

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

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Feature

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A Cartoon and Other Takeaways from the *Tronox* Case



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In an information age where emails, instant messages and texts have generated thousands of terabytes of information that is available for attorneys, consultants, testifying experts, juries and judges to review, it is perhaps not surprising that a cartoon in the record depicting “mordant humor” was used in the recently released *Tronox* decision to explain the heart of the matter.¹ The *Tronox* matter concerned the solvency of a spun-off business that was burdened with legacy environmental and tort liabilities which, according to Hon. **Allan L. Gropper**, rendered it insolvent. Judge Gropper’s finding, according to the Environmental Protection Agency (EPA), resulted in the “largest environmental bankruptcy award ever.”²

The aforementioned cartoon, drawn contemporaneously by an investment banker and referenced on multiple occasions in the decision, depicts a pot containing a flower (the spun-off business) and a weed (the legacy liabilities) strangling the flower. The court essentially found that *Tronox*’s subsequent bankruptcy filing occurred because the weed strangled the flower.³ The court appeared to place more weight on this cartoon than it did on the numerous contemporaneous indicators of solvency for reasons that are discussed in this article.

While this might be one of the few times that a cartoon from the record was used to epitomize a case, the *Tronox* decision is also important because of the rationale behind Judge Gropper’s findings. There are at least four important takeaways: *Tronox* (1) casts doubt on the reliability of contemporaneous market data in certain situations; (2) highlights the difficulty in converting future obligations into present value; (3) sharply criticizes the defendants

for not providing a comprehensive analysis of the “critical issue in this case — the amount of [the debtor’s] contingent liabilities,”⁴ calling it a “major failure of proof;”⁵ and (4) provides more context for interpreting cases such as *Vlasic*,⁶ *Iridium*⁷ and *ASARCO*.⁸ The first two takeaways leave us with more questions than answers, the third takeaway is a reminder that testifying experts can provide context for contemporaneous analysis, and the last takeaway shows how a plaintiff can convince a court to disregard contemporaneous indicators of solvency.

Contemporaneous Market Data

The use of contemporaneous market data is typically not controversial when the parties agree that it is reliable. However, *Tronox*, following in the footsteps of *W.R. Grace*,⁹ suggests that there might be an exception to this rule for debtors with large amounts of certain liabilities. In *Tronox*, the court stated that the large size¹⁰ of the debtor’s environmental liabilities means that “the market as a whole, no matter how efficient or inefficient, cannot be relied on to determine solvency or insolvency.”¹¹

Thus, the court declared that in this case, the market cannot reliably assess hard-to-value liabilities. As discussed below, another court in the same venue (*Iridium*) arrived at a different view when it assessed a debtor with hard-to-value assets. This suggests that hard-to-value liabilities may be treated differently in courts than hard-to-value assets.

1 *Tronox*, 2013 WL 6596696, *25 (Bankr. S.D.N.Y. Dec. 12, 2013).

2 See “Case Summary: Court Decision in *Tronox* Bankruptcy Fraudulent Conveyance Case Results in Largest Environmental Bankruptcy Award Ever,” EPA, available at www2.epa.gov/enforcement/case-summary-court-decision-tronox-bankruptcy-fraudulent-conveyance-case-results-largest.

3 *Tronox* at *57.

4 *Tronox* at *30.

5 *Id.* at *47.

6 *VFB LLC v. Campbell Soup Co.*, 2005 WL 2234606 (D. Del. Sept. 13, 2005), *aff’d*, 482 F.3d 624 (3d Cir. 2007).

7 *Iridium IP LLC v. Motorola Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

8 *ASARCO LLC v. AMS Mining Corp.*, 396 B.R. 278 (S.D. Tex. 2008).

9 *Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (In re W.R. Grace & Co.)*, 281 B.R. 852 (Bankr. D. Del. 2002).

10 *Tronox* at *3.

