

## Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Federal Courts, Oversight, Agency Action and Federal Rights

Senate Committee on the Judiciary

United States Senate

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Thank you for the opportunity to testify about “Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy.” It is a great honor to appear before you, and to provide this written testimony.<sup>1</sup>

I should start by noting that this testimony reflects my own views, not the views of the University of Pennsylvania Carey Law School, where I work, or of the Financial Oversight & Management Board for Puerto Rico, which I currently chair.

The issue we’re focusing on today—the potential abuse of so-called Texas Two-Step transactions and other divisive mergers—is one of the principal reasons for a growing backlash against perceived abuses in the Chapter 11 reorganization process. I have written about some of the other controversial practices in detail elsewhere and will refer to those practices in a footnote below.<sup>2</sup>

The term “divisive” or “divisional” merger is an oxymoron. A merger ordinarily combines two firms, with one or the other emerging as the “surviving” firm. In a divisive merger, by contrast, a firm tears itself asunder, separating its assets and/or liabilities into two entities. In the controversial recent Johnson & Johnson divisive merger, for instance, Johnson & Johnson put its talc liabilities into a new entity called LTL. Shortly after this transaction, LTL filed for bankruptcy, seeking to resolve the talc liability in bankruptcy. This strategy—effecting a divisional merger under the Texas statute and then putting the new entity in bankruptcy, has become known as the “Texas Two-Step.”

Texas Two-Step transactions are part of a larger pattern of transferring assets or liabilities from one corporate entity to another in a way that potentially disadvantages creditors of the original entity. In Johnson & Johnson’s case, talc claimants were shunted off to a separate entity

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<sup>1</sup> I am grateful to Caroline Nowlin and David Wreesman, both University of Pennsylvania Carey Law School class of 2020, for providing excellent research for this testimony on very short notice.

<sup>2</sup> Other controversial practices include third party releases, forum shopping by corporate debtors, payment of bonuses to managers before or after filing for bankruptcy, and “equitable mootness.” For discussion, see David Skeel, *The populist backlash in Chapter 11*, ECONOMIC STUDIES AT BROOKINGS, Jan. 10, 2022.

with essentially no assets of its own. The new entity, LTL, is the passive recipient of funds from Johnson & Johnson and the entity that retained the assets (now called Johnson & Johnson Consumer Inc., or New JJCI) as expenses are incurred or victims obtain judgments.

Texas’s divisive merger statute was not created with bankruptcy in mind. Texas lawmakers introduced it in 1989, hoping to add flexibility to corporate transactions.<sup>3</sup> Its potential use to shift liabilities to a separate entity and then address those liabilities in bankruptcy seems to have been discovered roughly five years ago by companies with mass tort liability.<sup>4</sup> The opportunity for abuse—and for undercutting the rights of victims and other creditors—is obvious.

Bankruptcy law offers at least two major mechanisms for policing potential abuses. The first is to ask the court to dismiss the case as having been filed in bad faith or because the case is not suitable for Chapter 11. The J&J case has been challenged on these grounds—victims argue that LTL has essentially no assets of its own other than the funding agreement, that it was created simply for the purpose of capping Johnson & Johnson’s talc liability, and thus it not the kind of enterprise Chapter 11 is designed to restructure.

The second response is fraudulent conveyance law, which comes into play if the case is not dismissed at the outset. When a transaction is intended to defraud creditors (known as “actual fraud”) or assets are transferred or liabilities incurred for less than “reasonably equivalent value” (constructive fraud), the transaction can be challenged as a fraudulent conveyance and its harm undone by reversing (“avoiding”) the transaction.

Legislation recently introduced in the United States House would take a much more sweeping approach.<sup>5</sup> The legislation would amend bankruptcy law to require dismissal of any divisive merger that “had the intent of foreseeable effect of ... separating material assets from material liabilities ... and ... assigning all or a substantial portion of those liabilities to the debtor.”<sup>6</sup> This language would essentially bar the doors to bankruptcy for divisive mergers.

