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**Spinning Out of Control:
Potential Pitfalls and Liabilities in
Spin-Off Transactions**

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Stephen Glover
Robert A. Klyman

Kristin A. Linsley
Sabina Jacobs Margot

Special Thanks to Brittany N. Schmeltz

Spinning Out of Control: Potential Pitfalls and Liabilities in Spin-Off Transactions

Overview

1. Spin-Off Transactions
2. Breach of Fiduciary Duties
3. Fraudulent Transfer Litigation
4. Other Potential Pitfalls Related to Spin-Offs

Spin-Off Transactions

Spin-Off Transactions

Spin-Off

- Parent company distributes the stock of a subsidiary to its stockholders in the form of a pro rata dividend.
- Following the distribution, the stockholders hold stock of the parent and stock of the company that was spun-off.
- The spun-off entity is no longer a subsidiary of the parent and instead is an independent company.

Partial Spin-Off

- Parent company distributes some of the stock and retains some of the stock.
- Parent and the parent's stockholders become co-owners of the subsidiary.

Other Business Separation Transactions

Split-Off

- Parent company makes an offer to its stockholders in which it proposes to exchange some or all of the stock of a subsidiary for its own stock. The stockholders have the opportunity to swap some or all of their parent stock for subsidiary stock.

Split-Up

- Parent company that operates two or more businesses distributes the stock of the subsidiaries that operate these businesses to its stockholders. The parent company then dissolves.

Subsidiary IPO

- Parent company sells some or all of the stock of a subsidiary to the public in a registered public offering. Alternatively, the subsidiary sells newly issued shares to the public.

Purpose and Appeal of Spin-Off Transactions

Reasons that companies pursue spin-offs include:

- Improving management focus
- Enabling free trade with other business competitors
- Implementing better compensation packages
- Improving capital management of separated business
- Disposing of unwanted businesses or assets with high risk or low return
- Raising capital by monetizing interest in spun-off entity
- Reducing indebtedness
- Addressing agitation by stockholder activists
- Raising stock price for stockholders' benefit (last but definitely not least)

Liability Risks in Spin-Off Transactions

Possible claims include the following:

- The parent company's board of directors breached its **fiduciary duties**.
- The transaction constituted a **fraudulent conveyance** under federal bankruptcy or state law.
- The parent company's board of directors declared an **unlawful dividend**.
- Claims in bankruptcy proceedings seeking substantive consolidation, recharacterization, equitable subordination, or avoidance of preferential payments.
- Disclosures about the spin-off violated the securities laws.
- The transaction violated indenture covenants or other third party contract rights.

A well-run, thoughtful deal structuring process provides the best opportunity for minimizing these risks.

Considerations for Structuring Spin-Offs

Transaction planners must consider a variety of issues when structuring spin-offs. Their choices can significantly impact liability risks. Some of these considerations are set forth below.

- Identification and allocation of business lines and assets among the parent and the subsidiary to be spun off
- Allocation of liabilities between the parent and the subsidiary to be spun off
- Good company/bad company spin-off
- Spin-off coupled with subsidiary IPO and/or exchange offer
- Spin-off as a precursor to a disposition or a merger and acquisition
- Cash payments to parent or debt retirement
- Sponsored spin-off transactions

Preparing for a Spin-Off

Spin-offs require a number of preparatory steps. Each of these steps raises its own liability concerns.

- Existing subsidiary vs. creation of new subsidiary
- State of incorporation and corporate documents (charter and bylaws)
- Adoption of takeover defenses before subsidiary goes public
- Selection of directors, officers, and employees for subsidiary
- Liquidity needs of subsidiary and covenants in existing debt documents
- Tax considerations
- Third-party consents and regulatory approvals
- Organization and filing of SEC disclosure documents, including Form 10 and information statement.
- Preparation of subsidiary stock for listing on appropriate exchange
- Negotiation of spin-off transaction agreements
- Covenants not to complete
- Spin-off “road shows”

Coming Attractions & Important Takeaways

- Carefully allocate assets and liabilities among parent and subsidiary to be spun off
- Ensure that parent and subsidiary to be spun off will be viable entities that will remain solvent.
- The board of directors should supervise the process. It should consider alternatives, and carefully examine the purpose, risks and benefits of the proposed transaction, taking into account alternatives.
- The board should obtain the advice of experts, including investment bankers, lawyers, and valuation experts. These experts can provide valuable advice on structuring, valuation, and solvency issues.
- Draft disclosure documents carefully.

Breach of Fiduciary Duties

Overview of Fiduciary Duties

- Primary fiduciary duties under Delaware law:
 - **Duty of Care**
 - **Duty of Loyalty**
- **Directors.** The business affairs of a corporation are to be managed under the direction of the board of directors.
 - The law of the state (country/province) of incorporation or organization of the company determines the scope and extent of the directors' fiduciary duties.

Overview of Fiduciary Duties (cont'd)

- **Officers.** The Delaware Supreme Court has held that an officer's fiduciary duties are the same as the fiduciary duties imposed on a director. See *Gantler v. Stephens*, 965 A.2d 695, 708-09 n. 37 (Del. 2009).
- **Shareholders.** Fiduciary duties are imposed on controlling shareholders. A shareholder entity generally owes fiduciary duties to a corporation if the shareholder:
 1. Owns more than 50% of the voting power of the corporation; or
 2. Exercises actual control over the business and affairs of the corporation

The controlling interests of more than one shareholder will be considered together if the shareholders are part of a "control group" (i.e., there is a formal or informal voting agreement between the shareholders).

Duty of Care

Duty of Care

- Directors must be diligent and informed, and exercise prudent and unbiased business judgment.
- Directors are entitled to rely in good faith and with ordinary care on reports prepared by officers of the company or outside experts within the area of their expertise.
- Delaware permits exculpation of directors (but not officers) from personal liability for breaches of the duty of care.
- Delaware courts apply a **gross negligence standard** in determining whether directors and officers have met their duty of care.

