

Structuring Divisive Mergers Under the Delaware and Texas Statutes

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Welcome

Outline

- I. Texas Divisive Merger Statute
- II. Delaware Division Statutes
- III. Effect of Transaction
- IV. Sample Plan of Merger
- V. Federal Income Tax Treatment of Divisive Mergers
- VI. Divisive Mergers and Creditors

I. Texas Divisive Merger Statute

- Overview:
 - Divisive mergers have been permitted under Texas law since 1989.
 - Applies to corporations, partnerships and LLCs and can involve entities organized under the laws of another state so long as such state permits divisive mergers.
 - TBOC § 1.002(55): Defines “merger” to include “(A) the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations.”

I. Texas Divisive Merger Statute

- Overview (cont.):
 - A divisive merger is effected by (i) adoption of a plan of merger that provides (a) the manner and basis for allocating and vesting the property of the parties and (b) the manner and basis of allocating each liability and obligation of the parties or making adequate provision for the payment and discharge thereof and (ii) the filing with the Texas Secretary of State of a certificate of merger and a certificate of formation for each newly formed entity.
 - Under Texas statutes any kind of Texas entity can be divided into any kind of entity.

I. Texas Divisive Merger Statute

- Plan of Merger (TBOC § 10.002):
 - Name of each party to merger.
 - Name of each surviving entity.
 - Name of each entity created by the merger.
 - Organization form and jurisdiction of each created entity.
 - Manner and basis (including use of a formula) of converting or exchanging ownership or membership interests of each party to merger into ownership of surviving entities or other property.
 - Any ownership interests that will be cancelled or remaining outstanding and not converted.
 - Certificate of formation for each new entity.
 - Governing documents for each new entity.

I. Texas Divisive Merger Statute

- Approval – same as approval of any merger:
 - If a corporation, approved by the board of directors (TBOC § 21.452) and 2/3ds of shareholders entitled to vote (TBOC § § 1.002(32) & 21.457) including class voting in some circumstances (TBOC § 21.458).
 - If an LLC, as provided in the company agreement (TBOC § § 101.052 & 101.054), or if the agreement is silent, approved by a majority of all of the company's members (TBOC § § 1.002(37) and 101.356(c)).
 - If a partnership, the partnership agreement must contain provisions that authorize the merger and must be approved in the manner prescribed by the agreement (TBOC § § 10.009(f) & (g)).
 - Approval required from any owner that will become liable under the merger for liability of any other person (TBOC § 10.001(e)).

I. Texas Divisive Merger Statute

- Certificate of Merger:
 - Name, organization form and jurisdiction of each party to the merger.
 - Name and organization form and jurisdiction of each entity created by the merger.
 - Attach certificate of amendment for any party to the merger with a certificate being amended.
 - If no amendments, a statement of no amendments.
 - Attach certificate of formation for any entities being created by the merger.
 - Plan of merger on file at the principal place or business of each surviving entity and include addresses.
 - Plan of merger will be provided without cost to each any owner of an entity party to or created by the merger and any creditor or obligee of a party to the merger.
 - Statement that plan of merger approved as required by law and governing documents of each party to merger.
- Certificate of merger signed on behalf of each party to merger.

I. Texas Divisive Merger Statute

- Dissent and Appraisal Rights:
 - Shareholders of Texas corporations are entitled to assert dissenters rights when objecting to a merger (including a divisive merger) and seeking to be paid the value of their shares as determined in a judicial appraisal.
 - LLCs and partnerships do not have statutory rights of dissent and appraisal unless the entity's governing documents expressly grant these rights.

II. Delaware Division Statutes

- Overview:
 - Recently enacted statutes apply to limited liability companies (LLCs) and limited partnerships (LPs), but not corporations.
 - A division is effected by (i) the adoption of a plan of division setting forth the terms and conditions of the division, including, among others, the allocation of assets, property, rights, series, debts, liabilities and duties of the dividing LLC or LP among the resulting LLCs or LPs and, if it survives, the dividing LLC or LP and (ii) the filing with the Delaware Secretary of State of a certificate of division and a certificate of formation for each newly formed LLC or LP.
 - Under Delaware statutes an LLC can only be divided into LLCs and an LP can only be divided into LPs.

II. Delaware Division Statutes

- Title 6, § 18-217 (effective August 1, 2018) enables a Delaware LLC to divide into two or more LLCs, with the dividing LLC either continuing its existence or terminating as part of the division.
- Vocabulary:
 - “Dividing company” – the LLC effecting a division.
 - “Resulting company” – a domestic LLC formed as a consequence of a division.
 - “Surviving company” – a dividing company that survives.
 - “Division company” – a surviving company, if any, and each resulting company.

II. Delaware Division Statutes

- Title 6, § 17-220 (effective August 1, 2019) enables a Delaware limited partnership (LP) to divide into two or more LPs, with the dividing LP either continuing its existence or terminating as part of the division.
- Vocabulary:
 - “Dividing partnership” – the LP effecting a division.
 - “Resulting partnership” – a domestic LP formed as a consequence of a division.
 - “Surviving partnership” – a dividing partnership that survives.
 - “Division partnership” – a surviving partnership, if any, and each resulting partnership.

II. Delaware Division Statutes

- Plan of Division:
 - How are interests treated: exchanged/converted into cash, property, rights or securities of, or interests, in, the surviving company or any resulting company; may remain outstanding.
 - Is dividing company surviving?
 - Name of resulting companies.
 - Allocation of assets, property, rights, debts, liabilities.
 - Name and business address of contact person that has a copy of the plan of division.
- Similarities to considerations in a merger:
 - For example, may amend LLC agreement of surviving company.

II. Delaware Division Statutes

- Approval (§ 18-217(c) and § 17-220(c)):
 - Division approved as provided in the LLC agreement or partnership agreement.
 - If not specifically addressed and not prohibited, approved in same manner as for merger or consolidation as set forth in LLC agreement or partnership agreement.
 - If LLC agreement is silent, division must be approved by members who own more than 50% of the then current percentage or other interest in the profits of the dividing company.
 - If LP agreement is silent, division must be approved by all general partners of the dividing partnership and limited partners who own more than 50% of then current percentage or other interest in the profits owned by all limited partners of the dividing partnership.

II. Delaware Division Statutes

- Certificate of Division:
 - Name of the dividing company or partnership and whether it survives.
 - The date of filing of the dividing company's or partnership's original certificate of formation.
 - The name of each division company or division partnership.
 - The name and business address of the contact person.
 - Future effective date (if not effective upon filing).
 - Division has been approved in accordance with applicable statutes.
 - The plan of division is on file and state address.
 - A copy of the plan of division will be provided to any member of the dividing company or partner of the dividing partnership.
 - Certificate of formation for each resulting company or partnership.
-

III. Effect of Transaction

- Texas:
 - TBOC § 10.008(a) provides that, if properly allocated in the plan, all assets and liabilities of the parties to the merger will be allocated (subject to existing contracts, liens and encumbrances) among the surviving entities in the manner provided in the plan, and not to any other party.
 - If the plan fails to provide for the allocation or vesting of any particular item of property or any liability or obligation of any party to the merger, TBOC 10.008(b) provides that “the unallocated property is owned in undivided interest by, or the liability or obligation is the joint and several liability and obligation of, each of the surviving and new organizations, pro rata to the total number of surviving and new organizations resulting from the merger.”

III. Effect of Transaction

- Delaware:
 - § 18-217(l)(2) and § 17-220(l)(2) provide that for all purposes of the laws of the State of Delaware, all of the rights, privileges and powers, and all the property, real, personal and mixed, of the dividing company or partnership and all debts due on whatever account to it, as well as all other things and other causes of action belonging to it, shall without further action be allocated to and vested in the applicable division company or partnership in such a manner and basis and with such effect as is specified in the plan of division, and the title to any real property or interest therein allocated to and vested in any division company or partnership shall not revert or be in any way impaired by reason of the division.
 - If debts and liabilities are not allocated by the plan, they shall be the joint and several debts and liabilities of all of the division companies or division partnerships.

III. Effect of Transaction

- Both Texas and Delaware law expressly provide that the interest in the property of the dividing entity shall not be deemed, as a result of the division, to have been assigned or transferred.
- TBOC § 10.008(a): “When a merger takes effect ... all ... property ... is allocated to and vested, subject to any existing liens or other encumbrances on the property, ... as provided in the plan of merger without ... any transfer or assignment having occurred.”
- Delaware § 18-217(l)(8) and § 17-220(l)(8): “The ... interests in property ... as well as the debts, liabilities and duties ... shall not be deemed, as a result of the division, to have been assigned or transferred ... for any purpose of the laws of the State of Delaware.”

