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Claims Chat

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When the Music Stops

The Texas Two-Step and Forecasting Its Future Application

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Bankruptcy is a dynamic, fast-moving practice that demands effective management and creativity to best satisfy the needs of clients. There are many opportunities, and sometimes there is even a great deal of expectation, for professionals to come up with something novel. This article explores the Texas Two-Step — a tactic that is young but might be destined for wider application, especially in the chaotic, public arena of mass tort bankruptcies.

Background

Every state provides a statutory predicate allowing corporations to implement "spin-offs," which is the name given to a transaction in which the parent company creates an independent company and transfers to it a particular line of the parent's business. The parent then distributes shares of the independent company to the parent's shareholders. There are many reasons a parent company might decide to implement a spin-off. For example, cleaving particular assets from the parent may attract investors to the spun-off entity who are interested only in a particular line of the business and not the parent company as a whole. The reasons to implement a spin-off are varied, but one contentious motivation is an entity's desire to transfer its liabilities to another entity while keeping for itself all of its valuable assets.

An example of such a spin-off is found in *In re Tronox*.[1] In *Tronox*, Kerr-McGee Corp. (Old KM) was a chemical and energy company plagued with onerous liabilities. To rid itself of these liabilities, Old KM created a new parent entity, NKM, and transferred to it all of Old KM's equity in its profitable subsidiaries. Old KM was renamed Tronox, and it retained Old KM's liabilities.

Burdened by poor cash flow and enormous liabilities, Tronox filed its chapter 11 petition in January 2009. Meanwhile, NKM was purchased by Anadarko Petroleum Corp. for nearly $18 billion. After filing its petition, Tronox commenced an adversary proceeding against NKM and Anadarko alleging that the transfer of Old KM's profitable lines of business was actually and constructively fraudulent under the Uniform Fraudulent Transfer Act (UFTA) in Oklahoma and §§ 548 and 550 of the Bankruptcy Code. Tronox sought $15 billion in damages. After a 34-day trial, Hon. **Allan L. Gropper** ruled that the defendants were liable for actual and constructive fraudulent transfer and ordered damages in an amount between $5 billion and $14 billion (the parties subsequently settled for $5 billion).

Not surprisingly, many companies may face the challenge of a fraudulent-transfer action if they structure spin-offs to leave one entity with an undue amount of assets and the other with debt. Nevertheless, every state permits spin-offs, and they are mostly used for legitimate aims. Similarly, every state allows for mergers. In a merger, two corporations will typically merge into one — and the assets and liabilities of the corporations become shared in one entity.

The Texas Two-Step

In an effort to encourage incorporation in Texas,[2] the Texas Business Organizations Code (TBOC) defines "merger" to mean the division of one entity into two or more new entities.[3] This type

1 *Tronox Inc. v. Kerr-McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013).

2 H. Comm. on Bus. & Com., Bill Analysis, H.B. 472, 1989 Leg., 71st Reg. Sess., at 23 (Tex. 1989) (divisive merger is intended "to provide domestic corporations with greater flexibility in structuring business combinations and to make Texas a uniquely desirable jurisdiction in which to incorporate ... this would provide Texas corporations with unprecedented ability to effect 'spin-offs' and similar restructuring transactions through a simplified statutory process that is not available in other jurisdictions").

3 TBOC § 1.002(55)(A).

of merger is called a "divisive merger." The TBOC's definition of "merger" is important because the TBOC also provides that "all liabilities and obligations of each organization that is a party to the merger [be] allocated to one or more of the surviving or new organizations in the manner provided by the *plan of merger*."[4] In turn, the plan of merger provides the manner for allocating the property and liabilities of each organization that is party to the merger.[5] Essentially, a company can divisively merge into two entities, and the plan of merger will specify which entity holds the assets and which holds the liabilities.

The Texas Two-Step raises the specter of a possible fraudulent-transfer action. In the context of traditional spin-offs previously discussed herein, transferring liabilities this way triggers potential fraudulent-transfer liability. However, the TBOC accounts for this and provides that a merger takes effect "without any transfer or assignment having occurred."[6] If the merger's allocation of assets does not constitute a transfer, then how can there be a claim of fraudulent transfer? It is therefore possible that a merger whereby one entity ends of up with assets and the other with liabilities will not be ruled a fraudulent transfer because the underlying predicate — the occurrence of a transfer — is not met.