Duty of Loyalty

Duty of Loyalty

- Directors and officers must act in good faith and in the best interests of the company, and deal fairly with the company.
- Board members cannot favor a particular group or an appointing entity
 - *Klaassen v. Allegro Development Corp.*, 2013 WL 5967028 (Del. Ch. Nov. 7, 2013) (“Delaware decisions consistently reject the related concept of ‘constituency directors’ as well as the notion that a director appointed by a particular minority stockholder or a particular class or series of stock can or should serve the particular interests of the appointing entity”).
 - Directors of a C-corporation may not be exculpated from the duty of loyalty, including the implied covenant of good faith and fair dealing

Defense: Business Judgment Rule

- **The Rule.** “[A] presumption that in making a business decision, the directors and officers acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”
- Focus is on the **process**, not the result.
- Deference is given to the directors and officers if they:
 - Are **disinterested** and **independent**
 - Are informed of all material information reasonably available
 - Act in good faith
 - Have a reasonable belief their acts are in the company’s best interests
- To rebut, a **plaintiff must show** that the directors or officers breached the duty of care or loyalty or failed to act in good faith (heavy burden).

Defense: Business Judgment Rule (*cont'd*)

Steps for directors towards receiving the benefit of the business judgment rule include:

- Attend and participate in board meetings so that they can be kept informed of company business
- Make reasonable inquiries regarding maintenance issues, employee; violations, and contract issues
- Make decisions on company business
- Ensure adequate company records are kept

Business Judgment Rule – An Imperfect Shield

- When things go wrong, the directors' and officers' actions often are scrutinized with the biases of “20/20 hindsight”
 - Did they act with **sufficient care**?
 - Did they have any **conflicting loyalties**?
- While directors may comply with the duty of loyalty even if they are interested in a particular transaction, in order to receive the benefit of the *business judgment rule*, directors must be both **disinterested** and **independent** with respect to the transactions, financings, payments, or restructuring alternatives being considered
- If directors or officers do not obtain the benefit of business judgment rule, the burden shifts to them to demonstrate the “**inherent**” or “**entire**” **fairness** of a challenged action (much higher standard).

Application of Fiduciary Duties: Solvent Companies

Corporations

- General Rule: Directors and officers of a solvent company owe their fiduciary duties to the company; shareholders are beneficiaries of those duties.
- Only shareholders may derivatively enforce breaches of fiduciary duties.
- Creditor protections are contractual: “[T]he general rule implies that courts do little more than protect creditors’ contractual rights to priority of repayment.”

LLCs and LPs

- General Rule: Delaware law allows members and partners of LLCs and LPs to waive fiduciary duties owed by management in their LLC or LP agreements.

Application of Fiduciary Duties: Insolvent Companies

Corporations

- General Rule: directors owe fiduciary duties to the entire company, but the parties entitled to enforce those duties **derivatively expands** to include creditors and shareholders (and appointed bankruptcy trustees).
- Officers and directors do not owe direct fiduciary duties to specific creditors when the corporation is insolvent: all duties are derivative.
- It is prudent for directors to assume that, with the benefit of hindsight, a court might find the corporation was insolvent.
- Directors should act in a manner that maximizes the value of the corporation.

Application of Fiduciary Duties: Insolvent Companies (cont'd)

LLCs and LCs

- General Rule: Management of an insolvent Delaware LLC or LP that has waived all fiduciary duties in its operating agreement owes no fiduciary duties, even though the entity's residual beneficiaries (i.e., creditors) never agreed to the fiduciary duty waivers.
 - Even without such complete waiver, creditors of an LLC or an LP (unlike creditors of an insolvent corporation) do not have derivative standing to bring breach claims in that context.
- Note: Whether an insolvent company is in bankruptcy may alter this analysis. Courts generally hold that post petition, debtors owe traditional state law fiduciary duties to the estate. While courts have not directly addressed the issue of derivative standing for creditors to assert breach of fiduciary duty claims, it is possible that they may hold that such duties to the estate are enforceable by creditors.

Breach of Fiduciary Duties in Spin-Offs

Conflicts of Interest

- Multiple Board Positions. If an individual serves on the boards of both the parent and the spun-off entity, and parent and spun-off entity continue to engage in business transactions, a director who owes fiduciary duties to both the parent and the spun-off entity will face a significant conflict, tax issues and litigations risks.
- Consulting Contracts. If members of the parent's board of directors may expect to benefit from consulting contracts with the spun-off subsidiary, the business judgment rule may not protect them from liability.

Scope of Duty

- Parent Stockholders. Neither the board of directors of the parent nor the board of directors of the subsidiary to be spun-off owes fiduciary duties to the future stockholders of the spun-off subsidiary; fiduciary duties are owed only to the parent stockholders.

Anadarko Petroleum Corp. v. Panhandle Eastern Corp.

Anadarko Petroleum Corp. v. Panhandle Eastern Corp.,
545 A.2d 1171 (Del. 1988).

- Anadarko, the wholly owned subsidiary of Panhandle, was engaged in the exploration and production of crude oil and natural gas.
- The parent's board unanimously voted to spin off the production and exploration assets by distributing Anadarko common stock.
- Following the approval but prior to the distribution, the boards of both the parent and Anadarko modified several agreements between the companies to enhance the value of the spin off.
- After four new directors replaced prior directors on the Anadarko board, Anadarko's newly constituted board reviewed these modified agreements and found that they were unfair and voidable.

Anadarko Petroleum Corp. v. Panhandle Eastern Corp. *(cont'd)*

- The newly constituted Anadarko board voted unanimously to rescind the modified agreements and brought suit, claiming that the parent directors and the former Anadarko directors had breached their fiduciary duties to the prospective shareholders of the spun-off Anadarko by approving the modification of these agreements.
- Upon review, the court dismissed the claims for the breach of fiduciary duties, holding that the declaration of the intent to spin off Anadarko did not impose fiduciary duties on the parent's and Anadarko's directors that were owed to the prospective shareholders of Anadarko.