IV. Sample Plan of Merger

FORM¹ OF PLAN OF MERGER

DIVISIONAL MERGER OF OLDCO, LLC INTO TWO TEXAS ENTITIES

This Plan of Merger is entered into as of the ____ day of _____, 20__ by Oldco, LLC, a Texas limited liability company (the “Merging Entity”).

WITNESSETH:

WHEREAS, The Merging Entity is a limited liability company duly organized and existing under the laws of the State of Texas; and

WHEREAS, the Manager and Members of the Merging Entity deem it advisable and in the best interests of such entity that the Merging Entity be divisionally merged to become two separate entities (the “Merger”), as authorized by the statutes of the State of Texas, under and pursuant to the terms and conditions hereinafter set forth; and

WHEREAS, as a result of the Merger, the surviving entities will be the Merging Entity and Newco, LP, a newly formed Texas limited partnership (collectively, the “Post Merger Entity”); and

¹ This form agreement is not a form to be completed by filling in the blanks. Drafters should be certain that any agreement used by them is appropriate for the particular transaction. The presence or the absence of a particular provision in this form should not be taken as an indication that the provision is or is not “market standard.”

IV. Sample Plan of Merger (cont'd)

WHEREAS, as a result of the merger, the name of the surviving entity will be changed to New Name, LLC;

NOW, THEREFORE, in consideration of the premises and the mutual covenants and agreements herein contained, and for the purpose of setting forth the terms and conditions of the Merger, the mode of carrying the same into effect, the manner and basis of converting the membership interests of the Merging Entity into ownership interests of the Post Merger Entities and such other details and provisions as are deemed necessary or desirable, the parties hereto have agreed and do hereby agree, subject to the conditions hereinafter set forth, as follows:

1. The name, organizational form, and jurisdiction of formation of each entity that is a party to the Merger is:

(a) Oldco, LLC, a Texas limited liability company.

2. The name of the entity that will survive the merger is:

(a) Oldco, LLC, a Texas limited liability company.

IV. Sample Plan of Merger (cont'd)

3. The name, organizational form, and jurisdiction of formation of the new organization that is to be created by this Plan of Merger are:

(a) Newco, LP, a Texas limited partnership.

4. The terms and conditions of the Merger are (in addition to those set forth elsewhere in this Plan of Merger) as follows:

At the Effective Time of the Merger (as hereinafter defined):

(a) The Merging Entity shall be divided into two separate entities, which shall be the Merging Entity and Newco, LP.

(b) The separate existence of the Merging Entity shall continue after the Merger.

(c) The property of the Merging Entity shall be allocated and vested among the Post Merger Entities as outlined in Exhibit A attached hereto.

(d) All property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the Post Merger Entity to which it is assigned under Exhibit A, and the title to any real estate vested by deed or otherwise in the Merging Entity shall not revert or be in any way impaired by reason of the Merger; but all rights of creditors and all liens upon any property of the Merging Entity shall be preserved unimpaired, and all debts, liabilities and duties of the Merging Entity shall thenceforth attach to the Post Merger Entity to which it is assigned under Exhibit A, and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it.

IV. Sample Plan of Merger (cont'd)

(e) All acts, plans, policies, contracts, approvals and authorizations of the Merging Entity and its members, managers, officers, or committees elected or appointed by the members, managers, officers and agents, which were valid and effective immediately prior to the Effective Time of the Merger shall be taken for all purposes as the acts, plans, policies, contracts, approvals and authorizations of the Post Merger Entities and shall be as effective and binding thereon as the same were with respect to the Merging Entity.

(f) The manner and basis of allocating each liability and obligation of the Merging Entity to the Post Merger Entities is set forth on Exhibit B attached hereto.

(g) The assets, liabilities, reserves and accounts of the Merging Entity shall be recorded on the books of the Post Merger Entities as described in Exhibit B subject to such adjustments or eliminations of intercompany items as may be appropriate in giving effect to the Merger.

(h) The Post Merger Entities shall be responsible for all fees and franchise taxes of the Merging Entity as described in Exhibit B, and the Post Merger Entities shall be obligated to pay such fees and franchise taxes if the same are not timely paid.

5. The Certificate of Formation of the Merging Entity, as amended and existing and constituted immediately prior to the Effective Time of the Merger shall, upon the Merger's becoming effective, be and constitute the Certificate of Formation of the Merging Entity until amended in the manner provided by law, subject to the filing of a Certificate of Merger reflecting the following change:

IV. Sample Plan of Merger (cont'd)

(a) Article I shall read in its entirety as follows: The name of the limited liability company is New Name, LLC.

6. The Certificate of Formation for Newco, LP to be filed with the Secretary of State at the time of filing of the Certificate of Merger is attached hereto as Exhibit C.

7. The Company Agreement of the Merging Entity, as amended and existing and constituted immediately prior to the Effective Time of the Merger shall, upon the Merger's becoming effective, be and constitute the Company Agreement of the Merging Entity until amended in the manner provided by law, subject to the following changes:

(a) All references in the Company Agreement to "Oldco, LLC" shall be changed to "New Name, LLC"; and

(b) Exhibit A to the Company Agreement showing the names and Percentage Interests of the Members shall be amended to reflect the change in Members and Percentage Interests set forth in Exhibit E hereto.

8. The Agreement of Limited Partnership for Newco, LP, which will take effect upon the filing of the Certificate of Merger, is attached hereto as Exhibit D.

9. The manner and basis of converting the membership interests of the Merging Entity into ownership interests of the Post Merger Entities and the mode of carrying the Merger into effect are outlined in Exhibit E.

IV. Sample Plan of Merger (cont'd)

10. This Plan of Merger shall be submitted to the members of the Merging Entity as provided by Chapter 10 and § 101.356 of the Texas Business Organizations Code (“TBOC”) and as required by the Company Agreement of the Merging Entity. After the approval or adoption thereof by the members of the Merging Entity in accordance with the requirements of the laws of the State of Texas and the Company Agreement of the Merging Entity, all required documents shall be executed, filed and recorded and all required acts shall be done in order to accomplish the Merger under the provisions of the applicable statutes of the State of Texas.

11. The Merging Entity shall bear and pay all costs and expenses incurred by it or on its behalf (including without limitation fees and expenses of financial consultants, accountants and counsel) in connection with the consummation of the Merger.

12. At any time, whether before or after submission to or adoption by the members of the Merging Entity, this Plan of Merger may be amended in matters of form, or supplemented by additional agreements, articles or certificates, as may be determined in the judgment of the members of the Merging Entity to be necessary, desirable or expedient to clarify the intentions of the parties hereto or to effect or facilitate the filing, recording or official approval of this Plan of Merger and the consummation hereof and the Merger provided for herein, in accordance with the purpose and intent of this Plan of Merger.

13. The Merger shall become effective (such time of effectiveness being herein referred to as the “Effective Time of the Merger”) when all the following actions shall have been taken:

(a) this Plan of Merger shall have been adopted and approved on behalf of the Merging Entity in accordance with the TBOC and the Company Agreement of the Merging Entity; and

IV. Sample Plan of Merger (cont'd)

(b) a Certificate of Merger, setting forth the information required by, and executed and verified in accordance with, the TBOC, shall have been filed in the office of the Secretary of State of the State of Texas.

14. This Plan of Merger cannot be altered or amended except pursuant to an instrument in writing signed on behalf of the parties hereto.

IN WITNESS WHEREOF, the Merging Entity has caused this Plan of Merger to be executed by its Manager pursuant to authorization contained in the Consent of Members approving this Plan of Merger, all as of the date first above written.

