**Alabama Bankruptcy and Commercial Law Section**

**Bankruptcy at the Beach 2023**

**Commercial Bankruptcy Panel**

**The Texas Two-Step and LTL Management LLC’s Chapter 22**

By: Christopher Hawkins, Bankruptcy Judge

United States Bankruptcy Court

Middle District of Alabama

**Introduction**

The Constitution authorizes Congress to enact "uniform Laws on the subject of Bankruptcies." U.S. Const. art. I, § 8. Notwithstanding the framework of the Bankruptcy Code, variations in applicable nonbankruptcy law and differing judicial interpretations have chipped away at the constitutional goal of uniformity. Resourceful lawyers often are the ones holding the chisels, seeking out strategic advantage for their clients from every possible angle. While the lawyer’s job is to advocate zealously on behalf of the client, bankruptcy courts often are asked to draw the line between creativity and overreach. Courts on multiple levels in multiple jurisdictions have grappled with this question in the bankruptcy cases filed by LTL Management LLC (“LTL”), a subsidiary of Johnson & Johnson.

**Background**

Johnson & Johnson (the “Parent Company”) is an American corporation headquartered in New Jersey. It develops medical devices, pharmaceuticals, and consumer goods and is ranked in the top 50 of the largest American corporations by revenue. Johnson & Johnson Consumer Inc. (“Old J&J”) was a subsidiary of the Parent Company, also with its base of operations in New Jersey. For over forty years, Old J&J sold Johnson’s Baby Powder, a talc-based skin product. In recent years, Old J&J began to face significant litigation in connection with its talc-based products. Plaintiffs in the litigation alleged that the products caused ovarian cancer and other medical complications. The litigation consisted of nearly 40,000 ovarian cancer actions and 400 mesothelioma actions against Old J&J, and the company anticipated that the litigation would continue to increase in the coming years.

To manage pending and potential litigation, Old J&J executed a divisional merger under Texas law, which is also known as the “Texas Two-Step.” Texas’ divisional merger laws permit an entity to divide into two new entities. The old entity does not survive the merger, but it allocates its assets and liabilities between the new entities.[[1]](#footnote-1) An entity created in a divisional merger is not liable for the debts or obligations of the other new entity except as otherwise provided by law or contract.

Through the divisional merger, Old J&J was divided into LTL and a new Johnson & Johnson Consumer Inc. (“New J&J”). LTL was formed as a Texas limited liability and then converted into a North Carolina limited liability company. New J&J was initially formed as a Texas limited liability company, then merged into a New Jersey corporation that was its direct parent and changed its name to Johnson & Johnson Consumer Inc. Pursuant to the divisional merger, LTL received, without limitation: (a) responsibility for all liabilities of Old J&J tied to talc-related litigation; (b) Old J&J’s contracts; (c) ownership of a North Carolina limited liability company that owns a portfolio of royalty revenue streams from products such as Clorox, Lactaid, Rogaine, and Mylanta; and (d) $6,000,000.00 in cash. 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 created a funding agreement that gave LTL rights to funding from New J&J and the Parent Company (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 Company up to the value of New J&J for purposes of satisfying talc-related costs. The Funding Agreement provided that inside of bankruptcy, LTL was entitled to a cash infusion from New J&J and the Parent Company in an amount to satisfy its administrative costs in bankruptcy and to fund a talc-related trust created through the bankruptcy. The amount of any payment could not drop below 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 with any increase in the value of New J&J.

**Original Bankruptcy Venue**

Two days after Old J&J’s 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 almost certainly was driven 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 via Texas Two-Step without reaching the issue of bad faith, limiting it analysis to a determination that the debtor was capable of reorganizing under Chapter 11.

