

Alert

Solvency Finding Drives Fifth Circuit to Affirm Dismissal of \$2.5-Billion Fraudulent Transfer Suit

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The U.S. Court of Appeals for the Fifth Circuit, on July 30, 2014, affirmed a district court's dismissal of a litigation trustee's \$2.5-billion fraudulent transfer suit against the Chapter 11 debtor's corporate parent based on the debtor's solvency. *U.S. Bank Nat'l Ass'n v. Verizon Communications, Inc.*, 2014 WL 3746476 (5th Cir. July 30, 2014). The district court, using a market capitalization valuation, found the debtor to be solvent when it closed a major transaction with its parent. That ruling ultimately forced the dismissal of all the trustee's related claims including breach of fiduciary duty and improper dividends.

The suit arose out of the parent's November 2006 tax-free spinoff of its "domestic print and electronic directories business into an independent company," a wholly owned subsidiary that eventually became a Chapter 11 debtor three years later. *Id.* at *1. Essentially, the trustee alleged that the parent had created the new entity "as a receptacle to place its 'obsolete' directory, or 'yellow pages,' business and 'load it up' with over \$9 billion of debt [to the parent]." *Id.* at *2. From the unsecured creditors' perspective, the parent had dumped worthless assets into its subsidiary, taken \$2.5 million of the subsidiary's cash and further saddled its remaining assets with a huge amount of secured debt.

Facts

The newly formed subsidiary, known as Idearc Inc., in exchange for the parent's print and directories businesses, "incurred a total of \$9.1 billion in debt" (\$6.2 billion secured and \$2.85 billion unsecured), including \$7.115 billion of debt to the parent with the remainder of the debt going to the public. *Id.* at *2. The parent received not only \$2.5 billion in cash from Idearc, but also all of Idearc's common stock "to be distributed" to the parent's shareholders. *Id.*

Crucial facts in the record included the following:

- "Following the spin-off, Idearc was an independent, publicly traded company";
- "On the day of the spin-off, Idearc's stock, which was trading on the New York Stock Exchange ..., closed at \$26.25 per share";
- Idearc "paid quarterly dividends of approximately \$50 million in 2007 and the first quarter of 2008";
- "Six months after the spin-off, Idearc's shares traded at a high of \$37.66 per share";
- "In October 2008, Idearc acquired another company by using cash from its ongoing operations";

- Idearc “also made every interest payment on its debt through March 2009”

Idearc filed its Chapter 11 petition in March 2009 because its business, “heavily dependent on revenues from the sale of advertising, was adversely affected during the recession that began in 2008.” *Id.* After the bankruptcy court confirmed Idearc’s reorganization plan in December 2009, the post-confirmation litigation trustee sued the debtor’s corporate parent, its affiliates and an Idearc director, claiming, among other things: a fraudulent transfer in connection with the spinoff (i.e., the debtor did not receive reasonably equivalent value in exchange for its cash payment and huge debt obligations); the director’s breach of fiduciary duty; a fraudulent transfer in connection with interest payments; unlawful dividends; [and] unjust enrichment.

The District Court

The district court conducted a lengthy non-jury bench trial to resolve “a single factual issue”: the value of Idearc as of the date of the spinoff. After trial, the district court found that the value of Idearc as of the spinoff date, Nov. 17, 2006, was at least \$12 billion. Having given the trustee a chance to explain whether its remaining legal claims were viable in light of the valuation finding, the district court then rejected all of the trustee’s remaining claims, entering judgment in favor of the defendants.

The Court of Appeals

The trustee unsuccessfully challenged, among other things, the district court’s denial of its right to a jury trial and other procedural rulings. *Id.* Central to the Fifth Circuit’s ruling, however, was the district court’s solvency finding.

The district court’s finding of solvency was made after a 10-day trial. Reviewing the district court’s fact findings “for clear error,” the Fifth Circuit explained that it could “not reverse” the district court’s findings, even if it “would have weighed the evidence differently.” *Id.* at *17, quoting *Anderson v. City of Bessemer City*, 470 U.S. 564, 573–74 (1985). Unless the court of appeals found no evidence to support the solvency finding or was definitely and firmly convinced that a mistake had been committed, it could not reverse.

