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Country Dancing in the Bankruptcy Court: The "Texas Two-Step"

By Michael J. Lichtenstein*

The author examines a maneuver intended to avoid enormous liabilities through using the bankruptcy courts when the entity that holds the liabilities files a bankruptcy petition.

A popular country dance, the "Texas two-step," is now in the process of being experimented with in the bankruptcy courts. The trick is to convert a business into a Texas organization that is then split into two entities, one of which retains all the liabilities and the other retains all the assets. The purpose of this carefully choreographed maneuver is to avoid enormous liabilities through using the bankruptcy courts[1] when the entity that holds the liabilities files a bankruptcy petition.[2]

The "Texas two-step" was made possible by the 1989 enactment of a provision in the Texas Business Organization Code as updated.[3] While Texas recognizes typical mergers (combining two companies into one), this provision recognizes "divisive mergers" where a company divides into two entities and then allocates assets and liabilities as it chooses.[4]

Several major companies and organizations have attempted this strategy in the recent past with varying degrees of success. In re *Bestwall LLC*,[5] the debtor filed a Chapter 11 to resolve mass asbestos claims through Section 524(g) after being created using the divisive merger statute. After the bankruptcy court appointed an official committee of asbestos claimants, the committee filed a

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* Michael J. Lichtenstein, a shareholder in the Potomac, Maryland, office of Shulman, Rogers, Gandal, Pordy & Ecker, P.A., represents companies and financial institutions in bankruptcy and restructuring matters. He may be contacted at mjl@shulmanrogers.com.

[1] According to the Financial Times, Congress is planning legislation to outlaw the "Texas two step" to prevent large companies from abusing Chapter 11. The chair of the Senate judiciary committee, Dick Durbin, has advised that there are negotiations under way to remove what he called a "get out of jail free card" being used by some of the wealthiest companies. "US lawmakers plan bill to outlaw 'Texas two-step' bankruptcy ploy," Jamie Smyth, February 28, 2022.

[2] That entity then seeks an injunction against future liabilities under 11 U.S.C. § 524(g) after a plan is confirmed.

[3] Tex. Bus. Orgs. Code Ann. § 10.001 *et seq*.

[4] *Id.* at Section 10.008(3).

[5] 605 B.R. 43, 46 (Bankr. W.D. N.C. 2019).

motion seeking to dismiss the Chapter 11 petition as a bad faith filing.[6] In the alternative, the committee requested that venue be transferred for the convenience of the parties or in the interests of justice.[7] As the bankruptcy court explained, the former Georgia-Pacific LLC, which had a long history of asbestos litigation, effectuated a corporate restructure though a Texas divisional merger.[8] As a result, *Bestwall* received certain assets and liabilities, including the asbestos liabilities (64,000 asbestos claims were pending as of the petition date).[9]

The bankruptcy court declined to dismiss the Chapter 11 proceeding for several reasons. First, the court noted that attempting to resolve asbestos claims through Section 524(g) of the Bankruptcy Code is a valid reorganizational purpose.[10] The court also analyzed the debtor's finances and concluded that Bestwall had the resources with which to reorganize.[11] Having concluded that the case was not objectively futile, the court saw no need to review subjective bad faith.[12]

The *Bestwall* bankruptcy court also rejected the request to transfer venue[13] even though Bestwall formed as a Texas LLC (in a divisional merger) and then transferred its domicile to North Carolina only 94 days before filing its Chapter 11 petition. However, the court found no compelling reason to transfer venue when the debtor was domiciled in North Carolina and had considerable assets in that state.[14] It appears that, while acknowledging the Texas divisional merger, the *Bestwall* bankruptcy court was not particularly troubled given that the debtor had $20 million in cash and also held subsidiary stock worth $145 million.[15]

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[6] *Id.*

[7] *Id.*

[8] *Id.* at 47.

[9] *Id.*

[10] *Id.* at 49.

[11] *Id.* at 50.

[12] *Id.* at 50–51.

[13] *Id.* at 51.

[14] *Id.* at 52.

[15] While the NRA Chapter 11 was dismissed in Texas (after a divisional merger), the grounds for dismissal were a more broad based-based lack of good faith. *See In re NRA of America*, 628 B.R. 262, 285–86 (Bankr. N.D. Tex. 2021 (dismissing petition for lack of good faith because case was not filed to a purpose intended to be sanctioned by Bankruptcy Code).