In re Columbia Pipeline Group, Inc. Shareholder Litigation

In re Columbia Pipeline Group, Inc. Shareholder Litigation,
C.A. No 12152-VCL (Del. Ch. Mar. 7, 2017).

- CPG was a wholly owned subsidiary of the parent.
- The parent's directors declined an opportunity to sell CPG, and instead spun-off CPG.
 - The spin-off triggered change-of-control benefits for the directors, while the sale would not have triggered such benefits.
- CPG subsequently entered into a merger agreement resulting in the sale of the company, which was approved by 95% of CPG's stockholders.

In re Columbia Pipeline Group, Inc. Shareholder Litigation (cont'd)

- The plaintiffs – CPG stockholders – alleged that the directors had breached their duty of loyalty by spinning off the company and then selling it to trigger their change-of-control benefits.
- Ultimately, the court held that the business judgment rule applied to the transaction and protected the directors because the transaction had been approved by a majority of the disinterested stockholders.
- The court noted that only conflicted transactions with controlling stockholders cannot be cleansed by stockholder approval and are subject to the entire fairness standard.

Francis M. Ford (VMware Inc.) v. VMware Inc.

Francis M. Ford (VMware Inc.) v. VMware Inc.,
C.A. No. 11714-VCL (Del. Ch. May 2, 2017).

- VMware was under majority ownership of a publicly traded corporation.
- The corporation considered spinning off VMware.
- However, instead of a spin-off, the corporation then decided to pursue a reverse triangular merger with a holding company.
- VMware's stock value fell immediately after the merger was announced.

Francis M. Ford (VMware Inc.) v. VMware Inc. (cont'd)

- The plaintiff – a minority stockholder of VMware – alleged that the corporation breached its duty of loyalty as a majority stockholder by failing to spin off VMware when given the opportunity to do so before the merger.
- The court dismissed this claim, holding that a majority stockholder has no obligation to alienate its own shares and is permitted to act in its own interest in deciding whether and when to sell its property.

Takeaways: Breach of Fiduciary Duties

- Fiduciary duties are owed by directors, officers, and controlling stockholders.
- Preparing a subsidiary for a spin-off and effecting the spin-off are likely to result in claims for breach of fiduciary duties if the spin-off results in any damage to the parent and/or the spun-off subsidiary.
- Directors should establish a good record showing process was insulated from conflict and that directors exercised due care.
- The business judgment rule is an imperfect defense to a claim for breach of fiduciary duties.
- Where board members or a parent company maintain a relationship with a spun-off company, conflicts of interest are likely to arise.
- Disinterested and independent directors should approve the spin-off and related transactions between the parent and the spun-off entity.

Fraudulent Transfer Litigation

Potential Fraudulent Transfer Claims

Fraudulent Transfer Claims under the Bankruptcy Code

- Intentional Fraud: 11 U.S.C. § 548(a)(1)(A)
- Constructive Fraud: 11 U.S.C. § 548(a)(1)(B)
- State Law Fraud Claims: 11 U.S.C. § 544(b)(1)
 - Each state has fraudulent transfer/conveyance statutes.
- Liability and Damages: 11 U.S.C. § 544(b)(1)

Intentional Fraud: 11 U.S.C. § 548(a)(1)(A)

Transfer of interest in debtor's property or incurrence of obligation by debtor.

- **Parties with Standing.** Trustee, debtor in possession, litigation trust (or other party that is granted standing by the bankruptcy court).
- **Statute of Limitations.** Covers transfers or incurrence of obligations that occurred within 2 years of commencement of debtor's bankruptcy case.
- **Basis for Claim.** Actual intent to hinder, delay, or defraud any creditor of debtor.

Constructive Fraud: 11 U.S.C. § 548(a)(1)(B)

Transfer of interest in debtor's property or incurrence of obligation by debtor

- **Parties with Standing.** Trustee, debtor in possession, litigation trust (or other party that is granted standing by the bankruptcy court).
- **Statute of Limitations.** Covers transfers or incurrence of obligations that occurred within 2 years of commencement of debtor's bankruptcy case.
- **Basis for Claim.** (1) debtor received less than reasonably equivalent value in exchange for such transfer or obligation and (2) debtor:
 - a. Was insolvent when transfer was made or obligation was incurred, or was rendered insolvent as a result thereof,
 - b. Was engaged in business for which it retained unreasonably small capital,
 - c. Would incur debts beyond its ability to pay such debts as they matured; or
 - d. Made such transfer or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

State Law Fraud Claims: 11 U.S.C. § 544(b)(1)

Transfer of interest in debtor's property or incurrence of obligation by debtor.

- **Parties with Standing.** Trustee, debtor in possession, party granted leave by court.
- **Applicable law.** Applicable state law.
- **Statute of Limitations.** Depends on applicable state law (could cover transfers or incurrence of obligations that occurred up to 4 or 6 years prior to commencement of debtor's bankruptcy case, depending on state law).
- **Required element.** Existence of "triggering creditor" with allowable unsecured claim.

Liability and Damages: 11 U.S.C. § 550(a)

Plaintiff can recover, for the benefit of the debtor's estate:

- **Property** transferred; or
- **Value** of property transferred.

There are some protections for good faith transferees that provided value to debtor.

Calculation of damages is a complex issue:

- Valuation of assets is complex; multiple valuation methods.
- Valuation and damages experts are often engaged on both sides.
- Courts engage in fact-intensive, case-by-case analysis.

