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The Music Stops on the Texas Two-Step: Third Circuit Dismisses LTL Bankruptcy Case

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The United States Court of Appeals for the Third Circuit wasted no time getting the new year off to a roaring start through its ruling in *In re LTL Mgmt., LLC,* Case No. 22-2003, 2023 WL 1098189 (3d Cir. Jan. 30, 2023). In *LTL*, the Third Circuit affirmatively dismissed the so-called "Texas Two-Step" by which a solvent corporation had tried to cabin potentially billions of dollars of mass tort liability through an internal corporate restructuring.

In that ruling, the Third Circuit determined that:

- A corporate bankruptcy requires the debtor to have "some degree of financial distress," *id*. at *8; and
- A funding arrangement by which the putative debtor's corporate parent agreed to, in effect, fund the debtor's liquidated tort liability eliminated the possibility of any such financial distress, *see id*. at *15.

At the same time, the Third Circuit emphasized that "[g]ood intentions—such as to protect [a] brand or comprehensively resolve litigation—do not suffice alone" in satisfying the good-faith filing requirement. *Id*. at *1.

Under *LTL*, the Texas Two-Step and similar transactions that seek to divorce legacy liabilities from healthy operating assets prior to a bankruptcy filing will face challenges in the Third Circuit going forward. Indeed, coupled with the recent opinion issued in *In re 3M Combat Arms Earplug Products Liability Litigation*, Case No. 19-2885, 2022 WL 17853203 (N.D. Fla. Dec. 22, 2022) ("3M"), a pattern of judicial hostility directed towards such attempts to address mass tort liability may be emerging. *Cf. id.* at *6 ("3M's machinations have frustrated, manipulated, and delayed the fair, efficient, and effective resolution of hundreds of thousands of [mass tort] claims.").

Background and Lower Court Ruling

While the background facts underlying the mass tort liability at issue are complex, the facts relevant to the *LTL* opinion are relatively simple. In 2021, Johnson & Johnson, the consumer products company, and certain of its controlled subsidiaries entered into a series of intercompany transactions to channel potential asbestos liability allegedly connected to its baby powder and certain other products. In sum, Johnson & Johnson caused LTL Management LLC ("LTL") to be formed and, in turn, caused LTL to bear responsibility for potentially billions of dollars in baby-powder-related tort liability: "LTL became in bankruptcy talk the 'bad company' . . . ." *In re LTL Mgmt., LLC*, 2023 WL1098189, at *5. To satisfy these potential tort liabilities, however, LTL benefitted from a series of royalty rights and a funding agreement by which Johnson & Johnson and an affiliate jointly and severally agreed to pay cash for purposes of covering LTL's obligations under the operative tort claims.

These transactions were effectuated through a series of intercompany steps, most notably a divisive merger available under Texas law, now generally referred to as a "Texas Two-Step." *See* Tex. Bus. Orgs. Code. § 1.002(55)(A). Two days after that divisive merger was complete, LTL filed bankruptcy in October 2021 in the Western District of North Carolina and sought to enjoin baby powder and related claims that might otherwise be asserted against Johnson & Johnson and its non-debtor affiliates. The purpose of LTL's bankruptcy was to channel all pending (and future) claims into the bankruptcy forum to take advantage of its claims process, eliminate piece-meal litigation, and bring certainty under the expedited timeline the bankruptcy process provides.

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LTL's North Carolina bankruptcy filing was subsequently transferred to New Jersey, and various stakeholders sought to dismiss that bankruptcy. These stakeholders argued, among other things, that LTL's bankruptcy was filed in bad faith. *Cf.* 11 U.S.C. § 1112(b). The New Jersey bankruptcy court denied the motion, seeing, as the Third Circuit described, "[itself] as having a superior ability, compared to trial courts, to protect the talc claimants' interests, [and] viewing this as an 'unusual circumstance' that precluded dismissal . . . ." *In re LTL Mgmt., LLC*, 2023 WL1098189, at *6 (quoting *In re LTL Mgmt., LLC,* 637 B.R. 396, 406 n.8 (Bankr. D.N.J. 2022)). This ruling was promptly appealed and certified for direct review by the Third Circuit.

