

THE LAST DANCE OF THE TEXAS TWO-STEP? EXAMINING THE RISE AND (POTENTIAL) FALL OF THE USE OF DIVISIVE MERGERS IN UNITED STATES BANKRUPTCIES



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In 2021, Johnson & Johnson's ("J&J") deployment of the Texas divisional merger statute, more colloquially known as the "Texas Two-Step," to cabin its talc-related liabilities into its newly formed bankruptcy-bound subsidiary, LTL Management LLC ("LTL"), immediately attracted the attention of the bankruptcy community¹ and the world more generally². J&J drew the ire of those who argued that J&J's use of the Texas Two-Step was an abuse of the bankruptcy system³, while others argued that the bankruptcy court could be an ideal forum for resolution of mass torts⁴. However, with the United States Court of Appeals for the Third Circuit dismissing LTL's first bankruptcy filing, and the Bankruptcy Court for the District of New Jersey dismissing LTL's successive bankruptcy filing, it may be that LTL is one of the last debtors to dance the Texas Two-Step into bankruptcy court.

This article provides an overview of the background of the Texas Two-Step, how it has recently been utilized in connection with mass tort cases, with a focus on the bankruptcy of LTL, and the Texas Two-Step's potential future (or lack thereof) as a legal tactic in addressing mass tort liabilities.

Texas Two-Step background

Texas originally enacted a divisive merger law in 1989⁵ and enacted the modern version in 2006⁶. The purpose of the statute was to encourage freedom of contract by permitting corporate restructurings that might otherwise have been blocked by contractual transfer restrictions—the statute was not enacted to alter or impact creditor rights, despite its recent implementation.⁷ The statute allows companies to split an entity into two new entities and allocate the assets and liabilities from the original entity among the two successors (the original entity usually ceases to exist).

In the mass tort context, the Texas Two-Step enables an enterprise to consolidate liabilities into one entity and cause that entity to file for bankruptcy, while allowing the rest of the enterprise to continue operations in the ordinary course (and without the restrictions and oversight of the bankruptcy court). The debtor then may seek to extend the automatic stay under the Bankruptcy Code to its non-debtor parent and affiliates, as well as estimate the total amount of contingent claims for the purposes of confirming a Chapter 11 plan that resolves the liabilities and avoids the expense and extended timeline of jury trials.

Though the Texas Two-Step would appear to be a dream come true for companies facing mass tort liabilities, it is not without risk: a Texas Two-Step transaction critically does not protect a debtor or its parent from fraudulent transfer claims or other claims from creditors, including substantive consolidation and veil piercing.

In the past five years or so, the Texas Two-Step has been implemented in at least three other bankruptcies: *In re BestWall LLC*⁸, *In re Aldrich Pump LLC*⁹, and *In re DBMP LLC*¹⁰, all of which involve debtors facing mass tort liabilities related to asbestos or talc. These cases were all filed by the same law firm in the Bankruptcy Court for the Western District of North Carolina (the "North Carolina Bankruptcy Court"). At this time, none of these debtors has reached the plan solicitation stage; all three have been mired in protracted litigation concerning their respective Texas Two-Step transactions.

In re LTL Management LLC

In the fall of 2021, facing approximately 38,000 ovarian cancer talc-related tort claims, nearly \$1 billion in defense costs over the preceding five years, and payments for settlements and

1 See *Texas Two-Step and the Future of Mass Tort Bankruptcy Series*, HARV. BANKR. ROUNDTABLE, <https://bankruptcyroundtable.law.harvard.edu/2023/02/14/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-postscript-and-analysis-of-third-circuit-dismissal-of-ltl-managements-bankruptcy/>.