Procedural Considerations

Procedural considerations in fraudulent transfer litigation:

- Likely Plaintiffs. Litigation trust, creditors' committee, equity holders.
- Likelihood of asserted claims. Likely if the claims are valuable.
- Venue. Bankruptcy court vs. district court (bench vs. jury trial).
- Motion to dismiss. Claims are likely to survive a motion to dismiss.
 - *See, e.g. In re HH Liquidation, LLC* No. 15-11874 (KG), 2017 WL 4457404 (Bankr. D. Del. Oct. 4, 2017) (denying defendant's motion to dismiss plaintiff's fraudulent transfer claims pending findings in trial on substantive consolidation and undercapitalization).
- Discovery. Time-consuming and costly document discovery and fact depositions.
- Motion for summary judgment. Fact-intensive and, given sufficient evidence, claims are likely to survive a motion for summary judgment.
- Trial. Parties are likely to proceed to time-consuming and costly trial.

Fraudulent Transfer Claims in Spin-Offs

Lack of Reasonably Equivalent Value. Spin-offs raise fraudulent conveyance issues because by definition the dividend distribution is not a transfer for reasonably equivalent value—the parent company receives nothing in return.

- Courts have consistently held that the payment of a dividend is a conveyance lacking fair consideration in return.
- Other concerns, such as the risks posed by allocation of assets and liabilities or incurrence of new debt, are present other business separation transactions such as subsidiary IPS or split-offs.

Potential Insolvency. If the spin-off leaves the parent insolvent because the parent no longer owns the spun-off company's assets, then the parent's creditors can assert fraudulent transfer claims. Likewise, if the spin-off leaves the spun-off entity insolvent, then the spun-off entity's creditors can assert fraudulent transfer claims.

VFB LLC v. Campbell Soup Company

VFB LLC v. Campbell Soup Company,
482 F.3d 624 (3d Cir. 2007).

- Campbell spun off Vlasic Foods; Campbell sold several food companies to Vlasic in exchange for \$500 million in promissory notes.
- Campbell used accounting techniques to inflate short-term sales and earnings. After the spin-off, the inflated sales and earnings self-corrected, and share prices remained steady for about 1 year.
- Spin-off was approved by Vlasic's directors and by Campbell's officers.
- Within 3 years, Vlasic filed for bankruptcy and sold the food companies for \$504 million (discounted to \$385 million at time of spin-off – less than it had paid Campbell).
- Post-petition valuation analysis by three experts at time of spin-off: \$569 million, \$270-360 million, and \$377 million.

VFB LLC v. Campbell Soup Company *(cont'd)*

- Vlasic asserted fraudulent transfer claims against Campbell.
- District court concluded that the value of the food companies at time of spin-off exceeded \$500 million (based on stock prices).
- Therefore, Vlasic received reasonably equivalent value from Campbell at the time of the spin-off.
- District court found for Campbell.
- Third Circuit affirmed.

In re Iridium Operating LLC

In re Iridium Operating LLC,
373 B.R. 283 (Bankr. S.D.N.Y. 2007).

- Motorola spun off certain satellites to Iridium for approximately \$3.7 billion, retaining what is a 20% interest in the company and its role as general contractor.
- Four years after the spin-off and nine months after Iridium launched its satellite service (which was an “epic” failure), Iridium filed for chapter 11 bankruptcy.
- As of petition date, the price per share still reflected a positive enterprise value for Iridium, even though the price had dropped significantly in the months leading up to the bankruptcy filing.

In re Iridium Operating LLC (cont'd)

- Iridium's creditors committee asserted fraudulent transfer claims against Motorola.
- After years of discovery focusing on Iridium's solvency, the court adopted the "market test" in *VFB LLC v. Campbell Soup Co.* and determined that Iridium was solvent during the 4-year period leading up to the bankruptcy filing.
- Dismissing the committee's argument in favor of expert testimony regarding discounted cash flow valuation, the court held that market data provides a better guide of fair value than expert valuation testimony (even if market data can be overly optimistic and poor predictors of value at times) because they are impartial and unbiased (no hindsight bias) gauges of investor confidence.

In re Tronox Inc.

In re Tronox Inc.,
503 B.R. 239 (Bankr. S.D.N.Y. 2013).

- In 2002, Kerr McGee began spinning off certain business lines for the purpose of retaining just the E&P business lines.
- The chemical business line was spun off as Tronox.
- Following the spin-off, Tronox had \$550 million in debt and \$40 million in cash, and substantial environmental and tort liability (that cost approximately \$1 billion in prior years).
- Tronox began to struggle immediately following the spin-off: poor cash flow, had to cut costs, had to fund legacy liabilities left behind, and legacy liabilities impeded potential merger discussions.
- In 2009, Tronox filed for chapter 11 bankruptcy.

In re Tronox Inc. *(cont'd)*

- Tronox asserted fraudulent transfer claims against Kerr McGee.
- The court found evidence of defendants' actual intent to hinder or delay creditors by spinning off their businesses. It was apparent to the court that defendants devised a scheme to free the E&P business from legacy liabilities.
- Tronox's ability to survive for several years after the spin-off was not dispositive evidence of solvency.
- The court was persuaded that the value of assets transferred from Tronox was \$15 billion, but defendants sought a \$10 billion offset for their claims against Tronox.
- The court requested additional briefing on the damages issue, and ultimately approved a \$5.15 billion settlement by the parties.

In re Crown Vantage Inc.

In re Crown Vantage Inc.,
198 F. App'x 597 (B.A.P. 9th Cir. 2006).

- Fort James was Crown Paper's sole shareholder.
- Fort James spun off certain paper businesses to Crown Paper, and in exchange Crown Paper dividend approximately \$948 million in cash and gave promissory notes, and assumed of liabilities for the benefit of Fort James.
- Valuation of sold paper businesses: Approximately \$429-457 million.
- Following the spin-off, Crown's stock sold on open market for \$1.025 billion.