If divisive mergers pose a serious risk of abuse—and I believe they do—the question is whether the best solution is to rely on bankruptcy’s existing remedies, or to amend the Bankruptcy Code to intervene more directly.

The current remedies are not perfect. Courts are generally reluctant to dismiss cases as filed in bad faith in the absence of egregious behavior. Fraudulent conveyance actions face legal and practical obstacles in some contexts. Texas’s divisive merger statute adds to these obstacles by explicitly stating that the divisive merger does not constitute a “transfer,” which is the

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<sup>3</sup> See H.B. 472. Bill Analysis of H.B. 472 of the 71<sup>st</sup> Legislature (1989)(stating that the reforms “introduce options for structuring business combinations that are not available in other jurisdictions and are intended to make the State of Texas a more attractive jurisdiction in which to incorporate”); see also Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY’S L.J. 109, 114-15 (1989).

<sup>4</sup> The first appears to have been Bestwall, which filed for bankruptcy in the Western District of North Carolina in 2017.

<sup>5</sup> H.R. 4777, 117<sup>th</sup> Cong., 1<sup>st</sup> Sess. (July 28, 2021). The primary purpose of the proposed legislation is to ban so-called third party releases, but it includes a provision (§ 4) barring divisional mergers.

<sup>6</sup> *Id.* § 4.

principal basis for a fraudulent conveyance action. Some commentators also worry that venue shopping-- debtors' ability to choose where to file their bankruptcy case—discourages oversight. This concern has been fueled in part by the filing of a series of Texas Two-Step bankruptcy cases in the same, somewhat unlikely location: the Western District of North Carolina.

Despite these concerns, I think the existing remedies are likely to be adequate to the task. Courts can dismiss divisive merger bankruptcies that are clearly abusive, and the obstacles to fraudulent conveyance actions do not appear to preclude intervention. Moreover, the notoriety of the cases already has seemed to have prompted transfer of the Johnson & Johnson case to New Jersey from its favored venue in North Carolina.

My optimism could be mistaken. Courts may fail to adequately police divisional mergers. If they do, legislative intervention would be warranted. But I do not believe it is currently warranted and I worry that any legislation may have unfortunate unintended consequences.

The remainder of this testimony will discuss these points in slightly more detail. After providing the context and describing the Texas merger statute, I will assess the principal current tools for curbing abuses, as well as the proposed legislation.

### **The Context**

The strategy of shuffling assets and liabilities prior to bankruptcy in ways that can harm the company's current creditors—whether they be tort victims as in the Johnson & Johnson case or financial creditors—is not new, but it seems to have become more prevalent and at times more brazen in recent years. In several of these recent cases, a private equity fund acquired a company—largely using borrowed money-- then moved assets around to the detriment of its creditors before filing for bankruptcy.<sup>7</sup>

Perhaps the most notorious example—if only because it is the subject of a recent book-- was Caesars.<sup>8</sup> After acquiring the casino enterprise, two private equity funds transferred some of its most valuable casino properties to a new entity that its current creditors did not have an interest in. Although the current creditors might nevertheless have been protected by the parent corporation's guaranty of their obligations, the private equity sponsors took actions that terminated the guaranties. The transactions were challenged as fraudulent conveyances in the Caesars bankruptcy. These challenges were central to the Chapter 11 reorganization that ensued.

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<sup>7</sup> Private equity funds, which previously were called leveraged buyout (LBO) or takeover firms, often buy publicly held companies using borrowed funds, run them for a few years, then take them public again.

<sup>8</sup> MAX FRUMES & SUJEET INDAP, *THE CAESARS PALACE COUP: HOW A BILLIONAIRE BRAWL OVER THE FAMOUS CASINO EXPOSED THE POWER AND GREED OF WALL STREET* (2021).