OLDCO, LLC a Texas limited
liability company

By: _____
Name: _____
Its: Manager

V. Structuring Divisive Mergers Under the Delaware and Texas Statutes

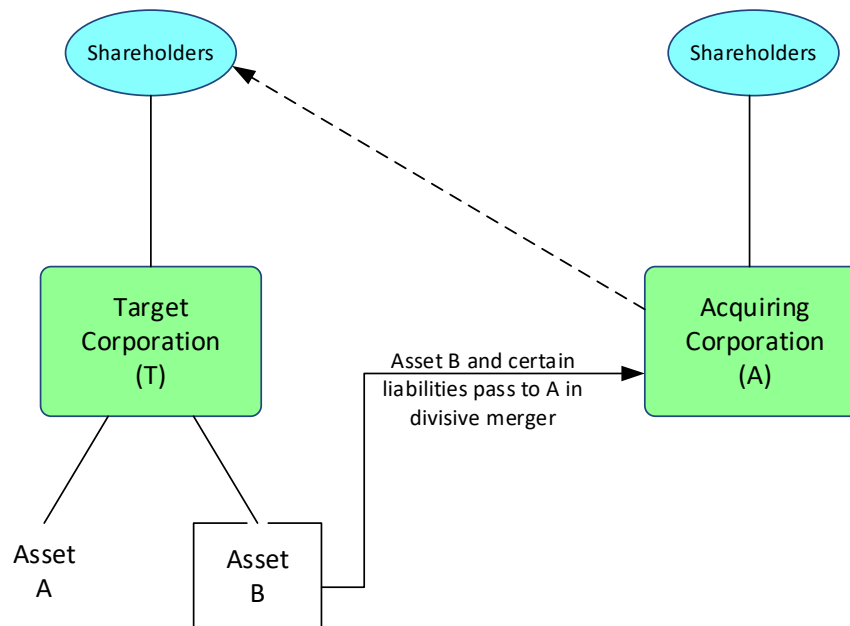
Federal Income Tax Consequences of a Divisive Merger: One Size Does Not Fit All

**Strafford
August 24, 2022**

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USE OF DIVISIVE MERGERS WITH C CORPORATIONS

REV. RUL. 2000-5 (SITUATION 1)



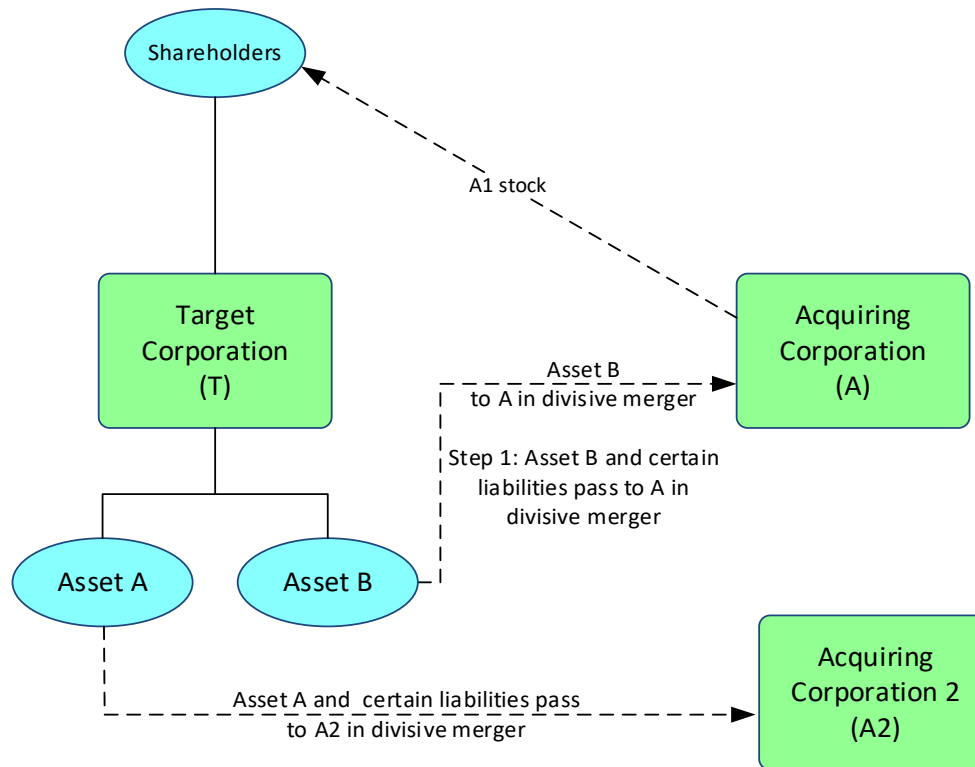
Rev. Rul. 2000-5 - Conclusion: The transactions described in Situations (1) and (2) do not qualify as reorganizations under section 368(a)(1)(A). However, the transactions described in Situations (1) and (2) possibly may qualify for tax-free treatment under other provisions of the Code.

Cf. Treas. Reg. § 1.368-2, Example 1 (same facts as above), concluding:

(ii) Analysis. The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of Z, the coming entity of the transferor unit, do not become the assets and liabilities of Y, the combining entity and sole member of the transferee unit. In addition, the transaction does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because the separate legal existence of Z does not cease for all purposes. Accordingly, the transaction does not qualify as a statutory merger or consolidation under section 368(a)(1)(A).

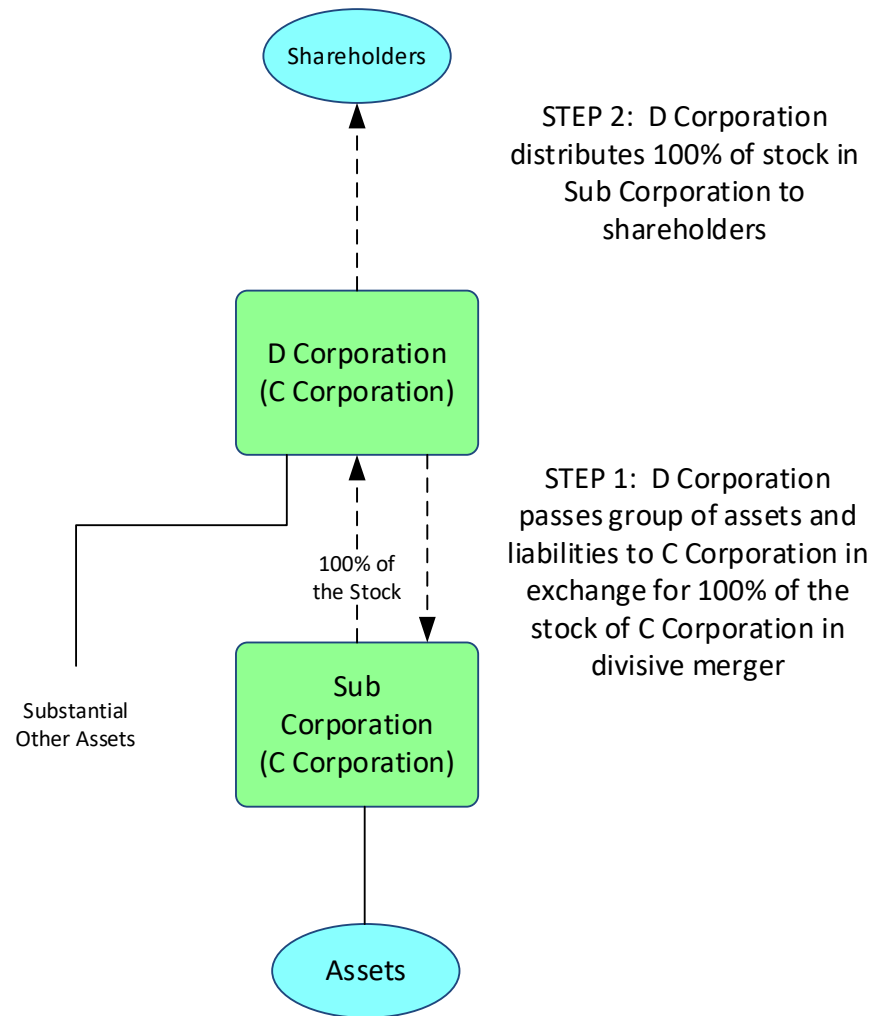
USE OF DIVISIVE MERGERS WITH C CORPORATIONS

REV. RUL. 2000-5 (SITUATION 2)



