By Andrew V. Alfano

Plastronics, *LTL* and the "Texas Two-Step"

Andrew V. Alfano
Pillsbury Winthrop Shaw Pittman LLP
New York

Andrew Alfano is a senior associate with Pillsbury Winthrop Shaw Pittman LLP in New York.

Chapter 10 of the Texas Business Organizations Code permits an entity to undergo a "divisive merger" by splitting into two or more new entities and apportioning the assets and liabilities of the original entity among the new entities pursuant to a plan of merger.[1] The Texas statute is the subject of recent controversy because of its use by businesses to shed mass tort liabilities by using the so-called "Texas Two-Step."

Step one of the Texas Two-Step involves an entity splitting into two or more new entities. One of the new entities is apportioned liabilities and limited assets (BadCo), and the other new entity is apportioned some or all the assets (GoodCo). Step two involves BadCo filing for bankruptcy. The newly vested liabilities of BadCo are then addressed in the chapter 11 plan process.

A nonbankruptcy decision by the U.S. Court of Appeals for the Federal Circuit casts some doubt on whether the "Texas Two-Step" is a viable legal maneuver in light of the text of the Texas statute. On Jan. 12, 2022, in a nonprecedential opinion, the Federal Circuit held that a licensee could not avoid contractual royalty obligations in a divisive merger because the statute does not "abridge [the] rights of any creditor under existing laws."[2] It is the first circuit-level decision of its kind involving the Texas divisive-merger statute.

Despite the Federal Circuit's decision in *Plastronics* and the text of the statute, both of which provide that creditors' rights cannot be "abridged" by a divisive merger, businesses have been successful thus far in using the Texas Two-Step by funneling creditors to a new entity and blocking those creditors from pursuing entities that could have been tagged with liability pre-merger.

For example, a recent and highly publicized Texas Two-Step case is *In re LTL Management LLC*, which is pending in the U.S. Bankruptcy Court for the District of New Jersey.[3] The court endorsed the Texas Two-Step as a legitimate legal maneuver.[4] The debtors in *LTL*, along with other businesses that have employed the Texas Two-Step, have relied, in part, on the ability to tap into pre-petition funding agreements with well-resourced, nondebtor affiliates to pay for liabilities. The decision in *LTL Management* is currently on appeal before the U.S. Court of Appeals for the Third Circuit.

This article examines the Federal Circuit's decision in *Plastronics* and the potential split in authority represented by *In re LTL Management*. The article concludes that, irrespective of whether the Texas Two-Step can ultimately withstand legal challenges through plan confirmation, the maneuver's utility likely lies in the settlement leverage it provides debtors over potential challengers. These challengers face significant and expensive hurdles in bringing a successful legal challenge, and the desire to side-step those hurdles may drive them toward a settlement.

Plastronics

Background

The plaintiff, Plastronics Socket Partners Ltd., and the defendant, Dong Weon Hwang, entered into a royalty agreement in 2005 that provided for the development and sale of a special spring pin, called the "H-Pin," invented by Hwang to receive and test semiconductor chips.[5] The H-Pin became a commercial success due to its design, which made it cheaper to produce than competing devices.

The royalty agreement between the parties provided that Plastronics Socket would pay for the commercial development of the H-Pin, the costs of patent applications worldwide, and a 3 percent royalty on sales to Hwang.[6] In turn, Hwang granted Plastronics Socket the joint right to use the H-Pin technology worldwide (except in Korea) and agreed to share royalties that he received from third parties. Importantly, both Plastronics Socket and Hwang were obligated to receive consent from one another before licensing the H-Pin to third parties.[7]

However, Hwang left Plastronics Socket in 2008, founded a company called HiCon Co. Ltd. in Korea, and licensed the Korean patent rights to HiCon, which Plastronics would later allege was done without its consent under the royalty agreement. In 2012, Plastronics Socket created a new entity, Plastronics H-Pin Ltd., in a divisive merger

1 *See* Tex. Bus. Orgs. Code Ann. § 10.008(a)(3).

2 *Plastronics Socket Partners Ltd. v. Hwang*, Nos. 2020-1739, 2020-1781, 2022 WL 108948, at *3 (Fed. Cir. Jan. 12, 2022) (quoting Tex. Bus. Orgs. Code Ann. § 10.901 (West 2015)).

3 *See In re LTL Mgmt. LLC*, Case No. 21-30589 (MBK) (Bankr. D.N.J.).

4 *See In re LTL Mgmt. LLC*, 637 B.R. 396, 422-28 (Bankr. D.N.J. 2022). *See also* Joshua A. Lesser, "*LTL Management*: 'Not a Case of Too Big to Fail … a Case of Too Much Value to Be Wasted,'" XLI *ABI Journal* 5, 40-41, 88-89, May 2022, *available at* abi.org/abi-journal.

