to free substantially all of its assets – certainly its most valuable assets- from 85 years of environmental and tort liabilities." Moreover, the Bankruptcy Court noted "[t]he obvious consequence of this act was that the legacy creditors would not be able to claim against 'substantially all of the Kerr-McGee assets,' and with a minimal asset base against which to recover in the future, would accordingly be 'hindered or delayed' as the direct consequence of the scheme. This was the clear and intended consequence of the act, substantially certain to result from it."

Actual Fraudulent Transfers (cont'd)

- The Bankruptcy Court concluded that the record supported the finding that a principal goal of the separation of the E&P assets from the chemical assets was to cleanse the E&P assets of every legacy liability resulting from the 85 year history of the company and to make the cleansed company more attractive as a target of an acquisition.
- Furthermore, the records from Lehman Brothers' files make clear the centrality of the liability issues to the transactions undertaken and that the effect on creditors was well understood. Lehman Brothers recognized that the environmental liabilities being left with Tronox were unique. Lehman Brothers' principal witness (Watson) testified that "other chemical companies didn't have legacy liabilities of other businesses that were attached to a chemical business in addition to environmental liabilities which were attached to . . . the ongoing operations.
- Lehman Brothers' documents showed that potential effect of liabilities on Tronox and its creditors was the subject of mordant humor: during the negotiations leading up to the spinoff, Watson more than once drew a picture of a pot containing a flower (Tronox TiO2 business) and a weed (the legacy liabilities) strangling the flower. Watson explained that "the problem is, there is a weed at the base of this flower and it is going to choke off the company's ability to be prosperous."
- On the basis of the record, the Bankruptcy Court found that even without badges of fraud, the Plaintiffs established by clear and convincing evidence that the Defendants acted to hinder or delay creditors when they imposed all the legacy liabilities on Tronox.

Badges of Actual Fraud

- Actual fraudulent intent may be inferred from circumstances commonly called "badges of fraud."
- These badges of fraud are not conclusive, but they help focus the inquiry on circumstances that suggest a conveyance was made with fraudulent intent.
- The Oklahoma UFTA provides the following non-exhaustive list of factors indicative of fraud (or badges of fraud):

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

Application of the Badges of Fraud

- The Bankruptcy Court found that the following badges or factors of fraud were present:
  - Factor 1 – "The transfer or obligation was to an insider."
    - Both the 2002 transfers and the transfer of additional consideration in the IPO were to affiliates – which are insiders.
  - Factor 2 – "The debtor retained possession or control of the property transferred after the transfer."
    - Kerr-McGee retained control of the property after the 2002 transfers.
    - After the IPO, Kerr-McGee had exclusive control of the property transferred.
    - Kerr-McGee effectively controlled Tronox until the final spinoff in March 2006.
    - Even after the spinoff, Kerr-McGee retained influence over the management it had appointed.

Application of the Badges of Fraud (cont'd)

- Factor 3 – "The transfer or obligation was disclosed or concealed."
  - Although the 2006-2006 transfers were disclosed, disclosure of the 2002 transfers was ineffective and insubstantial.
- Factor 4 – "Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit."
  - Kerr-McGee had been in litigation for years regarding its environmental and tort liabilities.
- Factor 5 – "The transfer was of substantially all the debtor's assets."
  - Kerr-McGee represented that the December 2002 transfer represented substantially all of its assets.
  - Even if this was a false representation, it represented more than 80% of the assets of the consolidated enterprise.

Defenses to Actual Fraudulent Transfer

- The Defendants put forward three legitimate supervening purposes as defenses to the Plaintiffs' contention that they acted with "actual intent to hinder or delay creditors."
  - First: The Plaintiffs failed to show that the Defendants intended or believed in anything other than that Tronox would be a successful standalone company, capable of paying its creditors.
  - Second: Even if the Plaintiffs were able to prove or raise an inference of intent, the purpose of the IPO and spinoff was to unlock the value of the chemical and E&P businesses and not to evade the legacy liabilities.
  - Third: It was appropriate for the Defendants to attempt to contain or limit the environmental exposure of the group.