In re Crown Vantage Inc. *(cont'd)*

- Crown asserted fraudulent transfer claims against Fort James.
- Court considered indicia/badges of fraud to determine whether Crown had asserted a prima facie case against Fort James for fraudulent transfer.
- Court was not persuaded by the Crown's market price as dispositive evidence of Crown's valuation.
- Crown's liquidating trustee offered evidence of Crown's insolvency as of spin-off.
- Ultimately, the court did not dismiss the claims against Fort James and denied Fort James's motion for summary judgment.
- Ninth Circuit B.A.P. affirmed.

In re Crown Vantage, Inc.: Defenses Against Liability in Third-Party Claims

Two earlier opinions in the *Crown Vantage* litigation highlight certain defenses to third-party claims against directors, officers, law firms, accounting firms, and others.

- *In re Crown Vantage, Inc.*, 2003 WL 25257821 (N.D. Cal. Sept. 25, 2003), *aff'd sub nom. Crown Paper Liquidating Tr. v. Pricewaterhousecoopers LLP*, 198 F. App'x 597 (9th Cir. 2006).
- *In re Crown Vantage, Inc.*, 2004 WL 1635543 (N.D. Cal. July 12, 2004), *aff'd sub nom. Crown Paper Liquidating Tr. v. Pricewaterhousecoopers LLP*, 198 F. App'x 597 (9th Cir. 2006).
 - Claims for fraudulent transfer, aiding and abetting fraudulent transfers, breach of fiduciary duties, and negligent misrepresentation were filed against directors, law firm, investment bank, financial adviser, accounting firms, and parent.
 - Court granted defendants' motions to dismiss in part based on *in pari delicto* defense and failure to state claims cognizable under Virginia law.

Current Case Study: Paragon Spin-Off by Noble

- On August 1, 2014, Noble Corporation plc spun off Paragon Offshore plc. Prior spin-off and IPO efforts in 2011, 2012, and 2013 had failed.
- Paragon acquired standard specification business line in the spin-off. Noble retained high specification business line.
- Within one month of spin-off, Paragon recognized a \$929 million impairment charge. In November 2014, Paragon acquired majority stake in another drilling company for \$202 million in cash.
- On February 14, 2016, Paragon filed for chapter 11 bankruptcy protection.
- On June 7, 2017, the bankruptcy court confirmed Paragon's fifth chapter 11 plan, which provided for the funding of a Litigation Trust through a loan from Reorganized Paragon of up to \$10 million to pursue fraudulent transfer claims against Noble on behalf of certain secured creditors of Paragon.

Current Case Study: Paragon Spin-Off by Noble (*cont'd*)

Noble's potential defenses against liability include:

- At the time of the spin-off, Paragon was properly funded, solvent and had appropriate liquidity, approximately \$2 billion in backlog, a well-maintained fleet, \$200 million of working capital and an undrawn \$800 million revolver.
- Paragon's GC stated in his affidavit that Paragon's management believed that the spin-off was a sound business deal and a great opportunity, and that fraudulent transfer claims against Noble would be difficult to prove.
- Valuations by Barclays and Houlihan, and Houlihan's solvency opinion, reflected positive forecasts for Paragon following the spin-off.
- A number of comparable public companies in the industry took large impairment charges towards the end of 2014 as outlook for oil weakened (e.g., Transocean, Diamond, Ensco).

Preparing Defenses to Fraudulent Transfer Claims related to Spin-Offs

- Independent, third-party **valuations** of the parent's and subsidiary's assets, both before and after the spin-off transaction to show reasonably equivalent value.
- **Cash flow projections** showing the ability of the parent and the subsidiary to pay their debts as they come due and adequate capitalization.
- Compare the **capitalization** of the parent and the subsidiary with that of companies in comparable lines of business.
- Obtain a **solvency opinion**.

Takeaways: Fraudulent Transfer Litigation

- Spin-offs raise fraudulent transfer concerns because they may involve transfers that lack reasonably equivalent value and may implicate potential solvency issues of the parent and/or the spun-off entity.
- Fraudulent transfer claims are likely to be brought in the bankruptcy context if they are valuable, so the parent and the subsidiary to be spun-off should take measures to avoid and defend against such claims from the moment a spin-off is considered.
- Assets and liabilities should be allocated keeping in mind the potential of fraudulent transfer allegations.
- Basic rule of thumb: Design the spin-off transaction so that both the parent and the spun-off entity will be viable following the spin-off, and create a record to establish good faith efforts in service of such a transaction.

Other Potential Pitfalls Related to Spin-Offs

Liability for Unlawful Dividend

Directors have personal liability for unlawful dividends under most corporate statutes.

Stockholders who knowingly receive unlawful dividends are liable to the corporation for the amount improperly received, subject to certain limitations.

- **Similar Tests.** A company that fails a fraudulent conveyance test is also likely to fail to meet the requirements of the applicable dividend statute.
- **Similar Risks.** Because the value of the dividend is in excess of the parent's net assets or because the parent is insolvent, fraudulent conveyance risks in spin-offs are closely related to unlawful dividend risks.

Breaches of Indenture Covenants and Other Third Party Claims

- The parent's debt indentures and credit agreements may contain covenants that would arguably be violated by the spin-off transaction. For example:
 - An indenture covenant may restrict transfers of a substantial portion of the parent's assets. The question of whether a spin-off would violate this covenant may not have a clear answer. Bond investors may take aggressive positions regarding how to interpret such covenants.
 - Contracts with a third party supplier may contain change of control provisions. The supplier may take the view that the spin-off constitutes a change of control.
 - The case law may not provide a clear answer to the question of whether covenants like these will be violated by the spin-off transaction. Corporate law principles may not control.
- Litigation that challenges transactions, whether before or after closing, can be costly and disruptive.
 - This litigation is quite common. Some bond investors are willing to be aggressive in pursuing these kinds of claims.