11 *Tronox* at *42 (emphasis added). The court also found that the market could not assess *Tronox*’s solvency due to inaccurate disclosures.

The contemporaneous market indicators of solvency in *Tronox* were not limited to market prices for securities. There were other varied indicators that reflected the sentiment of multiple stakeholders. For example, all of the trial fact witnesses that were employed by Tronox testified that they believed that Tronox was solvent. Other contemporaneous indications of solvency came from a solvency opinion that was procured, and from an offer to buy Tronox by a potential buyer at a price indicating solvency.

However, the court disregarded each of the solvency indicators because of the defendant's inability to substantiate them and the plaintiff's ability to cast doubt on their reliability. The court's assessment of the market's (in)ability to assess Tronox was not, however, limited to the environmental liabilities. The court also found that the market could not assess Tronox's solvency due to inaccurate disclosures, although unlike *Vlasic*, the *Tronox* court did not assess, in its opinion, the effect of these inaccurate disclosures.¹²

Discount Rate for Environmental Liabilities

The framework for developing the discount rate is straightforward when valuing assets. The starting point is the risk-free rate, and a premium is added to reflect the incremental riskiness of the asset being valued relative to the risk-free rate. The framework for developing the discount rate is more complicated when valuing certain liabilities. There are two reasons for this complication.

First, the standard of value matters. On the one hand, the discount rate for funded interest-bearing debt is irrelevant under a hypothetical sale-based standard of value because the valuation assumes that the buyer acquired the assets "free and clear" of this debt on the valuation date. On the other hand, the discount rate for funded interest-bearing debt is very relevant under a value-in-place standard of value because the valuation assumes that this debt will remain outstanding after the valuation date. The same concept should apply to other types of liabilities (e.g., those that are *pari passu* with funded interest-bearing debt). Simply put, a company's ability to pay (credit risk) either matters or it does not, and the application should be consistent across similarly situated creditors.

Second, practitioners may have different views on risk in the context of liability valuation. Assume that a liability has two potential outcomes. In the first scenario, there is a 100 percent probability that the debtor will have to pay \$100 five years from now. In the second scenario, there is a 50 percent probability that the debtor will have to pay \$200 and a 50 percent probability that the debtor will have to pay nothing five years from now. Both scenarios have the same probability-weighted expected value: \$100 to be paid five years from now. However, there is more volatility in the second scenario. Which liability should have a higher present value: the first or second scenario?

Some practitioners may believe that the discount rate should be higher in the second scenario to reflect the greater volatility of outcomes that are relative to the first scenario. A greater dis-

count rate applied to the same probability-weighted cash flows (\$100 five years from now) results in a lesser present value for the liability. Thus, under this logic, a company would prefer the second scenario over the first scenario. However, other practitioners may counter that such a result is illogical because a company should prefer the first scenario over the second scenario.

For context, consider a homeowner without a mortgage who has the option to insure, or not insure, her house. Assume that the probability-weighted expected claim over the next year is \$1,000. This homeowner has two choices: Do not insure and take her chances, or obtain insurance for the next year at a cost in excess of \$1,000. The insurance company has to charge this homeowner more than the \$1,000 probability-weighted expected claim in order to cover its costs of doing business and to generate a return on its investment. This homeowner will often choose to pay this greater amount due to her risk aversion in general and her aversion to long-term risk in particular (i.e., the very low probability of incurring a very large expense).

The preceding discussion provides context for interpreting the discount rate used to arrive at the present value of environmental liabilities in *Tronox*. In *Tronox*, the parties disagreed over whether an "element of risk" should be incorporated into the discount rate.¹³ The court found that an "element of risk" should not be incorporated because the "fair valuation" of these liabilities should not take into account the debtor's "ability to pay."¹⁴ Thus, the court found that the discount rate should equal the risk-free rate. The court's implied logic was simple: The choice of discount rate for these liabilities only matters when the debtor is insolvent when using a risk-free rate and solvent when an "element of risk" is included. It is illogical, on its face, for a third party's questioning of a debtor's solvency to cause an insolvent debtor to become solvent.

