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Backspin: Challenging Spin-Offs as Fraudulent Transfers

Parties must consider exposure to fraudulent transfer claims in corporate spin-offs.

Spin-off transactions have become a common restructuring mechanism for companies to enhance shareholder value. The typical spin-off transaction includes, at a minimum, two principal steps: (1) the parent company's (Parent) transfer of specific assets and/or liabilities into a new entity (SpinCo), followed by (2) the distribution of SpinCo stock to Parent's shareholders as a dividend, or a sale of SpinCo stock to public investors through an initial public offering.[1] Parent is often provided consideration in connection with step (1) above, and at times in connection with step (2). Most commonly, the Parent is paid cash for the assets (generally, the proceeds from a financing by SpinCo in connection with the transaction), but the consideration may also include SpinCo's assumption of debt from which the Parent is released. The end result is two separate and distinct companies with different risk profiles. The business justifications for such transactions can be numerous; however, if SpinCo finds itself in distress in the aftermath of a spin-off, the transaction may be challenged as a fraudulent conveyance under federal bankruptcy law or similar state statutes. The basis for such challenge would be the allegation that SpinCo transferred property to Parent (the consideration paid in connection with steps (1) or (2) above) either with the actual intent to hinder, delay, or in exchange for assets that did not constitute "reasonably equivalent value," resulting in SpinCo's insolvency.

More specifically, once SpinCo files for bankruptcy, pre-petition transactions in which the debtor transferred property to another entity are subject to challenge as fraudulent conveyances. At bottom, fraudulent transfer law is designed to prevent valuable assets from being transferred away from a debtor in exchange for less than fair value, or with the intent to damage the debtor's creditors. Actual fraudulent transfer requires a showing of intent to "hinder, delay or defraud," each of which is independently sufficient to "avoid" such a transfer. A "constructive" fraudulent transfer, on the other hand, requires no particular intent, and instead exists when a company transfers its property for less than "reasonably equivalent value" while the transferor is "insolvent" or has "unreasonably small capital." Determining whether a transaction constitutes a constructive fraudulent transfer *ex ante* is complicated by the fact that the Bankruptcy Code does not define "reasonably equivalent value," and determinations of value and solvency (which must be determined as of the transfer date) are usually made years after the transfer has occurred. Thus, all stakeholders may find themselves in uncertain territory when spin-offs prove unsuccessful.

Recent examples of spin-offs where the spun-off business has declined in value (measured by share price) in the aftermath of the transaction include: E.I. du Pont de Nemours and Company's spin-off of its performance chemicals segment into The Chemours Company and Noble Corporation plc's spin-off of the division that provides standard specification offshore drilling rigs into Paragon Offshore plc.

Identifying a Potential Fraudulent Transfer Claim

Section 548 of the Bankruptcy Code provides two bases upon which the debtor in possession or trustee can seek to unwind a pre-petition transfer of assets: (1) actual fraudulent transfer and (2) constructive fraudulent transfer.

Statute of Limitations

A transfer can only be challenged under Section 548 if it occurred within two years of the company's bankruptcy filing. However, a longer statute of limitation may exist under applicable state law.[2]

The statute of limitations ostensibly starts to run from the date on which the Parent transfers assets to SpinCo and receives consideration from SpinCo in exchange. However, courts may collapse a series of independent spin-related transactions into a single transaction to the extent such transactions represent an integrated scheme for accomplishing the spin-off, in which case the statute of limitations would not start to run until the last of the collapsed transactions occurs. The collapsing transaction doctrine is a powerful tool that allows a court to reach back to events that may have occurred beyond the applicable statute of limitations. In *In re Tronox Inc.*, for example, although the debtor filed for bankruptcy protection in 2009, the court found liability in connection with a transfer of assets that occurred in 2002 (beyond the applicable state law statute of limitations) because the transfer was "merely one step in a process" that was not finalized until 2005.[3]

Actual Fraudulent Transfers

Successfully challenging spin-offs as actual fraudulent transfers is a relatively rare occurrence. This is because actual fraudulent transfers require a showing of "actual intent to hinder, delay or defraud any entity to which the debtor was or became ... indebted," and courts hold the plaintiffs to a high "clear and convincing evidence" standard. A survey of the case law suggests that only the most egregious facts will rise to the level of an actual fraudulent transfer.[4] The discussion below focuses on determining judicially whether a given spin transfer can constitute a constructive fraudulent transfer.

Constructive Fraudulent Transfers

For a spin-off to be adjudicated a constructive fraudulent transfer, the debtor in possession or trustee must prove by a preponderance of the evidence that (1) SpinCo did not receive "reasonably equivalent value" in exchange for the consideration paid to Parent <u>and</u> (2) SpinCo either (i) was insolvent on the date of the transfer or became insolvent as a result of the transfer; (ii) was engaged in a business for which it had "unreasonably small capital"; or (iii) intended to incur or believed it would incur debts that would be beyond SpinCo's ability to pay when the debt matured.[5] Each prong is discussed in turn below.