Of most significance to the Fifth Circuit was the district court’s rejection of the trustee’s expert witness testimony. Her valuation of Idearc “at \$8.5 billion was unpersuasive.” *Id.* at *18. To reach that figure, she had ignored “all available information, such as the trading price for Idearc on” the New York Stock Exchange at the time of the spinoff; she used “unreliable ... financial projections”; and she engaged in “double counting” that had “infected both” her “analysis and her overall conclusions.” *Id.* The district court, in short, had found “numerous errors” in the “methodology” of the trustee’s expert witness. *Id.* at *19. In contrast, “the evidence of Idearc’s value based on the market price of Idearc stock was a reliable indicator of Idearc’s value because the market was not misled.” *Id.* at *18. Despite the trustee’s assertions that information had been withheld from the market, “the information that the trustee alleged was withheld from the market [had, in the district court’s view, been] actually disclosed or, if not disclosed, was not material.” *Id.* In addition, “[c]omprehensive disclosures of the risks associated with [the] Idearc post-spin-off were made in documents filed with the Securities and Exchange Commission and in the offering documents for the publicly-held debt.” *Id.* at *1. Because evidence in the record supported the district court’s “lengthy” fact findings, its finding of “at least \$12 billion [of value] on the date of the spin-off” was not “clearly erroneous.” *Id.* at *19. The valuation finding thus drove both the district court and Fifth Circuit decisions.

Other Issues

The Fifth Circuit rejected the trustee's asserted entitlement to a jury trial. Agreeing with the district court, the appeals court relied on the corporate parent's having filed claims against the debtor. Before disposing of the parent creditor's claim, the bankruptcy court here was required "to determine whether, under 11 U.S.C. § 502(d), property of the creditor is recoverable as a fraudulent transfer. *Id.* at *5. Resolution of the trustee's fraudulent transfer claims was thus part of the equitable (i.e., non-legal) claims-allowance process, extinguishing the trustee's right to a jury trial.

The court also affirmed the district court's rejection of the trustee's "actual" fraudulent transfer and "constructive" fraudulent transfer claims. First, because of "Idearc's solvency at the time of the spinoff, it was clear that the Trustee's constructive fraud claim would fail." *Id.* at *20. Also the "Trustee had not 'presented specific direct evidence of [the defendants'] fraudulent intent, nor has it pointed to any such evidence that it may yet present.'" *Id.* at *21. Moreover, "the weight of the evidence on intent was negated by the valuation finding." *Id.* Because "the Trustee does not argue that it had presented the district court with any direct evidence of fraudulent intent," and because "the Trustee should have been well aware that it needed to present the district court with any direct evidence of fraud," the Fifth Circuit easily affirmed the district court's judgment in favor of the defendants due to the trustee's failure of proof. *Id.* at *21.

Comment

The *Verizon* decision is consistent with a 2007 Third Circuit decision. *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007) (market evidence held crucial to ultimate value determination in fraudulent transfer context). See also *In re Iridium Operating LLC*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007) (same); and M. W. Schwartz and D. C. Bryan, "Campbell, Iridium, and the Future of Valuation Litigation," 67 Bus. Law. 939 (2012) (courts should rely on market evidence instead of expert testimony). In both *Campbell* and *Iridium*, the plaintiffs failed to undo pre-bankruptcy transactions under a fraudulent transfer theory. The plaintiffs in both cases had tried to prove insolvency through expert testimony in the face of overwhelming evidence that the capital and securities markets were, at the time in question, working properly, well informed and supportive of the transaction. In both cases, the courts held that the expert testimony was insufficient.

The Third Circuit's *Campbell* decision criticized the competing expert witness testimony, stressing that "the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'" 482 F.3d at 633, quoting *In re Prince*, 85 F.3d 314, 320 (7th Cir. 1996). In *Verizon*, though, the Fifth Circuit found the competing expert testimony helpful in ascertaining the truth. Both experts were "qualified," but the defendants' expert "heavily criticized" the trustee's expert, noting "numerous errors in her methodology." 2014 WL 3746476, at *19. The adversarial system, therefore, not ideology, worked for the defendants.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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