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Two Steps Too Far: New Limitations on the Use of the Texas Two-Step to Resolve Mass Tort Liability in Bankruptcy

Samuel E. Bartz*

This paper explores the mechanisms by which companies have utilized corporate restructuring through divisive mergers in conjunction with the available protections and tools of the United States Bankruptcy Code to resolve mass tort liability without placing the entirety of the business under bankruptcy. Popularized in Texas, a divisive merger is a mechanism by which an existing business entity divides itself into two new entities, allocating all pre-existing assets and liabilities to each as they see fit. Although intended to be a means by which to easily sell assets of a business, it has been more popularly used to resolve mass tort liability burdening a business.

Known as the Texas Two-Step, this procedure requires two simple steps. First, a business undergoes a divisive merger and allocates all liability associated with its mass tort claims to a newly created entity. Second, the liability-burdened entity places itself under Chapter 11 bankruptcy, in order to enjoin further prosecution of claims and to resolve all current and future liability through the creation of a settlement trust administered by the bankruptcy court. In addition to presenting the mechanisms of the Texas Two-Step and a case study of its use, this paper will present the series of decisions culminating in the Third Circuit's instruction to reject its use.

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INTRODUCTION

Business entities do not frequently engage in the use of divisive mergers. While the name appears oxymoronic given that a merger typically implies the union of two entities, a divisive merger is a mechanism popularized under Texas law by which an existing entity divides itself into two entities, allocating pre-existing assets and liabilities from the original entity into two newly created entities. While divisive mergers were originally intended to create a means for a business to easily spin off a line of its business, it has, in recent years, become frequently used within the bankruptcy arena as a means by which a business can resolve mass tort liability in a less costly, but more time-efficient manner, as compared to the traditional tort system.

Popularized in the last two decades, and now known as the Texas Two-Step, this procedure requires only two actions. First, a business burdened with mass claims of products liability, engages in a divisive merger and allocates all liability related to such claims to a newly created entity. The other surviving or newly created entity is allocated all other assets of the business, as a going concern. Second, the liability-saddled entity files for bankruptcy under Chapter 11 of the United States Bankruptcy Code (the "Code"). The filing entity and its related parties are not only protected from further prosecution of claims but can also resolve all current and future liability through a settlement trust administered by the bankruptcy system.

While divisive mergers are not traditionally used within the realm of bankruptcy, this article provides a case-study of the Texas Two-Step, its implications for both the claimants and corporations engaged in the process of resolving mass-tort liability, and the current divide between the bankruptcy courts and the Third Circuit. Part I of this article discusses the mechanisms of the Texas Two-Step and provides a case-study example through *In re Bestwall LLC*.[1] Part II presents some current criticisms by legal scholars who warn that the use of the Texas Two-Step has exceeded the limits of the Code. Part III presents the series of orders and opinions, culminating with *In re LTL Management, LLC*[2] in which the Bankruptcy Court for the District of New Jersey complied with the Third Circuit's instruction that, in essence, has rejected the Texas Two-Step.

This article presents the current legal and policy arguments within the Third Circuit regarding the relationship between the bankruptcy system, mass-tort liability, and corporate restructuring. While the article does not advocate for adoption of any judicial opinion presented, it does present the various advantages and disadvantages of the proposed methods of resolving this issue.

I. THE MECHANICS AND A CASE STUDY OF THE TEXAS TWO-STEP

A. *Mechanics and Procedures of the Texas Two Step*

When an entity becomes financially distressed, it may voluntarily file a petition for bankruptcy under Chapter 11 of the Code and reorganize. Once the petition is filed, the debtor assumes the role of "debtor in possession," allowing them to retain possession and control of their assets during reorganization.[3] In order to successfully reorganize, the petitioner must provide the court with both a written disclosure statement and a plan of reorganization.[4] The disclosure statement must contain adequate information regarding the petitioner's assets, liabilities, and affairs that would enable a creditor to make an informed decision regarding their vote of approval for the plan of reorganization.[5] Whether adequate disclosure has been provided is subject to judicial discretion and is evaluated by the totality of the circumstances. The plan for reorganization must:

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1 606 B.R. 243 (Bankr. W.D.N.C. 2019).
2 652 B.R. 422 (Bankr. D.N.J. 2023)
3 *See* 11 U.S.C. § 1107.
4 *See id.* § 1121; *id.* § 1125.
5 *See id.* § 1125.

