KIRKLAND & ELLIS

RESTRUCTURING **UPDATE**

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Avoiding Underfunded Spin-Offs

A recent judicial decision confirms that directors and managers should carefully construct corporate spin-off transactions that have the effect of shielding, in whole or in part, a parent company from liabilities transferred to the spun-off company. While a carefully executed spin-off can unlock tremendous value for a corporation, an underfunded spin-off may be economically unwound in bankruptcy. Consider Kerr-McGee's spin-off of Tronox, its chemical business, after incurring decades of environmental, tort and retiree liabilities. The U.S. Bankruptcy Court for the Southern District of New York voided the transaction as a fraudulent transfer and found Anadarko-owned Kerr-McGee liable for damages ranging from $5.15 billion to $14.46 billion. On November 10, 2014, the U.S. District Court for the Southern District of New York approved a settlement of the case that requires Kerr-McGee to pay $5.15 billion to trusts that will satisfy claims by Tronox's former environmental and tort creditors.

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Following a 34-day trial, the Bankruptcy Court found that Kerr-McGee's separation of its valuable oil and gas assets from its legacy environmental, tort and retiree liabilities was a fraudulent transfer. Through a series of transactions from 2002 to 2006, Kerr-McGee transferred these oil and gas assets to a newly created corporation, which it renamed Kerr-McGee Corporation, and spun-off what remained — a small, cyclical chemical business weighed down by decades of liabilities — as Tronox. Tronox then incurred secured bank debt, issued unsecured bonds, issued equity in an IPO, and dividended the proceeds of the financings to the new Kerr-McGee. Three months after the spin-off was completed, Kerr-McGee sold its oil and gas assets to Anadarko for $19 billion.

Tronox filed for chapter 11 in January 2009 because of the weight of Kerr-McGee's historic environmental, tort and other liabilities. Tronox filed a lawsuit against the new Kerr-McGee Corporation seeking billions in damages on the grounds that the spin-off was undertaken to hinder, delay or defraud Kerr-McGee's environmental, tort and other creditors, that it left Tronox insolvent and undercapitalized, and that it was not consummated for reasonably equivalent value. Kerr-McGee, on the other hand, asserted that it executed the spin-off primarily to maximize shareholder value and relied heavily on the successful IPO of Tronox equity in connection with the spin-off as evidence that the company was solvent and poised to succeed before the economic downturn in 2008.

The Bankruptcy Court agreed with Tronox. It found that (1) Kerr-McGee knew that, by executing the spin-off, recovery by the company's historic environmental and tort creditors would be delayed or hindered, (2) Tronox was rendered insolvent as a result of the spin-off notwithstanding that it was able to raise financing and capital pursuant to the IPO, and (3) a series of internal transfers could be avoided by viewing the individual steps as part of a single integrated transaction.

So, what's the upshot? Spin-offs have become a popular way for corporations to unlock shareholder value by, among other things, separating unrelated businesses in anticipation of a sale of a "pure play" subsidiary to a third party, allowing the parent and the subsidiary to raise capital separately and more effectively, and/or identifying and addressing burdensome liabilities. While successful spin-offs can achieve these objectives, *Tronox* illustrates that spin-offs are complex transactions that require careful attention to legal and other issues. If the spin-off is challenged, courts may scrutinize a company's decision-making process in connection with a spin-off or similar transaction. If SpinCo later fails, a fraudulent transfer lawsuit may follow. In structuring a transaction, it is prudent to undertake a reasonable assessment of future liabilities to ensure that the asset base will be sufficient to cover them. The Bankruptcy Court concluded that Kerr-McGee failed to undertake such an analysis and instead opted to put its "head in the sand" with respect to assessing the scope and likely future costs of its liabilities. The Bankruptcy Court also concluded that Kerr-McGee's limited efforts to value Tronox's legacy liabilities were insufficient because they were based on materially understated contingent liability reserves in Kerr-McGee's financial statements. Kerr-McGee also relied on Tronox's ability to issue unsecured debt and stock as evidence of solvency, but the Bankruptcy Court determined that the IPO was based on inflated, sell-side projections that were unreliable and was not persuaded by other market evidence.

Contingent liabilities are inherently difficult to quantify in light of the number and uncertainty of potential outcomes, and there is no magical formula that will guarantee the absence of ParentCo's liability in connection with a spin-off. This is not to suggest that spin-offs should be avoided, but as the Bankruptcy Court stated, experts should be consulted, and ParentCo should work diligently to arrive at a reasonable valuation of the contingent liabilities of SpinCo. In evaluating contingent liabilities, ParentCo, with the help of valuation experts, should consider if the valuation of SpinCo's contingent liabilities is consistent with the company's own historical practices. Other factors to consider: What would have been the cost to obtain insurance coverage sufficient to satisfy contingent liabilities? Can the company provide for the likely future cash cost of the liabilities based on ordinary course projections? What is the likely trading price of SpinCo's equity after consummation of this transaction, and does the trading price have a factual basis?

Ultimately, as evidenced in *Tronox*, if ParentCo believes that SpinCo will not be adequately capitalized, it may need to consider an alternative to a spin-off. Potential acquirers of ParentCo after it has executed a spin-off, too, should consider whether SpinCo was adequately capitalized in determining whether to invest in ParentCo and to mitigate potential liability. Spin-offs are often a worthwhile endeavor to enhance value for a corporation and investors, but care must be given to make sure they are properly executed.

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If you have any questions about the matters addressed in this Restructuring Update, please contact the following Kirkland attorneys or your regular Kirkland contact.

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