In other recent cases, companies have taken advantage of loopholes in loan documents to transfer assets to other entities or to borrow additional funds. Widely discussed examples include Serta and Nine-West.<sup>9</sup>

Texas's divisive merger statute is more than simply a loophole in loan documents. It is a statutory provision that seems to invite abusive behavior.

### **Texas's Divisive Merger Statute**

Dating back to 1989, Texas's divisive merger statute consists of three related provisions in the Texas Business Organizations Code. The central provision is Tex. Bus. Orgs. Code § 1.002(55)(A), which defines the term "merger" to include "the division of a domestic entity into two or more new domestic entities." This provision supplies the basis for a merger whose oxymoronic purpose is "divisive"—intended to divide.

The second provision is Tex. Bus. Orgs. Code § 10.003, which requires that for mergers that result in more than one organization, the "plan of merger" must allocate the property (§ 10.003(1)) and liabilities (§ 10.003(3)) of the original organization(s) to the surviving organizations.

Finally, Tex. Bus. Orgs. Code § 10.008(a)(4) states that newly created entities are not responsible for the liabilities assigned to other newly created entities.

Together, these provisions enable a business to hive off liabilities—with or without assets—to a separate entity. The divisive merger statute gives the company complete flexibility to decide which assets or liabilities to put in which entity. The company theoretically could put all of the liabilities in a new entity without any source of funds for paying them, though most divisive mergers include a funding agreement with the entity that retains the assets.

The Texas House Committee that produced the divisive merger protection signaled that its goal in redefining the concept of a merger in this fashion was to make Texas an attractive jurisdiction for incorporation. The Committee sought to enhance flexibility, with a particular concern for potentially risky farming operations. I am not aware of any evidence that the drafters contemplated that companies would effect divisive mergers as an immediate prelude to bankruptcy. The Texas Two-Step seems to have emerged in the past five years, as companies with mass tort liabilities have created a separate entity for this liability and subsequently put the new entity in bankruptcy.

In a Texas Two-Step transaction, a company shifts its liabilities into a new entity, and the original entity enters into a funding agreement that provides payments to and/or indemnification of the new entity. If the funding agreement were backed by all of the assets of the original entity,

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<sup>9</sup> For discussion of these maneuvers, see, for example, Diane Lourdes Dick, *Hostile Restructurings* (unpublished manuscript, 2021); Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J. FORUM 363 (2021).

the transaction might not leave the victims or other creditors any worse than they were before. If it isn't, the risk that the transaction is abusive from the victims' perspective is far higher.

Johnson & Johnson is a troubling use of the divisive merger statute.<sup>10</sup> Johnson & Johnson effected a divisional merger on October 12, 2021, transferring its talc liabilities to LTL. LTL's only real asset is its funding agreement with Johnson & Johnson and the original entity (now called New JJCI). Under this agreement, LTL can obtain payments from the original entity or Johnson & Johnson. One commentator describes agreements that take this form as "drip financing."<sup>11</sup> Just two days after the transaction, Johnson & Johnson put J&L into bankruptcy. The point of the divisive merger seems to have been to separate the talc liabilities from the original entity and from Johnson & Johnson itself, so that they can be resolved in bankruptcy—or, as the victims have put it, quoting internal Johnson & Johnson documents, to "capture the liability in one subsidiary ... and then basically bankrupt that subsidiary."<sup>12</sup> The new entity was domiciled in North Carolina so that the bankruptcy could be filed in the Western District of North Carolina, as several other cases had been.<sup>13</sup>

### **Existing Remedies: Bad Faith**

Under existing law, victims and other creditors have at least two significant remedies against abusive transactions: alleging bad faith and bringing a fraudulent conveyance challenge.