2 See Jesus Jimenez, *Johnson & Johnson Subsidiary Seeks Bankruptcy Protection to Handle Talc Product Claims*, N.Y. TIMES (Oct. 14, 2021), <https://www.nytimes.com/2021/10/14/business/johnson-johnson-bankruptcy-talc-claims.html>; Jamie Smyth, *Johnson & Johnson's 'Texas-two-step' sparks outcry over US bankruptcy regime*, FIN. TIMES (Oct. 28, 2021), <https://www.ft.com/content/de13b1ec-9b4a-4a27-ae63-c8ea38ffc683>.

3 See Smyth, *supra* note 2. The United States Senate Committee on the Judiciary further held a subcommittee hearing entitled, "Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy," which may be accessed at <https://www.judiciary.senate.gov/committees-activity/hearings/abusing-chapter-11-corporate-efforts-to-side-step-accountability-through-bankruptcy>.

4 See Anthony Case & Joshua Macey, *A Qualified Defense of Divisional Mergers*, HARV. BANKR. ROUNDTABLE (June 28, 2022), <https://bankruptcyroundtable.law.harvard.edu/2022/06/28/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-a-qualified-defense-of-divisional-mergers/>. See generally, Debtor's Objection to Motions to Dismiss Chapter 11 Case, *In re LTL Mgmt. LLC*, No. 20-30589 (MBK) ("LTL I") (Bankr. D.N.J. Dec. 22, 2021), Docket No. 965.

5 See Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109, 110 (1989).

6 See Tex. Bus. Orgs. Code Ann. §§ 10.003, 10.008 (2006).

7 See Huff, *supra* note 5 at 122.

8 No. 17-31795 (LTB) (Bankr. W.D.N.C. 2017)

9 No. 20-30608 (JCW) (Bankr. W.D.N.C. 2020)

10 No. 20-30080 (JCW) (Bankr. W.D.N.C. 2020)

verdicts totaling approximately \$3.5 billion,¹¹ J&J sought to follow in the footsteps of Bestwall, Aldrich Pump and DBMP by forming a new subsidiary via a Texas Two-Step process to address its talc-related liabilities in bankruptcy.

Pursuant to its divisive merger, Johnson & Johnson Consumer Inc. (“Old JJCI”) split into two Texas entities, LTL and Johnson & Johnson Consumer Inc. (“New JJCI”).¹² LTL received all talc-related liabilities, along with several assets from Old JJCI.¹³ New JJCI received the remainder of Old JJCI’s assets. LTL then converted into a North Carolina LLC in order to file its Chapter 11 case in the North Carolina Bankruptcy Court.¹⁴

As part of this set of transactions, LTL and New JJCI became parties to a set of prepetition intercompany agreements that provided for the operation and funding of LTL, its Chapter 11 case and any eventual settlement trust for the tort claims.¹⁵ Crucially, under an uncapped funding agreement (the “2021 Funding Agreement”) among LTL, New JJCI and J&J, New JJCI and J&J were obligated, on a joint and several basis, to provide funding for a trust in Chapter 11 to satisfy LTL’s talc-related liabilities; the 2021 Funding Agreement contemplated a minimum payment right of nearly \$62 billion.¹⁶ J&J and New JJCI also committed to funding \$2 billion into a North Carolina qualified settlement fund trust to address current and future talc-related claims.¹⁷

Once filed, however, the North Carolina Bankruptcy Court, finding that venue had been artificially manufactured as part of the Texas Two-Step, ordered that the case be transferred to the Bankruptcy Court for the District of New Jersey (the “New Jersey Bankruptcy Court”), where J&J and LTL are headquartered and where the talc multi-district litigation against J&J and various of its subsidiaries (the “MDL”) is proceeding.¹⁸

As a keystone of its case, LTL filed a motion to extend the Bankruptcy Code’s automatic stay, which halts ongoing and new litigation from being brought against a bankrupt debtor during the case, to non-debtor J&J and other related non-debtor entities. If granted, the automatic stay and attendant preliminary injunction would relieve J&J from having to litigate the pending cases in the MDL and elsewhere.