> [S]pecify the treatment of any class of claims or interests that is impaired under the plan; . . . provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest[;] . . . [and] provide adequate means for the plan's implementation.[6]

Creditors whose claims are impaired by the plan must vote and approve the plan.[7] After receiving notice of approval, the bankruptcy court will also confirm the plan once it determines that the requirements set forth in 11 U.S.C. § 1129 have been met.[8]

As is true with filings made under other bankruptcy chapters, once a petition is filed under Chapter 11 with the appropriate bankruptcy court, 11 U.S.C. § 362 places an automatic stay against the commencement or continuation of actions against the debtor that arose prior to the petition's filing.[9] In addition to enforcing an automatic stay, a bankruptcy court is permitted, per 11 U.S.C. § 105(a), to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," including a preliminary injunction. Essentially, these provisions enable the debtor to potentially resolve existing claims prior to the commencement of reorganization.

While either the automatic stay or injunction is in place, parties to the bankruptcy case may resolve existing liabilities through the confirmation of a trust under § 524(g) of the Code.[10] Funded by the debtor, and potentially other protected parties, the trust extinguishes specified liabilities which existed at the time of reorganization.[11] In order for a § 524(g) trust to be permitted, the court must determine that the following factors exist:

> (I) the debtor is likely to be subject to substantial future demands for payment arising out of the same or similar conduct or events that gave rise to the claims that are addressed by the injunction; (II) the actual amounts,

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6 *See id.*

7 *See id.* § 1126 (stating a creditor's claims are impaired by a plan of reorganization if their contractual rights are modified or they are to receive less than full value of a claim).

8 *See id.* § 1129.

9 *See id.* § 362 ("(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities . . . .")

10 *See id.* § 524(g).

11 *See id.* § 524(g).

> numbers, and timing of such future demands cannot be determined; (III) pursuit of such demands outside the procedures prescribed by such plan is likely to threaten the plan's purpose to deal equitably with claims and future demands; (IV) as part of the process of seeking confirmation of such plan - (aa) the terms of the injunction proposed to be issued under paragraph (1)(A), including any provisions barring actions against third parties pursuant to paragraph (4)(A), are set out in such plan and in any disclosure statement supporting the plan; and (bb) a separate class or classes of the claimants whose claims are to be addressed by a trust described in clause (i) is established and votes, by at least 75 percent of those voting, in favor of the plan; and (V) subject to subsection (h), pursuant to court orders or otherwise, the trust will operate through mechanisms such as structured, periodic, or supplemental payments, pro rata distributions, matrices, or periodic review of estimates of the numbers and values of present claims and future demands, or other comparable mechanisms, that provide reasonable assurance that the trust will value, and be in a financial position to pay, present claims and future demands that involve similar claims in substantially the same manner.[12]

Although created during the pendency of bankruptcy, a § 524(g) trust can function as a negotiated settlement with both current and future claimants. As discussed in Parts II and III, business entities have utilized divisive mergers in conjunction with the protections and procedures of the Code to develop a new method of controlling the resolution and settlement of mass-tort obligations.

Filing Chapter 11 bankruptcy is principally designed to enable a company to stay in business and restructure its obligations without dissolving. However, in recent years, it has also become an integral step to achieving the Texas Two-Step. Although judicial scrutiny of the Texas Two-Step is relatively complex and novel, the process of effectuating this statutory dance is simple to understand.

First, a Texas entity, saddled with mass tort liability carries out a divisive merger. Adopted into law in 2006 as a new method of corporate restructuring, divisive mergers allow for "the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities

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12 *Id.*

or non-code organizations."[13] When the original Texas entity does not survive the merger, it must allocate all assets and liabilities among the two newly created entities.[14] Considered an innovative tool for practitioners to permit companies to easily spinoff certain lines of business in a simple and straightforward manner, divisive mergers have become an effective tool to shield corporate debtors from mass tort liability.

Essentially, the original business entity, which has become subject to either existing or potential liability for mass tort claims, will divide itself into two new, separate business entities. One of the newly created entities will be allocated the assets representing the business as a going concern, while the other entity is allocated all significant liabilities associated with the original business.[15] As a note, typically, within the context of this restructuring, the resulting companies are often part of a vertically integrated business, so there are often several layers of affiliated parent and subsidiary organizations involved.

