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Texas Two-Stepping Mass Tort Claimants

By Robert Dremluk
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A relatively new and controversial legal tactic is being used by debtors facing mass tort liability using an obscure Texas law that allows a business organization to perform a divisive merger. In a divisive merger, a legacy entity divides itself into two or more new entities and allocates its assets and liabilities—with a larger portion of assets being placed into one entity and the mass tort liabilities and a smaller portion of assets being placed in one or more of the other entities.

The second step is to cause the entity with the mass tort liabilities to voluntarily file a Chapter 11 bankruptcy case, seeking to discharge those liabilities.

This strategy is intended to preserve and protect the legacy entity's assets and going concern value against overwhelming mass tort claims while creating a single forum to resolve mass tort claims fairly and equitably.

Background

This Texas two-step begins with a divisive merger under the Texas Business Organization Code §1.002(55)(A), which divides an existing entity into two or more new entities. This divisive merger, however, is not treated as an assignment or transfer of assets or liabilities under this statute and usually contains some form of funding agreement to pay mass tort claims and provisions dealing with various indemnification agreements to address claims made against third parties.

Recent Cases

One of the first Texas two-step cases occurred in 2017. In that case, Bestwall was spun off from Georgia-Pacific which was facing over 60,000 asbestos cases. Once the Texas divisive merger was completed the Texas entity holding the asbestos liabilities was converted to a North Carolina entity and subsequently filed Chapter 11 in the Western District of North Carolina, which has a history of being a debtor-friendly forum for mass tort cases. Accordingly, Texas two-step cases are frequently filed there.

In 2021, Johnson & Johnson, facing a huge mass tort liability for talc injuries, formed two new entities—LTL Management and New J&J. All talc claims were allocated to LTL Management which also received approximately $2 billion and other assets to fund a settlement trust for talc claimants. The remaining assets were allocated to New J&J.

LTL Management reconstituted itself as a North Carolina corporation and filed Chapter 11 thereafter in the Western District of North Carolina. A timely motion to change venue to New Jersey was granted.

A Few Open Issues

A few intriguing issues are presented by the Texas two-step. First, does the process constitute a fraudulent transfer under either applicable Texas law or the Bankruptcy Code? Currently, there is no definitive answer. In Texas, the two-step process theoretically could be treated as a transfer to hinder, delay, or defraud creditors under the Texas fraudulent transfer statute. On the other hand, the Texas Business Organization Code clearly states that a divisive merger does not involve any *transfer* or assignment of assets. So at least under Texas law, there is an unresolved question as to whether any transfer has even occurred.

Another key issue presented is whether the bankruptcy case should be dismissed because the case was filed in bad faith. While the Bankruptcy Code does not define bad faith, case law has developed some criteria that courts typically consider. One factor is whether the case was filed for an improper purpose. In LTL Management, the bankruptcy court considered the litigation posture outside the bankruptcy court, the subjective intent of debtor and management, the degree of financial distress facing the debtor, the pressures from non-moving creditors, pre-petition litigation conduct, the nature of the creditor body and the extent of assets, the structure and formation of the debtor, and debtor's reorganizational purpose and exit strategy. The court concluded that the debtor was created pursuant to—and in compliance with—the long-standing Texas statute and that concerns about absurd and unjust results did not establish bad faith or undermine the legitimate purpose of the LTL Management bankruptcy case.

This totality of the circumstances analysis used by the LTL Management court reflects a standard by which many courts have routinely analyzed good faith challenges. The good faith filing requirement is designed to ensure that the burdens imposed by bankruptcy on creditors are justified by fulfillment of Chapter 11's objectives: preserving going concerns and maximizing assets available to satisfy creditors.

The basic thrust of the good-faith inquiry has traditionally been whether, in view of the totality of the circumstances, the debtor needs Chapter 11 relief. See *C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304, 1309-10 (2d Cir. 1997) where the court held that dismissal was warranted if "there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings."

In *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express)*, 384 F.3d 108, 119-20 (3d Cir. 2007) the court determined that the test

focuses on "whether the petition serves a valid bankruptcy purpose … [or] whether the petition is filed merely to obtain a tactical litigation advantage."

In a similar approach, the court in *In re Premier Automotive Services*, 492 F.3d 274, 279-80 (4th Cir. 2007) found that a Chapter 11 filing was made in "subjective bad faith" where the debtor had no demonstrable need to organize and was not experiencing financial difficulties and where the filing revealed a solvent business with no unsecured creditors and few, if any, secured creditors.

However, some courts are more tolerant with respect to the good faith analysis. For example, the court in *In re Capitol Food Corp. of Fields Corner*, 490 F.3d 21, 26 (1st Cir. 2007) declined to address whether §1112(b) imposes the "good faith" requirement, but ruled that the debtor's use of Chapter 11 to obtain "time-out" and delay foreclosure of its leasehold interest did not mean that the petition had been filed solely to obtain a tactical litigation advantage, which many courts have found to be a hallmark of bad faith.

A second bad faith factor is whether the debtor entity was created on the eve of bankruptcy—the concept being described as the new debtor syndrome. Courts have uniformly dismissed bankruptcy cases under this doctrine which would seem to apply to the Texas two-step, except that the entities using the two-step process are not insolvent shells but have assets and/or funding arrangements to at least partially satisfy mass tort claims and, in some cases, may have ongoing business operations.

What Happens Next?

Congress has taken notice of the Texas two-step and it is rumored to be planning to introduce legislation to outlaw the process because of the public perception that it abuses the bankruptcy process and unreasonably favors well-capitalized entities that supposedly can afford to pay mass tort claims. One compelling concern is that these well-capitalized companies that are facing mass tort liabilities will resort to the Texas two-step process, thereby potentially depriving mass tort claimants of any meaningful recovery. However, there are countervailing concerns that absent a bankruptcy proceeding where all tort claimants can theoretically participate, the current non-bankruptcy system may only reward those claimants that aggressively litigate claims and thus potentially deprive some claimants of any recovery as assets are depleted to pay more aggressive claimants.

In effect, making this a race to the court creates the potential situation where some claimants may be paid while others may not, which is not fundamentally fair and equitable. One of the primary reasons why Congress amended the Bankruptcy Code several years ago to include special provisions for the resolution of asbestos claims was to create a trust and to preserve the ongoing operation of the debtor to fund asbestos claims into the future. Congress realized that the better alternative was to find a way to

pay current and future claims *pro rata* out of the resources of an operating company, including its insurance coverages.

The Texas two-step accomplishes the goal of paying claimants in a controlled process under the supervision of one court and avoids the inequity of a race to the courthouse. It is not perfect, but to the extent that it limits costs, provides a forum where all claimants have an equal opportunity to participate, and funds both current and future claims using resources including insurance coverage and payments from future operations of a going concern or a similar mechanism to satisfy future claims, then it may work.

Conclusion

Allowing well-capitalized entities to use the Texas two-step to pay mass tort claimants only a small portion of their damages, isolating substantial assets from recovery, and failing to address payment of both current and future claims seems grossly unfair. While these are typical matters for negotiation, some modification of the Bankruptcy Code to codify criteria and formalize a process as part of an early good-faith case assessment of a mass tort bankruptcy filing would be helpful. This process and criteria seem to have been used by the court in the LTL Management case and could serve as a good blueprint for a Bankruptcy Code amendment.

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Robert Dremluk (*rdremluk@cm.law*) *is a partner with the New York offices of Culhane Meadows PLLC. His practice includes bankruptcy and distressed debt and restructuring, litigation and real estate law.*

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