Defense: Plaintiffs Believed Tronox Could Stand Alone

- The Bankruptcy Court noted that if the Defendants' intention was to spin off a business that was well capitalized, with excellent long-term prospects, the record did not indicate so. Notably, the Defendants spun off Tronox with a capital structure that included $550 million in debt, a mere $40 million in cash and environmental liabilities that had cost Kerr-McGee more than $1 billion in the years prior to the IPO.
- Tronox's projected cash flow was inadequate to service its debt without significant land sales, was not assured, and its prospects were clouded by a down-turn in the business cycle of its one product.
- The Bankruptcy Court found that the real inquiry was 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. The Bankruptcy Court found that the record on this point was extraordinary because it did not exist, and that the lack of an internal analysis on the issue of the impact of the transfers on Kerr-McGee's legacy creditors was striking given the fact that Kerr-McGee's sophisticated management gave the closest attention to divesting the liabilities, and specifically to the fraudulent conveyance issue.

Defense: Transfers were Legitimately Aimed at Unlocking Value

- The Defendants asserted that there was a legitimate supervening purpose of the separation of the E&P and chemical businesses.
- The Bankruptcy Court stated that "[n]otwithstanding the Defendants' identification of a legitimate purpose for the separation of the two businesses, Defendants are not being sued because they made a business decision to spin off chemical from E&P or E&P from chemical. They are being sued because of their decision to spin off "substantially all of the assets" of the enterprise (the E&P assets) and impose 85 years of legacy liabilities on a fraction of the assets."
- Notably, the Bankruptcy Court stated "notwithstanding post-trial briefs numbering more than 385 pages and Findings of Fact numbering more than 451 pages, Defendants never articulated a legitimate business reason for imposing all of the legacy liabilities on Tronox. The record does, however, contain a reason. Before the spinoff of chemical and the 'clean separation' of the E&P business, Kerr-McGee was an unattractive merger candidate."

Defense: Transfers were Legitimately Aimed at Limiting Environmental Exposure

- The Defendants' final defense was that they merely attempted to limit the overall environmental liability of the group. They equated conveyance that separated "substantially all" the assets of Kerr-McGee from the burden of the legacy liabilities and ultimately imposed these liabilities on Tronox as 'simply' the management of one concern out of many that Kerr-McGee knew [it] had to manage – and it did so well, particularly after forming the S&EA group dedicated to this function."
- The Bankruptcy Court concluded that the Defendants cannot claim they merely "managed" a liability. If the Defendants' conduct were simply management of legacy liabilities, all enterprises with substantial existing environmental liability would be encourage to do what the Defendants did – manage the liabilities so as to leave them attached to a fraction of the assets unable to support them.

Constructive Fraudulent Transfers

- The Plaintiffs also asserted that the Defendants were liable for constructive fraudulent transfers.
- Under the Oklahoma UFTA, a plaintiff must prove the following to establish constructive fraud:
  - there was a conveyance of an interest in property or the incurrence of an obligation;
  - receipt of less than reasonably equivalent value; and
  - the transferor was or was deemed by the conveyance insolvent, inadequately capitalized or unable to pay its debts as they became due.

  See Okla. Stat. tit. 24, §§ 116(A)(2), 117(A).
- The burden of proof is a preponderance of the evidence standard.
- As there was no dispute that a transfer occurred, the Bankruptcy Court focused on whether the Plaintiffs received reasonably equivalent value and whether the transferor was, or was deemed by the transfer, insolvent, inadequately capitalized or unable to pay its debts as they became due.

Reasonably Equivalent Value

- The Plaintiffs' expert testified that Tronox conveyed $17 billion and received in return $2.6 billion, a $14.5 billion reduction in value.
- The Defendants did not submit their own valuation report, object to the Plaintiffs' expert's calculation, or dispute that Tronox transferred out billions more in value than it received. Instead, the Defendants only attempted to rebut the Plaintiffs' expert's determination regarding reasonably equivalent value, arguing:
  - the analysis cannot include the transfer of the E&P assets that allegedly took place at the end of 2002 due to the statutes of limitations issues;
  - the alleged conversion of equity of an intercompany account running from Old Kerr-McGee (now Tronox Worldwide) to Kerr-McGee must be valued at its face amount of $377.9 million as a contribution by Kerr-McGee to Tronox; and
  - the reasonably equivalent value analysis must be performed on a strict entity-by-entity basis (i.e., each affiliated entity that transferred out property must have received reasonably equivalent value).
- The Bankruptcy Court rejected each of the Defendants arguments and concluded that Tronox, on a consolidated basis, received less than reasonably equivalent value when, at the conclusion of the IPO, $17 billion of assets had been spun off and $2.6 billion was transferred in.