Once the divisive merger is complete and all assets and liabilities have been allocated, the liability-holding entity proceeds with the second step of the Texas Two-Step: the entity is placed into bankruptcy under Chapter 11.[16] As previously discussed, this places an automatic stay on all adverse actions by creditors or tortious claimants, or the debtor may motion for a preliminary injunction for actions against themselves or any other protected party, such as the other surviving asset-rich entity.[17] Within the context of mass tort liability, by placing a freeze on adverse actions, the liability-holding entity could work towards an equitable resolution regarding these claims through the creation of a § 524(g) trust that is, in theory, able to more efficiently and fairly compensate claimants.

B. *Case Study of Texas Two-Step: In re Bestwall LLC*[18]

Although the Texas statute allowing divisive mergers was adopted in 2006, there have been relatively few large-scale implementations of the Texas Two-Step, and prior to the decision rendered by the Third Circuit in

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13 TEX. BUS. ORGS. CODE ANN. § 1.002(55)(A) (West 2022).

14 *Id.* § 10.003 (West 2022).

15 Jordan Chavez et al., *Texas Two Step Creates Unique Restructuring Opportunity – But Not Without Challenges*, HAYNES BOONE (Sep. 9, 2021), https://www.haynesboone.com/news/alerts/texas-two-step-creates-unique-restructuring-opportunity-but-not-without-challenges.

16 Michael A. Francus, *Texas Two-Stepping Out of Bankruptcy*, 120 MICH. L. REV. 38, 40 (June 2022) (arguing that the use of such restructuring techniques is a method of gaining an upper hand against creditors, and providing for methods by which to counteract this tactic).

17 *See* 11 U.S.C. § 362; *see also* 11 U.S.C. § 105(a).

18 *In re* Bestwall LLC, 606 B.R. 243 (Bankr. W.D.N.C. 2019).

In re LTL Management, LLC,[19] in July of 2023, most major uses have been approved without issue, as demonstrated by the following example.[20]

In *In re Bestwall LLC*, Georgia-Pacific ("Old GP") had been engaged in a "decades-long history of asbestos litigation that derived from its acquisition of Bestwall Gypsum Co." and its continued sale of asbestos-containing products following the acquisition.[21] In 2017, Old GP underwent a corporate restructuring through the Texas divisive merger statute, resulting in the creation of Bestwall LLC ("Bestwall") and Georgia-Pacific LLC ("New GP").[22] According to the plan of merger, Bestwall received nearly all of the pre-existing asbestos liabilities and certain assets related to the business.[23] New GP, on the other hand, received all other business assets and liabilities unrelated to the asbestos-containing products.[24] At the time of the divisive merger, there were "approximately 64,000 asbestos-related claims pending against Bestwall, and Bestwall projected that tens of thousands of additional claims would continue to be filed or asserted against it . . . through at least 2050."[25]

In addition to receiving the liabilities related to the asbestos claims, Bestwall was allocated approximately $32 million in cash, all contracts related to the asbestos-related litigation, certain real property, and equity interests in a North Carolina limited liability company valued at approximately $145 million.[26] Bestwall subsequently became party to a funding agreement with New GP, by which New GP agreed to pay all resulting costs incurred by Bestwall in the normal course of its business and to fund any amount required to satisfy Bestwall's asbestos-related liabilities in the absence of a bankruptcy case.[27] However, the agreement also stated that, in the event of a Chapter 11 filing, New GP would "provide the funding for a § 524(g) asbestos trust in the amount required by a confirmed plan of reorganization for the Debtor to the extent that the Debtor's assets are insufficient to provide the requisite trust funding."[28] Essentially, while Bestwall would be laden with liability related to the asbestos claims, this funding agreement provided that New GP could be

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19 64 F.4th 84 (3d Cir. 2023).

20 *See In re* Aldrich Pump LLC, No. 20-30608, 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021) (upholding a preliminary injunction under 11 U.S.C. § 105(a) and the automatic stay under § 362); *see also In re* DBMP LLC, No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021).

21 606 B.R. 243, 247-248 (Bankr. W.D.N.C. 2019).

22 *Id.* at 248.

23 *Id*.

24 *Id*.

25 *Id*.

26 *Id*.

27 *In re Bestwall LLC*, 606 B.R. at 248.