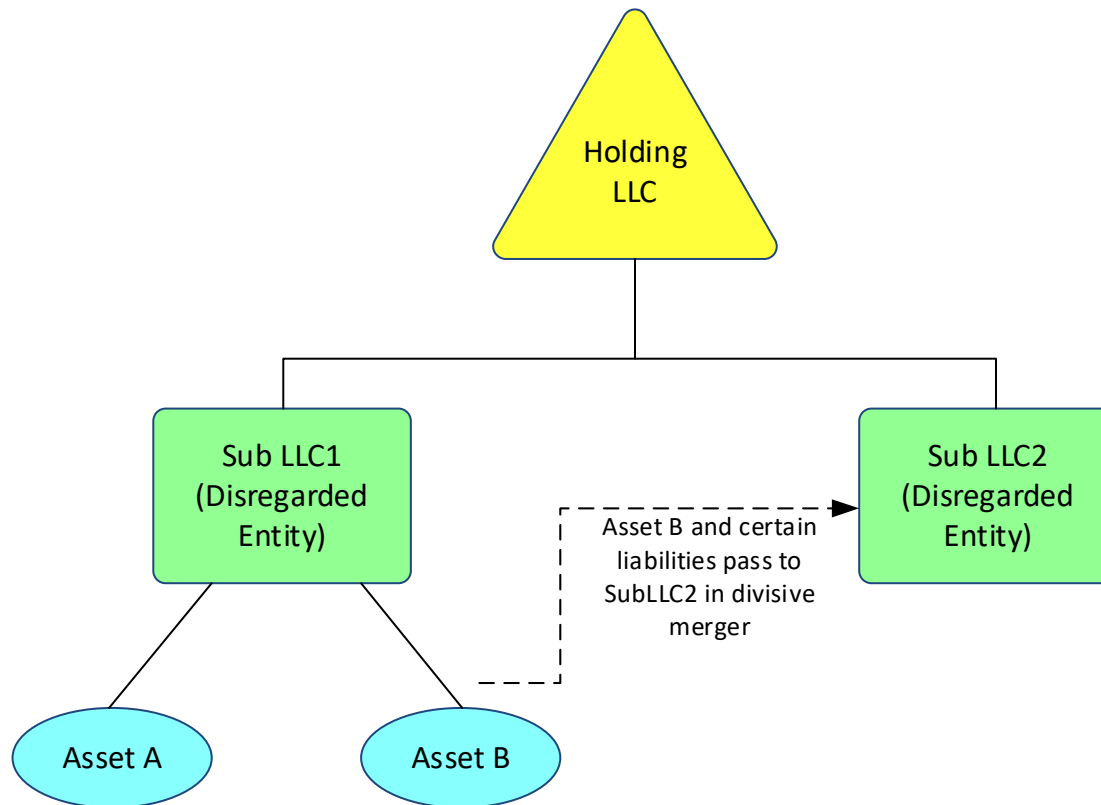
Rev. Rul. 2000-5 – Conclusion: The transactions described in Situations (1) and (2) do not qualify as reorganizations under section 368(a)(1)(A). However, the transactions described in Situations (1) and (2) possibly may qualify for tax-free treatment under other provisions of the Code.

USE OF DIVISIVE MERGERS WITH C CORPORATIONS



Taxable or Nontaxable?

USE OF DIVISIVE MERGERS WITH ENTITIES CLASSIFIED AS DISREGARDED ENTITIES FOR FEDERAL INCOME TAX PURPOSES



Use of Divisive Mergers With Entities Classified As Partnerships For Federal Income Tax Purposes - Partnership Division Regulations

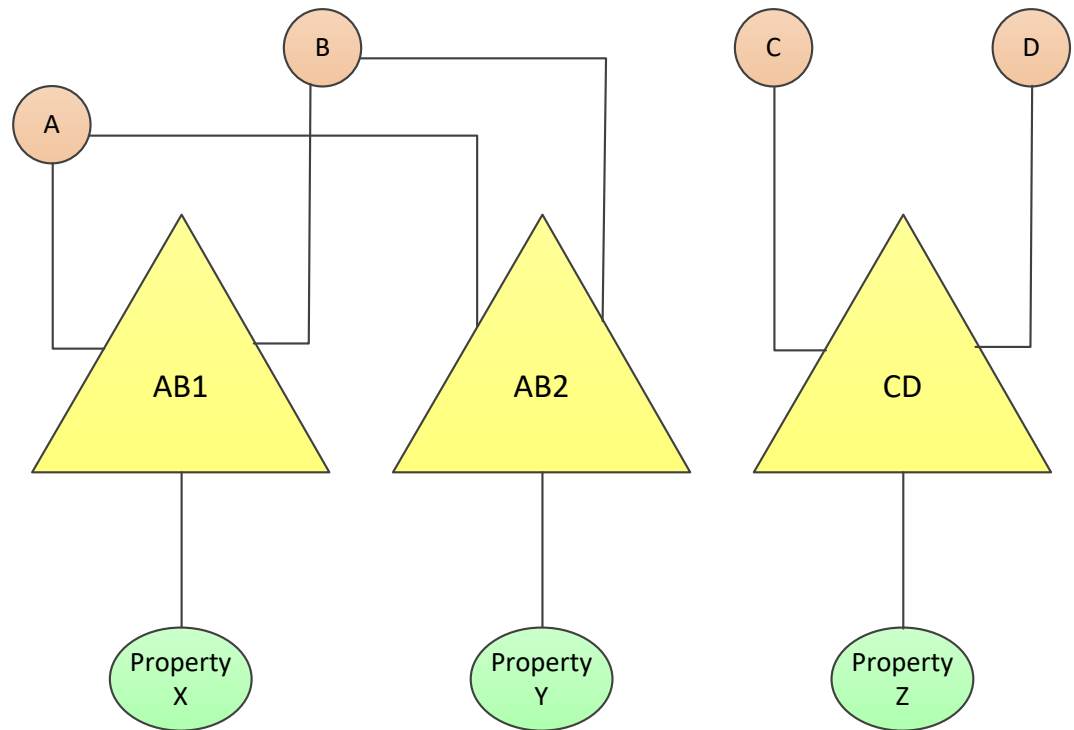
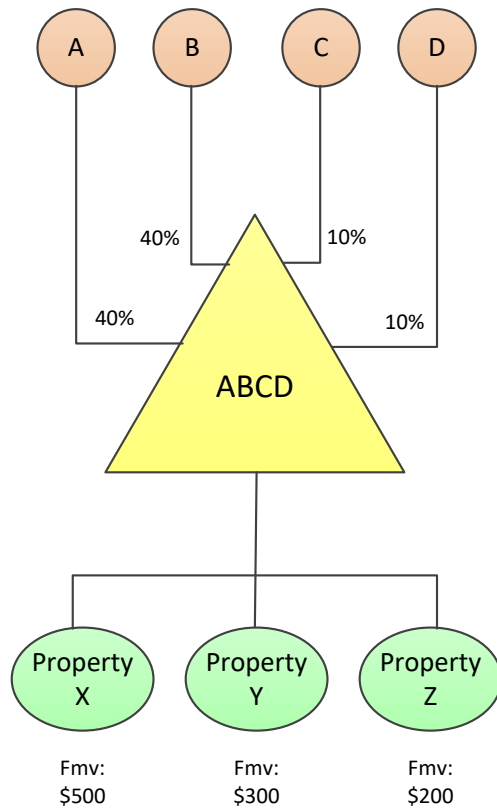
- Identify:
 - Prior Partnership
 - Resulting Partnership
 - Divided Partnership
 - Recipient Partnership

- In the division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50-percent or less in the capital and profits of the prior partnership) are considered a continuation of the prior partnership. Any other resulting partnership is not considered a continuation of the prior partnership but is considered a new partnership.
- If none of the members of the resulting partnership owned an interest of more than 50-percent in the capital and profits of the prior partnership, the prior partnership is terminated.
- Where members of a partnership that has been divided do not become members of a resulting partnership that is considered a continuation of the prior partnership, such partner's interest is considered liquidated as of the date of the division.

General Rules Concerning Form of Partnership Division

- Assets - Over Form
- Asset - Up Form

PARTNERSHIP DIVISION REGULATIONS EXAMPLE (ASSETS-OVER FORM)



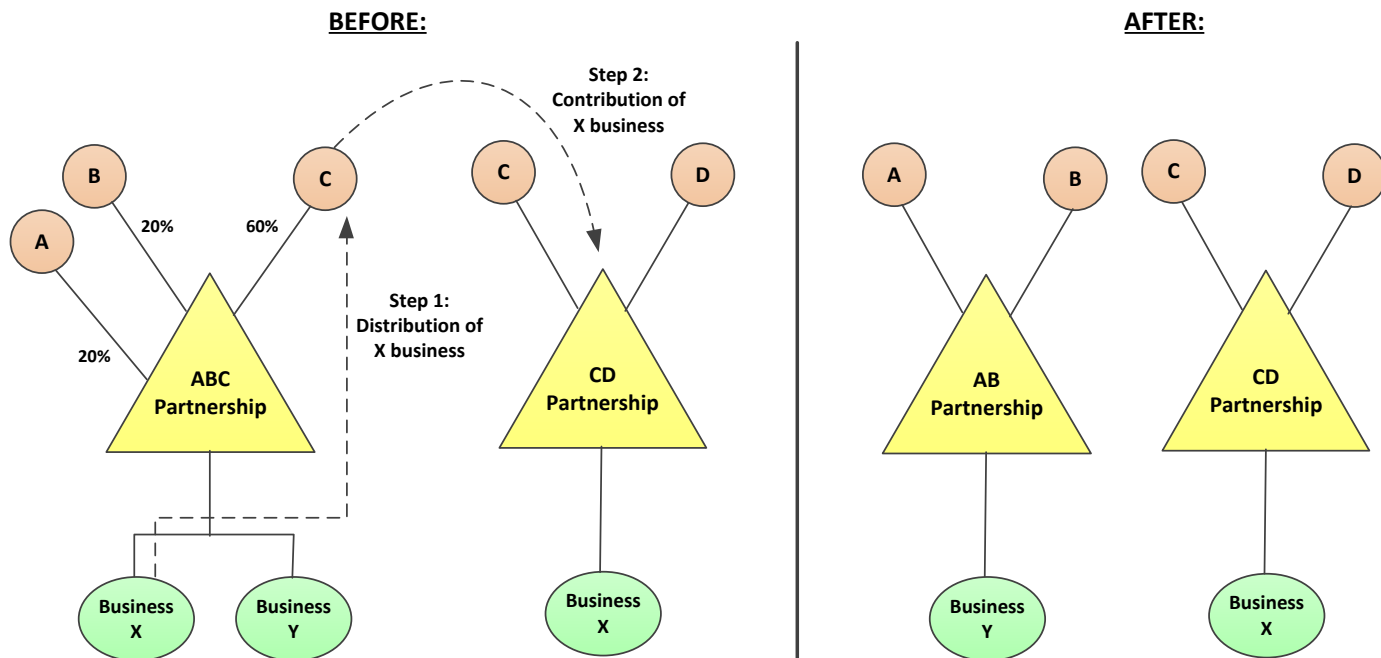
Selected Partnership Transactions Falling Outside Divisive Merger Regulations

