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The Texas Two-Step

A LEGITIMATE FEDERAL TOOL TO DEAL WITH MASS-TORT CLAIMS?

The Texas Two-Step (also the name of a famous country/western dance) is a two-step bankruptcy strategy. A healthy, solvent parent company spins off certain liabilities (commonly mass-tort claims) into a new company pursuant to Texas divisive merger law, and the new company then files for bankruptcy, often in the Fourth Circuit [See, e.g., *In re DBMP LLC*, Case No. 20-30080 (Bankr. W.D.N.C.); *In re Aldrich Pump LLC*, Case No. 20-30608 (Bankr. W.D.N.C.); *In re Murray Boiler LLC*, Case No. 20-306069 (Bankr. W.D.N.C.], where succeeding in dismissing a chapter 11 case in its early phase as a bad-faith filing is perceived as being difficult. They then seek approval of a channeling injunction and a special fund for the claimants and a broad release for the parent comany under a confirmed plan.

Such a release prevents all litigants from recovering for their harms from the parent company. Third-party releases are controversial in their own right. Broad third-party releases have been approved by courts in the Third, Fourth, Sixth, Seventh, and Eleventh Circuits, while the Fifth, Ninth, and Tenth Circuits have disallowed nonconsensual third-party releases. Whether nonconsensual third-party releases are permissible under the Bankruptcy Code is presently before the U.S. Supreme Court, with a decision in the *Purdue* appeal expected in June 2024. One concern for proponents of the Texas Two-Step is what the Supreme Court may do with respect to the viability of broad third-party releases in chapter 11 plans.

Many legal participants and commentators criticize the Texas Two-Step as an inequitable and improper way for solvent companies to shield their own assets from mass-tort claimants and litigants. Notably, in a Texas Two-Step, the parent company will commonly still exert some control or influence over the spin-off by appointing its board and executives.

In some Texas Two-Step cases, the debtor and its corporate parent argue that there is no real prejudice to the affected claimants because the debtor may have access to a funding agreement with the parent. Such was the case with LTL, the spin-off of health-product giant Johnson & Johnson, which itself faces tens of thousands of mass-tort claims related to its talcum-based baby powder products.

Fundamentally, the Texas Two-Step and cases employing it (such as the LTL case) raise important questions about the basic, overarching purposes and limits of the federal bankruptcy law system, including whether bankruptcy should be used as a tool to help address societal and broad-impact problems (like the opioid epidemic and child sex abuse) and the tensions between and among allowing a business to shed certain liabilities and restructure its affairs; implementing an equitable, efficient, effective framework to address thousands of claims; and holding culpable companies accountable.

The LTL/Johnson & Johnson case

Last year, in the LTL case, the U.S. Court of Appeals for the Third Circuit rejected the debtor's use of the Texas Two-Step, claiming that Johnson & Johnson's specially created subsidiary, LTL, was not eligible for bankruptcy protection because it was not in financial distress. (*In re LTL Mgmt., LLC* (2023) 64 F.4th 84.) Arguably, the Third Circuit seemed to espouse a new standard by requiring financial distress as a threshold requirement for filing bankruptcy.

For over 40 years, Johnson & Johnson Consumer Inc. ("Old J&J"), a subsidiary of the parent company Johnson & Johnson, sold Johnson's Baby Powder, a talc-based skin product. In recent

years, Old J&J began to face significant mass tort litigation in connection with its talc-based products, with plaintiffs alleging that the products caused ovarian cancer and other medical complications.

To manage pending and potential litigation, Old J&J implemented a divisional merger under Texas law, through which Old J&J was divided into LTL and a new Johnson & Johnson Consumer Inc. ("New J&J"). LTL received responsibility for all liabilities of Old J&J tied to talc-related litigation, $6,000,000 in cash and certain other significant assets. New J&J received all assets and liabilities of Old J&J not allocated to LTL – in essence operating as the parent company's consumer products subsidiary – free of the talc-related litigation liabilities.

The divisional merger also included a funding agreement that gave LTL rights to funding from New J&J and the parent (the "Funding Agreement"). The Funding Agreement provided that outside of bankruptcy, LTL was entitled to direct a cash infusion from New J&J and the parent up to the value of New J&J for purposes of satisfying talc-related costs. The Funding Agreement provided that in bankruptcy, LTL was entitled to a cash infusion from New J&J and the parent in an amount to satisfy its administrative costs in bankruptcy and to fund a talc-related trust. The amount of any payment could not be less than the value of New J&J as of the time of the divisive merger (approximately $61.5 billion), but it was not capped and could potentially grow.

Two days after the divisional merger, LTL filed for chapter 11 protection in the Bankruptcy Court for the Western District of North Carolina. The strategy behind LTL's filing in the Western District of North Carolina was likely incentivized by *In re Bestwall LLC*, 605 B.R. 43 (Bankr. W.D.N.C. 2019) and its progeny. In the *Bestwall* case, the court denied a motion to dismiss a case involving a debtor created through the Texas Two-Step without reaching the issue of bad faith, limiting its analysis to a determination that the debtor was capable of reorganizing under chapter 11. The bankruptcy administrator in the LTL case in North Carolina successfully moved the court to transfer the case to New Jersey (headquarters of J&J); the bankruptcy court ruled that LTL was forum shopping.