The talc claimants’ committee and thousands of individual claimants opposed such an extension of the automatic stay

and the issuance of a preliminary injunction for J&J¹⁹ and further sought to have LTL’s Chapter 11 case dismissed, arguing that the case had not been filed in good faith, was an abusive litigation tactic, and that there were no valid reorganizational purposes served by the filing.²⁰

However, the New Jersey Bankruptcy Court denied the motions to dismiss and extended the automatic stay to and issued a preliminary injunction in favor of J&J and several other non-debtor entities.²¹ The claimants appealed these rulings directly to the Third Circuit.²²

The Third Circuit agreed with the claimant appellants and reversed the New Jersey Bankruptcy Court’s rulings, remanding the case back to the New Jersey Bankruptcy Court with orders to dismiss LTL’s bankruptcy case.²³ The Third Circuit found that, due to the 2021 Funding Agreement, at the time of its Chapter 11 filing, LTL was “highly solvent with access to cash to meet comfortably its liabilities as they came due for the foreseeable future.”²⁴ The Third Circuit observed that J&J had previously settled thousands of cases for under \$1 billion and had obtained dismissals in over a thousand other cases without payment, and, though there had previously been outsized verdicts, these were not representative.²⁵ Ultimately, the Third Circuit held that, because LTL was not in financial distress, its Chapter 11 filing was at best “premature,” and that LTL could not show that its Chapter 11 “petition served a valid bankruptcy purpose and was filed in good faith.”²⁶

After its first bankruptcy case was dismissed on April 4, 2023, *later that same day*, LTL refiled for bankruptcy in the New Jersey Bankruptcy Court, with a new set of funding and support agreements (collectively, the “2023 Agreements”), to replace the 2021 Funding Agreement (which had, by then, been terminated). The 2023 Agreements obligated HoldCo (formerly known as Old JJCI) to fund LTL’s operations and liabilities at all times, but only obligated J&J to fund the talc liabilities *while LTL was in bankruptcy*.²⁷

Notably, because HoldCo had transferred its assets as part of the spinoff of J&J’s consumer health business, which was formerly held by HoldCo, LTL argued that it no longer had the same access to J&J’s balance sheet and therefore was financially distressed going into its second bankruptcy filing.²⁸

11 See Informational Brief of LTL Management LLC at 4, 124, *LTL I* (Bankr. W.D.N.C. Oct. 14, 2021), [Docket No. 3].

12 See Declaration of John K. Kim in Support of First Day Pleadings ¶ 16, *LTL I* (Bankr. W.D.N.C. Oct. 14, 2021), [Docket No. 5] (“LTL I First Day Decl.”).

13 See *id.* ¶¶ 16–26.

14 See *id.* ¶¶ 23, 25.

15 See *id.* ¶¶ 23–30.

16 See *id.* ¶ 27; *In re LTL Mgmt., LLC*, 64 F.4th 84, 97 (3d Cir. 2023) (“The value of the payment right could not drop below a floor defined as the value of New Consumer measured as of the time of the divisional merger, estimated by LTL at \$61.5 billion, and was subject to increase as the value of [New JJCI] increased after it.”).

17 See LTL I First Day Decl. ¶ 81.

18 See *In re LTL Mgmt. LLC*, Case No. 21-30589, 2021 WL 5343945, at *6–7 (Bankr. W.D.N.C. Nov. 16, 2021).

19 See Objection of the Official Committee of Talc Claimants to Debtor’s Motion for an Order (I) Declaring that the Automatic Stay Applies to Certain Actions Against Non-Debtors or (II) Preliminarily Enjoining Such Actions and (III) Granting a Temporary Restraining Order Pending a Final Hearing, *LTL I* (Bankr. D.N.J. Dec. 22, 2021), [Adv. Pro. Docket No. 142]; Opposition of Aylstock, Witkin, Kreis & Overholtz PLLC to Debtor’s Request for Preliminary Injunctive Relief, *LTL I* (Bankr. D.N.J. Dec. 22, 2021), [Adv. Pro. Docket No. 143].