Securities Law Claims

- If either the parent or the spun-off entity underperforms after the spin-off transaction is completed, and the stock price drops, stockholders may file lawsuits claiming that the spin-off disclosure documents failed to disclose material risks.
- Stockholders may also claim that post-spin-off SEC filings (e.g., 10-Ks, 10-Qs, and 8-Ks) contain material misstatements or omissions.
- Claims may be made under Section 10(b) of the Exchange Act and Rule 10b-5. Depending on the circumstances, the parties may also allege claims under other provisions of the Exchange Act or under the Securities Act.
- Well-drafted disclosure documents, and in particular risk factor disclosures, provide the best defense to these claims.
- More generally, the parent or the spun-off entity can reduce the risk of these claims by taking steps during the structuring process to ensure that both the parent and the spun-off entity will thrive following the spin-off transaction.

Alter Ego & Piercing the Corporate Veil

The court may “pierce the corporate veil” and hold a stockholder responsible for the actions of the corporation where a corporation is found to be an “alter ego” or “mere instrumentality” of the stockholder.

- **Subsidiary IPOs and Partial Spin-Offs.** Greater risk that the parent’s relationship with the subsidiary will cause the parent to be held liable for the subsidiary’s actions based on an alter ego theory.
- **Pre-Spin-Off Liabilities.** Parent could be held responsible for pre-spin-off liabilities if the court finds that a spun-off subsidiary was an alter ego of the parent before the spin-off.

Substantive Consolidation in Bankruptcy

The court may consolidate the assets and liabilities of affiliated or related entities into the debtor's estate, and treat the related entities as one consolidated entity for purposes of the debtor's bankruptcy proceedings.

- **Subsidiary IPOs.** Greatest risk of substantive consolidation, particularly where the parent retains a controlling interest, and both parties file for bankruptcy.
 - Less likely where only one of the two entities is a debtor in a bankruptcy proceeding.
- **Common Control.** Should not be invoked in a spin-off, split-up, or split-off, unless the parent continues to own a stake in the subsidiary following the transaction or the two companies are subject to common control.

Preference Liability: 11 U.S.C. § 547(b)

Any unsecured payment made by the debtor within 90 days of the commencement of its bankruptcy proceeding to or for the benefit of a creditor (or within one year if the creditor was an insider when the payment was made) on account of an antecedent debt may be avoided as a preference, subject to certain defenses.

- **Payments to Subsidiaries.** Section 547 of the Bankruptcy Code may be invoked when a parent company makes payments to the subsidiary to be spun-off, or vice versa.

Recharacterization & Equitable Subordination

- **Recharacterization.** A bankruptcy court may recharacterize a claim as an equity interest where the court determines that the parties intended the loan to be a disguised equity contribution.
- **Equitable Subordination.** A bankruptcy court may subordinate a claim when the claimant has engaged in inequitable conduct that either resulted in injury to other creditors or conferred an unfair advantage on the claimant.
 - Insiders are held to a more stringent standard when the court evaluates whether their conduct was equitable.
 - Equity investors and lenders will face much greater risk of recharacterization and equitable subordination of their claims if they lent money to the debtor at a time when the company was insolvent or undercapitalized.

Tax Implications and Anti-Inversion Rules and Regulations

Inversion transactions. Generally, where U.S. companies become foreign companies by way of merger or acquisition, minimizing U.S. tax and non-U.S. income. In 2016, the IRS issued comprehensive rules and regulations restricting inversion transactions and limiting U.S. tax benefits following an inversion.

- **Penalties.** Under the anti-inversion rules, companies can trigger penalties by violating foreign ownership thresholds (e.g., when former shareholder of an acquired U.S. company owns 60 percent or more a new foreign parent's stock).
- **Reallocation of Tax Liabilities**

Disclaimer

Although this presentation may provide information concerning potential legal issues, it is not a substitute for legal advice from qualified counsel. This presentation is not created nor designed to address the unique facts or circumstances that may arise in any specific instance. You should not, nor are you authorized to, rely on this content as a source of legal advice. This material does not create any attorney-client relationship between you and Gibson Dunn.

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Professional Profiles

Stephen Glover

1050 Connecticut Avenue, N.W., Washington, DC 20036

T: +1 202.955.8593

SIglover@gibsondunn.com



Stephen I. Glover is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher and Co-Chair of the Firm's Mergers and Acquisitions Practice. Mr. Glover has an extensive practice representing public and private companies in complex mergers and acquisitions, joint ventures, equity and debt offerings and corporate governance matters.

Mr. Glover was named the 2016 Washington, D.C. M&A Lawyer of the Year by The Best Lawyers in America® and has been ranked in the top tier of corporate transactions attorneys in Washington, D.C. for the past twelve years (2005 – 2016) by Chambers USA America's Leading Business Lawyers. Mr. Glover has also been selected by Chambers Global 2016 and 2017 as a top lawyer for USA Corporate/M&A. In 2017, Chambers also singled out Mr. Glover and elevated him to a "Star Individual". In 2015, Mr. Glover was recognized in Who's Who of M&A Lawyers by Who's Who Legal. He was recognized as a BTI Client Service All-Star in 2017, 2016 and 2015, and has been named as a top Washington M&A lawyer by The Washington Business Journal on several occasions. Mr. Glover has also been identified among "Ten of the D.C. Area's Top Deal-Making Attorneys" by Legal Times.

His clients include large public corporations, emerging growth companies and middle market companies in a wide range of industries. He also advises private equity firms, individual investors and others.

Mr. Glover is the author or co-author of several books, including M&A Practice Guide (revised 2012); Business Separation Transactions: Spin-Offs, Subsidiary IPOs and Tracking Stock (revised 2012); and Partnerships, Joint Ventures and Strategic Alliances (revised 2012). He has written more than 60 articles and speaks frequently on corporate and securities law issues.