5 *Plastronics*, 2022 WL 108948, at *1.

6 *Id.*

7 *Id.*

under the Texas statute. The merger's objective was to "spin off" all H-Pin business to a newly created entity by assigning all rights and obligations under the royalty agreement to Plastronics H-Pin. Plastronics H-Pin manufactured the H-Pins and sold them to Plastronics at cost, but Plastronics H-Pin received no payments on sales to customers.[8] As a result, Plastronics asserted that liability for unpaid royalty obligations was barred by the divisive merger.

Plastronics later sued Hwang and HiCon for patent infringement, breach of the royalty agreement, and various torts, among other claims, based on Hwang's failure to receive Plastronics' consent to license the H-Pin technology to HiCon.[9] Hwang countersued for patent infringement and breach of the royalty agreement, alleging Plastronics' failure to pay royalties to Hwang notwithstanding its legal maneuver to avoid such liabilities in a divisive merger.[10]

Decision

The Federal Circuit found that the Texas divisive-merger statute could not be used by Plastronics to avoid liability for royalties.[11] In doing so, the Federal Circuit relied on the text of the Texas divisive-merger statute, the statute's legislative history and general principles of contract law.

The Federal Circuit observed that although the text of the statute contemplates the allocation of liabilities and obligations between entities in a divisive merger, the statute clearly states that it does not "abridge [the] rights of any creditor under existing laws."[12] According to the Federal Circuit, "[t]his language indicates that a purpose of the statute was to enable mergers that did not adversely affect the rights of parties under preexisting contracts with the entities undergoing the mergers."[13] This purpose was confirmed by the statute's legislative history, which states that "[a c]reditor's rights would not be adversely affected by the proposed amendment, and creditors would continue to have the protections provided by the Uniform Fraudulent Transfer Act and other existing statutes that protect the rights of creditors."[14]

Further, under general contract law principles, a merger cannot adversely impact the rights of parties in contract with an entity undergoing a merger if it would "materially change the duty of the obligor ... materially increase the burden or risk imposed on him by his contract ... materially impact his chance of obtaining return performance, or materially reduce its value to him."[15] Therefore, the court reasoned that Plastronics's use of the statute violated these basic contract principles. For these reasons, the Federal Circuit affirmed the lower court's award of damages in Hwang's favor for unpaid royalty obligations that Plastronics attempted to avoid in the divisive merger.

The *LTL* Chapter 11 Case

A much different result has occurred thus far in the recent and highly publicized Texas Two-Step case of *In re LTL Management LLC*. The debtor, LTL, filed for bankruptcy hours after a divisive merger created LTL and allocated to it billions of dollars in asbestos-related tort liabilities from its affiliate Johnson & Johnson Consumer Inc.[16] The tort liabilities were from Johnson & Johnson Consumer's talc baby powder, which is alleged to have caused ovarian cancer and/or mesothelioma in thousands of victims. LTL was created in the divisive merger as a special-purpose entity with no business operations or purpose other than to file for chapter 11 and employ the automatic stay and asbestos-resolution schemes for the benefit of its affiliates.[17]

LTL's pre-petition funding agreement with Johnson & Johnson and Johnson & Johnson Consumer Inc. provided LTL with a contractual right to receive funding up to at least the fair market value of Johnson & Johnson Consumer, which was estimated at approximately $60 billion, in order to pay for the asbestos liabilities allocated to it in the divisive merger. LTL explained that the purpose of its maneuver was not to avoid liability, but to use bankruptcy to "produce an equitable resolution of both current and future talc claims by means of a settlement trust ... that can promptly, efficiently, and fairly compensate claimants."[18]

In its decision on requests to dismiss LTL's bankruptcy case for bad faith, the bankruptcy court endorsed the Texas Two-Step and defended the bankruptcy system's ability to effectively adjudicate mass tort cases.[19] The bankruptcy court found that the existence of the funding agreement, and proper oversight and jurisdiction from the bankruptcy court to ensure that LTL pursues its rights under the agreement, meant that the bankruptcy case was unlikely to impair the ability of tort creditors to recover on their claims.[20] Given the company's potential ability to tap into more than $60 billion in funding, the bankruptcy court was also unpersuaded that tort victims were worse off as a result of the divisive merger. An appeal of the bankruptcy court's denial of dismissal of the LTL chapter 11 case is currently pending before the U.S. Court of Appeals for the Third Circuit.

The Texas Two-Step's Leverage

Whether there is a legitimate legal basis to use the divisive-merger statute to shed mass tort liabilities that can withstand challenge from creditors through plan confirmation has yet to be settled. In either case, the utility of this maneuver likely lies in its settlement leverage. Debtors know that creditor challenges to this maneuver face a multitude of obstacles, which can push parties to a settlement. There are several examples of these obstacles.