Insolvency

- The Oklahoma Uniform Fraudulent Transfer Act defines insolvency as follows for a non-partnership debtor:

  A. A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation.

  B. A debtor who is generally not paying his debts as they become due is presumed to be insolvent....

  D. Assets pursuant to the provisions of this section do not include property that has been transferred, concealed, or removed with intent to hinder, delay or defraud creditors or that has been transferred in a manner making the transfer voidable pursuant to the provisions of the Uniform Fraudulent Transfer Act.

See Okla. Stat. tit. 24, § 114.

Insolvency (cont'd)

- The Bankruptcy Court noted that the Bankruptcy Code contains the following nearly identical definition of insolvency:

  (A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of –

  (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and

  (ii) property that may be exempted from property of the estate under section 522 of this title.

  See 11 U.S.C. § 101(32).

- The analysis of solvency for fraudulent transfer purposes is a "balance sheet test" examining whether debts in the aggregate are greater than assets in the aggregate.

Evidence of Solvency – Public Market

- The Bankruptcy Court found the Defendants' argument that the "market" proved that Tronox was solvent unavailing.
  - The Bankruptcy Court found that the ability to issue the $450 million in debt did not deserve any weight in the solvency analysis because the debt was secured by all of the assets of the Tronox companies, and the lenders who bought the debt knew that they would come first in a bankruptcy or liquidation proceeding.
    - The Bankruptcy Court noted, however, that Tronox's ability to issue $350 million in unsecured bond debt and $224.7 million in stock in the IPO was the Defendants' strongest indication of solvency.
  - The Bankruptcy Court also found that the financial statements were false and misleading because certain projections contained inflated sell-side projections with key numbers imposed by Tronox's chief financial officer and financial statements omitted certain critical contingencies and potential liabilities.

Evidence of Solvency – Public Market (cont'd)

- However, the Bankruptcy Court ultimately also found that the accuracy of the financial statements was not relevant to the solvency analysis because the action centered on the size of the legacy liabilities and the impact of those liabilities on Tronox's solvency and there was never any contention that the financial statement reserved for or disclosed all of the legacy liabilities or calculated these liabilities in a manner consistent with determining Tronox's solvency.
- Additionally, the Bankruptcy Court noted that financial statements are of little use in a solvency analysis since generally accepted accounting principles require reserves only for claims that are "probable and reasonably estimable" and the market could not have fully incorporated the extent of the environmental liabilities into Tronox's pricing in the absence of such information.

Evidence of Solvency – Apollo's Unaccepted Bid

- The Bankruptcy Court also rejected the Defendants' argument that the bid by Apollo to acquire Tronox for $1.3 billion immediately prior to the IPO was evidence that Tronox was solvent mainly for the following reasons:
  - Kerr-McGee never considered Apollo to be a serious bidder;
  - Apollo's analysis of the environmental liabilities was not comprehensive and resulted in a materially understated estimate of exposure of $556.1 million;
  - Apollo's analysis was undertaken as a project management exercise and not a risk management exercise; and
  - Apollo's bid was not final (i.e., it contained open items and critical parts still to be negotiated).

Evidence of Solvency – Officer and Director Confidences in the Future

- The Bankruptcy Court rejected the Defendants argument that the confidence of Tronox's officers and directors in its future was evidence of Tronox's solvency.
- The Bankruptcy Court noted that, while many in Tronox's management were "hopeful" about prospects, many were not, and that like Kerr-McGee, Tronox's management attempted to manage the liabilities.
- The Bankruptcy Court found that "the optimism of some of Tronox's management is no better proof of solvency than the despair of others."

Evidence of Solvency – Expert Solvency Analysis

- Ultimately, the Bankruptcy Court determined that, "under the UFTA, there is no substitute for performing an analysis of Tronox's assets as at the date of the IPO and measuring them against its liabilities, both at a fair value."
- Both the Plaintiffs' and Defendants' experts presented extensive testimony analyzing Tronox's assets and liabilities as of the IPO, which was analyzed by the Bankruptcy Court.
- Relying on the Plaintiffs' expert's valuation of environmental liabilities, the Bankruptcy Court found the fair value of Tronox's liabilities, including environmental, tort and other liabilities, to be $2.073 billion.
- Similarly relying on the Plaintiffs' insolvency expert's valuation of Tronox's assets, and considering discounted cash flow, comparable company and comparable transaction analyses, the Bankruptcy Court found that the fair value of Tronox's assets was $1.223 billion (i.e., an average business enterprise value of $1.03 billion plus a value for non-operating assets of $193 million).
- Based on the foregoing, the Bankruptcy Court found that Tronox's insolvency could be calculated as $850 million as of the IPO.