20 See Motion of the Official Committee of Talc Claimants to Dismiss Debtor’s Chapter 11 Case, *LTL I* (Bankr. D.N.J. Dec. 1, 2021), [Docket No. 632-1] (filed by the Official Committee of Talc Claimants) (“This bankruptcy case was not filed in good faith. It serves no legitimate purpose. It was designed to provide a litigation advantage for non-debtors. It serves only to deprive a single group of creditors of the full panoply of assets backing their claims, rather than making the full range of an entity’s assets open and available for fair distribution to all creditors. It seeks to manipulate Texas law and the Bankruptcy Code for the sole purpose of discharging the Debtor’s large and healthy non-debtor affiliates of direct and indirect tort liability, liability that J&J has admitted it was financially capable of paying. And, worse still, it makes dying cancer victims, even those with a judgment, scratch, claw, and fight, potentially for years, to be compensated from funds that would have been available to those creditors just two days before the filing.”); Memorandum of Law in Support of Motion to Dismiss Bankruptcy Case, *LTL I* (Bankr. D.N.J. Dec. 9, 2021), [Docket No. 766-1] (filed by Arnold & Itkin LLP on behalf of over 7,000 talc personal injury claimants); Motion of Aylstock, Witkin, Kreis & Overholtz, PLLC to Dismiss Bankruptcy Case and Joinder in Related Filings, *LTL I* (Bankr. D.N.J. Dec. 29, 2021), [Docket No. 1003] (filed by Aylstock, Witkin, Kreis & Overholtz, PLLC “on behalf of thousands of holders of talc personal injury claims”).

21 See *In re LTL Mgmt., LLC*, 638 B.R. 291 (Bankr. D.N.J. 2022) (extending the automatic stay to J&J and other non-debtors); *In re LTL Mgmt., LLC*, 637 B.R. 396 (Bankr. D.N.J. 2022) (denying motions to dismiss).

22 The New Jersey Bankruptcy Court certified the direct appeal of the orders to the Third Circuit, bypassing the United States District Court. See Order Certifying Direct Appeal to the United States Court of Appeals for the Third Circuit of Order Denying Motions to Dismiss, *LTL I* (Bankr. D.N.J. Apr. 4, 2022), [Docket No. 1955]; Order Certifying Direct Appeal to the United States Court of Appeals for the Third Circuit of Order Extending Automatic Stay and Issuing Preliminary Injunction, *LTL I* (Bankr. D.N.J. Apr. 4, 2022), [Adv. Pro. Docket No. 231].

23 See *In re LTL Mgmt., LLC*, 64 F.4th at 111.

24 *Id.* at 108.

25 *Id.* at 107–08.

26 *Id.* at 109–10.

27 See Declaration of John K. Kim in Support of First Day Pleadings ¶¶ 80–82, *In re LTL Mgmt., LLC*, Case No. 23-12825 (“LTL II”) (Bankr. D.N.J. Apr. 4, 2023), [Docket No. 4] (“LTL II First Day Declaration”).

28 *Id.* ¶ 83.

However, even without access to the full balance sheet of J&J, LTL still had access to the value of HoldCo’s “significant cash holdings, anticipated annual dividends, and equity interests having a value approaching \$30 billion.”²⁹

Despite LTL’s efforts to “address the guidance provided by the Third Circuit in its dismissal opinion,”³⁰ following motions to dismiss LTL’s second bankruptcy filing filed by the United States Trustee and various tort claimants³¹ and a subsequent four-day trial, the New Jersey Bankruptcy Court dismissed LTL’s bankruptcy filing on the basis that the 2023 Agreements sufficiently precluded LTL’s argument that it was in financial distress.³² The New Jersey Bankruptcy Court nevertheless appeared sympathetic to LTL’s desire to use the bankruptcy system to resolve its mass tort claims.³³

LTL has appealed its dismissal to the Third Circuit, where the appeal is currently pending. At this time, oral argument has not yet been scheduled.

