Senate Judiciary Committee Subcommittee Hearing on the "Texas Two-Step": A Recap

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By Amelia S. Ricketts (Harvard Law School) and Jin Lee (Harvard Law School)

On February 8, 2022, the Senate Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights (a subcommittee of the Senate Judiciary Committee) held a hearing on the process through which corporations allegedly side-step accountability through divisive mergers undertaken immediately prior to declaring bankruptcy, commonly known as the "Texas Two-Step."

The witnesses included:

- The Honorable Judith K. Fitzgerald (Tucker Arensberg, P.C., former bankruptcy judge)
- Professor David A. Skeel, Jr. (S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School)
- Ms. Kimberly Ann Naranjo (Speaking about her experience with a mesothelioma diagnosis and lawsuit against Johnson & Johnson)
- Mr. Paul H. Zumbro (Cravath, Swaine & Moore LLP)
- Mr. Kevin C. Maclay (Caplin & Drysdale)

Mechanism of Texas Two-Step Bankruptcy

Both Texas and Delaware have divisive merger statutes. The Texas statute, which was the focus of the hearing, was enacted in 1989 with the stated intention of making merger transactions more flexible. The Texas Two-Step is a recent development, popularized within the last five years.[1]

Companies have used the Texas Two-Step when they have incurred significant liabilities in mass tort cases. The process unfolds as follows: the original company (OriginalCo) first changes its state of incorporation to Texas (or Delaware).[2] It then carries out a divisive merger, splitting into GoodCo and BadCo. GoodCo retains all the company assets and the non-tort liabilities, while BadCo retains the mass tort liabilities and nominal assets. As described in more detail below, BadCo often receives some form of credit support from GoodCo, but usually in an amount that is far below the amount of liabilities alleged by litigants against OriginalCo. BadCo then files for bankruptcy, while GoodCo continues business in the ordinary course, operating under the original company name, and does not file for bankruptcy. BadCo requests that the automatic stay be extended to affiliates, including GoodCo, so tort victims are stayed from seeking relief from GoodCo and are instead tied up in the bankruptcy process.

[1] Jones Day pioneered the use of the Texas Two-Step in 2017.

[2] The Delaware divisive merger statute prohibits these transactions from affecting any preexisting agreement entered before August 1, 2018, that restricts the company initiating the divisive merger from transferring or assigning assets. Because the Texas statute does not contain a similar provision, companies engineering a Two-Step may favor that statute.

BadCo is not incentivized to expedite bankruptcy proceedings, as is normally the case for debtors in bankruptcy, because there is no going concern value to preserve. This allows the company to drag out the process in the hopes of settling for a lower value with the creditor-claimants. As time passes, tort victims are dying and need funds to support their treatments.

Although the Texas Two-Step has only been used for mass tort liabilities so far, it could be applied to any kind of disfavored debt.

<u>Discussion of Legislation Action</u>

The House is currently considering a bill would ban bankruptcy filings by companies that have executed divisive mergers in the prior ten years. Panelists disagreed on the proper remedy for the Texas Two-Step. Judge Fitzgerald and Mr. Maclay urged legislative reform to prevent divisive merger bankruptcies. However, Professor Skeel and Mr. Zumbro argued that current bankruptcy protections are sufficient to guard against abuse of divisive merger bankruptcies and that Congress would better spend its time creating uniform rules on nondebtor releases. Mr. Zumbro posited that the tort system is broken and the bankruptcy system offers better mechanisms to deal with mass tort cases, such as through the use of trusts for asbestos bankruptcies as permitted under section 524(g) of the Bankruptcy Code.

Texas Two-Step Goes Against the Principles of Bankruptcy

Judge Fitzgerald and Mr. Maclay emphasized that the principles of bankruptcy mandate that the debtor accept both the "benefits and burdens" that go along with filing. They objected to using the Texas Two-Step to obtain the benefits of bankruptcy, i.e., the automatic stay, without the burdens. Through the Two-Step, GoodCo avoids all the burdens that the bankruptcy system imposes to protect creditors, e.g., requirements to make regular financial reports to creditors and the bankruptcy court, prohibitions on incurring new debts or engaging in transactions out of the ordinary course of business without prior approval. Meanwhile, BadCo can request the automatic stay to be extended to GoodCo, giving GoodCo the primary benefit of the bankruptcy system. Judge Fitzgerald further argued that one of the main motivations for divisive merger bankruptcies is to obtain nondebtor releases, which gives the victims and creditors less than full compensation, while taking away their ability to sue the nondebtor tortfeasor, GoodCo.

