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Texas "Two-Step" Forward, Three Steps Back for Mass Tort Debtors in the Third Circuit After LTL

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In a decision that may provide much-needed boundaries around the permissibility of debtors created from “out-of-the-box” prepetition corporate transactions, on January 30, 2023, the United States Court of Appeals for the Third Circuit issued a unanimous opinion dismissing Johnson & Johnson subsidiary LTL Management, LLC’s (“LTL”) chapter 11 case pending in the United States Bankruptcy Court for the District of New Jersey as not being filed in good faith.[1]

The LTL case is one of several recent high-profile, mass tort bankruptcy cases that are the by-product of a unique divisional merger feature of Texas law, sometimes referred to as the “Texas Two-Step.” The Two-Step involves dividing a predecessor into two new entities, one vested with valuable assets and the other burdened with onerous liabilities (in LTL’s case, potential talc liability), then putting the liability-burdened company into bankruptcy. This corporate maneuver has sparked public outcry and even led to recent proposed legislation to limit such tactics.[2] Meanwhile, based on the facts in LTL (including the financial wherewithal of its affiliate guarantors), the Third Circuit has taken the Texas Two-Step back three paces, encouraging companies and their advisors to explore inventive solutions to corporate woes while taking into account the financial condition of non-debtor affiliates before filing for bankruptcy.

Since 1979, Johnson & Johnson Consumer Inc. (“Old JJCI”) and its predecessors have sold, among other household products, Johnson’s Baby Powder, a well-recognized talc-based skin product.[3] Despite enjoying a largely litigation-free history, the last decade saw a significant rise in claims against Old JJCI asserting, among other things, that its talc-based products caused ovarian cancer, as well as adverse findings from the U.S. Food and Drug Administration and Health Canada. The wave of litigation culminated in over 38,000 ovarian cancer actions and 400 mesothelioma actions against Old JJCI with the expectation that the lawsuits would continue and grow in the following decades.

In an effort to manage this potential litigation, on October 12, 2021, Old JJCI executed a divisional merger under Texas law (colloquially called the “Texas Two-Step”), pursuant to which an entity divides into two new entities and the old entity—which does not survive the merger—allocates its property, liabilities and obligations among the new entities.[4] Importantly, except as otherwise provided by law or contract, no entity created in a divisional merger is liable for the debt or obligations of the other new entity.[5] Employing this method, Old JJCI was divided into LTL and a new Johnson & Johnson Consumer Inc. (“New JJCI”), with LTL receiving (a) responsibility for all liabilities of Old JJCI tied to talc-related claims, (b) Old JJCI’s contracts,

(c) certain equity interests in a separate royalty-owning affiliate, and (d) $6 million in cash. New JJCI, in turn, received all assets and liabilities of Old JJCI not allocated to LTL.

Critically, the merger also created a funding agreement which gave LTL rights to funding from New JJCI and J&J. More specifically, the funding agreement gave LTL the ability *outside of bankruptcy* to cause New JJCI and J&J to jointly and severally infuse cash into LTL up to the value of New JJCI for purposes of satisfying, among other things, any talc-related costs borne by LTL. The funding agreement also gave LTL the right *in bankruptcy* to cause New JJCI and J&J to jointly and severally infuse cash into LTL in an amount to satisfy its administrative costs in bankruptcy and to fund a talc-related trust created through the bankruptcy. Even more critically, the amount of any payment could not drop below the value of New JJCI measured as of the time of the merger (approximately $61.5 billion), but it was not capped and could potentially grow with any increase in value of New JJCI.

On October 14, 2021, two days after the divisional merger, LTL filed for Chapter 11 protection in the Bankruptcy Court for the Western District of North Carolina. The case was subsequently transferred to the Bankruptcy Court for the District of New Jersey and thereafter the Official Committee of Talc Claimants moved to dismiss LTL's petition under section 1112(b) of the Bankruptcy Code as not filed in good faith. Following a five-day trial, the New Jersey Bankruptcy Court denied the motion to dismiss and held that the petition was filed in good faith, noting that (a) the filing served a valid bankruptcy purpose by seeking to resolve talc liability through the creation of a trust under the Bankruptcy Code, (b) LTL was in financial distress given the scope of litigation faced by Old JJCI, and (c) LTL's bankruptcy was not undertaken to secure an unfair litigation advantage.

