Limitations on corporation's ability to free itself from legacy liabilities

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Introduction

When a corporation undergoes multiple corporate restructurings, the end result of which is to spin off most of its assets while keeping most of its liabilities, under what circumstances may its creditors pursue those spun-off assets? In a recent ruling, *In re Tronox Inc*,(1) the US Bankruptcy Court for the Southern District of New York held that corporate defendants which, through a complicated and multi-step series of corporate transactions that took place over several years, separated most of their liabilities from most of their assets, were liable under a fraudulent transfer theory to tort and environmental claimants for between $5.15 billion and $14.17 billion, and recently gave preliminary approval to a settlement for $5.15 billion. In its holding the court reaffirmed that courts will examine the substance, not the form, of corporate transactions, and also made clear that statute of limitations defences are subject to various overrides in the fraudulent transfer context, making it harder for corporations to 'play out the clock' and escape from otherwise applicable liabilities. Notably, the court gave little credence and weight to the testimony of defendants' witnesses regarding the motivations behind the transactions, as opposed to what the court viewed as the foreseeable result of such transactions.

Procedural background

On January 12 2009 Tronox Incorporated and 14 of its affiliates (collectively, 'the debtors') filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code.(2) On November 30 2010 a plan of reorganisation was confirmed which, among other things, created a litigation trust to pursue certain claims against Anadarko Petroleum Corporation and several of its subsidiaries, including Kerr-McGee Corporation (collectively, 'the defendants').(3) The beneficiaries of the trust included various environmental claimants, as well as another trust set up for tort plaintiffs.(4)

The amended complaint prosecuted by the trust was initially filed by three of the debtors:

- Tronox Incorporated, a holding company created in 2005 to hold the stock of the other members of the group;
- Tronox Worldwide LLC; and
- Tronox LLC, formerly known as Kerr-McGee Chemical LLC, which is the successor to the former Kerr-McGee's chemical business.(5)

The complaint alleged that:

- these three entities were left with many 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;
- the transfer was designed to "hinder, delay or defraud" creditors;
- it left the debtors insolvent and undercapitalised; and
- these creditors could recover the value of the transferred oil and gas assets from the defendants.(6)

Facts

Kerr-McGee, which later changed its name and business structure to become Tronox Worldwide LLC (and which was one of the plaintiff debtors), was founded in 1929 as an oil and gas exploration company.(7) It later acquired numerous other businesses, including chemical plants.(8) As early as 2000, former Kerr-McGee began a series of corporate transactions that transferred the oil and gas business to a new holding company known as Kerr-McGee Corporation, one of the defendants.(9) The court found that freedom from former Kerr-McGee's legacy liabilities was a central consideration in the decision to separate the valuable oil and gas business from the less-valuable chemical business, citing evidence as far back as January 2001.(10) New Kerr-McGee was advised by legal counsel that a spin-off could allow it to "get[] out from under legacy liabilities".(11)

After the transfer of the oil and gas assets in 2002, Kerr-McGee continued to operate as a consolidated entity. Until it finally spun off the oil and gas assets and the separation was complete, Kerr-McGee continued to pay 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.(12) Although some of the transactions regarding the severance of the chemical and oil and gas assets of the group were initiated at the end of December 2002, the split between the chemical and oil and gas businesses was not complete until 2005.

In 2005 the oil and gas business produced operating profits of $1.8 billion, while the chemical business had an operating profit of $106 million; these were the only two businesses remaining in former Kerr-McGee as of November 2005.(13) During the five previous years, the oil and gas business had produced cumulative operating profits of $5.2 billion, compared to $312 million for the chemicals business.(14)

As of 2005, former Kerr-McGee had incurred more than $1 billion in environmental response costs since 2000 and was spending an average of more than $160 million annually on remediation.(15) Moreover, during the six-year period ending in 2005, former Kerr-McGee had settled approximately 15,000 claims of creosote tort liability for $72 million (plus $26 million in defence costs), and was faced with an additional 9,450 pending claims and trial lawyers intent on prosecuting a new wave of creosote claims.(16)