The Third Circuit’s initial decision, however, has had influence outside of the jurisdiction, as demonstrated in the bankruptcy of Aearo Technologies LLC (“Aearo”).

In re Aearo Technologies LLC

Though not a Texas Two-Step case, 3M Corporation (“3M”) and its affiliate Aearo similarly sought to address a vast multi-district litigation of hearing injury claims related to Aearo’s earplugs using the bankruptcy system.

Like J&J and LTL, 3M and Aearo entered into a funding agreement and Aearo also sought to extend the automatic stay to non-debtor 3M in order to halt the tort claims pending against 3M.³⁴ However, following the Third Circuit’s dismissal in *LTL*, claimants filed motions to dismiss Aearo’s bankruptcy case on the basis that the Aearo debtors were “highly solvent” at the time of their Chapter 11 petitions, and that, “just like *LTL*, the Debtors’ bankruptcy filing was made without any immediate financial distress.”³⁵

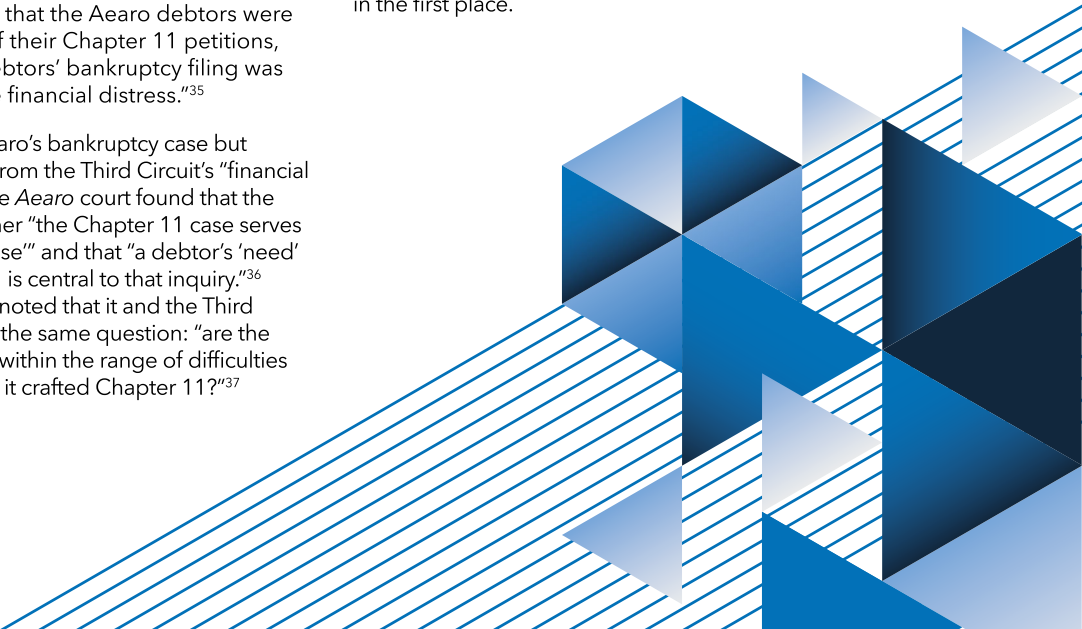
The *Aearo* court dismissed Aearo’s bankruptcy case but framed the inquiry differently from the Third Circuit’s “financial distress” test in *LTL*; namely, the *Aearo* court found that the key good faith inquiry is whether “the Chapter 11 case serves ‘a valid reorganizational purpose’” and that “a debtor’s ‘need’ for relief under the Chapter 11 is central to that inquiry.”³⁶ Nevertheless, the *Aearo* court noted that it and the Third Circuit were essentially asking the same question: “are the problems the debtor is facing within the range of difficulties envisioned by Congress when it crafted Chapter 11?”³⁷

Conclusion

Unlike typical mass tort bankruptcies, where most if not all of the enterprise files for bankruptcy protection and seeks to reorganize or liquidate, the companies deploying the Texas Two-Step are typically seeking to cordon off mass tort liabilities into a discrete subsidiary for the purpose of keeping the remainder of the enterprise, which is often quite profitable, out of the bankruptcy. If successful, the proponents of the Texas Two-Step strategy would likely argue that concentrating such liabilities into one subsidiary maximizes value for those tort claimants; the rest of the enterprise is free to operate as normal and generate funds to be funneled to tort claimants through the claims resolution process under a bankruptcy plan.