28 *Id*.

financially responsible for the claims both outside of bankruptcy and through a § 524(g) trust.

On November 2, 2017, Bestwall filed for bankruptcy under Chapter 11 in order to resolve the asbestos claims en masse through the use of a § 524(g) trust, and concurrently, it filed a motion to "prohibit and enjoin the Defendants from filing or continuing to prosecute any" further asbestos-related claims against Bestwall, Old GP, New GP, and the non-debtor affiliates of New GP and Bestwall.[29] The court granted this initial injunction on December 7, 2017, and granted continual extensions in the subsequent months.[30] On August 15, 2018, the court-appointed Official Committee of Asbestos Claimants (the "Committee") and the legal representatives of future asbestos claimants (the "FCR") objected to the continuation of the injunction.[31]

In review of the presented arguments, the court upheld the injunction.[32] In considering whether to approve a preliminary injunction in bankruptcy under § 105(a), the court applied a four-prong test that evaluated the following factors: (1) debtor's reasonable likelihood of a successful reorganization; (2) imminent risk of irreparable harm to the debtor's estate in the absence of an injunction; (3) balance of harms between the debtor and its creditors; and (4) whether the public interest weighs in favor of an injunction.[33] Here, the court concluded that all four factors were satisfied; therefore, Bestwall's motion for an injunction was granted over objection.[34]

In review of whether reorganization was likely, the court found that Bestwall "has a realistic possibility of achieving a successful reorganization" because the funding agreement allowed Bestwall to "draw from New GP the amount of money necessary to pay the costs of this Chapter 11 case and to fund a § 524(g) trust."[35] In review of whether there would be harm to the debtor's estate, the court held that Bestwall would be "irreparably harmed unless the requested injunction is continued" because the Chapter 11 case was filed by Bestwall as a method of obtaining a "global and fair determination of all current and future Bestwall Asbestos Claims."[36] The court also noted that due to the existing

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29 *Id*. at 246.
30 *Id.* at 247.
31 *Id*. at 247.
32 *Id*. at 258.
33 *Id*. at 253.
34 *In re Bestwall LLC*, 606 B.R. at 253.
35 *Id.* at 255 ("Debtor's assets also include approximately $145 million in equity value in PlasterCo and cash, in addition to its access to funds through the Funding Agreement[.]").
36 *Id*.

indemnification obligations between Bestwall and New GP, permitting the prosecution of current or future claims against either entity would essentially eliminate the protections intended by the automatic stay of bankruptcy. This would "undermine the Court's ability to achieve confirmation of a § 524(g) plan that treats all asbestos claimants, both current and future, fairly and equitably."[37]

In review of the balance of harms to the debtor and creditors, the court commented that a § 524(g) trust provides all current and future claimants with an "efficient means through which to equitably resolve their claims," as the process would be within the control of the parties, and not within the traditional tort system.[38] In review of the public interest, the court held the following: there is a traditional and continued opinion that there is a strong interest in a debtor's successful reorganization under Chapter 11; allowing for continued litigation would impede the debtor's ability to resolve all claims through a § 524(g) trust; resolution via trust would prevent the potential liquidation of claims that would occur if prosecuted in state courts; and Bestwall or any potentially responsible parties would be prevented from escaping liability for such tortious conduct.[39]

Concurrently filed with its motion to extinguish the injunction, the Committee filed a motion to dismiss the bankruptcy case as having been filed in bad faith. Likewise, the court denied this motion.[40] Citing to precedent from the Fourth Circuit, the court applied the following: "a court may dismiss a Chapter 11 filing as a bad faith filing only when the bankruptcy reorganization is both (i) objectively futile *and* (ii) filed in subjective bad faith."[41] Noting that the Fourth Circuit has one of the most stringent standards for dismissal on the basis of bad faith, the court highlighted that the burden of proving bad faith is upon the movant, not the debtor, once the issue is raised.[42] Determining whether objective futility exists requires "assessing whether there is no going concern to preserve . . . and . . . no hope of rehabilitation."[43] This assessment focuses "on the debtor's financial stability, whether there exists a going concern to preserve, and whether there exists any realistic hope of rehabilitation."[44]

Upon review of the presented facts, the court held that reorganization through bankruptcy was not objectively futile.[45] Central to this holding