The *LTL* Ruling

The Third Circuit's analysis in *LTL* focuses principally on the requirement that a Chapter 11 bankruptcy must be filed in good faith. In the Third Circuit, two inquiries are relevant in that analysis:

- Whether the petition serves a valid bankruptcy purpose, and
- Whether it was filed to merely obtain a tactical litigation advantage.

Id. at *8. The first inquiry, the Court noted, focuses on preserving a going concern or maximizing estate value. *Id*. Perhaps more importantly, it also assumes a debtor in financial distress, and, under Third Circuit precedent, a debtor who does not suffer from financial distress cannot demonstrate its petition serves any valid bankruptcy purpose. *Id*. Simply put, if there is no financial distress, a debtor's good intentions or desire to benefit from the Bankruptcy Code's protections and tools cannot justify its presence in bankruptcy.

Moreover, in assessing distress, the financial condition of the debtor itself is determinative. While the financial condition of another entity may be part of the determination, it is relevant only to the extent it affects the debtor's financial condition. *Id*. at *13.

With the standard properly established, the Court turned to LTL. However, LTL, the Court found, was not in financial distress – it had the funding agreement, no repayment obligation, and the potential for success in the defense and settlement of claims (its predecessor's pre-division success in both regards was not lost on the Court). *Id*. at *15–16. Rather than facing financial distress, LTL was instead "highly solvent" and would not be in distress for some time – if ever. *Id*.

Having determined that LTL's petition did not serve a valid bankruptcy purpose, the Court declined to consider the second inquiry and also held that "unusual circumstances" excepting dismissal were not applicable. Indeed, what was unusual to the Court was that LTL, having access to the funding agreement, sought bankruptcy protection at all. *Id*. at *16–17.

Takeaways from the Ruling

On its own, the Third Circuit's decision is not controversial: under applicable, settled law, a solvent, financially stable company cannot satisfy the good-faith filing requirement and, therefore, that petition must be dismissed, leaving parties to their pre-bankruptcy rights and options. *See In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 129 (3d Cir. 2004) ("Because [the debtor] was not in financial distress, its Chapter 11 petition was not filed in good faith"); *In re SGL Carbon Corp.,* 200 F.3d 154, 162–70 (3d Cir. 1999) (dismissing petition for lack of good faith and noting "[the debtor], by its own account, and by all objective indicia, experienced no financial difficulty at the time of filing[.]").

Regardless, the ruling disrupts the recent practice of separating a legacy company's productive business from its historic liabilities and then subjecting only the entity housing those liabilities, with the aid of a funding agreement, to the bankruptcy process. *C.f. In re Aearo Techs. LLC,* 642 B.R. 891 (Bankr. S.D. Ind. 2022).

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At least in the Third Circuit, this structure will face significant challenges. The "bad company" formed to house liabilities may be ineligible to file bankruptcy precisely because it benefits from the funding of its corporate parent or siblings. *In re LTL Mgmt., LLC*, 2023 WL1098189, at *17 ("[the debtor's] funding backstop plainly mitigates any financial distress foreseen on its petition date."). Nor is *LTL* alone in taking a somewhat skeptical view as to the *bona fides* around the Texas Two-Step or similar transactions. *C.f. 3M,* 2022 WL 17853203, at *7 (precluding corporate parent "from attempting to avoid any portion of its alleged liability for the [] claims in this litigation by shifting blame to the [debtor] defendants"). But this ruling does not solve the problem that many debtors will still need avenues by which they can address the complex issues that can and will arise from contingent tort liabilities.

Undoubtedly, the path chosen will be tailored to the particular needs, facts, and circumstances of the company – each of which presents its own opportunities and challenges. To be sure, "one-size-fits-all" approaches are seldom the answer in restructuring scenarios.

We encourage you to contact your Ropes & Gray team to discuss these matters more fully.

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