Unreasonably Small Capital

- The Oklahoma UFTA also provides for fraudulent transfer liability where property is transferred for less than reasonably equivalent value and the debtor "was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction." See Okla. Stat. tit. 24, § 116(A)(2)(a).
- Under the UFTA, unreasonably small capital means a "general inability to generate enough cash flow to sustain operations."
- The Bankruptcy Court found that the Plaintiffs' expert provided convincing evidence of its lack of adequate capital by showing the following:
  - "projections of future results were unreasonable and based on sell-side optimism";
  - "at the time of the IPO, Kerr-McGee caused Tronox to borrow $550 million in debt and to issue stock, and . . . Kerr-McGee thrust Tronox into a declining market with poor plants, high ongoing capital expenditure requirements and no comprehensive business plan"; and
  - Tronox "was struggling almost immediately to cut costs and survive within its limited cash flow."

Unreasonably Small Capital (cont'd)

- The Bankruptcy Court rejected the Defendants' arguments of adequate capital.
- In doing so, the Bankruptcy Court focused on the Defendants' argument that a court should not find that a company had unreasonably small capital if the company survives for a long period of time following the transaction.
  - The Bankruptcy Court found that, "although a court may consider 'the length of time [the debtor] survived after the challenged transfer and whether the deterioration of the enterprise was affected by unforeseeable intervening events,' it is only '[a]nother factor.'" Citing Asarco LLC v. Americas Mining Corp., 396 B.R. 278, 397 (Bankr. S.D. Tex. 2008).
- The Bankruptcy Court also found that the "record showed ample evidence that the legacy liabilities, in the end, suffocated the flower because they prevented Tronox from accessing the capital markets or engaging in capital transactions when its lack of capital caught up with it."

Inability to Pay Debts as They Come Due

- The Oklahoma UFTA also provides for fraudulent transfer liability where property is transferred for less than reasonably equivalent value and the debtor "intended to incur or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due." See Okla. Stat. tit. 24, § 116(A)(2)(b).
- The Bankruptcy Court noted that this "test has a subjective and objective element, *i.e.*, that the debtor was objectively unable to pay its debts or reasonably should have come to that conclusion."
- The Bankruptcy Court found that it was not clear that the Plaintiffs established the objective prong because the record did not establish that Tronox could not pay its debts as they matured in the short run following the IPO.
- However, the Bankruptcy Court found that the Plaintiffs proved the subjective prong because they established that the Defendants should have believed that Tronox would incur debts beyond its ability to pay.
  - The Bankruptcy Court noted that the Defendants never performed an analysis of its ability to satisfy the legacy liabilities and that they should have been aware that Tronox couldn't satisfy the legacy liabilities.

SECTION V

Damages

Measure of Damages

- The Plaintiffs' expert concluded that the value of the E&P assets was $15.9 billion as of the date of the IPO, when the conveyance actually took place.
  - The fair market value approach and so-called Guideline Publicly Traded Company Method were applied to calculate a value of approximately $6.6 billion as of the 2002 transfer and $12.5 billion as of the IPO date in November 2005.
  - A 30% control premium was applied to the 2005 value to account for the increase in the value based on control of the properties.
- The Plaintiffs' expert validated this value by reference to the fact that Anadarko acquired New Kerr-McGee for approximately $15.8 billion only a few months after the spin-off.
- There was no dispute that the value of the E&P assets adjusted to $15.8 billion when only the E&P assets were considered.
- The Bankruptcy Court rejected the Defendants' objections to the Plaintiffs' expert's valuation of the E&P assets, especially in light of the fact that both parties used $15.9 billion as the bottom line for the reasonably equivalent value analysis and Anadarko purchased the same assets for $15.8 billion.