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37 *Id*. at 256.
38 *Id*. at 257.
39 *Id*. at 258.
40 *In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019).
41 *Id.* at 48 (citing Carolin Corp. v. Miller, 886 F.2d 693, 700-701 (4th Cir. 1989)).
42 *Id.*
43 *Id.* at 49 (citing *Carolin*, 886 F.2d at 701-02).
44 *Id.* (citing *Carolin*, 886 F.2d at 701).
45 *Id*. at 50.

was the court's sentiment that "attempting to resolve asbestos claims through [a § 524(g) trust] is a valid reorganization purpose, and filing for Chapter 11, especially in the context of an asbestos or mass tort case, need not be due to insolvency."[46] Due to the sheer volume of asbestos-related cases that Bestwall faced, the court held that Bestwall was experiencing sufficient financial distress that qualified it for the use of a § 524(g) trust.[47] Importantly, the court noted that its allocated assets, its active business as a going concern, and its abilities to meet obligations to creditors in bankruptcy through the funding agreement, collectively, made reorganization and rehabilitation possible.[48]

Despite the Committee arguing that the funding agreement was illusory and insufficient to meet all claims, the court found that the record demonstrated a "binding and enforceable contractual obligation," and that New GP was acting in good faith to abide by its terms.[49] The court acknowledged the potential risk of New GP evading its performance but mitigated these concerns by providing confidence "in the plan confirmation process."[50] In support of this alternative to a traditional tort system, the court found that resolution of these claims en masse through a settlement trust administered under its direction could result in the claims being "sufficiently addressed and fairly adjudicated."[51] In conclusion, the court found not only that reorganization was not objectively futile but also that a § 524(g) trust was an efficient and fair means by which to resolve mass tort obligations; therefore, Old GP had successfully completed the Texas Two-Step.

II. CRITICISM OF THE TEXAS TWO-STEP

While the court in *In re Bestwall LLC* lauded the use of bankruptcy as an effective means by which an entity can resolve mass tort obligations, legal scholars have warned that the use of the Texas Two-Step has exceeded the limits and purposes of the Code. Criticized as an aggressive restructuring technique to gain an advantage over creditors and deprive them of compensation, the Texas Two-Step has been heralded as an example of a fraudulent transfer and an action made in bad faith contrary to the rules provided by either the Code or state law.

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46 *In re Bestwall LLC*, 605 B.R. at 49.
47 *Id.*
48 *Id.*
49 *Id*. at 49.
50 *Id*. at 50.
51 *In re Bestwall LLC*, 605 B.R. at 50.

While the use of a funding agreement, as described in *In re Bestwall LLC*, would appear to ensure payment of claims in bankruptcy, critics have noted that such indemnification agreements are only enforceable by the parties to the agreement. When an entity has undergone a divisive merger, both resulting entities are likely to be controlled by the same officers and directors, and as a result, there is no guarantee that indemnification will actually occur.[52] Additionally, because a preliminary injunction can be extended to interested parties, such as New GP in *In re Bestwall LLC*, the funding agreement essentially prevents claimants from seeking recourse through state court action against any other potentially liable party, even if the settlement via a § 524(g) trust is inadequate or future claims arise.[53] As a final note of skepticism, as theorized by Michael Francus, a Climenko Fellow with Harvard Law School, the newly created, asset-rich entity can also, in exchange for a contribution to the accepted § 524(g) trust, obtain a third-party release in the bankruptcy proceedings.[54]

Essentially, critics have noted that while a funding agreement could, in theory, provide full compensation to claimants, it, in practice, is a self-interested maneuver by the debtor-entity to strong-arm claimants into accepting a potentially less than full-value compensation because of their inability to seek compensation from entities not filing for bankruptcy.[55] While the enforcement of a preliminary injunction or automatic stay to encourage parties to reach a resolution via a § 524(g) trust could enable both parties to have more control and reach a settlement efficiently, it is more likely to result in an imbalance of bargaining power in favor of the debtor-entity and its related protected parties. Functionally, the funding agreement ensures that all potentially liable entities are protected from current and future actions, and the extension of this protection to all entities forces claimants to seek value only from the assets allocated to the liability-laden entity, or risk delay or liquidation of claims in the traditional tort system.[56]

In addition to these general concerns, critics have noted that the Texas Two-Step should not be permitted in bankruptcy as it is a violation of the laws concerning good-faith and fraudulent transfers.[57] In his article, *Texas Two-Stepping Out of Bankruptcy*, Francus argues that this statutory dance

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52 Francus, *supra* note 15, at 41.