In January 2023, the Third Circuit issued its opinion reversing the Bankruptcy Court for the District of New Jersey, after finding that the first bankruptcy case (Case No. 21-30589) was filed in bad faith, and remanding it with the instruction to dismiss the case. (*In re LTL Mgmt., LLC* (3d Cir. 2023) 64 F.4th 84.) The Third Circuit stated there are two inquiries in the good-faith requirement: "(1) whether the petition serves a valid bankruptcy purpose[;] and (2) whether [it] is filed merely to obtain a tactical litigation advantage." The Third Circuit held that the debtor LTL did not suffer immediate financial distress, and without financial distress, there was no valid bankruptcy purpose.

The Third Circuit noted that the Funding Agreement gave LTL – at minimum – a $61.5 billion payment right against New J&J and the parent, which right was reliable (the parent company's balance sheet was particularly strong, having hundreds of billions of dollars in equity value).

Subsequently, in April 2023, the Bankruptcy Court entered an order dismissing the first bankruptcy case. Thereafter, approximately two hours after the dismissal of the first LTL bankruptcy case, LTL filed the second chapter 11 bankruptcy in New Jersey. With the second filing, LTL included a plan support agreement that contemplated, among other things, an $8.9 billion commitment to be funded into a trust to resolve current and future talc-related claims.

After conducting a four-day trial on various motions to dismiss the second case, in July 2023, the Bankruptcy Court held that LTL's second bankruptcy was also filed in bad faith. (*In re LTL Mgmt., LLC* (Bankr. D.N.J. July 28, 2023) Case No. 23-12825 (MBK), 652 B.R. 433.) In following the Third Circuit's prior guidance, the Bankruptcy Court began its analysis by reviewing whether LTL was in "financial distress." While recognizing that LTL faces substantial liability due to the countless lawsuits, the Bankruptcy Court found that LTL was solvent, with the assistance of its parent and the Funding Agreement: "Most importantly, the Debtor was contractually entitled to a funding backstop – in the form of the 2023 Funding Agreement – that allowed it to access the value of HoldCo's significant cash holdings, anticipated annual dividends, and equity interests having a value approaching $30 billion – exceeding the projected near term and aggregate talc liability. This asset - which the Third Circuit previously described as 'an ATM disguised as a contract' – is properly considered in LTL's financial distress analysis." The possibility that the non-debtor parent might have to liquidate assets to meet its funding obligations to the debtor was not evidence of the debtor's financial distress.

The Bankruptcy Court reasoned that, in the Third Circuit, good faith necessarily requires some degree of financial distress on the part of a debtor, and the debtor's financial distress must be "immediate," "imminent" and "apparent." One can argue the Third Circuit's position as being somewhat at odds with a proactive, flexible approach to facilitating legitimate debtors seeking and obtaining bankruptcy relief.

Arguably, the LTL decisions can be viewed as rejections of the Texas Two-Step – that LTL was not in real financial distress (given the nature and details of the divisive merger transaction in this case) and thus had no legitimate purpose in filing for bankruptcy protection. This position implicitly rejects gamesmanship through the Texas Two-Step or otherwise.

The case against the Texas Two-Step

Texas Two-Step proponents argue that this process is not inherently bad faith, and that in the context of mass-tort litigation, bankruptcy via the Texas Two-Step is the fairest and most efficient way to aggregate and address large numbers

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of tort claims. In short, a corporate parent's use of the Texas Two-Step should be recognized as a valid use of the provisions of both state law and bankruptcy law. State law and bankruptcy tools that facilitate fair, efficient and more streamlined resolution of numerous tort claims should be encouraged (for the benefit of all tort victims), and courts can guard against improper abuse by the debtor, parent or other parties. Properly used, the Two-Step / third-party release process can prevent holdout behavior and incentivizes culpable corporate parties to contribute assets to the bankruptcy estate.

On the other hand, the critics of the Texas Two-Step argue that it is an abuse of the bankruptcy system that, if allowed by the courts, may lead to significant problems:

(1) From the tort victims' perspective, there may be substantial delays, risks, conditions, and uncertainties relating to the special fund or group of assets, in whole or part provided by the non-debtor parent, under the chapter 11 plan, which may potentially turn out to be insufficient or inequitable at the end of the day.

(2) More fundamentally, the tort victims' negotiating power and leverage may be lessened or otherwise affected by the changed dynamics of the corporate parent's business and assets not being at stake in the debtor affiliate's chapter 11 case. If the parent were to be a debtor, the delays, risks and uncertainties of the bankruptcy process would likely impose substantial pressures on the debtor parent and its operations and business to exit bankruptcy expeditiously and effectively.

(3) Public confidence is undermined when high-profile companies appear to engage in unfair gamesmanship to shelter their assets, rather than providing what is perceived as fair remuneration for innocent tort victims.

The bigger questions

How one views the Texas Two-Step raises bigger questions such as: How flexible and empowered should the bankruptcy system be, together with state laws, in being able to restructure and rehabilitate debtors, as well as non-debtor corporate parents and other affiliates? Some observers argue that there can be legitimate, good-faith uses of the Texas Two-Step, depending on the circumstances. However, a strong case can and should be made that the Texas Two-Step, as used in cases like LTL, goes over the line as to what should be recognized and accepted by the courts and the bankruptcy system. Certainly, dealing with mass torts in a single bankruptcy forum in an efficient, cost-effective manner can be beneficial for tort victims as a whole. Yet, in the mass-tort context, public and claimants' confidence in the fairness, credibility and integrity of the bankruptcy process may be an even more important consideration.

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