One place to look for additional perspective on this issue is the estimation of liabilities for financial-reporting purposes. The good news is that there are ample examples of liabilities being estimated in the ordinary course in which the company and its auditors agree on the use of certain methodologies to arrive at the discount rate for these liabilities. The bad news is that these examples are inconsistent. For example, the International Financial Reporting Standards (IFRS) Interpretations Committee was asked the following question: "Can the discount rate or the estimated future cash flows be adjusted for the entity's credit risk when a provision is measured in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets?"¹⁵ Interestingly, this is the exact question that the court was asked to address in *Tronox*. The IFRS Interpretations Committee reported the following:

Some think [that] the discount rate should be adjusted for credit risk, others think [that] there is a choice [as to] whether to adjust or not, and yet others think that the adjustment is prohibited. The large international accounting firms appear to be divided on this issue, according to the guidance in their manuals.¹⁶

The court's approach in *Tronox* appears to have some supporters and some opponents among the valuation community.

¹³ *Tronox* at *50.

¹⁴ *Id.*

¹⁵ See IFRS Interpretations Committee Meeting, "New Items for Initial Consideration: IAS 37 Provisions, Contingent Liabilities and Contingent Assets," November 2010, available at www.ifrs.org/Meetings/Documents/IFRS-IC-Nov10/1011obs10IAS37DiscountRate.pdf.

¹⁶ *Id.*

¹² The *Vlasic* court explained that the market viewed the debtor as solvent when accurate disclosures were made after the transfer date. *Vlasic*, 482 F.3d 624, 632 ("[The district court] explicitly chose *not* to rely on VFI's market capitalization at the time of the spin, precisely because of Campbell's manipulation, and instead looked at market capitalization several months later, when the truth of VFI's situation had become clear. Nobody contends that VFI was worth more in September 1998 than at the end of March 1998. Consequently, if VFI's September 1998 market capitalization reflected a value for the Division businesses of at least \$500 million, despite no longer being affected by Campbell's pre-spin operations, then the Division must have been worth more than \$500 million at the time of the spin (emphasis in original).").

Independent Analyses and a Major Failure of Proof

Retrospective solvency cases for fraudulent transfer lawsuits typically include a review of contemporaneously prepared documents and analyses, some of which are presented as evidence at trial by one side or the other in support of their respective positions. However, sometimes certain contemporaneous analyses that might have been expected to be performed were never performed, were performed incorrectly, were incomplete or insufficient, or documentation cannot be located several years later in litigation. It is in these instances that *ex post* testifying experts become especially relevant in a retrospective solvency analysis, as was the case in *Tronox*.

While a solvency analysis considers the value of both assets and liabilities, the most “critical” element in *Tronox* was the value of environmental-related liabilities. However, the court did not find any comprehensive valuation analysis of the environmental liabilities performed contemporaneously, stating that this was “one of the most compelling facts in the enormous record.”¹⁷ It is not clear whether such an analysis existed and was lost, or was never performed. Regardless, one did not exist in the trial record.

While both sides had an opportunity to prepare *ex post* comprehensive analyses of Tronox’s environmental liabilities, it was only the plaintiffs that presented such an analysis in *Tronox*. The defendants instead relied on (1) what existed in the record (including a third-party analysis of the environmental liabilities that the court found to be “certainly not comprehensive”),¹⁸ and (2) a rebuttal of the plaintiff’s independent analysis that the court deemed not to be comprehensive. The court found it to be “significant” that the plaintiff’s analysis was the only comprehensive valuation of Tronox’s environmental liabilities. Ultimately, the Court noted that the [d]efendants’ failure, at any time, either before or after this case was filed, to come forward with a comprehensive analysis of the environmental liabilities ... is a major failure of proof.¹⁹

However, the lack of comprehensive analysis was not limited to environmental liabilities. Experts on both sides performed a comparable company analysis that valued Tronox’s assets in reference to the value of companies in a similar line of business. The plaintiff’s expert chose comparable companies independently, while the defendant relied on comparable companies chosen contemporaneously, admitting “that he did not subject any of his choices to independent analysis.”²⁰ The court found the defendant’s expert’s analysis to be “flawed” by his choice of companies, noting several companies that were not comparable to Tronox.