Partnership Division Regulations

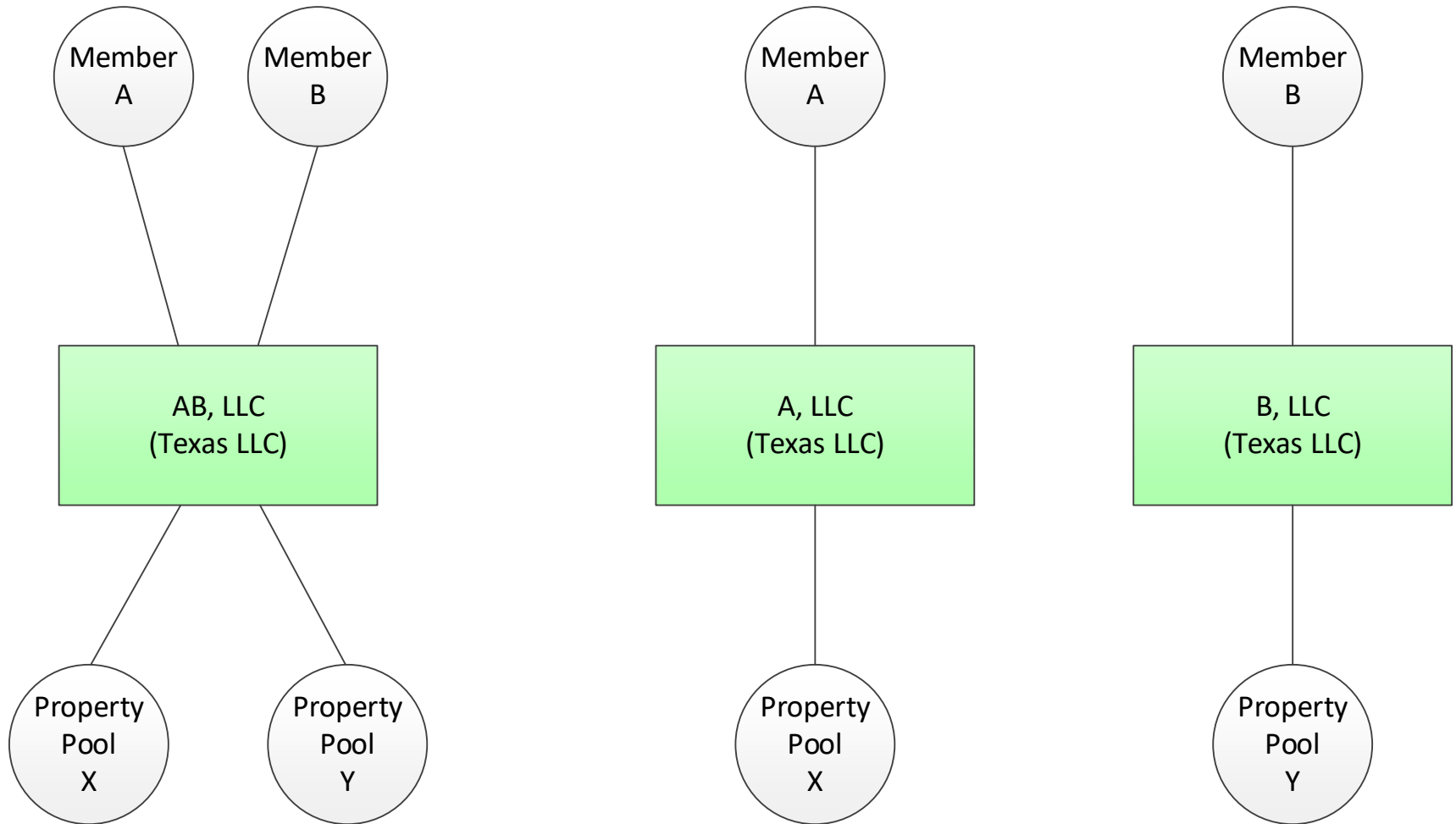
Preamble to Final Regulations:

“To have a division at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction.”

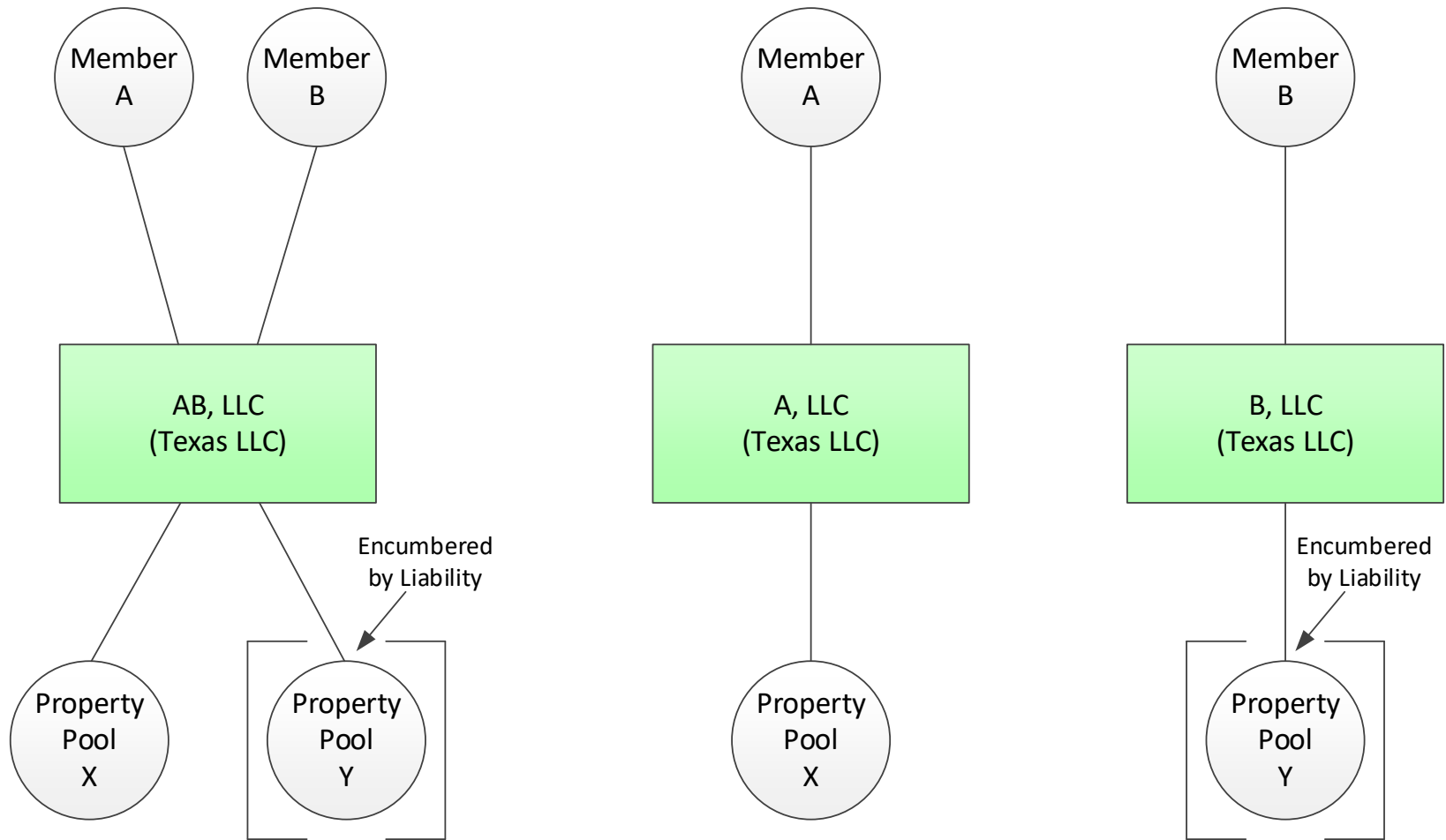
Thus, the following is not a division:



Divisive Merger

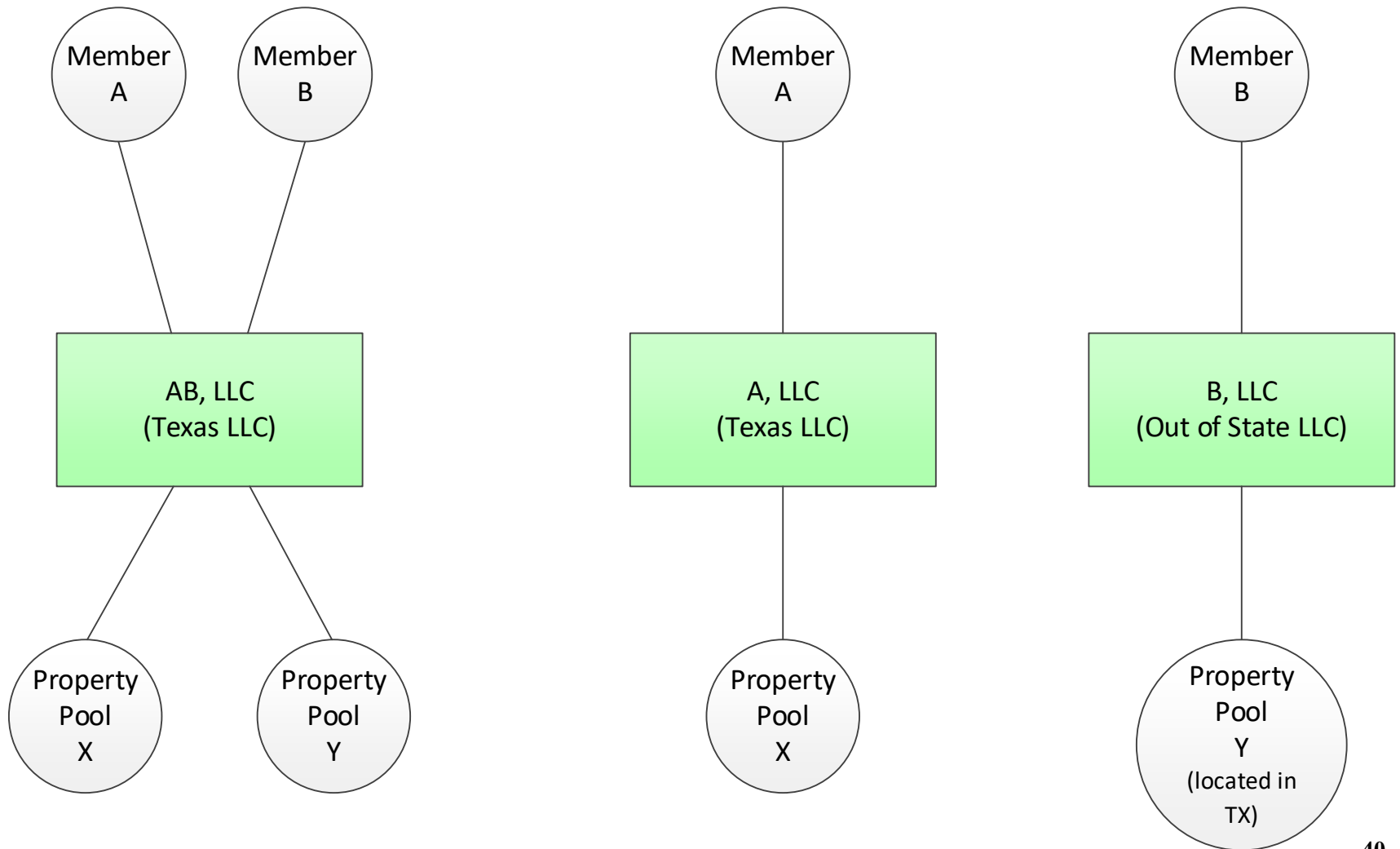


Divisive Merger (with Liabilities)

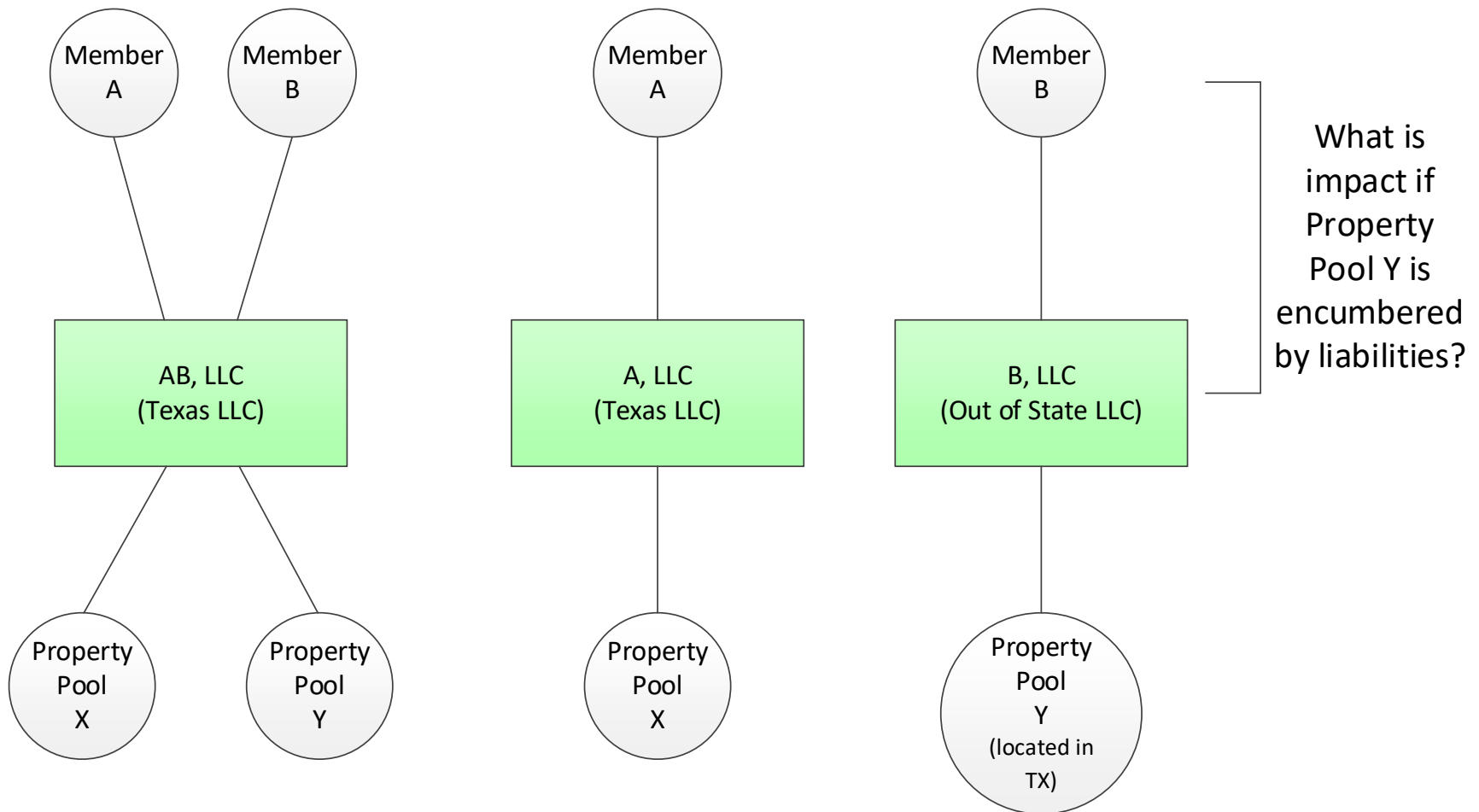


What is impact on A, LLC?