While framed differently, the dismissal decisions in both *Aearo* and *LTL* both closely analyzed the carefully-crafted structures and strategies of the respective debtors and their broader enterprises designed to resolve such mass tort liabilities in the bankruptcy system. Companies seeking to follow in their footsteps should expect similarly rigorous scrutiny of the steps taken to get the chosen debtor into bankruptcy, and if the enterprise as a whole is solvent, any funding arrangement could end up as a doubled-edged sword that effectively precludes the debtor from staying in bankruptcy.

Further, given the appeal of LTL’s second bankruptcy dismissal remains pending in the Third Circuit, and LLT has only just begun solicitation for a separate prepackaged plan of reorganization, it may be several more years before LTL’s dance of the Texas Two-Step is over, but its two-and-a-half-year fight across at least two jurisdictions (and potentially three when all is said and done) to even remain in bankruptcy court may be enough to deter others from taking to the dance floor in the first place.



29 *In re LTL Mgmt., LLC*, 652 B.R. 433, 448 (Bank. D.N.J. 2023)
 30 LTL II First Day Declaration ¶ 78.
 31 See MRHFM’s Plaintiffs’ Motion to Dismiss the Second Bankruptcy Petition of LTL Management, LLC, *LTL II* (Bankr. D.N.J. Apr. 28, 2023), [Docket No. 358]; Notice of Motion to Dismiss Bankruptcy Case, *LTL II* (Bankr. D.N.J. May 1, 2023), [Docket No. 384] (filed by Arnold & Itkin LLP on behalf of certain personal injury claimants); Notice of Motion of the United States Trustee to Dismiss Case Pursuant to 11 U.S.C. § 1112(B), *LTL II* (Bankr. D.N.J. May 1, 2023), [Docket No. 379].
 32 *In re LTL*, 652 B.R. at 456.
 33 *Id.* at 449-50 (“There have been no developments since LTL 1.0 that have abated the Court’s concerns or resolved the problems of the extensive tort-claim backlog, or the incontrovertible fact that many plaintiffs are denied any recovery in the tort system altogether.”).
 34 See Declaration of John R. Castellano in Support of the Debtors’ Chapter 11 Petitions and First Day Motions ¶ 12, *Aearo* (Bankr. S.D. Ind. July 26, 2022), [Docket No. 11].
 35 See Joint Motion to Dismiss the Debtors’ Bankruptcy Cases Pursuant to Bankruptcy Code Section 1112(b) ¶ 32, *Aearo* (Bankr. S.D. Ind. Feb. 2, 2023), [Docket No. 1066].
 36 *In re Aearo Techs., LLC*, Case No. 22-02890-JJG-11, 2023 WL 3938436, at *14 (Bankr. S.D. Ind. June 9, 2023).
 37 *Id.* Though the parties appealed the case directly to the Court of Appeals for the Seventh Circuit, such proceedings are suspended pending the implementation of a global settlement with the earplug MDL claimants. See Order, *In re Aearo Techs., LLC*, Case No. 23-2286 (7th Cir. Sept. 13, 2023), [Docket No. 17] (granting Joint Motion to Hold Appeals in Abeyance pending implementation of the settlement agreement in the MDL); see also *Combat Arms Earplugs Settlement Moves to Final Resolution*, 3M (Mar. 26, 2024), <https://investors.3m.com/news-events/press-releases/detail/1833/combat-arms-earplugs-settlement-moves-to-final-resolution>.