Defining "Reasonably Equivalent Value"

To determine whether SpinCo received "reasonably equivalent value" in exchange for the consideration transferred to Parent, a court is tasked with valuing the assets transferred to SpinCo at the time of the transfer.[6] The value of those assets is then compared to the consideration paid to Parent. The value transferred to Parent is often easy to determine because it includes cash or assumed debt. Courts have held that a company receives "reasonably equivalent value" when it "gets roughly the same value it gave"; in other words, a "common sense approach" is preferred over a highly mechanical one.[7] Determining whether SpinCo received reasonably equivalent value is largely a question of fact, viewed from the standpoint of SpinCo's creditors. Courts have considered the fair market value of the property, whether the transaction was undertaken at arm's length, whether competitive bidding was encouraged, the parties' bargaining position and the property's marketability, among other considerations.

Valuation exercises in the bankruptcy context do not arise solely in the case of fraudulent transfers.[8] While the proper valuation method in a particular factual context is a question of law, the factual context used to determine which method to apply is, not surprisingly, a question of fact and most often the source of tension.[9] Courts often consider a variety of different valuation methodologies, which creates uncertainty in predicting SpinCo's value. Among the common techniques are: (1) discounted cash flow analysis; (2) comparable transaction analysis; and (3) public market test (to the extent public securities are involved). The first two options rely heavily on expert witnesses, especially in more complex Chapter 11 cases.

Some courts have expressed a preference for relying on the public market if SpinCo becomes a publicly traded company upon completion of the spin transaction;[10] however, courts have also discounted the accuracy of market prices if provided with sufficient reason to do so. Conversely, if SpinCo does not list its shares on a public market, valuation becomes a battle of the experts.

In the public SpinCo context, the strongest endorsement for the market price approach to valuation is the Third Circuit's decision in *In re VFB v. Campbell Soup*.[11] The court noted that "absent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'"[12] The burden therefore falls on the plaintiff to show that, at the time of the transfer, the market did not accurately reflect SpinCo's value. In *In re VFB v. Campbell Soup*, plaintiffs, which were a group of unsecured SpinCo creditors, argued that Parent manipulated SpinCo's sales and earnings prior to the spin-off, thereby causing the market to overvalue SpinCo's assets as a standalone company. The court, however, took comfort in the fact that SpinCo's market capitalization several months after the spin-off (at a time when the market had presumably digested the alleged manipulation) was still higher than the amount transferred to Parent.

Conversely, in *In re Tronox, Inc.*, despite the fact that SpinCo survived for years after the spin-off, and maintained an "ostensible" market capitalization, the court opted to rely on the plaintiff's expert witness to value SpinCo instead of market prices because certain factors together allowed the plaintiffs to "overcome the assumption of market efficiency." The court pointed to the following factors: (i) SpinCo had difficulty selling its bonds; (ii) the proceeds from the issuances were lower than expected; (iii) the sales took place at the height of a market of "irrational exuberance"; and (iv) the financial statements and projections on which SpinCo relied to raise capital were false and misleading. Most notably, the financial statements and projections did not accurately reflect the amount of SpinCo's contingent liabilities.[13]

Determining Solvency, "Unreasonably Small Capital" and "Inability To Pay Debts"

In addition to proving that the debtor did not receive reasonably equivalent value for the consideration paid to Parent, a plaintiff must also show that the debtor was inadequately capitalized at the time of the transfer or immediately following the transfer. Inadequate capitalization is shown by proving (i) insolvency; (ii) unreasonably small capital for the continuance of the business in which the debtor is engaged; or (iii) the intention to incur debts that would be beyond the debtor's ability to pay as such debts matured.

The determination of insolvency is a "balance sheet test"; to be insolvent, SpinCo's aggregate debts (again, at the time of the transfer) must exceed its aggregate assets, at a fair valuation. In practice, the solvency analysis requires a very similar exercise to the "reasonably equivalent value" analysis discussed above, and courts are often required to choose between competing valuation methodologies that yield different conclusions on solvency.

In *In re Iridium Operating*, the creditors' committee asked the court to disregard empirical market data (*i.e.*, Iridium's share price at the time Iridium made transfers to Motorola) in favor of the conclusions of the committee's expert witness, whose analysis relied on a discounted cash flow model. The court recognized that the methodology it chose would have a material impact on determining solvency. In adopting the market test, the court noted that "contemporaneous market data for Iridium's publicly traded securities are both consistent with substantial enterprise value and inconsistent with insolvency," and held that plaintiffs did not adequately *explain* why the market had it wrong.[14] Even though the market ultimately proved to be a poor indicator of future success, this holding appears to reinforce the opinion in *In re VFB v. Campbell* that market prices will only be disregarded in favor of subjective expert witnesses when plaintiffs can explain, with sufficient specificity, why market prices were seriously flawed at the time of the spin-off.