The Bankruptcy Administrator called out LTL’s aggressive maneuvering and moved the court to transfer the case to New Jersey. In *In re LTL Mgmt. LLC*, Case No. 21-30589, 2021 WL 5343945 (Bankr. W.D.N.C. Nov. 16, 2021), the bankruptcy court granted the Bankruptcy Administrator’s motion, finding that debtor was not merely forum shopping but “manufacturing forum” and “attempting to outsmart the purpose of the [bankruptcy venue] statute.” *Id.* at \*15.[[2]](#footnote-2)

**New Bankruptcy Venue**

After the case was a transferred to the Bankruptcy Court for the District of New Jersey, the Official Committee of Talc Claimants moved to dismiss LTL’s petition under § 1112(b) of the Bankruptcy Code, alleging that LTL had not filed its case 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. *In re LTL Mgmt., LLC*, 637 B.R. 396 (Bankr. D.N.J. 2022). The bankruptcy court determined 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 J&J; and (c) LTL’s bankruptcy was not undertaken to secure an unfair litigation advantage.  *Id*. at 407-428. The court found that “justice will best be served by expeditiously providing critical compensation through a court-supervised, fair, and less costly settlement trust arrangement.” *Id*. at 430.

The Third Circuit reversed the Bankruptcy Court’s decision on appeal, finding that the LTL filing was not in good faith because LTL was not in financial distress.  In re LTL Mgmt., LLC, 64 F.4th 84 (3d Cir. 2023). The court held that while the Bankruptcy Code does not expressly require debtors to be in financial distress to file bankruptcy in good faith, Third Circuit precedent dictates that “a debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith.” *Id*. at 101.

The court distinguished distress from insolvency and enumerated several factors that were relevant to distress, including balance-sheet insolvency, insufficient cash flows, and uncertain and unliquidated future liabilities. The court 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. *Id*. at 102.

In applying these principles, the court considered only LTL’s financial condition, not that of Old J&J. *Id*. at 105. This reflected that state-law property interests should be given the same effect inside and outside of bankruptcy, and such interests were created through Old J&J’s divisional merger, at which point Old J&J ceased to exist. With this framework, the court disagreed with the bankruptcy court’s finding that LTL was in financial distress at the time of its bankruptcy filing. *Id*. at 106. The court noted that the Funding Agreement gave LTL – at minimum – a $61.5 billion payment right, jointly and severally, against Old J&J and the Parent Company. The court found that the Funding Agreement provided LTL a right to cash that was very valuable, likely to grow, and minimally conditional. *Id*. The court reasoned this right was reliable, as Old J&J and the Parent Company were highly creditworthy counterparties with the capacity to satisfy it, noting that the Parent Company’s balance sheet was exceptionally strong - containing $400 billion in equity value - and that the Parent Company enjoyed a AAA credit rating and $31 billion in cash and marketable securities. *Id*.

The court also considered the relative success Old J&J had enjoyed in litigation, noting: (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. *Id*. at 107-108. The court held that the bankruptcy court’s projections ignored the possibility of meaningful settlement and/or successful defenses to the claims against the Parent Company. When comparing the five-year litigation costs thus far ($4.5 billion) against LTL’s funding right ($61.5 billion), the court concluded that there was no likely need in the present or near-term for LTL to file for bankruptcy. *Id.*

The court rejected the concept 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 § 1112(b)(2) of the Bankruptcy Code. *Id*. at 110. The court noted that the only unusual circumstance present was that LTL was entering bankruptcy in a highly solvent position with access to sufficient cash. *Id*.

The court offered some degree of encouragement to creative lawyers:

[W]e mean not to discourage lawyers from being inventive and management from experimenting with novel solutions. Creative crafting in the law can at times accrue to the benefit of all, or nearly all, stakeholders. Thus we need not lay down a rule that no nontraditional debtor could ever satisfy the Code's good-faith requirement.

