AIRA Association of Insolvency & Restructuring Advisors

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 28, Number 2 - Spring 2014

Boris J. Steffen, CDBV
Gavin/Solmonese LLC

Market Evidence vs. Expert Opinion: And the Winner Is . . .

Proponents of the use of "market" evidence in valuation litigation have pointed to decisions such as VFB LLC v. Campbell Soup Co., Iridium Operating LLC v. Motorola, Inc. and In re Old Carco LLC to argue that courts should defer to the "market" over expert opinion, including cases where the corporation being valued lacks publicly traded securities. In addition to market prices, the types of market evidence suggested consist of the actions and views of the subject firm's executives, creditors, investors and expert advisors on or around the valuation date. However, in the December 12, 2013 opinion of the U.S. Bankruptcy Court for the Southern District of New York in the case of Tronox Inc. v. Kerr McGee Corp. et al, such "market" evidence was rejected in essence due to lack of relevance and reliability based on the underlying facts and interpretations thereof expressed in expert opinion.

Kerr-McGee Corporation was at year-end 2005 one of the largest U.S.-based independent oil and natural gas exploration and production companies, with $5.9 billion in revenue and nearly 1 billion barrels of oil equivalent proven reserves. Accordingly, as part of a strategic restructuring initiated in 2000, in October 2005 the Board approved the spin-off of its chemical business, Tronox, through an IPO, to be followed by a distribution of its remaining interest in a stock dividend. The IPO was executed in November 2005, along with an issue of unsecured notes and a term loan. The proceeds of the financings, which came to about $775 million, together with existing cash in excess of $40 million, were distributed to Kerr-McGee. The Board subsequently declared a dividend of Tronox's Class B common stock on March 8, 2006, which in effect transferred ownership of Tronox to its shareholders, along with its environmental liabilities and those of the oil and gas business retained by Kerr-McGee. Further, Kerr-McGee required Tronox to assume $442 million in pension obligations and $186 million in unfunded other post-employment benefits.

Tronox experienced financial difficulties subsequent to the spin-off, and in January 2009 filed for Chapter 11. Confirmed in November 2010, Tronox' s First Amended Joint Plan of Reorganization established the Anadarko Litigation Trust to pursue claims against Anadarko Petroleum Corporation and its subsidiaries, including Kerr McGee. In its complaint, the Trust alleged that Tronox was 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."

Noting that the analysis of fraudulent transfers should focus on substance over form, the Court found that the sequence of transactions that was initiated in 2000 and culminated with the spin-off of Tronox in 2005 and 2006 should be collapsed for statute of limitations purposes. Further, the Court concluded that the transfers were actually fraudulent in view of Defendants' clear intent to hinder or delay creditors. Addressing the question of whether the transfers were constructively fraudulent, the Court began with an examination of whether Tronox received reasonably equivalent value in exchange.

Plaintiffs' expert testified that Tronox had transferred assets worth approximately $17 billion and received assets worth $2.6 billion in return. Defendants chose not to file a rebuttal expert report, object to the Plaintiffs' expert's calculations or dispute that Tronox had transferred billions of dollars more than it received, however. Instead, Defendants maintained that the transfer of E&P assets should be excluded based on statutes of limitations, that the conversion of an intercompany account from debt to equity should be recognized at face value as a $377.9 million contribution to Tronox, and that reasonably equivalent value and solvency should be analyzed entity-by-entity. The Court rejected each of

Market Evidence continues on p. 4

ALSO IN THIS ISSUE

Market Evidence *continued from pg. 1*

these arguments in finding, as did Plaintiffs' expert, that Tronox received $17 billion in return for assets worth $2.6 billion on a consolidated basis.