In two other asbestos related cases filed in North Carolina, *In re Aldrich Pump LLC*[16] and *In re DBMP LLC*,[17] the bankruptcy court was more direct about the potential harmful effects resulting from Texas divisional mergers and suggested some possible remedial actions that could be taken. In *Aldrich Pump*, the successor by merger to Ingersoll-Rand, which manufactured climate control products for homes and buildings, underwent a divisional merger in Texas.[18] The debtor, *Aldrich*, was left with no employees, no operations and relatively few assets but, in the caustic words of the bankruptcy court, in one respect, the merger was "quite generous" with *Aldrich* which was allocated 100 percent of its "predecessor's considerable asbestos liabilities."[19] Seven weeks after the merger, *Aldrich* filed a Chapter 11 petition in North Carolina and sought an injunction against existing asbestos claims that were being litigated outside of the bankruptcy court.[20]

The bankruptcy court held that, by virtue of the Texas divisional merger, the asbestos claims that claimants sought to pursue outside of the bankruptcy forum, were owed by the debtor and therefore the automatic stay applied.[21] However, the court also suggested that due to the apparent negative effects of the divisional merger and the ensuing Chapter 11 petition on the asbestos claimants, the allocation of assets and liabilities "*may* constitute avoidable fraudulent transfers" and/to be subject to attacks under the alter ego or successor liability doctrines.[22] Reviewing the chronology of the corporate restructuring, including the divisional merger, the court left no doubt as to its view on the purpose of the actions: "Nor were these actions undertaken for the benefit of the asbestos claimants. Rather these bankruptcies[23] were designed to isolate the asbestos claimants from the overall corporate enterprises and strand them in bankruptcy until such time as they agree to a Section 524(g) plan."[24]

Focusing on the Texas two-step resulting in an allocation of asbestos liabilities exclusively to *Aldrich*, the bankruptcy court suggested that the divisional merger

[16] 2021 LEXIS 2294 (Bankr. W.D.N.C., Aug. 23, 2021).

[17] 2021 LEXIS 2194 (Bankr. W.D.N.C., Aug. 10, 2021).

[18] 2021 LEXIS 2294 at *11.

[19] *Id.* at *13.

[20] *Id.*

[21] *Id.* at *17.

[22] *Id.*

[23] Referring to a companion Chapter 11 proceeding for another related spin-off.

[24] *Id.* at *60.

may have been improper.[25] The Texas business statute permits a divisional merger but does not thereby permit a company to prejudice its creditors.[26] In fact, the Texas business statute states explicitly that the merger provisions "do not abridge any right or rights of any creditor under existing laws."[27] Reviewing in detail the Texas Business statute regarding divisional mergers and the legislative history, the bankruptcy court concluded that: "if a corporation uses a divisional merger to dump its liabilities into a newly created "bad" company that lacks the ability to pay creditors while its "good" twin walks away with the enterprise's assets, a fraudulent transfer avoidance action lies."[28] The bankruptcy court went further and pointed out that in *Aldrich*, asbestos claimant's rights had been materially affected by the divisional merger and therefore an action to contests the divisional merger and the exclusive allocation of asbestos liabilities to the debtor appeared to be a viable cause.[29]

Having laid out a road map for relief for asbestos claimants, the bankruptcy court discussed the issue of who has standing to sue for fraudulent conveyances (initially the debtor but perhaps a creditors' committee) but did not rule on the issue which was not before the court.[30] In the end, the bankruptcy court issued the injunction that the debtor sought but expressed its concerns about the propriety of what the old entity accomplished in the divisive merger.[31] The same bankruptcy court issued virtually the same opinion in *In re DBMP LLC*,[32] formerly CertainTeed Corporation, a building products manufacturer. Under similar facts, the existing entity underwent a divisional merger in Texas and created the debtor with all the asbestos liabilities and virtually no assets.[33]

In an even more incredible timeline, the debtor was created in a Texas divisive merger and within four hours converted to a North Carolina LLC.[34] As the court mentioned: "Thus, in a matter of hours and without notice to any of its asbestos creditors, Old CertainTeed separated virtually all of its business, assets, and employees form its asbestos liabilities, transferring those liabilities to

[25] *Id.* at *76.

[26] *Id.*

[27] *Id. citing* Tex. Bus. Orgs. Code Ann. § 10.901.

[28] *Id.* at *80.

[29] *Id.* at *82.

[30] *Id.* at *86.

[31] *Id.* at *103.

[32] 2021 LEXIS 2194 (Bankr. W.D.N.C., Aug. 10, 2021).

[33] *Id.* at *7.

[34] *Id.*

DBMP [the debtor]."[35] The court went through the same analysis as in *Aldrich* regarding the effect of the Texas divisive merger and cautioned that: "to date, New CertainTeed has not escaped, discharged, or eliminated any liability for DBMP Asbestos Claims through the divisional merger."[36]

The most recent Chapter 11 case involving the Texas two-step is a spin off created by Johnson & Johnson, allegedly to avoid significant talc-related claims.[37] Initially, the Chapter 11 was filed in the bankruptcy court in North Carolina where the debtor, which operates out of New Jersey, has no operating business.[38] The bankruptcy administrator filed a motion to transfer venue to New Jersey.[39] The debtor, LTL, was created just two days before the bankruptcy filing in a Texas divisional merger.[40] The debtor was created as a Texas LLC but then converted to a North Carolina LLC and, though it received limited assets in the divisional merger, it also was saddled with all of Johnson & Johnson's talc-related asbestos claims.[41] The court granted the motion to transfer venue finding that the convenience of the parties and the interests of justice warranted the transfer.[42] Ironically, the official committee of talc claimants supported the transfer of venue to New Jersey which ultimately did not turn out so well for the talc claimants' strategy.[43]

After the case was transferred to New Jersey, the official committee of talc claimants moved to dismiss the Chapter 11 proceeding as not having been filed in good faith.[44] The committee (and other movants) argued that the Texas divisional merger and subsequent bankruptcy filing were simply a litigation tactic to address talc-related liabilities through the bankruptcy.[45] The movants argued further that the Texas two-step "was intended to force talc claimants to face delay and to secure a bankruptcy discount."[46] In the debtor's view, the corporate restructure was designed to provide an equitable resolution of present

[35] *Id.* at *27.