53 *See id.* ("[I]f the debtor, LiabilityCo, indemnifies AssetCo, the bankruptcy court will issue an injunction that bars plaintiffs from suing AssetCo, as liabilities incurred by AssetCo are potential liabilities of LiabilityCo.").

54 *Id*.

55 *Id.*

56 *See id.*

57 *Id.* at 43-44; *see also* Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Check and Balances*, 100 TEX. L. REV. 1080, 1105–06 (2022).

is "textbook bad faith bankruptcy."[58] While good faith is no longer a listed filing requirement under the Code, Francus notes that "every court to consider the question has found that it has the power to dismiss a case for bad faith."[59] Because the requirement of good faith has developed through judicial opinion, there are no bright-line standards by which to evaluate a filing. However, Francus notes that a simple pattern of bad faith filings has developed, termed "new debtor syndrome," by which a financially distressed entity, with no significant assets that can be used in the business as an ongoing concern, files bankruptcy soon after creation for the sole purpose of filing bankruptcy to extinguish liabilities.[60] In such cases, courts have denied a stay or preliminary injunction and dismissed the case.[61] Francus argues that because courts have found this to be a pattern of bad-faith filing, the Texas Two-Step should also be classified as such because the resulting corporate structures and actions are nearly identical.[62]

As a second element of bad-faith, Francus argues that bankruptcy courts should hold the Texas Two-Step as being without a valid bankruptcy purpose.[63] As an example, Francus cites to *In re Integrated Telecom Express, Inc.*,[64] in which the asset-rich Integrated Telecom Express, Inc., ("Telecom Express") filed for bankruptcy, not because of financial distress, but in order to reduce obligations via exploitation of the Code.[65] The Third Circuit held that the filing was not made for a valid bankruptcy purpose as it was not made for "preserving going-concern value or maximizing a debtor's estate value."[66] Rather, Telecom Express was utilizing the Code to reduce its obligations to one of its creditor.[67] Francus argues that the Texas Two-Step should be similarly viewed as a litigation tactic designed to "extract settlement value" from claimants in mass tort cases.[68]

In addition to arguing that bankruptcy filings made in the pattern of the Texas Two-Step should be dismissed as being against a judicially created standard of good-faith, scholars have noted that this maneuver

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58 Francus, *supra* note 15, at 44.
59 *Id*. at 45.
60 *Id.*
61 *Id.*
62 *Id.* at 45-46 (explaining that the original entity in the divisive merger was split with the intention of extinguishing liabilities via a § 524(g) trust, while the central assets of the business as a going concern are preserved with the other surviving entity).
63 Francus, *supra* note 15, at 46.
64 384 F.3d 108 (3d Cir. 2004).
65 *See* Francus, *supra* note 15, at 46.
66 *In re Integrated Telecom Express, Inc*., 384 F.3d at 121.
67 *Id*.
68 Francus, *supra* note 15, at 46.

should be rigidly examined under the rules regarding fraudulent transfers. A fraudulent transfer, according to the Code, is one in which the debtor transferred property or an obligation with "actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred."[69] Under the provisions of the Code, the trustee to a bankruptcy case may void such fraudulent transfers.[70] In additional to the Code's provisions, most states have adopted the Uniform Fraudulent Transfer Act, which repeats the same language regarding fraudulent transfers.[71] Scholars such as Michael Francus, Adam Levitin, and Samir Parikh argue that a divisive merger and bankruptcy filings made in the pattern of *In re Bestwall LLC* should be considered a fraudulent transfer as their sole purpose is "to limit the recovery of tort creditors."[72]

However, Francus notes that ascertaining compliance with the rules regarding fraudulent transfers "must be litigated in an adversary proceeding, with the full trappings of a trial."[73] Because of the unsettled nature of the application of fraudulent transfer rules to this scheme, there is little that claimants can do to challenge these actions without incurring significant cost and delay in presenting this argument to the judiciary: "the result is that the tort claimants are caught in a 'breath-holding contest' with the debtors, where resources and time favor the debtor and will be used to extract settlement value, reducing the claimants' ultimate recovery."[74]

As shown above and will be demonstrated in the series of opinions culminating in *In re LTL Management, LLC*,[75] significant divergence among courts and legal scholars has developed regarding the validity of the use of divisive mergers and the Code as a means to settle mass tort liability. Scholarly critics of the Texas Two-Step emphasize that the use of a § 524(g) trust in bankruptcy following the execution of a divisive merger has the potential to be a strong-arm tactic used by entities attempting to control the expense, time, and value of claimant compensation by avoiding the traditional tort system in state court. Bankruptcy courts, on the other hand, have supported the use of the Code and the bankruptcy system for this purpose, finding that such maneuvering is both in compliance with the Code and provides claimants with a more efficient method of securing compensation.

