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J&J Unit Ch. 11 Case Shows Texas 2-Step May Be Wrong Move

By **Sean Scott, Aaron Gavant and Josh Gross** (March 13, 2023, 1:33 PM EDT)

Sean Scott

Aaron Gavant

Josh Gross

Mass tort litigation is often unwieldy. Companies are sometimes defending thousands of cases, legal fees quickly add up and resolving claims can take years, long after the underlying environmental hazards are remediated or allegedly harmful products taken off the market.

All of this often drains resources from an entity that has a healthy business worth saving, while also forcing claimants into a race to the courthouse.

In response, businesses have started looking more to bankruptcy to utilize the automatic stay and to channel legacy tort claims into a trust while allowing for the reorganization of the company's healthy business.

To provide even greater protection, several companies have attempted to further protect their healthy businesses by engaging in the "Texas Two-Step," a term used to describe a company's exercise of rights under the Texas Business Organizations Code to split itself into multiple entities to use bankruptcy to deal with legacy liabilities while keeping its productive assets out of bankruptcy: first, by engaging in a divisional merger[1] under Texas law to divide a company into multiple entities, including one that just holds legacy liabilities, and second, by filing just that liability-laden entity for bankruptcy, while leaving the healthy remaining company to operate the viable business.

The U.S. Court of Appeals for the Third Circuit recently called that approach into question in ordering the dismissal of a Chapter 11 bankruptcy case **initially filed** in the U.S. Bankruptcy Court for the Western District of North Carolina by LTL Management LLC, an entity created by Johnson & Johnson via a Texas Two-Step to manage J&J's legacy talc-related liabilities.

In finding that LTL's case had not been filed in good faith, the Third Circuit concluded that LTL was not facing the kind of immediate financial distress necessary to justify bankruptcy, given that J&J had agreed to a funding arrangement in which it would effectively guarantee any LTL talc-related liabilities. The ruling raises new questions about the viability of divisional merger transactions as a means to manage mass tort liabilities through bankruptcy.

But, despite the outcome in LTL, the Third Circuit decision's overall impact on similar Texas Two-Step cases remains to be seen, particularly in cases that do not involve a robust funding arrangement like the one provided by J&J.

The Texas Two-Step

Filing a Chapter 11 case provides significant benefits to a financially distressed company. Upon a bankruptcy filing, the Bankruptcy Code's automatic stay goes into effect, halting all enforcement actions against the company. The Bankruptcy Code then governs how prepetition liabilities are treated.

Companies can seek to estimate not-yet-fully litigated claims and limit claimants' overall recoveries to those estimated amounts. Companies can also seek so-called channeling injunctions and other protections that ensure that all such claims will be paid solely from fixed funds held by a trust or other similar vehicle.

A key consideration is ensuring that legacy liabilities can be walled off from the otherwise healthy operations of a company, such that safe and profitable lines of business are protected from what is often an expensive and time-consuming bankruptcy process. Enter the Texas Two-Step.

While typical corporate merger statutes govern how multiple business entities can be combined into one, the Texas Business Organizations Code is one of few that defines a merger to also include "the division of a domestic entity."[2] Such divisional mergers are accomplished in the same way as combination mergers, i.e., pursuant to a plan of merger that allocates the assets and liabilities of the original entity among the surviving entities.[3]

Each surviving entity then becomes the primary obligor for the liabilities allocated to it and "except as otherwise provided by the plan of merger or by law or contract, no other party to the merger" assumes such liabilities, per the Texas Business Organizations Code, Section 10.008(a)(4).[4]

Standing alone, these provisions of the TBOC allow a business to divide itself into a good so-called NewCo entity and a bad OldCo entity, with the NewCo holding productive assets and operating free and clear of the liabilities allocated to the OldCo. The OldCo can then file a discrete Chapter 11 case while the NewCo carries on business as usual.

It is generally not sufficient to just carve out the "bad" from the "good." The risk of avoidance actions, in particular, remains high, especially where it appears that tort claimants and other creditors may be deprived of the NewCo assets that would otherwise have been available to satisfy their claims.[5]

To mitigate this risk, companies often couple the divisional merger with a funding agreement between the NewCo and OldCo under which the NewCo agrees to cover certain of the OldCo's bankruptcy costs and at least some legacy liabilities.[6]

J&J's Texas Two-Step

Bolstered by the apparent successes of prior Texas Two-Steps, J&J undertook its own divisional merger transaction in 2021. Prior to 2015, J&J's talc-based baby powder line and other products — and the liabilities relating to those product lines — were held by J&J subsidiary Johnson & Johnson Consumer Inc., referred to as Old JJCI.[7]

J&J and Old JJCI had been facing a series of lawsuits claiming that J&J's talc-based products caused serious diseases including ovarian cancer and mesothelioma.