Mr. Glover is a member of the DC Bar Board of Governors, as well as a former co-chair of the Steering Committee for the D.C. Bar's Corporation, Finance and Securities Law Section. He is a member of the advisory board of BNA's Mergers & Acquisitions Law Report and a member of the editorial board of The M&A Lawyer. He has served as D.C. representative to the New York Tribar Opinion Committee. Mr. Glover has also served as an Adjunct Professor at the Georgetown University Law Center.

Mr. Glover was the DC Bar Pro Bono Lawyer of the Year for 2004. He served as a law clerk to Justice Thurgood Marshall in the United States Supreme Court from 1981 to 1982 and to J. Skelly Wright, Chief Judge of the U.S. Court of Appeals for the District of Columbia Circuit from 1980 to 1981. He earned his law degree cum laude in 1980 from Harvard Law School, where he was Managing Editor of the Harvard Law Review. He received his undergraduate degree summa cum laude in 1977 from Amherst College.

Robert A. Klyman

333 South Grand Avenue, Los Angeles, CA 90071
Tel: +1 213.229.7562
RKlyman@gibsondunn.com



Robert A. Klyman is a partner in the Los Angeles office of Gibson, Dunn & Crutcher and Co-Chair of Gibson Dunn's Business Restructuring and Reorganization Practice Group. Mr. Klyman represents debtors, acquirers, lenders and boards of directors. His experience includes advising companies in connection with out-of-court restructuring, as well as, traditional, prepackaged and “pre-negotiated” bankruptcies; representing lenders and other creditors in complex workouts; counseling strategic and financial players who acquire debt or provide financing as a path to take control of companies in bankruptcy; structuring and implementing numerous asset sales through Section 363 of the Bankruptcy Code; and litigating complex bankruptcy and commercial matters arising in chapter 11 cases, both at trial and on appeal.

Turnarounds & Workouts named Robert Klyman to its 2016 list of Outstanding Restructuring Lawyers which honors 12 attorneys each year who are leaders in the bankruptcy field. In addition, Mr. Klyman has been widely and regularly recognized for his debtor and lender work as a leading bankruptcy and restructuring attorney by Chambers USA; named as one of the world's leading Insolvency and Restructuring Lawyers by *Euromoney*; listed in the K&A Restructuring Register, a leading peer review listing, as one of the top 100 restructuring professionals in the United States; named as a “Top Bankruptcy M&A Lawyer” by *The Deal's Bankruptcy Insider*; named as one of the 12 outstanding bankruptcy lawyers in the nation under the age of 40 (in 1999, 2000, 2002 and 2004) by *Turnarounds & Workouts*; and one of “20 lawyers under 40” to watch in California by the Daily Journal. Mr. Klyman was recently selected by his peers for inclusion in *The Best Lawyers in America*® 2017 in the field of Bankruptcy and Creditor Debtor Rights.

Mr. Klyman developed, and for the past 18 years co-taught, a case study for the Harvard Business School on prepackaged bankruptcies and bankruptcy valuation issues. He has also taught classes on dealmaking in the bankruptcy courts at the University of Michigan Business School and UCLA Law School. Mr. Klyman is also a member of the ABA Subcommittee that drafted the recently released ABA Model Bankruptcy Asset Purchase Agreement.

Mr. Klyman received both his J.D. from the University of Michigan Law School in 1989 and his B.A. degree from the University of Michigan in 1986. Mr. Klyman is admitted to the California Bar. Prior to joining Gibson Dunn, Mr. Klyman was a partner at the firm of Latham & Watkins for more than 17 years.

Kristin A. Linsley

555 Mission Street, San Francisco, CA 94105
Tel: +1 415.393.8395
KLinsley@gibsondunn.com



Kristin A. Linsley is a partner in the Litigation Department of Gibson, Dunn's San Francisco office. Ms. Linsley specializes in complex business and appellate litigation across a spectrum of subject areas, including bankruptcy, finance and fund litigation, technology and privacy, international and transnational law, regulatory matters, and complex litigation. She has earned a national reputation for achieving favorable results for her clients in high-profile complex matters, and is noted for the strength of her legal analysis and the depth and breadth of her litigation expertise.

In the area of business litigation, Ms. Linsley has defended clients, including high-profile funds, in high-stakes litigation involving financial issues arising from the mortgage crisis, commercial/contract disputes between companies, securities fraud and RICO violations, technology, telecommunications, and privacy issues, consumer class actions, intellectual property, and defense and aerospace-related issues. In the area of bankruptcy and related matters, Ms. Linsley litigated a highly complex case arising out of a spinoff of Crown Paper from Fort James, a Georgia Pacific subsidiary that went into bankruptcy after the spinoff. The case involved a broad spectrum of claims against the former parent and other players arising from the spin-off, including claims for fraudulent transfer, fraud, aiding and abetting, breach of fiduciary duty, and other claims. Ms. Linsley successfully briefed the case in the lower court and was selected by the defense group to defend the favorable result on appeal, in which the judgment was affirmed.

Ms. Linsley also represented a large group of funds that were adversely affected by events in the General Motors bankruptcy when a form UCC-3 was inadvertently filed that had the effect of rendering unsecured approximately \$1.7 billion of syndicated debt that had been paid out at the commencement of the bankruptcy. Ms. Linsley co-led a team that defended the funds in the resulting claw-back action, and also formulated and pursued claims against third parties in connection with the underlying UCC-3 filing.

Ms. Linsley also has an active appellate practice representing clients in a wide range of industries before the federal and state appellate courts and the U.S. Supreme Court. Ms. Linsley has briefed and argued appeals on a wide range of matters, including cases involving complex business transactions, jurisdictional and procedural issues, class actions, and telecommunications issues.