The Court considered next whether Tronox was solvent based on the balance sheet test, examining whether the sum of Tronox's debts was greater than all of its assets at a fair valuation as implied by market evidence. To start with, the Court found that since the $450 million in debt raised by Tronox at the time of its IPO was secured by all of its assets, Defendants' reliance on this market evidence was not creditable since those who bought the debt knew they would have priority in a bankruptcy. Further, the Court found that Plaintiffs' expert showed that the IPO financial statements relied on by the markets were false and misleading, and that the financial statements as prepared omitted relevant contingencies and potential liabilities. Notwithstanding, the Court concluded that Plaintiffs did not need to prove that the IPO financial statements were unreliable to overcome the market efficiency hypothesis since the issue related not to Tronox's earning power but to the legacy liabilities transferred from Kerr-McGee, which no one on either side maintained were adequately reserved for or disclosed for purposes of analyzing solvency.

Defendants' market-evidence defense similarly relied on the investment and financing decisions of Apollo Investors and investment banks JP Morgan, Credit Suisse First Boston and Lehman Brothers, each of whom conducted due diligence on non-public information. With respect to the banks, the Court found that their interests were unique and not indicative of "the market" since they had provided credit to Tronox in a facility secured by all of its assets and therefore expected to be paid in full. Each bank had also been paid millions of dollars by Kerr-McGee, or expected to receive similar fees from financing any Apollo offer. Moreover, none of the banks had valued Tronox's environmental or tort liabilities independently, and Defendants were unable to link the diligence performed by the banks with any independent insight regarding the legacy liabilities. The Court also rejected Defendants' assertion that Apollo's bid to acquire Tronox for $1.3 billion just before the IPO indicated that Tronox was solvent since Apollo never made a final and binding offer, its analysis of environmental and tort liabilities was materially understated and not comprehensive, and its analysis was limited to an assessment of whether it could manage the liabilities, and as such did not represent the basis for a solvency analysis.

The remaining leg of Defendants' market defense was that the contemporaneous statements and actions of Tronox's management represented evidence of solvency. The Court rejected this assertion, however, reasoning that management's efforts to continue operating the firm, and their belief that they could do so, did nothing to prove or disprove Tronox' s solvency. And though observing that many of Tronox' s employees were optimistic regarding its prospects while others saw failure, the Court concluded that the enthusiasm of certain Tronox employees offered no better indication of its solvency than the discouragement of others.

Proceeding from its rejection of Defendants' market evidence-based balance sheet test defense, the Court reasoned there was no substitute under Oklahoma's UFTA for analyzing the fair value of Tronox' s assets and liabilities. In this regard, the Court observed that while the parties did not differ for most of Tronox's liabilities, they did so widely in valuing its environmental and tort liabilities. But noting that Plaintiffs' expert's analysis of environmental liabilities was the only comprehensive valuation, and that the testimony of Defendants' tort expert was not credible, the Court rejected Defendants' experts' testimony and determined that the fair value of Tronox' s total liabilities was $2,073,000,000.

The Court also relied on Plaintiffs' expert's solvency analysis in determining that the fair value of Tronox's assets was $1,223,000,000, and as compared to the value of its liabilities of $2,073,000,000, found that Tronox was insolvent by $850,000,000 on the date of its IPO. The flaws identified by the Court in Defendants' expert's report included that he used Tronox's projections in his discounted cash flow valuation absent further analysis despite facts established by Plaintiffs' expert that they were inflated, overly optimistic and biased by key numbers ordered by the CFO of Kerr-McGee, and that the 15 comparable companies in his comparable company analysis were selected according to whether potential acquirers or industry analysts viewed the companies comparable to Tronox absent any independent analysis of his own.

Considering then if Tronox was left with unreasonably small capital, meaning "a general inability to generate enough cash flow to sustain operations" under the UFTA, the Court found based on Plaintiffs' expert's analysis that Tronox's capital was inadequate for reasons that its projections were unreasonable and overly optimistic, and that Kerr-McGee caused Tronox to upstream all the proceeds from its financing at the time of its IPO. Consequently, Tronox was left with only $40 million in cash despite having to operate in a declining market with poor plants, significant capital expenditures, and no comprehensive business plan while struggling to cut costs.