On appeal, the Third Circuit focused primarily on whether LTL suffered from financial distress, noting that good faith requires at least some degree of financial distress from a debtor and that, "absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose."[6] The Third Circuit was careful, however, to distinguish distress from insolvency, and instead enumerated several factors that were relevant to distress, including balance-sheet insolvency, insufficient cash flows, and uncertain and unliquidated future liabilities. Further, the Third Circuit found that the distress must also be immediate enough to justify a filing, as opposed to an attenuated possibility that may necessitate a filing at some point in the future.

In applying the above analysis, the Third Circuit found only LTL's financial condition to be determinative, rather than its predecessor Old JJCI, reflecting the principle that state-law property interests should be given the same effect inside and outside of bankruptcy. With this framework, the Third Circuit disagreed with the Bankruptcy Court that LTL was in financial distress at the time of its bankruptcy filing, primarily due to the Bankruptcy Court's disregard for the funding agreement, which gave LTL at minimum a $61.5 billion payment right jointly and severally against J&J and New JJCI. In other words, "the [funding agreement] provided LTL a right to cash that was very valuable, likely to grow, and minimally conditional. And this right was reliable, as J&J and [New JJCI] were highly creditworthy counterparties (an understatement) with the capacity to satisfy it."[7] In bolstering this valuation, the Third Circuit noted that J&J's balance sheet (to which LTL had access via the funding agreement) was exceptionally strong, containing $400 billion in equity value with a AAA credit rating and $31 billion in cash and marketable securities.

In contrast to the value provided to LTL through the funding agreement, the Third Circuit further disagreed with the Bankruptcy Court's disregard for Old JJCI's litigation successes, including: (a) the settlement of 6,800 talc-related claims for under $1 billion prior to bankruptcy, (b) obtaining dismissal of 1,300 ovarian cancer and 250 mesothelioma claims without payment, and (c) receiving adverse verdicts in a minority of completed trials. Declining to follow the Bankruptcy Court's astronomical projections, the Third Circuit held that the projections flatly ignored the possibility of meaningful settlement and/or successful defenses to the claims against J&J. Weighing the five-year litigation costs thus far ($4.5 billion) against LTL's funding right ($61.5 billion), the Third Circuit concluded that there was no likely need in the present or near-term for LTL to file for bankruptcy.

The Third Circuit further considered the Bankruptcy Court's determination that even if the bankruptcy was not filed in good faith, "unusual circumstances" necessitated a finding that dismissal was not in the interest of creditors and the estate under section 1112(b)(2) of the Bankruptcy Code. Contrary to the Bankruptcy Court's conclusion that the interests of current tort creditors and the absence of viable protections for future tort claimants constituted unusual circumstances, the Third Circuit noted that the only unusual circumstance present was that LTL was entering bankruptcy in a highly solvent position with access to sufficient cash.

While the Third Circuit's decision does not necessarily provide that entities formed through divisional mergers are prohibited from filing for bankruptcy, it should serve as a warning to lawyers and financial advisors that doing so in a way that still provides the newly formed debtor a lifeline from prosperous affiliates will potentially serve as grounds for dismissal. Indeed, while courts may not consider the pre-merger entity's financial condition as an indicator of the debtor entity's financial distress, courts will not shy away from considering all possible funding options available to the debtor entity prior to its bankruptcy, as well as the realities of its liquidity threats based on past results.

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1. *LTL Management, LLC v. Those Parties Listed on Appendix A to Complaint, et al.*, Doc. 50, Case Nos. 22-2003 – 22-011 (3d Cir. Jan. 30, 2023).

2. Section 4 of the Nondebtor Prohibition Act of 2021 (H.R. 4777) contained a prohibition on debtor entities that were the product of divisional mergers within the ten-year period prior to the petition date.

3. Johnsons' Baby Powder was first sold by Johnson & Johnson in 1894, but its sale under JJCI's umbrella was the product of intercompany transactions dating back to 1979.

4. Tex. Bus. Orgs. Code Ann. §§ 1.002(55)(A), 10.003, 10.008(a).

5. *Id.* at § 10.008(a)(4).

6. Opinion at 35-36.

7. Opinion at 46.