If a company has engaged in an abusive divisive merger, victims can ask that the bankruptcy case be dismissed. Although bad faith actions rarely succeed under ordinary circumstances when a troubled company files for bankruptcy, courts have dismissed cases where the debtor signaled that bankruptcy was not really necessary. In the best known case in the Third Circuit, the federal court of appeals that provides the governing law for the Johnson & Johnson case, the debtor said it had no need for bankruptcy and had only filed for Chapter 11 due to deal with a lawsuit it faced.<sup>14</sup> The court held that this constituted bad faith. In another case, the court dismissed that case because the entity had no real business that needed to be restructured in bankruptcy.<sup>15</sup>

With Johnson & Johnson, victims and the victims' committees have asked for the case to be dismissed on bad faith grounds. They argue, among other things, that the purpose of bankruptcy is to maximize the value of a company's assets for the benefit of its creditors and other constituencies. Because J&L has no real assets, they argue, and because the only purpose

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<sup>10</sup> Reuters recently ran a lengthy special report on the transaction. Mike Spector & Dan Levine, *Special Report: Inside J&J's secret plan to cap litigation payouts to cancer victims*, REUTERS, Feb. 4, 2022.

<sup>11</sup> Samir D. Parikh, *Mass Exploitation*, 170 U. PA. L. REV. ONLINE 53, 71 (2022).

<sup>12</sup> Arnold & Itkin Reply in Support of Motion to Dismiss Bankruptcy Case, In re LTL Management LLC, Case No. 21-30589 (MBK)(Bankr. D.N.J. Feb. 2, 2022), at 22.

<sup>13</sup> See In re Bestwall LLC, 606 B.R. 243 (Bankr. W.D.N.C. 2019), *aff'd*, No. 3:20-CV-105-RJC, 2022 WL 68763 (W.D.N.C. Jan. 6, 2022); In re DBMP LLC, No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021); In re Aldrich Pump LLC, No. 20-30608 (JCW), 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021).

<sup>14</sup> Official Comm. of Unsecured Creditors v. Nucor Corp. (In re SGL Carbon Corp.), 200 F.3d 154 (3d Cir. 1999).

<sup>15</sup> NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.), 384 F.3d 108 (3d Cir. 2004).

for creating LTL was to cap and contain Johnson & Johnson’s talc liabilities, the case does not belong in bankruptcy.

One limitation of dismissal is that it would not undo the effects of the divisive merger. The assets would still be separate from the original entity.<sup>16</sup> Dismissal would prevent bankruptcy from being used to reduce the liabilities, however, and the victims could invoke any rights they had against the original entity or other related entities, including fraudulent conveyance actions under state law.

### **Existing Remedies: Fraudulent Conveyance**

Assuming a divisive merger bankruptcy is not dismissed, the victims can challenge the transaction as a fraudulent conveyance. Fraudulent conveyance law can be used to reverse prebankruptcy transactions that are intended to defraud creditors (“actual fraudulent conveyances”)<sup>17</sup> or for which an insolvent debtor did not receive “reasonably equivalent value” (“constructive fraudulent conveyances”).<sup>18</sup> The Bankruptcy Code includes a federal fraudulent conveyance provision (§ 548) and nearly every state has very similar state law fraudulent conveyance provisions.<sup>19</sup>

With an abusive divisive merger, victims can argue the transaction was deliberately intended to harm creditors’ interests, or that the entity to which the liabilities were assigned did not receive reasonably equivalent consideration for assuming the liabilities.

The divisive merger statute creates an important complication for both actual and constructive fraudulent conveyance challenges. Because the statute explicitly states that no “transfer” takes place, it is possible that fraudulent conveyance law simply does not apply. Fraudulent conveyance law applies when there has been a transfer (or the incurring of a debt, as discussed below). Courts have already begun wrestling with the question whether this feature of the divisive merger statute precludes fraudulent conveyance challenges. Several have suggested that it does not.<sup>20</sup> The statute explicitly states that it does not alter any existing creditors’ rights. Since fraudulent conveyance law is an important creditor protection, this may open the door to a fraudulent conveyance challenge. In addition, courts may apply a federal bankruptcy definition

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<sup>16</sup> The victims could challenge the divisive merger under state fraudulent conveyance law, which would raise the same issues as discussed below.