In contrast, Defendants' expert's capital adequacy analysis relied on downside and worst case projections prepared by independent third parties that had conducted due diligence during the IPO process. Defendants maintained from this that Tronox would have been able to (1) support its environmental, tort and pension liabilities, (2) pay-off approximately $413 million of its debt, (3) refinance all of its debt, and or (4) sell its land and its Uerdingen plant to raise additional cash. The Court found otherwise, however, concluding that the third party projections were overly optimistic, that hypothetical land sales could not make up for the shortfall, and that the ability of a debtor to raise cash by selling off assets was not supportable as an indication of capital adequacy. Additionally, the Court found that Defendants' expert's testimony regarding market evidence confirmed rather than refuted that Tronox was undercapitalized considering facts that Tronox was precluded by its legacy liabilities from raising additional capital, merging with another firm, entering into a joint venture, or attracting private equity.

The ability to pay test under the Oklahoma UFTA examines whether a 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." Accordingly, Plaintiffs' expert testified that Tronox would have been unable to pay its debts from

2007- 2012, and by year-end 2012 would have had a cash deficit of $475 million. Noting that the emphasis of the ability to pay test is more short-term, the Court found that the record did not show Tronox was unable to pay its debts as they matured in the short-run, post-IPO. However, the Court did find that Defendants should reasonably have believed that Tronox would incur debts exceeding its ability to pay, noting that Defendants failed to conduct an analysis of Tronox's ability to pay the legacy liabilities.

For purposes of measuring damages, Plaintiffs' expert opined that the fair market value of the E&P assets transferred out was $6.6 billion in 2002 using the Guideline Publicly Traded Company method, and assuming a rate of appreciation from energy indices, brought that amount forward to $12.5 billion as of the date of the IPO in November 2005. Applying a control premium of 30 percent derived from oil and gas transactions increased the value to $15.9 billion, which he corroborated with the $15.8 billion paid by Anadarko to acquire New Kerr-McGee shortly after the spin-off. From this the Court concluded that Plaintiffs had established the value of the E&P assets as of the date of the IPO, and noting that Defendants' expert did not provide an opinion regarding the value of the E&P assets, rejected his criticisms of the control premium and method used by Plaintiffs' expert to calculate the present value of the E&P assets in 2005.

As for the value of other property transferred, the Court observed that Tronox transferred out a total of $1.064 billion, comprised of cash, an interest in a battery company, and the assumption of unfunded OPEB obligations. In return, Tronox received approximately $2.555 billion in transfers from other parts of Kerr-McGee to Old Kerr-McGee, New Kerr-McGee's assumption of debt, the face value of a maximum environmental reimbursement, pre-paid insurance policies and environmental indemnities. Based on these findings, the Court concluded that the net value of the property transferred out was $14.459 billion, and while deferring final judgment, that Tronox would be liable for damages of from $5.1 billion to $14.1 billion depending on the value of Defendants' § 502(h) offset claim.

On April 3, 2014, in what was heralded by the Anadarko Litigation Trust as a "historic settlement," and by the U.S. Department of Justice as "the largest environmental enforcement payment in history," Anadarko Petroleum Corp. agreed to pay creditors $5.15 billion to settle the litigation. On the same day, with the uncertainty regarding the outcome of the litigation resolved, the market value of Anadarko's shares increased by approximately $5.3 billion.

***Boris J. Steffen**, MM, CPA, ASA, ABV, CDBV, is a Managing Director in the Corporate Restructuring group of Gavin Solmonese, LLC in Washington, DC. An expert in accounting, corporate finance and valuation, Mr. Steffen serves as a financial advisor and expert witness for corporations, financial institutions, government agencies and law firms requiring assistance in managing growth, policy and strategic initiatives including mergers, acquisitions, restructurings and related claims and litigation.*