First, debtors have been successful in obtaining litigation stays against nondebtor affiliates by seeking a preliminary injunction at the outset of the case to provide a respite for parties to reach a negotiated resolution.[21] These stays (com-

8 *Id.* at *3.
9 *Id.* at *1.
10 *Id.*
11 *Id.* at *4.
12 *Id.* at *3 (quoting Tex. Bus. Orgs. Code Ann. § 10.901).
13 *Id.*
14 *Id.* (quoting H. Comm. on Bus. & Com., Bill Analysis, H.B. 472, 71st Reg. Sess., at 23 (Tex. 1989)).
15 *Id.* (quoting *Restatement (Second) of Contracts* § 317(2) (1981)).

16 *See LTL Mgmt. LLC*, 637 B.R. at 403-04.
17 *Id.*
18 *Id.* at 404.
19 *Id.* at 414, 427.
20 *Id.* at 423.
21 *See, e.g., In re LTL Mgmt. LLC*, 638 B.R. 291, 319-22 (Bankr. D.N.J. 2022).

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plemented by the Bankruptcy Code's automatic stay with respect to debtors) confer leverage upon debtors and their nondebtor affiliates because creditors are unable to continue their pre-petition litigations or commence new ones.

Second, debtors have a panoply of Code tools at their disposal that make it difficult for challengers to shape the outcome of the bankruptcy and knock it off an intended path. For example, debtors maintain the exclusive right to file a chapter 11 plan for 120 days (extendable to 18 months).[22] In addition, standing to challenge the divisive merger on the basis of fraudulent transfer (and other estate claims) is vested exclusively in the debtor, unless the court grants standing to another party, which can be difficult to obtain.[23] Debtors also have the ability to liberally classify creditors (with some restrictions) and cram down dissenters to its plan over their objection.[24] In rare cases, courts have also found that debtors can obtain nonconsensual releases of nondebtors under a plan to bind holdouts, depending on the jurisdiction and as long as certain prescribed criteria are met.[25]

Third, there is a significant amount of legal risk in challenging the divisive merger to conclusion. On the one hand, the Texas statute provides that a divisive merger is not deemed an assignment or transfer of assets.[26] Therefore, the transaction is arguably insulated from fraudulent-transfer claims under Texas law.[27] On the other hand, as the Federal Circuit's decision in *Plastronics* and the statute make clear, the divisive merger cannot be used to abridge creditors' rights.

Fourth, litigating a challenge to the divisive merger in an adversary proceeding can be very expensive and protracted. It can take months or even years to receive a decision, with no guarantee of a positive outcome. The large amount of time that it takes to litigate a challenge (and the resources it requires) works in favor of the debtor who has the financial backing of well-resourced affiliates.

Fifth, the implementation of a pre-petition funding agreement, which purports to provide a more certain recovery in a large aggregate amount, when coupled with all the other hurdles identified herein, becomes a difficult proposition for creditors to refuse. Ultimately, that funding can provide the basis for a settlement. The certainty and potentially large aggregate recovery also can make a case for the imposition of nonconsensual third-party releases over challengers/dissenters.

Conclusion

Questions remain regarding the use of the divisive merger statute as part of a Texas Two-Step. The text of the statute and the *Plastronics* decision make it clear that debtors must show that the divisive merger will not abridge creditors' rights. However, the *LTL* case still stands as a valuable blueprint for other debtors to follow. Given the leverage that this legal maneuver provides debtors and their nondebtor affiliates, and depending on how the Third Circuit rules on the *LTL* appeal, the maneuver may remain an attractive strategy for businesses facing mass tort and other significant liabilities in the years to come. abi

22 *See* 11 U.S.C. § 1121(b), (d)(2)(A).
23 *See* 11 U.S.C. § 1107(a).
24 *See* 11 U.S.C.§§ 1122(a) and 1129(b).
25 *See, e.g., Deutsche Bank A.G. v. Metromedia Fiber Network Inc. (In re Metromedia Fiber Network Inc.)*, 416 F.3d 136, 141 (2d Cir. 2005) (holding that third-party releases are proper in "rare cases").
26 *See* Tex. Bus. Orgs. Code Ann. § 10.008(a)(2)(C).
27 *But see* H. Comm. on Bus. & Com., Bill Analysis, H.B. 472, 71st Reg. Sess., at 23 (Tex. 1989) (stating that under Texas divisive-merge statute "creditors would continue to have the protections provided by the Uniform Fraudulent Transfer act and other existing statutes that protect the rights of creditors").