<sup>17</sup> The Bankruptcy Code’s prohibition of actual fraud is 11 U.S.C. § 548(a)(1)(A). The debtor or trustee can also use any state law fraudulent provision that would apply outside of bankruptcy, because section 544(b) gives it access to nonbankruptcy avoidance provisions.

<sup>18</sup> 11 U.S.C. § 548(a)(1)(B).

<sup>19</sup> The debtor or trustee can invoke state fraudulent conveyance law in bankruptcy, as an alternative to the federal provision. See 11 U.S.C. § 544(b). The principal benefit of the state law provisions is that they often have a longer statute of limitations.

<sup>20</sup> In the *Bestwall* case, Judge Laura Beyer stated that “if a debtor used the Texas statute to commit a fraudulent transfer – creating the harm that the Committee complains of – such law would be available to address such acts.” *Bestwall*, 606 B.R. at 252. In the *DBMP* case, Judge Craig Whitley noted that, while the Bankruptcy Code does not preempt Texas law on divisional mergers, the Texas Two Step “appears” prejudicial to the rights of the claimants and “is subject to legal challenge.” *DBMP v. Those Parties Listed on Appendix A to Complaint and John and Jane Does 1–1000*, Adv. No. 20-03004 (Bankr. W.D.N.C. Jan. 23, 2020).

of transfer, rather than the language in the Texas statute, at least with respect to fraudulent conveyance challenges under the federal Bankruptcy Code. Finally, fraudulent conveyance law applies not only to “transfers” but also to the incurring of a debt. It is possible that courts would construe the assignment of liabilities to a new entity, as with LTL, as the incurring of debts.

Constructive fraudulent conveyance challenges face an additional obstacle. The debtor must be insolvent or nearly so at the time of the transaction. Because the funding agreement in the Johnson & Johnson transaction provides for payment of expenses and of talc judgments by the original entity and by Johnson & Johnson, the debtor (LTL) arguably is fully solvent.

Because LTL may be solvent, representatives of the talc victims have alleged actual fraud rather than constructive fraud. They argue that the divisive merger was designed to undermine their ability to pursue their claims. In cases where the funding agreement is more limited, the debtor may be insolvent, enabling victims to argue both for actual and for constructive fraud.

A final practical issue for victims and other creditors the questions of who is entitled to pursue the fraudulent conveyance action. Under the bankruptcy laws, the debtor or trustee is the one with explicit authority to challenge problematic transactions.<sup>21</sup> With a challenge to a divisive merger, the debtor itself obviously has little incentive to pursue a fraudulent conveyance action, especially if it is controlled by the original entity or the entity’s parent corporation. A creditors committee can ask to be permitted to bring the action under these circumstances.<sup>22</sup>

Overall, fraudulent conveyance law appears to offer a robust basis for challenging abusive transactions, but it does face potential obstacles.

### **Will Venue Shopping Impede Use of the Remedies?**

It is well-known that companies that file for bankruptcy can file their case nearly anywhere they wish to, and that a disproportionate percentage of the largest cases go to New York, Delaware, Richmond and Houston. I and others have written extensively about this phenomenon elsewhere.

Some worry that desire to attract large cases will cause courts to look the other way when abusive cases are filed in their district. Professor Lynn LoPucki, the most prominent critic of forum shopping, argues that bankruptcy courts are unable “to push back against anything the case placers [the debtor, its lawyers or others who decide where to file the case] demand. Pushback has no effect because the cases can so easily go elsewhere.”<sup>23</sup>

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<sup>21</sup> For example, § 548 authorizes the “trustee” (which is defined in § 1107 to include the debtor in possession) to challenge a fraudulent conveyance.