Measure of Damages (cont'd)

- There was little dispute regarding the value of the other property transferred in and out of Tronox as of the date of the IPO.
  - Tronox transferred out $1.064 billion.
    - This outbound transfer consisted of a transfer out of an interest in a battery company and cash from the stock and debt issued in connection with the IPO and an assumption of certain other post-employment benefits liabilities.
  - Tronox received inbound consideration of $2.55 billion.
    - This inbound consideration consisted of $285 million from the 2002 transfers from other parts of Kerr-McGee into Old Kerr-McGee, the assumption by New Kerr-McGee of about $2 billion in debt in 2002, the face amount of the environmental reimbursement under the Master Separation Agreement, approximately $140 million in pre-paid insurance policies and $41 million in oil and gas environmental indemnity liabilities under the A, A & I Agreement.

Measure of Damages (cont'd)

- The Plaintiffs provided the following exhibit to compare the damage valuation prepared by their expert and the Defendants' expert (Balcombe):

Tronox Consolidated Alternative Damages Summary

Damages summary ($ in millions)	Market Value of Equity	Market Value of Equity (Balcombe)	Book Value of Equity
Oil and Gas Interests	$12,270	$9,106	$6,246
+ Control Premium	30%	17.5%	
Oil and Gas Interests With Control Premium	$15,951	$10,700	
+ Other Outbound Transfers	$1,063	$1,063	$1,207
Total Outflow	$17,014	$11,763	$7,453
– Inbound Transfers	($2,555)	($2,555)	($2,656)
Net Damages (Nov. 28, 2005)	**$14,459**	**$9,208**	**$4,797**
Net Damages (Jun. 15, 2012)(30.4% appreciation rate)	**$18,855**	**$12,008**	**$6,255**

Source: Williams Direct ¶¶ 31, 34, 61-71, 90-91, Tables 1, 5, 6; PX1287 at 27-31, Tables 5, 6

Source: Tronox Inc. v. Kerr-McGee Corp., No. 09-01198 (Bankr. S.D.N.Y. Nov. 20, 2012) (Pl.'s Post-Tr'l Br. Exh. 1)

Limitation on Liabilities

- The Bankruptcy Court previously rejected the Defendants' argument that section 550(a) of the Bankruptcy Code capped Tronox's recovery on its fraudulent transfer claims at the amount of "unpaid creditor claims" upon a summary judgment motion.
  - Section 550(a) provides that "the trustee may recover, for the benefit of the estate, the property transferred or, if the court so orders, the value of the property . . ."
- The Bankruptcy Court noted, however, that limitations on the scope of the damages in this case might possibly be found in (i) other provisions of section 550(a); (ii) other section of the Bankruptcy Code; or (iii) the Bankruptcy Court's equitable powers.
- The Defendants relied on all three of these bases to assert that the Plaintiffs were not entitled to a recovery, or that their recovery should otherwise be limited as a matter of law and equity and that any recovery above the actual value of the legacy liability claims would constitute an unconscionable windfall to the Plaintiffs.

Inapplicable Damage Defenses

- The Bankruptcy Court found that the following provisions of the Bankruptcy Code and the Oklahoma UFCA did not support a limitation on the Defendants' liability:
  - Section 550(e) of the Bankruptcy Code – defense for good faith transferee;
  - Section 550(b) of the Bankruptcy Code – defenses for subsequent transferees;
  - Section 120(D) of the Oklahoma UFCA – which is almost identical to section 548(c) of the Bankruptcy Code – defense for good faith transferees to the extent of the value given to the debtor the transfer or obligations; and
  - Section 502(d) of the Bankruptcy Code – defense that bars transferee's claim unless it has paid the amount, or turned over any such property, for which such entity or transferee is liable.

Section 502(h) Defense

- The Bankruptcy Court devoted a substantial section of its opinion to discussing the application of section 502(h) of the Bankruptcy Code.
- Section 502(h) of the Bankruptcy Code provides:
  - 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.
- This provision recognizes the existence of a possible claim against the estate "arising from the recovery of property" under section 550.
- There is limited authority applying section 502(h), or its predecessor, section 57g of the Bankruptcy Act, to fraudulent transfers.

Section 502(h) Defense (cont'd)

- The amount of a section 502(h) claim is generally based on the consideration paid for the transferred property – not the total value of the property.
- However, cases have construed section 502(h) broadly to include more than consideration paid.
  - See, e.g., In re Verco Industries, 704 F.2d 1134, 1138 (9th Cir. 1983) (allowing a 502(h) claim for loss the defendant suffered when the transfer – the purchase of a portion of the debtor's business operation – was set aside);
  - Misty Mgmt Corp. v. Lockwood, 539 F.2d 1205, 1215 (9th Cir. 1976) (measuring 502(h) damages by the consideration paid but noting that the defendant "should be allowed to prove whatever claim it would have had in the absence of the fraudulent transfer").