Comparable company analyses are common in retrospective solvency analyses such as *Tronox*, and valuation practitioners are often faced with the issue of identifying comparable companies. The contemporaneously chosen companies are sometimes reliable indicators of the debtor’s value (e.g., *Idearc*).²¹ In other instances, the testifying expert’s analysis performed after the fact is found to be more reliable (e.g., *Tronox*). We believe that it is best practice to consider both (e.g., *Vlasic*).

Both of these examples in *Tronox* underline the importance of *ex post* independent analyses in certain retrospective solvency matters. *Tronox* is a reminder that contemporaneous information, analyses and indications of value, no matter how rooted in market-based information, can be buttressed with independent analyses.

Vlasic, Iridium and ASARCO

Finally, the *Tronox* decision provides more context for interpreting cases such as *Vlasic*, *Iridium* and *ASARCO*, all of which addressed the use of contemporaneous market evidence as well as determining retrospective solvency.²² The courts in *Vlasic* and *Iridium* found that the plaintiff did not carry its burden in its attempt to disregard the contemporaneous market evidence that indicated solvency. *Iridium* (also tried in the Southern District of New York) is particularly relevant because the debtor was a speculative, hard-to-value business. The facts in *ASARCO* were quite different from *Vlasic* and *Iridium*, and the contemporaneous market evidence suggested that the debtor was insolvent.

While the contemporaneous market evidence in *Tronox*, on its surface, more closely resembled the contemporaneous market evidence in *Vlasic* and *Iridium*, the court ultimately compared *Tronox* to *ASARCO*. In both cases, the defendant was engaged in a transaction that benefited itself at the expense of certain creditors, and the court found that the defendant acted with the intent to hinder, delay or defraud creditors. *Tronox* was different than *ASARCO* in the sense that its independent professionals effectively “signed off” on the deal. Nevertheless, the court did not place much weight on these contemporaneous actions. A key factor in the court’s finding that *Tronox* had more in common with *ASARCO* than with *Vlasic* and *Iridium* appears to be the “mordant humor” contained in the cartoon of the weed choking *Tronox*.²³

Conclusion

Four important takeaways from *Tronox* related to contemporaneous market data, cost of capital, *ex post* independent analysis and further interpretation of other relevant cases have been highlighted. While there are a number of other issues addressed in *Tronox*, they were not addressed in this article, and we chose to instead focus on four issues. The reader should read the decision in its entirety for a complete understanding of all the issues raised by the parties and how they were addressed by the court. **abi**

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¹⁷ *Tronox* at *29.

¹⁸ *Id.* at *47.

¹⁹ *Id.*

²⁰ *Id.* at *53.

²¹ *U.S. Bank Nat'l Ass'n v. Verizon Communs. Inc.*, 2013 WL 230329 (N.D. Tex. Jan. 22, 2013).

²² Notably, the defendant in *Tronox* believed that the market evidence was “far stronger” in *Tronox* than it was in *Vlasic* and *Iridium*. Market evidence encompasses more than just security prices because it also includes the views of contemporaneous actors. *Tronox* at *38 (“Citing three recent decisions on [the] use of the ‘market’ to determine solvency in fraudulent conveyance cases, [the] Defendants assert, ‘In this trial, the enormous body of contemporaneous market evidence of solvency was far stronger than in *VFB, Iridium and CarCo* — all of which found for [the] defendants on solvency’ (emphasis in original)).

²³ *Tronox* at *57.