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69 11 U.S.C. § 548(a)(1)(A) (2023).
70 *Id*.
71 Uniform Fraudulent Transfer Act (UFTA), Practical Law Glossary Item 7-382-389.
72 Francus, *supra* note 15, at 38-39, 43.
73 *Id*. at 44.
74 *Id*.
75 652 B.R. 422 (Bankr. D.N.J 2023).

III. THIRD CIRCUIT'S REJECTION OF THE TEXAS TWO-STEP

A. Johnson and Johnson Talc-Related Liability

As part of its ongoing business since 1894, Johnson & Johnson ("J&J") sold a line of baby products, including its talc-containing JOHNSON'S® Baby Powder ("Johnson's Baby Powder").[76] In 1979, J&J transferred all assets and liabilities associated with its production of Johnson's Baby Powder to Johnson & Johnson Baby Products Co., which was a wholly owned subsidiary of J&J.[77] In the subsequent decades, Johnson's Baby Power was transferred to Johnson & Johnson Consumer Inc. ("Old Consumer"), another wholly owned subsidiary of J&J.[78] It is alleged that as result of this intercompany transaction, Old Consumer had become successor in interest to the agreements, including a responsibility to indemnify J&J for all claims relating to the product.[79]

Although Johnson's Baby Powder was a vastly successful product, between 2013 and 2016, plaintiffs began to successfully argue to juries that this talc-based products line caused ovarian cancer.[80] The most successful case resulted in a verdict of $25 million to each of twenty plaintiffs and $4.14 billion in total punitive damages against the manufacturer.[81] Other trials since 2018 have resulted, on average, in $39.7 million per claim. Prior to the current bankruptcy proceedings, the talc-related claims had resulted in $2.5 billion in verdicts and settlements, $1 billion in defense costs, and approximately $10 to $20 million per month in defense-related expenses.[82] Despite the already significant costs of provided settlements, jury awards, and the continued exposure to current and future claims, "Old Consumer was a highly valuable enterprise, estimated . . . to be worth $61.5 billion (excluding future talc liabilities)."[83]

B. Corporate Restructuring

In order to capture and separate the liabilities associated with the talc-related claims, Old Consumer underwent a divisive merger on October 12, 2021, via Texas law.[84] This restructuring eventually resulted in the creation of two new entities, Johnson & Johnson Consumer Inc. ("New

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76 *In re* LTL Mgmt., LLC, 64 F.4th 84, 93 (3d Cir. 2023).
77 *Id.*
78 *Id.*
79 *Id.*
80 *See* Ingham v. Johnson & Johnson, 608 S.W.3d 663, 678 (Mo. Ct. App. 2020).
81 *Id.* at 680.
82 *In re* LTL Mgmt., LLC, 637 B.R. 396, 419 (Bankr. D.N.J. 2022).
83 *In re* LTL Mgmt., LLC, 64 F.4th 84, 95 (3d Cir. 2023).
84 *Id.*

Consumer") and LTL Management LLC ("LTL").[85] LTL was allocated "responsibility for essentially all liabilities of Old Consumer tied to talc-related claims," both current and future.[86] In addition to these liabilities, LTL was allocated the following assets: Old Consumer's "contracts related to talc litigation, indemnity rights, its equity interests in Royalty A&M LLC ("Royalty A&M"), and about $6 million in cash."[87] According to LTL's valuation, Royalty A&M's portfolio at the time of this merger was approximately $367.1 million.[88] New Consumer was allocated all other assets of Old Consumer.[89]