Restorative Value Under Section 502(h)

- Like the defendants in Verco Industries and Misty Management, the Defendants argued that they were entitled to something more than the consideration paid – they were entitled to "restorative" value.
  - That is, if the transactions were collapsed, the parties should be placed in the same position as though the 2002 transfers had been avoided at that time – with the residual value after payment of all legacy liabilities available to the owner – New Kerr-McGee, not the Plaintiffs.
  - This "restorative" principal was based on the Supreme Court's ruling in Bangor Punta Operations, Inc. v. Bangor & Arostook R.R. Co., 417 U.S. 703 (1974), a case which related to shareholder standing to sue of corporate waste, not fraudulent conveyance liabilities.
- The Plaintiffs dismissed the "restorative" value argument claiming that it was another version of the Defendants' previously rejected argument that the Plaintiffs' claims should be limited to the value of the legacy liabilities.

Restorative Value Under Section 502(h) (cont'd)

- The Bankruptcy Court noted that no authority exists applying the Bangor Punta to fraudulent transfer actions and that some courts have found that it does not apply to actions brought on behalf of creditors.
- However, the Bankruptcy Court found that several cases have found that section 502(h) and its predecessors were based on a type of restorative principal.
  - The Bankruptcy Court cited, for example, In re Best Products, in which the court found that section 502(h) is based on the principal "that when a fraudulent transfer is avoided, the parties are restored to their previous positions." 168 B.R. 34, 57 (Bankr. S.D.N.Y. 1994) (quoting G. Glenn, FRAUDULENT CONVEYANCES AND PREFERENCES (1940)).
- The Bankruptcy Court ultimately found that, if the parties are to be restored to the positions they held before the transfers, the Defendants would be entitled to the residual value of the E&P assets after their debts, including legacy liabilities.
- However, the Bankruptcy Court noted that the determination of the measure of damages under section 502(h) is complicated because distributions are governed by the Plan.

Reservation of Damages Decision

- The Bankruptcy Court reserved its decision on damages to allow the Defendants to file a section 502(h) claim, which they previously reserved their right to do, and file supplemental briefing on damages.
  - The Bankruptcy Court permitted supplemental briefing, in part, because, pursuant to section IV.C.5 of the Plan, the parties reserved their rights with respect to the extent of the dilutive effect of any section 502(h) claim to reduce the Plaintiffs' recovery, and therefore, the parties had not yet briefed this issue.
- Nonetheless, the Court issued a provisional finding on the subject of damages.

Provisional Damages Decision

- The Bankruptcy Court found that, applying the Plaintiffs' valuation of the legacy liabilities for purposes of confirmation of the Plan as $4 billion, the residual value of the E&P assets after satisfaction of the legacy liabilities was $10.459 billion ($14.459 billion less the $4 billion value of the legacy liabilities).
- Accordingly, the Bankruptcy Court found that the Defendants should provisionally have an allowed claim under section 502(h) in the amount of $10.459 billion.

Provisional Damages Decision (cont'd)

- The Bankruptcy Court next analyzed the impact of the provisions of the Plan on the damages.
- Section IV.C.5 of the Plan provided that the section 502(h) claim, if any, would be multiplied by "the percentage recovery" of an Allowed Class 3 General Unsecured Claim.
- The disclosure statement for the Plan estimated the recovery of general unsecured creditors in Class 3 who participated in the rights offering would be between 78% and 100% and that the Defendants would be entitled to receive the economic benefit of Class 3 and 6 claims that participated in the rights offering.
- Accordingly, the Bankruptcy Court found that the mean percentage recovery for general unsecured creditors, which was 89%, should be applied to the section 502(h) claim.
  - The Bankruptcy Court rejected the Defendants' argument that that general unsecured creditors recovered 337% on their claims against Tronox and that their section 502(h) claim should be valued accordingly.
- Based on the foregoing, the Bankruptcy Court provisionally found that the Defendants would be entitled to an offset of approximately $9.309 billion on account of the section 502(h) claim from the Plaintiffs' recovery of $14.459 billion resulting in a damages award to the Plaintiffs, not including attorneys' fees or costs, of approximately $5.150 billion.