J&J and Old JJCI largely prevailed on the merits in such cases; however, they incurred more than $1 billion in defense costs, several billion dollars in adverse verdicts, and $3.5 billion in related indemnities to other parties.[8] And the litigation had no clear end in sight — more than 38,000 ovarian cancer cases and 430 mesothelioma cases remained pending as of LTL's petition date.[9]

To manage the pending cases, J&J pursued a Texas Two-Step pursuant to which all the remaining talc-related liabilities of J&J and Old JJCI were transferred to a new J&J subsidiary eventually called LTL Management LLC.[10]

Central to this series of transactions was the funding agreement between legacy J&J and LTL. Absent such agreement, LTL would have been plainly undercapitalized to address even known talc-related liabilities, holding only about $375 million in assets.

But under the funding agreement, New JJCI and J&J agreed to provide LTL with nonrecourse funding sufficient to pay LTL's operating and administrative costs and to either satisfy LTL's talc-related liabilities or fund a litigation trust to address such liabilities.[11]

The transactions — including the funding agreement — were designed to ensure that LTL had "at least the same, if not greater, ability to fund talc-related claims and other liabilities as Old JJCI had" beforehand, according to LTL.[12]

LTL Bankruptcy Court Proceedings

LTL commenced its Chapter 11 case in the Western District of North Carolina just three days after the completion of its divisional merger transactions. LTL filed its bankruptcy case in North Carolina specifically because of that venue's experience handling mass tort bankruptcies, including those involving divisional mergers.[13]

LTL promptly faced motions to transfer venue to New Jersey, where J&J is headquartered and much of the talc-related litigation against J&J was pending. The bankruptcy court agreed that New Jersey was a more appropriate venue and that LTL had filed in North Carolina to take advantage of its more debtor-friendly case law in mass tort cases.[14]

In New Jersey, LTL was able to extend the protections of the automatic stay to nondebtor J&J and its affiliates, but several claimants moved to dismiss LTL's bankruptcy on the grounds that it had been filed in bad faith and not for legitimate reorganization purposes. The bankruptcy court sided with LTL and denied these motions, allowing LTL's case to proceed.

As the bankruptcy court noted, in the Third Circuit, the "general focus" of the good faith analysis is on "(1) whether the petition serves a valid bankruptcy purpose and (2) whether the petition is filed merely to obtain a tactical litigation advantage."[15]

The bankruptcy court stated its view that "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."[16]

The court also expressly approved of J&J's use of the Texas Two-Step, noting that "[t]he potential loss in market value, the disruptions to operations, and the excessive administrative costs associated with independent chapter 11 filings [by nondebtor J&J entities] justify the business decision to employ the divisional merger statute as a means of entering the bankruptcy system."[17]

The fact that the funding agreement may have rendered LTL solvent — and thus not in need of reorganization — was irrelevant to the court, given that "bankruptcy law does not require that a bankruptcy debtor be insolvent," and the ongoing litigation against LTL and New JJCI clearly demonstrated financial distress.[18]

The Third Circuit's Reversal

On appeal, the Third Circuit reversed the bankruptcy court's denial of the motions to dismiss. Reviewing the bankruptcy court's decision anew, the Third Circuit evaluated whether LTL's financial distress was sufficient to entitle it to the protections of the Bankruptcy Code.

The Third Circuit held that the good faith test "asks whether the debtor faces the kinds of problems that justify Chapter 11 relief" and, in that regard, a debtor's financial distress "must not only be apparent, but it must be immediate enough to justify a filing."[19]

The court further cautioned against "premature filing," especially in mass tort cases, given the difficulties in estimating liabilities before a sufficient number of tort cases have been resolved.[20] Thus, to determine whether cases like LTL's must be dismissed, "courts must always weigh not just the scope of liabilities the debtor faces, but also the capacity it has to meet them."[21]

The Third Circuit compared the significant financial resources available to LTL including up to $61.5 billion potentially available to it under the funding agreement against the potential scope of talc-related liabilities — particularly in light of LTL's apparent successes at avoiding sizable judgments and settlements — but without regard for the financial implications on J&J's business.

Based on that analysis, the Third Circuit held that LTL was not in the kind of immediate financial distress that could support a bankruptcy filing, that its case had therefore not been filed in good faith and that its case must therefore be dismissed.[22]

Conclusion

The Third Circuit's LTL Management decision presents new challenges to companies seeking to manage mass tort litigation through a Texas Two-Step. In addition to potential fraudulent transfer liability and/or courts' refusal to extend the automatic stay to nondebtor affiliates, companies now also face the risk of dismissal based on questions about their good faith in pursuing bankruptcy.

