TESTIMONY

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**U.S. SENATE
COMMITTEE ON THE JUDICIARY**

SUBCOMMITTEE ON FEDERAL COURTS, OVERSIGHT, AGENCY ACTION AND FEDERAL RIGHTS

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Introduction

Good afternoon Chairman Whitehouse, Ranking Member Kennedy, and Subcommittee members. I am honored to appear before you today to discuss divisional merger bankruptcies, known more colloquially — and colorfully — as the "Texas Two-Step". I am testifying today solely as an expert in the field and not on behalf of any person or party.[1]

Testimony

Texas Two-Step has a lighthearted ring to it, but the underlying issues are serious and important, and I commend the Committee for examining the topic. My

[1] Certain of the companies that are involved in the divisional merger bankruptcies that are the subject of this hearing are or have been clients of my law firm, but neither I nor anybody else at Cravath is representing any person or party in any of the relevant pending bankruptcy proceedings.

perspective as a bankruptcy practitioner is this: *divisional merger bankruptcies of the type that have been filed are an* ***appropriate use of bankruptcy*****.**

Before discussing the reasons for that conclusion, let me first briefly describe what a divisional merger is. Two States have enacted divisional merger statutes: Delaware and Texas. Unlike a traditional merger, where two entities merge together to form a new entity, a divisional merger involves one entity dividing into two. In a divisional merger bankruptcy, the original company is divided into two parts: one new company that attempts to resolve the asbestos-related claims globally through a Chapter 11 bankruptcy process, and one new company that continues to operate the business.

Here is where a critical misunderstanding may arise: while the transaction involves two steps—the separation of entities and a bankruptcy filing—it ***does not*** involve the side-stepping of accountability or financial responsibility for the asbestos-related claims. The law should not and would not allow that.

Going all the way back to the Fraudulent Conveyances Act of 1571, also known as the Statute of 13 Elizabeth, it has been illegal to take actions with the purpose and intent to "delay, hinder or defraud creditors". Those same or similar words appear in our Federal Bankruptcy Code and in the laws of all 50 U.S. States. Importantly, the Delaware and Texas divisional merger statutes do not attempt to

override this longstanding body of law; rather, both provide that any division of assets and liabilities is subject to existing creditors' rights laws.

The reason these transactions should not constitute a violation of creditors' rights laws is the ***funding agreement*** — an agreement from the operating company to fund the trust to be established under section 524(g) of the Bankruptcy Code to pay the claims. There is a funding agreement in each of the divisional merger bankruptcy cases filed to date. At the core, the funding agreement evidences an affirmative acceptance of financial responsibility and access to the value of the company that existed pre-separation, not a corporate effort to side-step accountability.

So why split the company before the bankruptcy? Because it allows companies to use the tools contained in the Bankruptcy Code (such as 524(g) trusts) to address mass tort liabilities and compensate claimants, while preserving as much value as possible for all constituents. By separating the company into two, productive assets and businesses (which often have operations separate from the operations that resulted in the potential liabilities) will be able to operate without the overhang of bankruptcy, which among other things affects employee retention and relations and relationships with suppliers and customers. That value inures to the benefit of the claim holders through the funding agreement, so the claim holders are no worse off (and may be better off). It also enables the

company to use the Bankruptcy Code to address tort liabilities in a way that is more streamlined and fair to the claim holders as a whole than the tort system, through the use of provisions like section 524(g) of the Bankruptcy Code.

Claimant trusts have been an accepted method of addressing asbestos claims since at least 1994, when Congress added section 524(g) to the Bankruptcy Code. They are ***fair***: they can only be established if approved by at least ***75% of the claimants*** themselves; they are ***efficient***: bankruptcy provides a single, centralized forum to resolve and pay all claims; and they are ***equitable***: lottery-like results of a pot of gold for some and little or nothing for others is not allowed in bankruptcy.

Both for these reasons and the strong Federal policy of access to bankruptcy, I do not believe the legislation that has been proposed to outlaw a bankruptcy filing within 10 years of a divisional merger is necessary or appropriate. In my opinion, Congressional time and effort would be better spent on other bankruptcy topics, such as establishing uniform standards for third party releases in appropriate cases.

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Mr. Chairman, I thank you again for the opportunity to share my thoughts on these very important issues.