In 2005 new Kerr-McGee and former Kerr-McGee entered into a series of agreements that documented the terms of the separation. Those agreements purportedly made the chemical company solely responsible for all of the legacy liabilities of the terminated businesses of the group, including those associated closely with the oil and gas business. The only liabilities assumed by the oil and gas business would be those directly associated with the "currently conducted" oil and gas operations.(17) Certain of those agreements were finalised and signed in 2005, but were backdated to December 31 2002. As a result of the agreements, Tronox was left with only $40 million in cash for its business; new Kerr-McGee took the rest, and also required Tronox to take responsibility for $442 million in pension obligations and $186 million in unfunded "other post-employment benefits".(18)

Tronox began to struggle almost immediately after the spin-off was completed in March 2006. Over time, its cash position continued to deteriorate and it filed for bankruptcy in January 2009.(19)

Statute of limitations

The court reached several conclusions of note in its discussion of statute of limitations issues. The court rejected the defendants' argument that transactions in 2002 made the oil and gas assets unavailable to creditors of old Kerr-McGee as of that date. As part of its analysis, the court first rejected the defendants' contention that the operative documents were appropriately backdated to an earlier time because the agreements were allegedly merely memorialising earlier agreements. Among other things, it held that "parties to a contract cannot make it retroactively binding to the detriment of third persons", and that "[b]ackdating cannot be used... if it has an improper effect, such as compromising the rights of third parties".(20)

Second, the court ruled that the statute of limitations did not start to run in 2002 because, among other things, the plaintiffs suffered no immediate injury from the stock transfers at that time.(21) This was in part due to the fact that Kerr-McGee continued to pay all of the environmental expenses and claims out of its centralised cash management system until at least the date of the initial public offering in November 2005, including amounts that it knew its subsidiaries could not repay.(22)

Third, the court ruled that the various transactions over the years comprised a "single integrated scheme" that culminated in 2006, and thus that the four-year statute of limitations applicable to the state law fraudulent transfer claim had not run before the bankruptcy filing in 2009.(23)

Most importantly, the court determined that "the final and conclusive reason" why the statute of limitations period could not be measured from the corporate reorganisations in 2002 was one of "policy".(24) In the court's view, to hold otherwise would mean that "a shrewd and unscrupulous enterprise" could "divest itself of substantially all of its assets" and then "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". (25) As the court noted:

> "*[i]f 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.*"(26)

The court paid special attention to the plight of "[i]nvoluntary creditors such as environmental and tort claimants", noting that they "must rely, for the most part, on the protection of the fraudulent conveyance laws".(27)

Actual fraudulent conveyance

The plaintiffs alleged an actual intent to "hinder and delay" creditors by the defendants under the Oklahoma Uniform Fraudulent Transfer Act, which - as a version of a uniform act adopted by many states - is similar to state fraudulent transfer laws elsewhere in the United States. The court recognised an argument that the defendants had disclosed their plan to impose the legacy liabilities on Tronox, but 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 Plaintiffs cannot prove fraud, disclosure of a scheme is no defense".(28) As the court held, "[l]iability 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".(29)

The court held that "[i]n the present case, there can be no dispute that Kerr–McGee acted to free substantially all its assets—certainly its most valuable assets—from 85 years of environmental and tort liabilities",(30) and that:

> "*[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.*"(31)

The court gave little credence to the assertions of the defendants' management witnesses that they:

> "*never gave a moment's thought to the effect of the transactions on legacy creditors who had in recent years cost the company more than $1 billion and were currently imposing on Kerr-McGee costs of $160 million per year.*" (32)

The court also noted certain "badges of fraud", including that "[t]he transfer or obligation was to an insider" because it was to an affiliate, and that "[b]efore the transfer was made... the debtor had been sued or threatened with suit".(33)

The court then analysed whether the defendants had been able to rebut the evidence by showing a "legitimate supervening purpose" for the conveyances.(34) The court held they had not. In part, the court noted that the "real question" 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.(35) The court viewed it as "compelling" that there was an "absence of any contemporaneous analysis of Tronox's ability to support [those] legacy liabilities".(36) The court paid less attention to retrospective expert testimony on this particular issue.(37) The court made clear that a "legitimate business reason" for the transaction was insufficient; instead, a "legitimate supervening purpose for the 'manner in which the transfer was structured' was required".(38)

As a fundamental matter, the court's conclusion was influenced by policy considerations in evaluating the presence of a fraudulent transfer, as well in analysing statute of limitations issues, noting that:

> "*[i]f Defendants' conduct were simply management of legacy liabilities, 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.*"(39)

The court rejected the defendants' attempt to rely on *Lippe v Bairnco Corp*(40) for the proposition that there "was nothing inappropriate about a company's management looking for lawful ways to reduce the adverse impact" of contingent liabilities.(41) Among other things, the court noted that under the facts before it, the "Defendants were acutely aware of the legacy liabilities, and if they did not have a precise amount, the reason is they assiduously avoided performing the analysis necessary to obtain one".(42) Instead, the court relied on *In re WR Grace & Co*,(43) quoting that case's analysis that:

> "*it is not too much to expect that firms with well-established legacies of mass-tort liability should realize that transfers for less than equivalent value may harm their tort claimant-creditors should prognostications of future claims be inaccurate*."(44)

Accordingly, transactions "must take the reality of the companies' existing liability and inherent difficulty in defining that liability's scope into consideration".(45)

The court also found that the defendants were liable for a constructive fraudulent conveyance,(46) holding in part that the defendants "reasonably should have believed that the debtor would incur debts beyond the debtor's ability to pay as they became due".(47)

Settlement

On May 30 2014 the bankruptcy court in *Tronox* issued a report and recommendation that the district court approve a settlement reached between the trust and the defendants that settled the parties' dispute: that settlement amount was $5.15 billion.(48) The district court will rule on that settlement in the coming months.

Comment

Tronox demonstrates that courts evaluating fraudulent transfer claims may disregard the form of transactions and consider their substance, both for statute of limitations purposes and when evaluating the underlying liability. Perhaps more importantly, *Tronox* illustrates that when doing so, courts may be sceptical of arguments that, if successful, would allow transfers of value to the substantial detriment of creditors through careful planning intended to evade the legal prohibitions against fraudulent transfers, and may also be sceptical of after-the-fact justifications for alleged fraudulent transfers unsupported by sufficient contemporaneous documentation.

Tronox also makes clear the difficulty inherent in attempting to 'cleanse' assets from underlying liabilities through corporate transactions. This is especially true when there are significant involuntary creditors such as present and anticipated tort creditors, whose interests cannot be ignored without substantial risk.

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Endnotes

(1) *In re Tronox Inc*, 503 BR 239 (Bankr SDNY 2013).

(2) *Id* at 247-48.

(3) *Id* at 248.

(4) *Id.*

(5) *Id.*

(6) *Id.*

(7) *Id* at 249.

(8) *Id.*

(9) *Id* at 250.

(10) *Id* at 250-51.

(11) *Id* at 252 (alteration in original).

(12) *Id* at 250.

(13) *Id* at 249.

(14) *Id.*

(15) *Id* at 249-50.

(16) *Id* at 250.

(17) *Id* at 254.

(18) *Id* at 254-55.

(19) *Id* at 260-62.

(20) *Id* at 267.

(21) *Id* at 267-68 (internal quotation marks omitted).

(22) *Id* at 268.

(23) *Id* at 269-70.

(24) *Id* at 271.

(25) *Id* (internal quotation marks omitted).

(26) *Id.*

(27) *Id* at 272 n 39 (citing *In re WR Grace & Co*, 281 BR 852, 867 (Bankr D Del 2002)).

(28) *Id* at 277.

(29) *Id* at 278.

(30) *Id* at 280.

(31) *Id.*

(32) *Id* at 281.

(33) *Id* at 282-84.

(34) *Id* at 284-89.

(35) *Id* at 285.

(36) *Id* at 285-86.

(37) *Id* at 287-88.

(38) *Id* at 289 (quoting *ASARCO*, 396 BR at 392).

(39) *Id* at 290.

(40) 249 F Supp 2d 357 (SDNY 2003).

(41) *Id.*

(42) *Id.*

(43) 281 BR 852, 868-69 (Bankr D Del 2002).

(44) *Id* at 291.

(45) *Id.*

(46) *Id* at 291-324.

(47) *Id* at 324.

(48) Findings of Fact and Conclusions of Law on Joint Motion for a Report and Recommendation of the District Court Recommending Approval of Settlement Agreement Resolving the Adversary Proceeding and Issuance of an Injunction in Support Thereof at 9, *In re Tronox Inc*, No 09-ap-1198 (Bankr SDNY May 30 2014), ECF No 661.