Possible Mechanisms to Curb Divisive Mergers

Professor Skeel argued that bad faith dismissal could be an effective check on abuse of divisive mergers.[3] However, courts are generally reluctant to dismiss a case for bad faith, and in particular, the Fourth Circuit has an especially high standard for evaluating whether a filing should be dismissed as being made in bad faith, leading to forum shopping. All the divisive merger bankruptcies so far have at least initially been filed in the Western District of North Carolina, in part to benefit from the Fourth Circuit's more demanding standard. Almost all present at the hearing agreed that forum shopping was an issue. Professor Skeel was particularly concerned about judge shopping, though this issue may be mitigated by random judge assignments, which have been implemented in some jurisdictions.

[3] Although the Bankruptcy Code does not explicitly require good faith to file for bankruptcy, courts may dismiss a case for lack of good faith to prevent abuse of the bankruptcy process. See 7 Collier on Bankruptcy ¶ 1112.07.

Professor Skeel also argued that fraudulent transfer law could serve as an effective limit on abuse of divisive mergers, but this mechanism is also uncertain. This is because the Texas divisive merger statute provides that, following completion of a divisive merger, state law shall treat the transaction as though no transfer has occurred. As a result, the property that each new company holds is treated as if such company has always held that property. Although the statute indicates that the divisive merger does not alter creditors' preexisting rights, it is unclear how fraudulent transfer law should apply to a Texas divisive merger. It is also unclear who might bring the fraudulent transfer claim because BadCo – the party that would typically bring a fraudulent transfer claim against GoodCo – has the same management as GoodCo. Furthermore, even a fraudulent transfer victory fails to bring GoodCo into the bankruptcy court, since a party that prevails on a fraudulent transfer claim is merely able to claw back the assets that were fraudulently transferred.

Typically, as part of the divisive merger, the GoodCo and BadCo execute a funding agreement where GoodCo agrees to fund any victims' trust established in bankruptcy (in a fashion meant to mirror the requirements for asbestos trusts created under section 524(g)). Mr. Zumbro argued that Congress should not be concerned about divisive merger bankruptcy due to these funding agreements. Mr. Maclay and Judge Fitzgerald disagreed, indicating that these agreements did not offer real recourse for tort victims. It is unclear what happens if the victims' claims exceed the assets of BadCo. In theory, GoodCo would be responsible for contributing more funds, but BadCo is responsible for enforcing the funding agreement against GoodCo, its affiliate company. The victims and the creditors are only third-party beneficiaries of the funding agreement and therefore cannot enforce it on their own under ordinary bankruptcy law.

Johnson & Johnson

Much of the hearing discussion focused on Johnson & Johnson's ("J&J") use of the Texas Two-Step. J&J's consumer division subsidiary was facing tort liability for alleged asbestos exposures from its talc baby powder, with 38,000 currently known claimants. J&J denies that the asbestos was in its talc baby powder. However, after a jury awarded over $2 billion in a case involving just 22 plaintiffs, J&J engineered a Texas Two-Step. J&J's consumer subsidiary executed a divisive merger under Texas law, forming an entity called LTL Management, which will hold only $2 billion in assets (following contribution by J&J under the funding agreement) but all the baby powder liabilities. LTL filed for bankruptcy and requested that the automatic stay be extended to 670 J&J affiliates, including the post-merger consumer division subsidiary (its GoodCo counterpart). The bankruptcy court granted the stay on a preliminary basis, halting the tort litigation. Ms. Naranjo, one of the victims whose case has been put on hold, testified at the hearing about her desire to have her day in court and obtain relief for her family. The bankruptcy court's decision on whether to dismiss the case for bad faith is currently pending.[4]

[4] In a speech following the hearing, on February 15, 2022, Senate Majority Whip and Chair of the Senate Judiciary Committee Dick Durbin spoke on the Senate floor criticizing J&J for using the Texas Two-Step process to avoid liability against cancer-stricken customers. The full speech is available here.