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Locke Lord QuickStudy: Last Dance? Third Circuit Shuts Down ?J&J Affiliate’s Chapter 11 Case Predicated on “Texas Two-Step”?

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At the end of January, the Third Circuit Court of Appeals issued its long-awaited decision in the Chapter 11 bankruptcy case of LTL Management LLC (“LTL”), an affiliate of Johnson & Johnson (“J&J”). In a decision authored by Judge Thomas Ambro, a three-judge panel for the Third Circuit found the case to be a bad faith filing, and directed that it be dismissed by the bankruptcy court. In so ruling, the Third Circuit panel decisively rejected J&J’s use of a restructuring maneuver designed to insulate the company’s profitable lines of business from the burgeoning liabilities associated with its former talcum powder operations. This far reaching decision—authored by a highly-respected Judge from an influential court—is expected to prompt serious consideration as to the ongoing viability of this restructuring strategy, as well as analysis as to when and how the strategy might still work.

While Judge Ambro was too polite to adopt the terminology, the strategy at issue is commonly referred to as a Texas Two-Step—implemented in this case through the use of a divisive merger under Texas law. In October 2021, J&J implemented a divisive merger that, by way of several intermediate steps, allocated all of the corporate family’s talcum liabilities and related assets to LTL—an entity newly formed to hold these liabilities and assets. The profitable lines of business—and J&J is one of the most profitable businesses in the world—remained wholly separate from LTL. Importantly for Judge Ambro’s decision, the profitable corporate family members also provided LTL with an indemnity for the full amount of the eventual talcum exposure. Shortly after these restructuring transactions were complete, LTL filed for Chapter 11 relief—the second step in the Two-Step.

By way of background, these talcum liabilities arose from the decades in which J&J was a market leading manufacturer and distributor of baby powder. Allegations were made that ingredients in the baby powder caused cancer and a variety of other adverse health impacts, and a tsunami of litigation ensued. While J&J successfully defended a number of these cases, a combination of one show stopping verdict, the prospect of billions of dollars in claimed exposure, and an ever increasing legal spend impelled J&J to pursue a restructuring solution. The Texas Two-Step had been successfully implemented in numerous other cases. J&J apparently decided to give it a try.

Procedurally, on October 14, 2021, LTL filed a voluntary petition under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Western District of North Carolina. Following a venue transfer to the District of New Jersey—the jurisdiction where a substantial portion of the talc litigation was pending—an official committee of talc claimants moved to dismiss the bankruptcy case. The committee alleged that the case was not filed in good faith, and many interested parties filed joinders to this request for dismissal. After a five-day trial, the

Bankruptcy Court denied the motion to dismiss.

On direct appeal, the Third Circuit reversed the Bankruptcy Court's decision and directed the dismissal of LTL's case. In reaching this decision, Judge Ambro found that the value of the indemnity/funding backstop provided by J&J equaled or exceeded the amount of LTL's liabilities, including the trailing talc exposure: "LTL, after the divisional merger of that [a]greement, held assets having a value at least equal to its liabilities and had financial capacity sufficient to satisfy its obligations as they become due in the ordinary course of business, *including any [t]alc [r]elated [l]iabilities.*"^[1] Judge Ambro therefore concluded that LTL was not in any kind of financial distress, that there was therefore no legitimate need to reorganize under the auspices of Chapter 11, and that the case was ripe for dismissal as a bad faith filing.^[2] In a particularly interesting part of the opinion, Judge Ambro warned that the restructuring could not be salvaged by disclaiming or releasing J&J's funding obligation—inasmuch as that waiver or release would likely be subject to avoidance.^[3] Judge Ambro left for another day the question of whether a *partial* funding commitment could support a legitimate reorganization purpose.

On February 13, 2023, LTL filed a petition requesting a rehearing *en banc* on the Third Circuit panels' decision.^[4] In that petition, LTL vigorously challenges the substance and reasoning of the Third Circuit panel's decision. LTL argues that the panel analyzed its financial distress in a vacuum, separate from other entities in the J&J family, and manufactured a requirement that the debtor face "imminent" financial distress in order to qualify for bankruptcy. In its petition, LTL urges the Third Circuit to adopt the Fourth Circuit's standard—one of objective futility and subjective bad faith—when determining whether a debtor filed in bad faith. In a final plea, LTL warns that if the Third Circuit's decision stands, future claimants will have far less to recover given current defense costs of other J&J entities. Multiple amicus briefs have since been filed in support of the petition and agreeing with LTL's position.^[5] The Third Circuit subsequently ordered appellants to file a response to the petition for rehearing by March 7, 2023.^[6]

So how should practitioners and business teams react to these developments? Assuming that the Third Circuit does *not* grant rehearing, any bankruptcy venued in the Third Circuit (which notably includes the District of Delaware) will be subject to dismissal on the grounds articulated by Judge Ambro. Certainly, the viability of the Texas Two-Step itself has been placed in serious doubt. But any restructuring strategy that places a solvent debtor under the jurisdiction of the bankruptcy court will be vulnerable to challenge on these same grounds. LTL complains that "financial distress" is not a statutory element set forth in the Bankruptcy Code's eligibility requirements. That's true as far as it goes, but ignores the fact that bad faith dismissal has always been a consequence for cases filed without a legitimate reorganization purpose. Ultimately, Judge Ambro's decision can best be understood as a fresh application of the "legitimate reorganization purpose" case law—with specific reference to solvent entities attempting to resolve their mass tort exposures in bankruptcy court. The next evolution in restructuring practice will likely zero in on the opening left in Judge Ambro's decision—marginally insolvent or nearly solvent entities bringing their tort liabilities before the bankruptcy court, where the tort claimants are the fulcrum in the case.

[1] Case No. 22-2003, Docket No. 150, at page 51 (3rd Cir. Jan. 30, 2023).?

[2] Of course, mass tort liability *can* push debtor into true financial distress—one of the most notable examples

being Johns-Manville Corporation. But that case presented an overwhelming universe of tort liability, and nothing resembling the funding commitment made by J&J.

[3] *Id.*, page 53, note 18.

[4] Case No. 22-2003, Docket No. 153.

[5] Case No. 22-2003, Docket Nos. 155, 157, 159, 161.

[6] Case No. 22-2003, Docket No. 163.

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