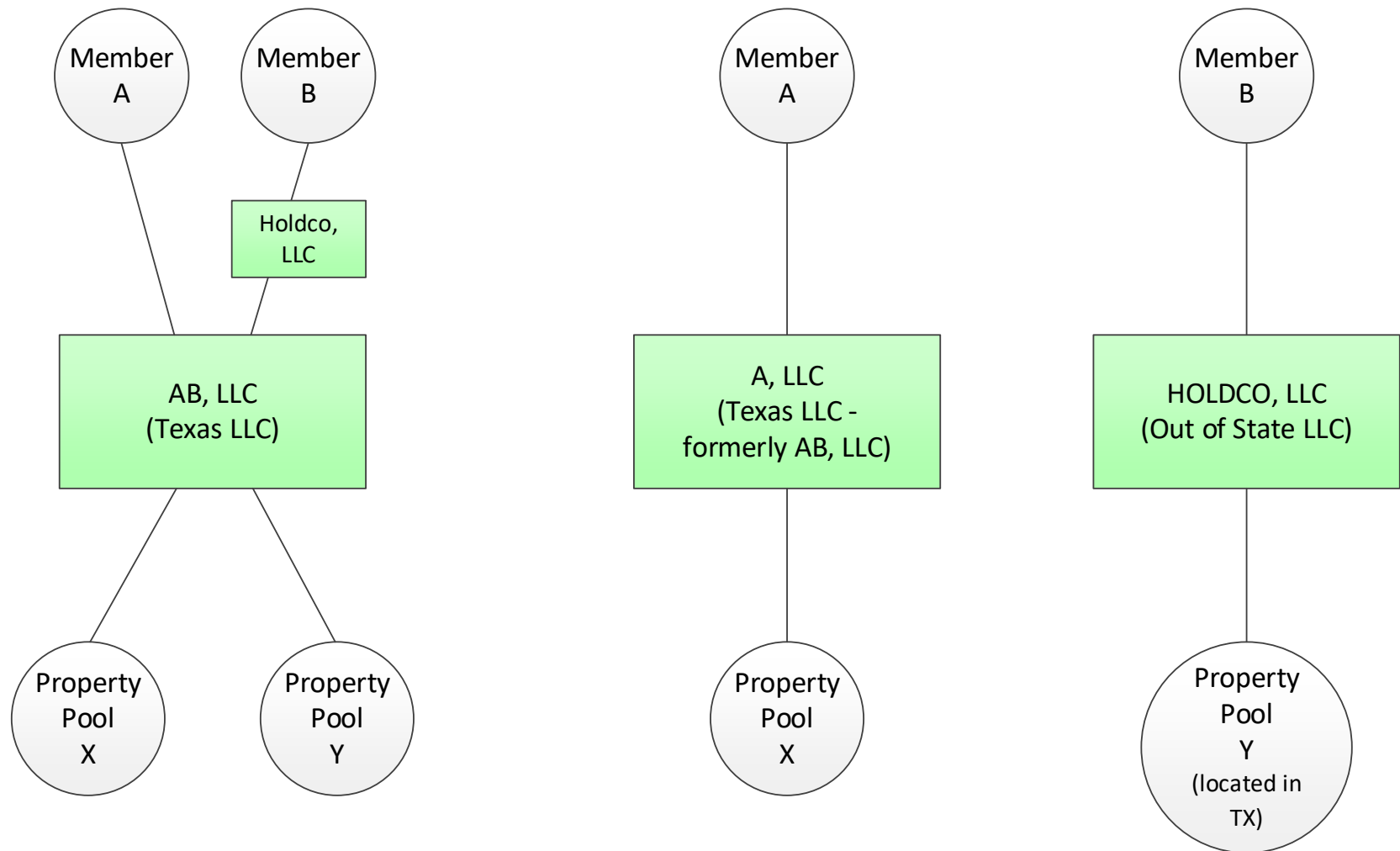
Divisive Merger (Out of State)



Divisive Merger (Out of State with Liabilities)



Divisive Merger Illustration (with Member)



VI. Divisive Mergers and Creditors

- A divisive merger/division may alter and reduce the pool of assets to which a creditor may look for repayment of a debt or assets needed to perform a contract.
- A division could result in moving collateral that secures a loan to a new entity that is not credit-worthy without breaching the terms of the credit agreement.
- Applies to lenders and all other creditors.

VI. Divisive Mergers and Creditors

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- Texas Statutory Protection:
 - Fraudulent transfer protections; creditors will continue to possess all other rights otherwise available under law and contract, including all security interests in the property of the debtor securing the payment of the debtor's claim (TBOC § 10.00(a)(2) & § 10.901).
- Delaware Statutory Protection:
 - The Delaware statutes provide that if an LLC formed prior to 8/1/2018 is party to an agreement entered into before 8/1/2018, or if an LP formed prior to 8/1/2019 is party to an agreement entered into before 8/1/2019 and the agreement restricts a merger or consolidation by the entity, then such restrictions will be deemed to also apply to a division of the entity.
 - A “division contact” must be specified in the plan of division to be available for 6 years following the division to advise creditors as to the division company to which such creditor's claim was allocated.
 - Any action or proceeding pending against a dividing LLC or LP may be continued against the surviving entity as if the division did not occur and against any resulting entity to which the asset, property, right, series, debt, liability or duty associated with the action was allocated pursuant to the plan of division.
 - Each division company or partnership is jointly and severally liable for any liabilities if a court determines that the division would constitute a fraudulent transfer under applicable law (§ 18-217(1)(5) & § 17-220(1)(5)).

VI. Divisive Mergers and Creditors

Plastronics Socket Partners, Ltd. v. Don Weon Hwang, 2022 WL 108948 (Fed. Cir. 2022)

- **Facts:** This case involved a dispute over royalty payments related to a device called an H-Pin used in testing semiconductor chips. The H-Pin was invented by Mr. Hwang. Hwang and Plastronics Sockets entered into a royalty agreement for payment of royalties to Hwang for sales of H-Pins with sockets. In 2012 Plastronics Sockets (Oldco) created Plastronics H-Pin (Newco) with a divisive merger that allocated all rights and obligations under the royalty agreement to Newco. After the merger, Newco began selling H-Pins without sockets to Oldco and Oldco continued to sell H-Pins with sockets to customers. Oldco refused to pay royalties because Newco only sold H-Pins without sockets, not H-Pins with sockets.
- **Findings:** First the Court found that under common law “the assignment of rights through mergers cannot adversely affect the rights of parties contracting with the entities undergoing the mergers.” Then the Court relied on TBOC § 10.901 to find “Plastronics Socket cannot divest itself of the obligation to pay royalties on sockets sold with H-Pins.”

TBOC § 10.901 provides: “This code does not ... abridge any right or rights of any creditor under existing laws.”

VI. Divisive Mergers and Creditors

In re DBMP LLC, 2021 WL 3552350 (Bankr. W. D. North Carolina 2021)

- **Facts:** This case is one of a group of cases involving the “Texas Two Step.” The Court describes the “Texas Two Step” as “a Divisional Merger followed by a bankruptcy by the new company bearing the old company’s asbestos liabilities and in which the debtor seeks 525(g) relief for the entire enterprise.” CertainTeed Corporation was a manufacturer of building products with asbestos liability that converted to a Texas LLC and then used the Texas divisive merger provisions to convert into two Texas LLCs: CertainTeed LLC with all operations, employees and non-asbestos creditors of the old company and DBMP LLC with no operations, few assets and 100% of CertainTeed Corporation’s asbestos liabilities. On the same day following the division, CertainTeed LLC converted to a Delaware LLC and DBMP converted to a North Carolina LLC. The Court notes that the companies “were Texas entities for less than four hours.” The parties also entered into a Funding Agreement where CertainTeed gave DBMP a limited indemnity for asbestos claims and administrative costs. Ninety-one days later, DBMP filed for Chapter 11 bankruptcy protection in North Carolina.

VI. Divisive Mergers and Creditors

In re DBMP LLC, (cont.)

- **Findings:** “[W]hile the TBOC permits a company to engage in a divisional merger, it does not permit that company to thereby prejudice its creditors. The TBOC explicitly states that the merger provisions do not ‘abridge any right or rights of any creditor under existing laws.’” The Court cites legislative history and particularly a 1989 law review article by one of statute’s authors for the proposition that despite the “no transfer” language of the statute, the allocation of assets in the merger should constitute a transfer and conveyance under the fraudulent transfer statutes and the Bankruptcy Code. Even though the Court tells us that a fraudulent transfer claim has not been made (since it needed to be made by DBMP, controlled by CertainTeed), court states “... if a corporation uses a divisional merger to dump its liabilities into a newly created ‘bad’ company which lacks the ability to pay creditors while its ‘good’ twin corporation walks away with the enterprise’s assets, a fraudulent transfer avoidance action lies.” The Court was critical of the Funding Agreement because it was not arm’s length and relied on management of CertainTeed (also managing DBMP) for its enforcement.