The Third Circuit focused mainly on the fact that LTL was highly solvent by virtue of the funding agreement, and its decision did not turn on LTL's subjective intent in the bankruptcy. The court likewise did not decide what would have happened absent the funding agreement.

Indeed, the LTL Management case could be read to encourage companies to obtain weaker funding commitments — but not so weak as to invite avoidance actions — to demonstrate that their financial distress is sufficiently immediate.

The decision also highlights a growing division among appellate courts regarding the viability of the

Texas Two-Step approach. Even without further appeals in the LTL case, it is unlikely that the LTL Management decision will be the last word on the topic.

Companies are well advised to keep an eye on this shifting legal landscape, assessing when and where a Texas Two-Step transaction may be used, or when using it may be a misstep.

Sean Scott and Aaron Gavant are partners, and Josh Gross is an associate, at Mayer Brown LLP.

[1] The terms "divisive merger" and "divisional merger" are typically used interchangeably to describe the type of transaction discussed herein.

[2] TBOC § 1.002(55)(A).

[3] TBOC § 10.008(a)(3).

[4] TBOC § 10.008(a)(4).

[5] See, e.g., Tronox Inc. v. Kerr McGee Corp (In re Tronox Inc.), 503 B.R. 239, 248 (Bankr. S.D.N.Y. 2013) (finding between $5 billion and $14 billion in fraudulent transfer liability for acquirer of NewCo where OldCo was insufficiently capitalized to satisfy tort liabilities).

[6] See, e.g., In re Bestwall LLC, 605 B.R. 43, 47 (Bankr. W.D.N.C. 2019) (holding that OldCo bankruptcy was filed in good faith under Fourth Circuit's debtor-friendly dismissal standards where existence of funding agreement meant reorganization was not "objectively futile"); In re DBMP LLC, No. 20-30080, 2021 WL 3552350, at *34 (Bankr. W.D.N.C. Aug. 11, 2021) (extending automatic stay to non-debtor co-defendants in mass tort litigation); In re Aldrich Pump LLC, No. 20-30608 (JCW), 2021 WL 3729335, at *1 (Bankr. W.D.N.C. Aug. 23, 2021) (same).

[7] Declaration of John K. Kim in Support of First Day Pleadings ("Kim Decl.") ¶¶ 11-15, ECF No. 5, Bankr. No. 21-30589 (Bankr. D.N.J. Oct. 14, 2021).

[8] Id. ¶¶ 38-40.

[10] First, (a) Currahee Holding Company Inc. ("Currahee") was organized as the new, direct parent of Old JJCI; and (b) "Royalty A&M" was incorporated as a direct subsidiary of Old JJCI and capitalized with $367.1 million to acquire certain royalty streams from Old JJCI and other J&J affiliates. Second, Currahee organized "Chenango Zero LLC" as a Texas LLC. Third, Old JJCI merged into Chenango Zero. Fourth, J&J and Currahee entered into a "Funding Agreement" with Chenango Zero. Fifth, Chenango Zero effected a divisional merger under the TBOC: Two new Texas LLCs—Chenango One and Chenango Two—survived, and were allocated assets and liabilities of Chenango Zero (formerly Old JJCI). Chenango One was allocated talc-related liabilities, $6 million cash, Chenango Zero's rights under the Funding Agreement, the equity interests in Royalty A&M, and certain other property. The remaining assets and liabilities were allocated to Chenango Two. Chenango One also agreed to indemnify Chenango Two for losses relating to talc-related liabilities. Sixth, Chenango Two merged into Currahee, and the surviving entity

changed its name to Johnson and Johnson Consumer Inc. ("New JJCI"). Seventh, Chenango One converted into a North Carolina LLC and renamed itself LTL Management LLC. Id. ¶¶ 22-25.

[11] Id. ¶ 27.

[12] Id. ¶ 26.

[13] In re LTL Mgmt. LLC, No. 21-30589, 2021 WL 5343945, at *6 (Bankr. W.D.N.C. Nov. 16, 2021).

[14] Id. at *6-7.

[15] In re LTL Mgmt., LLC, 637 B.R. 396, 406 (Bankr. D.N.J. 2022) (cleaned up).

[16] Id. at 407-408 (citations omitted).

[17] Id. at 426.

[18] Id. at 417-18.

[19] In re LTL Mgmt., LLC, 2023 WL 1098189 at *9 (3d Cir. 2023).

[20] Id.at *10.

[21] Id. at *12.

[22] Id.at *13-14.