On the international/transnational side, Ms. Linsley has spent nearly two decades litigating complex international law issues arising from clients' overseas operations, including claims brought under the Alien Tort Statute. Ms. Linsley is a frequent writer and speaker on these issues. She also has recently turned her transnational expertise toward actions seeking to impose liability on social media companies for terrorist activities occurring overseas.

Sabina Jacobs Margot

333 South Grand Avenue, Los Angeles, CA 90071
Tel: +1 213.229.7381
SJacobs@gibsondunn.com



Sabina Jacobs Margot is an associate in the Los Angeles office of Gibson, Dunn & Crutcher. She is a member of the Business Restructuring and Reorganization and Global Finance practice groups.

Ms. Jacobs Margot practices in all aspects of corporate reorganization and handles a wide range of bankruptcy and restructuring matters, representing debtors, lenders, equity holders, and strategic buyers in chapter 11 cases, sales and acquisitions, bankruptcy litigation, and financing transactions. Ms. Jacobs Margot also represents borrowers, sponsors, and lending institutions in connection with acquisition financings, secured and unsecured credit facilities, asset-based loans, and debt restructurings.

Ms. Jacobs Margot currently serves as Treasurer for the Southern California Network of the International Women's Insolvency & Restructuring Confederation and is a member of the American Bankruptcy Institute.

Ms. Jacobs Margot is a member of the Leadership Council of the Los Angeles Center for Law & Justice and has handled various pro bono matters in partnership with the Alliance for Children's Rights, Bet Tzedek, Neighborhood Legal Services, Inner City Law Center, and Public Counsel.

Prior to joining Gibson Dunn, Ms. Jacobs Margot served as the law clerk to the Honorable Brendan L. Shannon of the United States Bankruptcy Court for the District of Delaware from 2010 to 2011 and was an associate with Latham & Watkins LLP from 2011 to 2014. Ms. Jacobs Margot earned her Juris Doctor cum laude in 2010 from Loyola Law School, Los Angeles, where she served as Editor-in-Chief of the Loyola of Los Angeles Law Review and was elected to the Order of the Coif. While in law school, she also held judicial externships with the Honorable Richard M. Neiter and the Honorable Thomas B. Donovan, both of the United States Bankruptcy Court for the Central District of California.

Most recently, Ms. Jacobs Margot is the author of "Possible Make-Over for Make-Wholes After EFH Decision," which is published in the January 2017 issue of the *American Bankruptcy Institute Journal*. She also served as a research fellow for the ABI Commission to Study the Reform of Chapter 11 and edited the *ABI's Final Report and Recommendations of the ABI Commission*.

Brittany N. Schmeltz

333 South Grand Avenue, Los Angeles, CA 90071
Tel: +1 213.229.7991
BSchmeltz@gibsondunn.com



Brittany Schmeltz is an associate in the Los Angeles office of Gibson, Dunn & Crutcher. She currently practices in the firm's Corporate Department.

Ms. Schmeltz is a member of the Intellectual Property Section of the State Bar of California, the Young Lawyers Division of the American Bar Association, and the Black Women Lawyers Association of Los Angeles.

Most recently, Ms. Schmeltz is an author of "Minimizing Risk of Borrower Bankruptcy," which was published on October 11, 2017 in *Law360*.

Ms. Schmeltz earned her law degree in 2016 at Duke University School of Law, where she served as Executive Editor of the *Alaska Law Review* and was President of the Sports and Entertainment Law Society. In 2013, Ms. Schmeltz graduated *summa cum laude* from The Ohio State University, where she earned her Bachelor of Science degree in Economics.

Ms. Schmeltz is admitted to practice law in the State of California.

Our Offices

Beijing

Unit 1301, Tower 1
China Central Place
No. 81 Jianguo Road
Chaoyang District
Beijing 100025, P.R.C.
+86 10 6502 8500

Brussels

Avenue Louise 480
1050 Brussels
Belgium
+32 (0)2 554 70 00

Century City

2029 Century Park East
Los Angeles, CA 90067-3026
+1 310.552.8500

Dallas

2100 McKinney Avenue
Suite 1100
Dallas, TX 75201-6912
+1 214.698.3100

Denver

1801 California Street
Suite 4200
Denver, CO 80202-2642
+1 303.298.5700

Dubai

Building 5, Level 4
Dubai International Finance Centre
P.O. Box 506654
Dubai, United Arab Emirates
+971 (0)4 370 0311

Frankfurt

TaunusTurm
Taunustor 1
60310 Frankfurt
Germany
+49 69 247 411 500

Hong Kong

32/F Gloucester Tower,
The Landmark
15 Queen's Road Central
Hong Kong
+852 2214 3700

Houston

1221 McKinney Street
Houston, Texas 77010-2046
+1 346.718.6600

London

Telephone House
2-4 Temple Avenue
London EC4Y 0HB
England
+44 (0) 20 7071 4000

Los Angeles

333 South Grand Avenue
Los Angeles, CA 90071-3197
+1 213.229.7000

Munich

Hofgarten Palais
Marstallstrasse 11
80539 Munich
Germany
+49 89 189 33-0

New York

200 Park Avenue
New York, NY 10166-0193
+1 212.351.4000

Orange County

3161 Michelson Drive
Irvine, CA 92612-4412
+1 949.451.3800

Palo Alto

1881 Page Mill Road
Palo Alto, CA 94304-1125
+1 650.849.5300

Paris

166, rue du faubourg Saint Honoré
75008 Paris
France
+33 (0)1 56 43 13 00

San Francisco

555 Mission Street
San Francisco, CA 94105-0921
+1 415.393.8200

São Paulo

Rua Funchal, 418, 35° andar
Sao Paulo 04551-060
Brazil
+55 (11)3521.7160

Singapore

One Raffles Quay
Level #37-01, North Tower
Singapore 048583
+65.6507.3600

Washington, D.C.

1050 Connecticut Avenue, N.W.
Washington, D.C. 20036-5306
+1 202.955.8500