The question in the preceding paragraph hinges on how courts will resolve the glaring contradiction between the relevant statutes. The Texas Two-Step works only if the courts defer to the TBOC's definition of "merger" and find that based on such a definition, the reallocation of assets and liabilities under a divisive merger is not a transfer, and therefore cannot constitute a fraudulent transfer. However, courts may find that the logic and weight behind the UFTA and § 548 of the Bankruptcy Code override the TBOC, and accordingly they hold that an allocation of assets and liabilities under a divisive merger constitutes a fraudulent transfer of assets.[7]

Both the UFTA and § 548 provide that a fraudulent transfer occurs if the debtor makes a transfer or otherwise incurs an obligation with "actual intent to hinder, delay, or defraud any creditor of the debtor; or without receiving a reasonably equivalent value in exchange for the transfer or obligation."[8] From the creditors' perspective, the divisive merger is actually fraudulent if the transaction is implemented to keep valuable assets out of the hands of creditors, and constructively fraudulent if the assets and liabilities are separated without reasonably equivalent value.

Guidance is found in the divisive merger's legislative history, which states that "creditors' rights would not be adversely affected by the proposed amendment, and creditors would continue to have the protections provided by the [UFTA] and other existing statutes that protect the rights of creditors."[9] Language elsewhere in the TBOC explicitly states that the divisive-merger provisions do not "abridge any right or rights of any creditor under existing laws."[10] This body of authority weighs against a court's acceptance of the Texas Two-Step in the fraudulent-transfer context. However, there have been few occurrences where this strategy was tried, and in none of those has a court yet resolved the issue. Indeed, claimants may face procedural difficulties in raising this issue to the court. The claimants' lack of standing to bring, and the debtors' prerogative to settle, fraudulent-transfer claims may reduce claimants' bargaining power.

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Case Studies

In the cases involving debtors affiliated with Georgia-Pacific, Ingersoll-Rand and Johnson & Johnson (J&J), the debtors' petitions were filed in the Western District of North Carolina (WDNC) and are still pending.[11] The attraction to this district may be driven in part by a 2014 decision in which the bankruptcy court capped a debtor's asbestos liability at $125 million when the claimants were seeking $1.4 billion.[12] At this time, the ultimate question of whether the Texas Two-Step is a fraudulent conveyance lies dormant in three cases. Depending on how the courts resolve this issue, application of the Texas Two-Step may expand beyond these asbestos cases. Next, let's discuss the Texas Two-Step as implemented in relation to the bankruptcies associated with Ingersoll-Rand and J&J.[13]

Ingersoll-Rand

Ingersoll-Rand owned two entities (Old Trane and Old IRNJ) that manufactured equipment containing asbestos components, the exposure to which created enormous liabilities. As of July 31, 2020, there were nearly 90,000 asbestos-related claims pending against Old Trane and Old IRNJ, with projected liabilities totaling at least $547 million.

On April 30, 2020, Old Trane's parent, Trane Inc., formed a holding company, TUI Holdings, as a Delaware corporation and contributed its stock in Old Trane to TUI Holdings. On May 1, 2020, Old Trane converted from a Delaware corporation to a Texas corporation, then implemented a divisive merger by which Old Trane was dissolved and two new companies were created: New Trane as a Texas corporation, and Murray Boiler as a Texas limited liability company (LLC). Under the plan of merger, New Trane received 98 percent of Old Trane's assets and Murray Boiler received the remaining 2 percent of Old Trane's assets. Murray Boiler also received all of Old Trane's asbestos liabilities. Later that same day, New Trane converted to a Delaware corporation and Murray Boiler converted to a North Carolina LLC. Of note, New Trane and Murray Boiler were Texas entities for

4 TBOC § 10.003.
5 *Id.*
6 TBOC § 10.008(a)(2)(C).
7 The Uniform Fraudulent Conveyance Act (UFCA) also protects against fraudulent conveyances. However, the UFCA is still in effect only in Maryland. *See* Md. COML § 15-214.
8 TBOC § 24.005(a)(1). Similar language is found in 11 U.S.C. § 548(a)(1)(A).
9 H. Comm. on Bus. & Com., Bill Analysis, H.B. 472, 1989 Leg., 71st Reg. Sess., at 23 (Tex. 1989).
10 TBOC § 10.901.
11 Although filed in the WDNC, the case affiliated with Johnson & Johnson was recently transferred to the U.S. Bankruptcy Court for the District of New Jersey.
12 *See In re Garlock Sealing Techs. LLC*, 504 B.R. 71, 97 (Bankr. W.D.N.C. 2014).
13 For brevity's sake, this article did not summarize the case associated with Georgia-Pacific, but that case is *In re Bestwall LLC*, Case No. 17-31795 (Bankr. W.D.N.C. Nov. 2, 2017).

less than 24 hours. On June 18, 2020, Murray Boiler filed its chapter 11 petition in the WDNC.

During this same time period, Old IRNJ implemented a similar series of transactions creating two new entities through a divisive merger: New TTC (which received Old IRNJ's assets), and Aldrich LLC (which received the asbestos liabilities). Aldrich LLC filed its chapter 11 petition in the WDNC on the same date as Murray Boiler.