As noted above, to determine balance sheet insolvency, the court compares the value of the debtor's assets with its liabilities. In *In re Tronox Inc.*, the value of contingent liabilities garnered much attention. The court expressed concerns about relying too heavily on financial statements in solvency analysis: "A principal reason why financial statements are of little use in a solvency analysis is that generally accepted accounting principles (GAAP) require reserves only for claims that are 'probable and reasonably estimable.'"[15] Courts will therefore look to factors outside the four corners of a GAAP-compliant balance sheet to determine whether other liabilities rendered SpinCo insolvent. While the valuation of contingent liabilities is inherently speculative and highly fact-specific, courts heavily rely on expert testimony, and often consider historical expenditures on similar liabilities, anticipated costs for addressing such liabilities (to the extent they can be reasonably estimated), and the cost for obtaining sufficient insurance coverage, among other factors. Courts have held that contigent liabilities should not be counted at face value, but rather discounted to reflect the likelihood that the contingency will occur.[16]

Determining whether a debtor had "unreasonably small capital" at the time of the spin-off is similarly rooted in a valuation exercise. Case law suggests that proving "unreasonably small capital" is easier than demonstrating insolvency because it "denotes a financial condition short of equitable insolvency."[17] A company has unreasonably small capital when the company is unable to generate sufficient profits to sustain its operations. Proving unreasonably small capital requires an objective assessment of the debtor's financial projections, and determining whether such projections were "reasonable."[18] Reasonableness is a highly fact-specific inquiry, but certain factors courts consider include the length of time the company was able to survive after the transfer, whether the projections were in line with historical data, and whether there were unforeseeable intervening events since the date of the transfer that negatively impacted the company's cash flow generating ability.

Most courts interpret the test of a company's "ability to pay debts as they come due" as more "short-term than the 'unreasonably small capital' test."[19] Based on this view, a plaintiff is required to show that the debtor, either at the time of the spin-off or immediately thereafter, was unable to pay its debts as they came due. While this interpretation suggests an objective test, courts have also endorsed a subjective component, where the defendants "reasonably should have believed that the debtor would incur" debts beyond its ability to pay. Plaintiffs successfully showed this in *In re Tronox* due to the debtors' large contingent liabilities, which, had defendants performed an analysis of their ability to satisfy such liabilities, would have easily concluded they were unable to do so.

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Endnotes

1 This hypothetical fact pattern is for illustrative purposes only. In practice, spin-offs often involve a series of complex transactions, and therefore each requires fact-specific analysis to identify potentially problematic transfers of property. These facts contemplate that SpinCo holds a potential cause of action against Parent, however, Parent could hold the potential cause of action if the "good" assets are transferred to SpinCo.

2 Section 544(b) of the Bankruptcy Code allows for a debtor in possession or trustee to stand in the shoes of an unsecured creditor and bring state law fraudulent transfer actions. Generally, the statute of limitations under state laws are longer than the two-year period available under Section 548, and range from four to six years.

3 *Tronox v. Kerr McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239, 271 (Bankr. S.D.N.Y. 2013).

4 *In re Tronox Inc.*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013) (finding that the defendants acted with actual intent to hinder or delay creditors by spinning off a business with a capital structure that included US$550 million in debt, US$40 million in cash and environmental liability that had cost the company more than US$1 billion in the years prior to the spin-off); *see also In re Lyondell Chem. Co.*, No. 09-10023 (REG), (Bankr. S.D.N.Y. Nov. 18, 2015) (granting defendants' motion to dismiss the actual fraudulent transfer claim despite evidence of defendants' intent to enrich themselves, and "reckless disregard of the consequences that such enrichment would have on creditors").

5 These tests are often referred to as the "insolvency test," the "capitalization test" and the "cash flow test," respectively.

6 As a functional matter, valuing SpinCo's assets and liabilities may be the equivalent of valuing the SpinCo going concern business as a whole.

7 *In re VFB v. Campbell Soup*, 482 F.3d 624, 631 (3d Cir. 2007).

[8] For example, courts are often required to conduct a valuation exercise in the adequate protection/automatic stay context (*e.g.*, the value of collateral), as well as in the "cram down" context (*e.g.*, whether a plan provides a secured creditor the value of its collateral).

[9] *See In re VFB v. Campbell Soup*, 482 F.3d 624, 632 (3d Cir. 2007).

[10] The public market value of SpinCo will be most relevant for the "reasonably equivalent value" analysis when SpinCo consists entirely of the transferred assets. Said differently, the public market test will serve as a better proxy for "reasonably equivalent value" when SpinCo is an empty shell prior to the spin-off transaction.

[11] 482 F.3d 624 (3d Cir. 2007).

[12] *Id.* at 634.

[13] Perhaps most importantly for the court was the lack of disclosure of the legacy liabilities, which amounted to billions of dollars.

[14] *In re Iridium Operating LLC*, 373 B.R. 283, 293 (Bankr. S.D.N.Y. 2007).

[15] *In re Tronox Inc.*, 503 B.R. at 301.

[16] *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992); *In re Xonics Photochemical Inc.*, 841 F.2d 198 (7th Cir. 1988).

[17] *MFS/SUN Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995).

[18] *Moody v. Security Pacific Bus. Credit. Inc.*, 971 F.2d 1056, 1073 (3d Cir. 1992).

[19] *In re Tronox Inc.*, 503 B.R. at 324 (citing *In re Suburban Motor Freight, Inc.*, 124 B.R. 984, 1000 n. 14 (Bankr. S.D. Ohio 1990)).