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Legal Sidebar

Third Circuit Dismisses Johnson & Johnson Bankruptcy and Novel Mass-Tort Approach

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Introduction

On January 30, 2023, the Third Circuit denied the efforts of Johnson & Johnson Consumer, Inc. (Old Consumer), a subsidiary of Johnson & Johnson (J&J), to use the bankruptcy system as a forum for litigating tens-of-thousands of claims related to talcum powder (talc litigation). Old Consumer had availed itself of the "Texas Two-Step," also known as a divisional merger, a corporate restructuring strategy based in Texas law by which businesses divide themselves into separate companies, shift mass tort liabilities to one of them, and have that company declare bankruptcy. (While the term "Texas Two-Step" does not appear in the Texas Business Organizations Code, that is the sobriquet applied to the maneuver by third parties, and is colloquially used by this Sidebar in reference to this kind of divisional merger.)

In this case, Old Consumer divided itself into "New Consumer" and "LTL Management LLC" (LTL) and then had the liability-bearing company—LTL—declare bankruptcy, with funding from New Consumer to pay for the talc litigation claims. The Third Circuit dismissed LTL's Chapter 11 petition in *In re LTL Management, LLC*, reasoning that the New Consumer-funded LTL did not meet a prerequisite for bankruptcy: being in a state of financial distress. In so ruling, the court did not directly address the viability of the Texas Two-Step.

Below, this Sidebar summarizes the laws governing a motion to dismiss a bankruptcy petition. The Sidebar next explains the Texas Two-Step divisional merger practice. It then recounts the factual history of the LTL bankruptcy and the proceedings in bankruptcy court. It also discusses *In re LTL Management, LLC* and its effect on bankruptcies moving forward, along with congressional ramifications.

Motions to Dismiss Bankruptcy Petitions

Section 1112 of the Bankruptcy Code governs a motion to dismiss a Chapter 11 bankruptcy or convert it to another chapter. The debtor, the United States Trustee, or a "party in interest," may move for dismissal under this section. A party in interest may move to dismiss a Chapter 11 bankruptcy under § 1112(b). The Bankruptcy Code does not define the full scope of who may qualify as "party in interest," although § 1109 of the Code includes creditors and creditor committees as parties in interest.

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A court may dismiss a bankruptcy upon a showing of cause. The terms of the Code do not authorize dismissal on the ground that the debtor did not file for bankruptcy in good faith, but courts generally accept it as an example of cause.

The lack of a good-faith requirement in the Code gives circuit courts flexibility in how to rule on motions to dismiss based on an absence of good faith. The Third Circuit places the burden on the debtor to show good faith, while the Fourth Circuit requires a showing of the debtor's objective bad faith and the objective futility of any possible reorganization.

The Texas Two-Step

The legal foundations for the Texas Two-Step lie in the Texas Business Organizations Code. The definitions section defines the term "merger" as "the division of a domestic entity into two or more new domestic entities or other organizations." In dividing itself into two entities, the company allocates its assets to one company and its tort liabilities to the other company; this process has been described colloquially as an "Oldco" turning into a "GoodCo" and a "BadCo."

The liability-bearing entity then files for bankruptcy. This bankruptcy shields the original company's assets from creditors in bankruptcy, particularly creditors with tort claims. Additionally, the automatic stay that takes effect immediately after a bankruptcy filing gives the bankrupt company protection from any pending litigation. Further, the two companies often have a funding agreement that will allow the bankrupt company to pay for the mass-tort litigation.

Proponents of the Texas Two-Step contend that it creates an orderly process for resolving mass-tort claims that is more efficient than multi-district litigation. Critics assert that the Texas Two-Step amounts to a loophole that allows large companies to avoid accountability for committing mass torts.

Factual History of the LTL Bankruptcy and the Bankruptcy Court Ruling

The following factual summary is taken from the Third Circuit's opinion in *In re LTL Management, LLC*. Starting in the 2010s, Old Consumer encountered an increase in talc litigation. Findings by government agencies of asbestos traces in J&J Baby Powder and a "significant association" between exposure to talc and ovarian cancer precipitated an onslaught of litigation. By decade's end, more than 38,000 actions were pending against Old Consumer. Talc litigation, although not always successful against Old Consumer, cost the company $3.5 billion in talc-related verdicts and settlements, nearly $1 billion in defense costs, and additional billions in contested indemnification obligations to its talc supplier, Imerys Talc America, Inc.

Old Consumer started its Texas Two-Step restructuring by merging Old Consumer into a Texas limited liability company and J&J subsidiary named Chenango Zero, LLC (Chenango Zero), leaving Chenango Zero as the surviving entity. Chenango Zero then merged into two Texas LLCs named Chenango One LLC and Chenango Two LLC. Chenango One LLC converted into a North Carolina LLC and changed its name to LTL. Chenango Two LLC merged into LTL's corporate parent and changed its name to New Consumer.

The newly formed LTL assumed responsibility for nearly all of the talc-related claims that belonged to Old Consumer. LTL also obtained Old Consumer's rights as a payee under a funding agreement (the Funding Agreement) with J&J and New Consumer. In bankruptcy, the Funding Agreement permitted LTL the right to cause J&J and New Consumer, jointly and severally, to pay it cash in the same amount to satisfy its administrative costs and to fund a litigation trust to address ongoing talc liability. The value of the Funding Agreement had a floor of $61.5 billion, New Consumer's value at the time of the merger. It would be subject to increase as New Consumer's value increased moving forward.