Provisional Damages Decision (cont'd)

- As noted above, pursuant to section IV.C.5 of the Plan, the parties reserved their rights regarding the dilutive effect of the section 502(h) claim, and thus, the parties did not brief this issue.
- Nonetheless, the Bankruptcy Court also provisionally found that, based on the dilutive effect of the section 502(h) claim, the section 502(h) claim would be worth only $292.852 million.
  - General unsecured creditors held claims totaling $445.6 million.
  - With the Defendants' section 502(h) claim, the total amount of the general unsecured claims will be approximately $10.905 billion.
  - The value of the stock allocated to general unsecured creditors was $302.855 million.
  - If all general unsecured claims, including the Defendants' section 502(h) claim, shared in this value, the recovery of a general unsecured creditor would be only 2.8 cents on the dollar, and the section 502(h) claim would be worth only $292.852 million.
- Offsetting this against the Plaintiffs' recovery would result in a damages award to the Plaintiffs, not including attorneys' fees or costs, of approximately $14.116 billion.

SECTION VI

Stern v. Marshall: Consent to Jurisdiction

Stern v. Marshall, 131 S. Ct. 2594 (2011)

- According to 28 U.S.C. § 157(b)(1), bankruptcy courts have the authority to "hear and determine . . . all core proceedings" and "enter appropriate orders and judgments." 28 U.S.C. § 157(b)(1).

- Section 157(b)(2) provides a non-exclusive list of "core" proceedings that includes "counterclaims by the estate against persons filing claims against the estate," and "proceedings to determine, avoid, or recover fraudulent conveyances." 28 U.S.C. § 157(b)(2)(C) & (H).

- Stern effected a change in the existing law by declaring that – despite the language of section 157(b) – bankruptcy courts lack *constitutional* authority to issue final judgments on state law counterclaims that would not be resolved in the process of ruling on a creditor's proof of claim. Stern, 131 S. Ct. at 2620.

Application of Stern v. Marshall

- The Defendants argued that the Bankruptcy Court lacked authority to enter a final judgment or order, citing to Stern v. Marshall.
- The Bankruptcy Court firmly rejected this argument.
  - First, the Bankruptcy Court found that the Defendants' answer to the complaint constituted unconditional consent to the entry of a final order by the Bankruptcy Court.
    - The Defendants expressly consented to the entry of final orders by the Bankruptcy Court in their answer and did not attempt to revoke such consent until 8 months after their answer was filed and 2 months prior to trial.
    - In defense of such actions, the Defendants argued that they consented only because they could not contemplate a class of claims that was statutorily core but beyond the bankruptcy judges constitutional power to finally resolve.

Application of Stern v. Marshall (cont'd)

- Additionally, the Bankruptcy Court found that, regardless of whether the Defendants consented to the Bankruptcy Court's authority in their answer, all of the Plaintiffs' claims could be fully adjudicated by the Bankruptcy Court in connection with the Defendants' proofs of claim, except maybe the fiduciary duty claim that was already dismissed.
  - In other words, the Defendants consented to the Bankruptcy Court's adjudication by filing related proofs of claim.
  - Specifically, the Defendants filed proofs of claim against the Debtors for damages valued in the billions of dollars, in which they also asserted a right of recovery against the Debtors under section 502(h).
- Based on the foregoing, the Bankruptcy Court concluded that it had authority to enter final judgment in the adversary proceeding.
- Nonetheless, in its decision, the Bankruptcy Court requested that, if an appellate court should disagree, the decision be deemed proposed finding so of fact and conclusions of law for final entry by the District Court.

Post-Stern v. Marshall Case

- Last month, the Supreme Court was again asked to consider the extent of the Bankruptcy Court's authority in Executive Benefits Insurance Agency v. Arkison, Case No. 12-1200.
  - The United States Court of Appeals for the Ninth Circuit, following Stern, held that:
    - bankruptcy judges lack authority to enter a final judgment in federal-law fraudulent conveyance action against a nonclaimant to the bankruptcy estate;
    - however, the right to a hearing in an Article III court is waivable; and
    - and the nonclaimant at issue in that case consented to the bankruptcy judge's adjudication by failing to object until the case reached the court of appeals.

      Exec. Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency Inc.), 702 F.3d 553 (9th Cir. 2012).
  - The Supreme Court heard arguments on the appeal of this Ninth Circuit decision in mid-January, but has not yet issued a decision.