*Id*. at 111. However, the court ultimately held that dismissal was warranted, concluding that “Chapter 11 is appropriate only for entities facing financial distress,” which serves as a safeguard to ensure “that claimants' pre-bankruptcy remedies—here, the chance to prove to a jury of their peers injuries claimed to be caused by a consumer product—are disrupted only when necessary.” *Id*.[[3]](#footnote-3)

Within hours of the bankruptcy court’s dismissal of the original bankruptcy case in accordance with the Third Circuit’s opinion and judgment, LTL filed a new case. With this filing, LTL included a plan support agreement that contemplates, among other items, an $8.9 billion commitment from LTL and the Parent Company to be funded in a trust over 25 years to resolve current and future talc-related claims.[[4]](#footnote-4) LTL asserts that this is the “largest settlement ever reached in an asbestos bankruptcy case, even cases where (unlike here) the manufacturer conceded that its products contained asbestos.”[[5]](#footnote-5) LTL has indicated that representatives for over 60,000 current talc claimants have committed to support the proposed deal.[[6]](#footnote-6)

**Conclusion**

It remains to be seen how LTL will fare in its Chapter 22. Adjusting on the fly to the Third Circuit’s ruling, LTL terminated the Funding Agreement with New J&J and the Parent Company, in essence manufacturing a better argument on the issue of financial distress. LTL entered into a new funding agreement with its direct parent, Johnson & Johnson Holdco (NA) Inc. (“Holdco”), and a support agreement with the Parent Company. The Parent Company no longer is a party to the funding agreement, and its obligations are available only in bankruptcy and are subject to bankruptcy court approval. Holdco is the sole obligor under the new funding agreement.

These maneuvers, coupled with the fact that LTL’s proposed settlement enjoys the support of so many talc claimants, may lead to a different result in the second case. However, LTL’s approach – which appears to be a combination of papering over the financial strength of the Parent Company while substantially increasing the funds to be included in a settlement trust – may not be sufficient to address the Third Circuit’s concern that the talc “claimants' pre-bankruptcy remedies—here, the chance to prove to a jury of their peers injuries claimed to be caused by a consumer product—are disrupted only when necessary.”

1. The statute clarifies that the merger does not effect any transfers between the old entity and the new entity, presumably to eliminate the risk that the divisional merger constitutes a fraudulent transfer. [↑](#footnote-ref-1)
2. Notably, similar maneuvering in other cases led to the Bankruptcy Venue Reform Act of 2021 (H.R. 4193) (bill introduced in the House on June 28, 2021 (with similar related bill (S. 2827) introduced in Senate on September 23, 2021); among other things, would amend 28 U.S.C. § 1408 to require any corporate debtor to file its bankruptcy case in (a) venue in which debtor’s principal place of business or principal assets have been located for the 180 days immediately preceding the petition date (or longer portion of such 180-day period than they have been located elsewhere) or (b) district in which bankruptcy case concerning debtor’s affiliate is pending, but only if affiliate directly or indirectly owns, control, or holds at least 50% of outstanding voting securities of, or is general partner of, later-filing debtor, and only if affiliate’s pending case was properly filed in that district. The legislation died in committee, but was reintroduced by Reps. Zoe Lofgren, D-Calif., and Ken Buck, R-Colo.in February 2023. [↑](#footnote-ref-2)
3. Like the venue shopping issue, the divisional merger issue and issues related to nonconsensual third party releases attracted the attention of Congress. The Nondebtor Release Prohibition Act of 2021 (H.R. 4777/S. 2497) (bill introduced on July 28, 2021; would amend 11 U.S.C. § 1112 to require dismissal of any chapter 11 case in which debtor or its predecessor was involved in divisional merger or equivalent transaction that occurred within 10-year period preceding bankruptcy filing and “had the intent or foreseeable effect of . . . [s]eparating material assets from material liabilities of an entity eligible to be a debtor under [chapter 11]; and assigning or allocating all or a substantial portion of those liabilities to the debtor, or the debtor assuming or retaining all or substantial portion of those liabilities”). [↑](#footnote-ref-3)
4. Debtor’s Statement Regarding Refiling of Bankruptcy Case (Docket No. 3), *In re LTL Management LLC*, Case Number 23-12825-MBK (Bankr. D.N.J. Apr. 4, 2023) at ¶¶ 8, 74. [↑](#footnote-ref-4)
5. Id. [↑](#footnote-ref-5)
6. Id. [↑](#footnote-ref-6)