Days after completing the Texas Two-Step, LTL—a newly created North Carolina LLC—filed a Chapter 11 petition in the U.S. Bankruptcy Court for the Western District of North Carolina. The bankruptcy court granted LTL a 60-day preliminary injunction that enjoined talc claims against hundreds of non-debtors (the Protected Parties). The bankruptcy court also granted a motion brought by interested parties, including representatives for talc cases, to transfer the case to the U.S. Bankruptcy Court for the District of New Jersey. In granting the motion, the bankruptcy court commented that LTL was seeking to "manufacture venue" and seize on the "Fourth Circuit's two-prong dismissal standard."

In the District of New Jersey, the court-approved Official Committee of Talc Claimants (the Talc Claimants) moved under § 1112(b) of the Code to dismiss LTL's petition as not filed in good faith. The bankruptcy court denied the motion to dismiss, ruling that LTL had declared bankruptcy in good faith. The court reasoned that resolving talc liability by creating a litigation trust to benefit claimants under § 524(g) of the Bankruptcy Code constituted a valid bankruptcy purpose. Additionally, the bankruptcy court determined that LTL was in financial distress because of ongoing talc litigation. The bankruptcy court also ruled that the corporate restructuring that preceded the bankruptcy did not amount to an effort to obtain an unfair litigation advantage against the Talc Claimants.

The Talc Claimants timely appealed the order. The bankruptcy court certified the order directly to the Third Circuit under 28 U.S.C. § 158(d)(2), which allows a bankruptcy appeal to bypass district court review. This streamlined review applies in cases of, among other things, questions on which there is no controlling decision by the Supreme Court or a Circuit Court or where the issue is a matter of public importance.

The Third Circuit's Decision

The Third Circuit reversed the bankruptcy court's order and remanded the case with instructions for the bankruptcy court to dismiss LTL's petition. The premise underlying the court's decision was that financial distress is a necessary condition to having a petition that "serves a valid bankruptcy purpose supporting good faith." Citing Third Circuit precedent, the court held that a debtor's financial distress must be apparent and immediate enough to justify filing for bankruptcy. The prospect of large-scale, future tort claims is a plausible form of financial distress, the court observed.

Examining the status of LTL, the court held that the newly formed company was not in financial distress because of the value and quality of its assets. Under the Funding Agreement, LTL possessed a $61.5 billion payment right for talc litigation against J&J and New Consumer. The court found it difficult to imagine a scenario in which those companies could not satisfy their obligations under the agreement.

Also relevant to the court was the mixed record by plaintiffs in Old Consumer's talc litigation, rendering speculative the argument that future talc litigation expenses would imperil Old Consumer's continuing viability. The court observed that the aggregate costs of talc litigation had reached $4.5 billion, less than 7.5 percent of New Customer's $61.5 billion value on the petition date.

Key Points and Next Steps

The Third Circuit focused on financial distress as essential to a good-faith bankruptcy filing. This reasoning allowed the court to dispose of the LTL bankruptcy based on LTL's use of the Texas Two-Step without directly addressing whether the Texas Two-Step was consistent with the Bankruptcy Code's good-faith requirement. By focusing on the Funding Agreement, the court also appeared to espouse a scenario in which the Texas Two-Step would not violate the Bankruptcy Code's good-faith requirement, specifically, when the "BadCo" is actually insolvent. In other words, a Texas Two-Step bankruptcy without any funding for mass-tort litigation is on stronger good-faith footing than one in which a debtor has a mechanism in place to pay for those claims. The court commented on the "apparent irony" that "the

bigger a backstop a parent company provides to a subsidiary, the less fit that subsidiary is to file." The court also left open the possibility that an LTL bankruptcy with the current funding agreement may constitute a good-faith filing if, at some future point, the talc litigation costs amounted to a higher portion of New Consumer's value.

The results of *In re LTL Management, LLC* continue to highlight the differences among the circuits in their interpretation and application of the § 1112(b) standards. While all circuits agree that bad faith is grounds for dismissing a bankruptcy petition, they diverge on what constitutes a showing of bad faith. The Fourth Circuit's bad-faith plus objective futility test lowers the bar for debtors facing a motion to dismiss, making it an attractive forum for companies that employ the Texas Two-Step. As noted by the North Carolina bankruptcy court when it granted the transfer motion and by the Third Circuit when it dismissed LTL's petition, it comes as no surprise that LTL and others who have engaged in the Texas Two-Step have declared bankruptcy in the Western District of North Carolina. Whether this case prompts the Supreme Court to consider the varying interpretations of § 1112(b) is an open question.

As to Congress, the Third Circuit's decision suggests several potential paths forward. First, the legislative enactment of a national standard on what constitutes good faith under § 1112(b) could curtail efforts by debtors to, in the words of the North Carolina bankruptcy court, "manufacture venue." Second, Congress could resolve through legislation whether the Texas Two-Step and similar laws in Arizona, Delaware, and Pennsylvania violate the Bankruptcy Code. Third, it could take a wait-and-see approach and observe how the Third Circuit's decision affects other pending bankruptcies before the circuit courts in which debtors have employed the Texas Two-Step. Despite its somewhat circuitous route to invalidating the bankruptcy, the LTL decision marks the first time that a circuit court rejected a Texas Two-Step bankruptcy. That by itself is a significant result in this convergence of bankruptcy and mass-tort litigation.

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