VI. Divisive Mergers and Creditors

Other recent “Texas Two Step” cases:

In re Bestwall LLC, 606 B.R. 243, (Bankr. W.D. North Carolina 2019)

In re Alldrich Pump LLC, 2021 WL 3729335 (Bankr. W.D. North Carolina 2021)

In re LTL Management, LLC, Case No. 21-30589(MBK), (Bankr. New Jersey) — the Johnson & Johnson case.

Johnson & Johnson

- Divisive merger (i.e., “corporate restructuring”) on October 12, 2021
- Through a series of transactions Johnson & Johnson Consumer Inc. (“**OldJJCI**”) became (1) Johnson & Johnson Consumer Inc. (“**New JJCI**”) and (2) LTL Management, LLC (“**Debtor**”)
- **Funding Agreement**: J&J and New JJCI to provide funding to Debtor (1) for costs and expenses prior to and during bankruptcy, including cost of administering bankruptcy, and (2) to satisfy the Debtor’s talc-related liabilities via funding a trust, up to the full value of New JJCI.
- “[M]ake certain that the Debtor has the same, if not greater, ability to fund the costs of defending and resolving present and future talc-related claims[.]” Kim Declaration, ¶ 21.

Bankruptcy of LTL Management, LLC

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- Filed October 14, 2021 (Western District of North Carolina)
 - North Carolina limited liability company
 - Principal assets were located in North Carolina
 - Bank account with \$6 million; rights to the Funding Agreement; equity in Royalty A&M LLC, a North Carolina limited liability company (\$367.1 million)

BUT...

- Principal place of business in New Brunswick, New Jersey
- 92% of talc litigation cases pending in New Jersey (MDL)

Venue: North Carolina to New Jersey

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- On October 25, 2021, the Bankruptcy Administrator (i.e., U.S. Trustee) filed a Motion to Transfer Venue to New Jersey [Docket No. 205].
- On November 16, 2021, the Court ruled on the motion, acknowledging why the Debtor preferred North Carolina:

“Rather, the Debtor’s actions indicate a preference to file bankruptcy in this district, likely due to the Fourth Circuit’s two-prong dismissal standard and Judge Hodges’s estimation ruling in the Garlock case. *See In re Garlock Sealing Techs., LLC., et al.*, 504 B.R. 71 (Bankr. W.D.N.C. 2014).” Pg. 10.

“There are currently five mass tort bankruptcy cases pending in this district, including the four involving the ‘Texas Two Step.’” Pg. 11.

Order Transferring Venue

- Entered on November 16, 2021 [Docket No. 416]:

“[T]he Debtor is not just forum shopping; the Debtor is manufacturing forum and creating a venue to file bankruptcy.” Pg. 10.

“There is no reason this Court should be the only bankruptcy court to have the opportunity to weigh in on these novel legal issues, especially considering that the ‘Texas Two Step’ tactic is being employed by national corporations and impacts tens of thousands of present and future claimants across the country.” Pg. 11.

Motion to Dismiss

- Filed on December 1, 2021 by Official Committee of Talc Claimants [Docket No. 632]:

“J&J’s divisive merger subverts the very Texas law upon which it relies. The sole purpose of the merger was to hinder and delay talc claimants in the pursuit of their claims by separating the liability for those claims from the assets backing such claims.” ¶ 2.

Remember: TBOC Sec. 10.901. This code does not affect, nullify, or repeal the antitrust laws or abridge any right or rights of any creditor under existing laws.

Fraudulent Transfer

The trustee may avoid any transfer incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily made such transfer or incurred such obligation with **actual intent to hinder, delay, or defraud** any entity.

See 11 U.S.C. § 548(a)(1)(A).

Badges of Fraud

1. The transfer or obligation was to an insider;
2. the debtor retained possession or control of the property transferred after the transfer;
3. the transfer or obligation was disclosed or concealed;
4. before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
5. the transfer was of substantially all the debtor's assets;
6. the debtor absconded;
7. the debtor removed or concealed assets;
8. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Potential Risks to Creditors

- J&J and New JJCI could refuse to make payments under the Funding Agreement.
- Enforcement of the agreement rests with the Debtor, which is under the control of the funding parents (J&J and New JJCI).
- Funding agreement replaces assets with amorphous value of assets, which could take years to litigate.

See Motion to Dismiss [Docket No. 632], ¶ 23.

Order Denying Motion to Dismiss

- Entered on February 25, 2022 [Docket No. 1572]:

“Let’s be clear, the filing of a chapter 11 case with the expressed aim of addressing the present and future liabilities associated with ongoing global personal injury claims to preserve corporate value is unquestionably a proper purpose under the Bankruptcy Code.” Pg. 16.

“[T]he Court concludes that there have been no improprieties or failures to comply with the Texas statute’s requirements for implementation, and that the interests of present and future talc litigation creditors have not been prejudiced.” Pg. 42.

Was the Divisive Merger a Fraudulent Transfer?

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Order Granting the Debtor's Request for Preliminary Injunctive Relief [Adv. Docket No. 102]

“For the avoidance of doubt, all of the Court’s findings and conclusions herein are without prejudice, as set forth in the record, to (i) any further finding by a subsequent court with jurisdiction over this proceeding (the ‘Presiding Court’) that there are direct claims against any of the Protected Parties, other than the Debtor and Old JJCI, which should not be stayed or enjoined, and (ii) the right of any party to challenge on any basis the corporate transactions that created the Debtor.” ¶ E.

Memorandum Opinion Denying Motions to Dismiss [Docket No. 1572]

“Debtor highlights that the Funding Agreement [...] serves to eliminate any prejudice to creditors and overcome fraudulent transfer challenges.” Pg. 10.

“The Funding Agreement between Debtor, on the one hand, and J&J and New JJCI (on a joint and several basis) on the other, is not intended to—and is unlikely to—impair the ability of talc claimants to recover on their claims. [...] Thus, as a result of the 2021 Corporate Restructuring, Debtor would have the funding available to satisfy present and future claims against Old JJCI[.]” Pg. 44.

But...

“Moreover, remedial creditor actions addressing the pre-petition divisive merger and restructuring remain available for creditors to pursue, if necessary.”

-Memorandum Opinion Denying Motions to Dismiss [Docket No. 1572], pg. 32.

| Multi-District Litigation | Bankruptcy Court (Channeling Injunction) |
|---|--|
| “This Court is neither blind nor deaf to the stated preferences of plaintiffs who seek to remain in the tort system and have their cases tried before a jury.” Pg. 24 | “There have been countless plaintiffs denied any recovery and many of the plaintiffs’ verdicts have been reversed ultimately on appeal.” Pg. 26 |
| “[L]oss of jury trial rights would violate claimants’ Seventh Amendment jury rights.” Pg. 25 | “[T]here have been numerous asbestos trusts implemented under § 524(g) which provide tort victims with choices between receiving guaranteed compensation [...] or alternatively pursuing [...] jury trials.” Pg. 25 |
| “The trust distribution proceeds and plans, however, will usually place timing restrictions and caps on compensatory and punitive damage recoveries.” Pg. 25 | “Critically important is that § 524(g) ensures that present claimants do not exhaust the debtor’s assets before future claimants have even manifested injuries.” Pg. 26 |
| “Notably, since 2014, there have been only 49 trials that have proceeded to verdict. True, in this same period, there have been approximately 6,800 cases which have settled outside of court.” Pg. 20 | “In the eyes of this Court, the tort system produces an uneven, slow-paced race to the courthouse, with winners and losers.” Pg. 27 |
| “[T]he tort system offers the only fair and just pathway of redress” Pg. 27 | “Congress did not share this narrow view in developing the structure of asbestos trusts under § 524(g).” Pg. 27 |
| Channeling injunctions bar claims against third parties such as management and insurance. | Channeling injunctions (1) make it easier for claimants to pursue low-value claims, (2) buy certainty, fixing claim values and eliminating the risk of runaway juries, and (3) allows plaintiffs to recover quickly, without protracted litigation. |

Nondebtor Release

Prohibition Act of 2021

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- H.R. 4777 / S. 2497
- H.R. sponsor Jerrold Nadler (D-NY); Senate sponsor Elizabeth Warren (D-MA)
- Seeks to:
 - Prohibit nonconsensual third-party releases (opioid claims of Pharma Purdue and asbestos claims)
 - Prohibit divisional mergers
 - Upon request of an interested party, and after notice and a hearing, the court shall dismiss a Chapter 11 reorganization bankruptcy case if the debtor was involved in certain restructuring activity that (1) had the intent or foreseeable effect of separating a debtor's assets from a debtor's liabilities and the debtor assuming or retaining such liabilities, and (2) occurred in the 10-year period prior to the filing of the bankruptcy petition.

Q & A