Shortly thereafter, Murray Boiler and Aldrich LLC brought a complaint and motion in the bankruptcy court seeking a preliminary injunction barring asbestos claimants from bringing litigation against several entities, including New Trane and New TTC. Objections soon followed, and the court recently issued its findings of fact and conclusions of law on the issues, holding that "[b]y virtue of the Texas merger statutes," the asbestos claims are owed by the debtors and no other party and are thus subject to the automatic stay.[14] This means that for the time being, asbestos claimants are stayed from pursuing litigation against New Trane and New TTC.

The court acknowledged that it has not yet had occasion to rule on the most important issue to claimants: whether the divisive mergers are ultimately avoidable fraudulent transfers.[15] However, the court held that standing to assert the fraudulent-transfer claims belong to the debtors and not to individual asbestos claimants.

It is critical to note that underlying merger agreements called upon New TTC and New Trane to help fund payouts to asbestos claimants. Although New TTC and New Trane argued that these agreements demonstrate that the divisive merger ultimately has no negative effect on the claimants, the court was critical of this arrangement, noting that these underlying agreements are unsecured and conditional,[16] and that "the willingness of New TTC or New Trane to pay asbestos claimants cannot be assumed.... Thus, an action to contest the mergers and the exclusive allocation of all asbestos claims to Aldrich and Murray appears to be a viable cause."[17] For now, the authority to bring such a cause of action lies with the debtors. Subsequent to the entry of the court's findings of fact, New TTC and New Trane offered to settle current and future asbestos claims by funding a $545 million trust with an immediate infusion of $270 million for the benefit of asbestos claimants.[18]

Johnson & Johnson

After months of speculation,[19] in October 2021 J&J executed its own Texas Two-Step through a set of transactions similar to those previously detailed.[20] Prior to its Texas Two-Step, J&J's asbestos liabilities were held by Old JJCI. On Oct. 11, 2021, J&J created a Texas LLC into which Old JJCI was merged. The Texas LLC survived the merger but retained the Old JJCI name. On Oct. 12, 2021, Old JJCI effected a divisive merger by which Old JJCI dissolved, and two new entities were formed as Texas LLCs: New JJCI and LTL Management LLC. Pursuant to the plan of merger, New JJCI received most of the assets and LTL was assigned the asbestos liabilities. LTL subsequently converted to a North Carolina LLC and filed its bankruptcy petition in the WDNC on Oct. 14, 2021.

Similar to the other Texas Two-Steps (and mentioned in the *Ingersoll-Rand* case study), a funding agreement was put into place that required New JJCI and J&J to, up to the full value of New JJCI, provide funding for a trust dealing with asbestos claims. As part of this funding agreement, New JJCI and J&J agreed to infuse the trust with $2 billion in January 2022.[21]

It remains to be seen whether the claimants will try to challenge the Texas Two-Step as an actual fraudulent transfer for intentionally putting assets beyond the reach of creditors, and/or a constructive fraudulent transfer for reallocating assets and liabilities without reasonably equivalent value (*i.e.*, whether the $2 billion infusion into the trust is reasonable where the potential asbestos liabilities could be many times that amount). After initially being filed in the WDNC, LTL's case was transferred to the U.S. Bankruptcy Court for the District of New Jersey, and there is a temporary stay on litigation against J&J until January. After getting up to speed on the issues, the new court may eventually be tasked with weighing whether it will allow LTL to settle fraudulent-transfer claims or permit claimants standing to bring the fraudulent-transfer claims.

Conclusion

While it might not be the case that courts will uphold the Texas Two-Step when, and if, it is challenged by claimants as a fraudulent transfer, the costs of litigation for a debtor's estate, coupled with the parent's leverage in any litigation, make the Texas Two-Step an attractive strategy for parent corporations facing significant liabilities. abi

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14 *In re Aldrich Pump LLC, et al.*, Case No. 20-ap-30608 (Bankr. W.D.N.C. Aug. 23, 2021), Dkt. No. 308, p. 6.
15 *Id.*
16 *Id.* at 55.
17 *Id.* at 56.
18 *Id.*, Dkt. No. 834, at 3.
19 Andrew Scurria & Alexander Gladstone, "Johnson & Johnson Taps Jones Day to Explore Talc Bankruptcy," *Wall St. J.* (July 20, 2021), *available at* wsj.com/articles/johnson-johnson-taps-jones-day-to-explore-talc-bankruptcy-11626809000 (last visited Oct. 21, 2021).
20 *See In re LTL Mgmt. LLC*, Case No. 21-bk-30589 (Bankr. W.D.N.C. Oct. 14, 2021).
21 *Id.*, Dkt. No. 8, at 4.