<sup>22</sup> In the DBMP case, for instance, Judge Whitley noted that creditors seeking to challenge the divisive merger as fraudulent need to obtain derivative standing to bring such claims.

<sup>23</sup> Lynn M. LoPucki, *Chapter 11’s Descent into Lawlessness*, AM. BANKR. L.J. (forthcoming, 2022), manuscript at 58.

This conclusion strikes me as overly pessimistic, including with divisive mergers. Over the past few years, the Western District of North Carolina became an attractive filing location for divisive mergers, apparently because the standard for determining whether a bankruptcy case was filed in bad faith is more difficult for victims or other creditors to meet in the Fourth Circuit—the federal court of appeals that governs North Carolina—than in other circuits.<sup>24</sup> The pattern of filing Texas Two-Step bankruptcies in the Western District of North Carolina dates back to Bestwall, which filed for bankruptcy there in 2017.

With the controversy surrounding Johnson & Johnson, this seems to have quickly changed. The bankruptcy court transferred the case to New Jersey, since any connection to North Carolina was quite limited. This ruling seems likely to have diminished the attractiveness of filing Texas Two-Step bankruptcies in the Western District of North Carolina.<sup>25</sup>

### **Proposed Legislation**

H.R. 4777, which was recently proposed by Congressman Nadler, Congresswoman Maloney, and Congressman Cicilline to prohibit third-party releases includes a provision aimed at divisive mergers. This provision would amend bankruptcy law to require dismissal of any divisive merger that “had the intent of foreseeable effect of ... separating material assets from material liabilities ... and ... assigning all or a substantial portion of those liabilities to the debtor.” This language would essentially bar access to bankruptcy for a divisive merger such as the Johnson & Johnson transaction.

In my view, such a sweeping crackdown is not currently needed. Divisive mergers do not strike me as invariably pernicious—it is noteworthy in this regard that the Texas statute was not enacted with bankruptcy in mind. And the existing bankruptcy remedies seem likely to be sufficient to police problematic transactions. In my view, a wait-and-watch approach is preferable to a sweeping ban.

That said, if bankruptcy courts fail to adequately police abusive transactions, legislative reform might be warranted. A more tailored approach would be preferable to the approach of H.R. 4777—an approach that would focus more narrowly on clearly abusive transactions rather than barring every divisive merger from bankruptcy.

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<sup>24</sup> Under the Fourth Circuit standard, a party seeking to have the case dismissed needs to show that the reorganization would be objectively futile and the case was filed subjective bad faith. *Carolin Corp. v. Miller*, 886 F.2d 693, 700-01 (4th Cir. 1989)

<sup>25</sup> Delaware and other popular Chapter 11 venues do not appear to have handled divisive merger bankruptcies. The only divisive merger case I am aware of in Delaware is *In re Imerys Talc America, Inc.*, 2021 WL 4317388 (Bankr. D. Del. 2021), which found that the debtors, who claimed indemnification from Johnson & Johnson, did not have standing to seek to enjoin a divisive merger by Johnson & Johnson.



## Conclusion

Divisive or divisional mergers are one of a growing number of practices that are contributing to a growing perception that Chapter 11, our corporate reorganization framework, has become seriously dysfunctional. Many worry that it is controlled by insiders, and that outsiders fare poorly under current practices. This perception has prompted a populist backlash, as reflected in hearings like this one.<sup>26</sup>

I believe the concerns are indeed serious. In several recent cases, courts have pushed back against perceived abuses. Third party releases have been a particular focus, with federal district courts rejecting proposed releases in the Purdue Pharma and Ascena cases. As noted earlier, the Johnson & Johnson case was transferred to New Jersey, and the court appears to be giving serious consideration to a motion to dismiss the case.

If this pushback continues, it will obviate the need for legislative intervention, which often has unintended consequences. But if Texas Two-Step transactions escape meaningful oversight, the opposite conclusion may be warranted.

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<sup>26</sup> See, e.g., Skeel, *supra* note 1.