[36] *Id.* at *57.

[37] *In re LTL Management, LLC*, 2021 LEXIS 3173 (Bankr. S.D.N.J., Nov. 16, 2021).

[38] *Id.* at *3–4.

[39] *Id.* at *2.

[40] *Id.* at *2.

[41] *Id.*

[42] *Id.* at *7.

[43] *Id.* at *6.

[44] *In re LTL Management, LLC*, 2022 LEXIS 510 *3 (Bankr. S.D.N.J., Feb. 25, 2022).

[45] *Id.* at *13.

[46] *Id.* at *14.

and future talc claims through the establishment of a settlement trust under Section 524(g) of the Bankruptcy Code.[47] The movants received little sympathy from the bankruptcy court.

In fact, the bankruptcy court denied the motions to dismiss in their entirety for several articulated reasons.[48] First, the court believed that filing a Chapter 11 with the expressed purpose of addressing present and future talc-related liabilities to preserve corporate value is "unquestionably a proper purpose under the Bankruptcy Code."[49] The court then determined whether a resolution of the talc-related claims would be better served elsewhere than the bankruptcy court. The answer was negative: "this Court holds a strong conviction the bankruptcy court is the optimal venue for redressing the harms of both present and future talc claimants in this case-ensuring a meaningful, timely, and equitable recovery."[50] The court was swayed in part by the fact there were many, lengthy, delayed, pending talc-related cases in the state and federal courts.[51] In contrast, utilizing Section 524(g) trusts, the bankruptcy courts are far more efficient for mass tort claimants.[52] "A settlement trust, with proper oversight and funding, can best serve the needs of the Debtor and talc claimants alike."[53]

The court also was persuaded that the Johnson & Johnson parent company would not escape or be released from liabilities related to the talc claimants without a settlement in the bankruptcy court.[54] Further, there is a funding agreement that obligates Johnson & Johnson and the spin-off entity that has assets, jointly and severally, to pay for the debtor's talc-related liabilities.[55] The court also addressed whether engaging in the Texas two-step and then filing a Chapter 11 petition provided the debtor with an unfair tactical advantage. The court was unequivocal in the conclusion that the divisional merger (days before the bankruptcy filing) did not prejudice the interests of present or future talc litigation creditors.[56] The court went so far as to suggest that the divisional merger under the Texas statute, coupled with the bankruptcy filing, which was

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[47] *Id.*

[48] *Id.* at *79.

[49] *Id.* at *22.

[50] *Id.* at *26–27.

[51] *Id.* at *28.

[52] *Id.* at *42–43.

[53] *Id.* at *44.

[54] *Id.* at *45.

[55] *Id.* at *8–9.

[56] *Id.* at *59.

part of an integrated strategy, benefited talc creditors because the bankruptcy court now had jurisdiction and oversight over the estate and could thereby ensure that the funding obligations to the debtor would be fulfilled.[57] The court concluded that as to: "the now infamous 'Texas two-step,' the Court finds nothing inherently unlawful or improper with application of the Texas divisional merger scheme in a manner which would facilitate a chapter 11 filing for one of the resulting new entities."[58] The court reiterated that it did not find that the rights of talc claimants would be materially affected by the divisional merger.[59]

In conclusion, it is clear that there is no judicial consensus on the impact of the Texas divisive merger statute on mass tort claimants in bankruptcy court proceedings. The North Carolina bankruptcy court expressed concerns about the negative impact of the Texas two-step on asbestos claimants. The court actually laid out a road map for creditors' committees to follow in seeking to avoid pre-petition transfer of assets and liabilities that occur under the Texas divisional statute. On the other hand, the New Jersey bankruptcy court was not only not troubled but in fact expressed a view that talc claimants would benefit from the Texas divisional merger combined with a bankruptcy filing. That court clearly believes that resolution under Section 524(g) of the Bankruptcy Code together with a confirmed plan of reorganization to be funded at least in part by solvent parent or related entities will provide the most efficient and expeditious recovery for mass tort claimants.

It remains to be seen whether creditors' committees will take the next step in seeking standing to prosecute the transfer of assets and liabilities under the Texas two-step. It is too early to predict how successful such actions would be although it appears that some courts would be receptive to such claims. Also, as noted in the footnotes above, Congress may moot the entire dance by eliminating what Senator Durbin calls a "get out of jail free card." Stay tuned and . . . swing your partner.

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[57] *Id.* at *62.

[58] *Id.* at *75. One wonders whether the tort claimants' committee now regrets supporting the venue motion.

[59] *Id.*