In addition to these assets, LTL was also allocated Old Consumer's rights as a payee under a funding agreement (the "Funding Agreement"), which gave "LTL, outside of bankruptcy, the ability to cause New Consumer and J&J, jointly and severally, to pay it cash up to the value of New Consumer for purposes of satisfying any talc-related costs as well as normal course expenses."[90] If LTL filed for bankruptcy, New Consumer and J&J could be held to "pay it cash in the same amount to satisfy its administrative costs and to fund a trust, created in a plan of reorganization, to address talc liability for the benefit of existing and future claimants."[91]

C. Filing for Bankruptcy Under Chapter 11 of the Code

On October 14, 2021, LTL filed for bankruptcy under Chapter 11 in the Bankruptcy Court for the Western District of North Carolina. In addition to filing for bankruptcy, LTL sought to either extend the automatic stay for the talc-claims to over six hundred non-debtors, including J&J and New Consumer (the "Protected Parties") or have the court issue a preliminary injunction enjoining those claims.[92] In these initial filings, LTL admitted and described its bankruptcy petition as an effort to "equitably and permanently resolve all current and future talc-related claims against it through the consummation of a plan of reorganization that includes the establishment of a [funding] trust."[93]

The North Carolina Bankruptcy Court issued an order enjoining claims against the Protected Parties for a period of sixty days. Subsequently, the case was transferred to the District of New Jersey, and following the transfer, the official committee of talc claimants and other

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85 *Id*. at 96.
86 *Id.*
87 *Id.*
88 *Id.*
89 *Id*. at 97.
90 In re LTL Mgmt., LLC, 64 F.4th 84, 96 (3d Cir. 2023).
91 *Id*.
92 *Id*. at 97.
93 *Id*.

represented claimants ("Movants") filed a motion to dismiss the Chapter 11 case as not having been filed in good faith.[94] In addition, LTL filed a motion seeking an extension of the automatic stay under § 362(a) and, in the alternative, a preliminary injunction under § 105(a) of the Code.[95]

1. Motion to Dismiss for Lack of Good Faith

Generally, as framed by the United States Bankruptcy Court for the District of New Jersey (the "Bankruptcy Court") here, Movants filed their motion to dismiss for lack of good faith as both a moral and legal imperative, citing the need to prevent both J&J and Old Consumer from "utilize[ing] the bankruptcy system as a litigation tactic to address their talc-related litigation liabilities through" the Texas Two-Step.[96] In support of their motion, Movants provided several arguments. First, they argued that LTL was created as a "special purpose vehicle" only hours before filing for bankruptcy in order to take advantage of "bankruptcy's automatic stay and asbestos resolution schemes for the benefit of its solvent operating parent and affiliated entities . . . without such entities filing for chapter 11."[97] Second, they noted that LTL has "no business purpose, no employees apart from those seconded by J&J, and that LTL's board, management and employees all work for J&J and owe 100% fealty to J&J."[98] Third, Movants asserted that the "chapter 11 process offers nothing of value to this estate and its creditors."[99] Finally, in criticizing the legitimacy and ethical nature of the Texas Two-Step, Movants argued that the pre-petition restructuring of Old Consumer was intended to create both delay and a "bankruptcy discount," which would impose an unfavorable settlement upon the talc claimants.[100]

In response, LTL presented a more favorable perspective of its bankruptcy filings, arguing that its purpose was to "produce an equitable resolution of both current and future talc claims by means of a settlement trust . . . that can promptly, efficiently, and fairly compensate claimants."[101] Additionally, LTL strongly characterized the jury system as providing vastly inconsistent remedies, in which some claimants would be wholly denied remedy.[102] In contrast to Movants' beliefs concerning the pre-bankruptcy corporate restructuring, LTL argued that all assets that

94 *Id*. at 98.
95 *Id*.
96 *In re* LTL Mgmt., LLC, 637 B.R. 396, 403 (Bankr. D.N.J. 2022).
97 *Id*. at 404.
98 *Id.*
99 *Id.*
100 *Id.*
101 *Id.*
102 *In re* LTL Mgmt., LLC, 637 B.R. 396, 404 (Bankr. D.N.J. 2022).

existed pre-restructuring were still available for use in settlement via the Funding Agreement.[103] Generally, LTL characterized its corporate maneuvering and shifting of assets and liabilities as a means by which to accomplish a more equitable and efficient resolution of its mass tort liabilities, while Movants considered such actions to be self-interested and disadvantageous to claimants.

In review of whether the bankruptcy proceeding should be dismissed for lack of good faith, the Bankruptcy Court applied the following standard from the Third Circuit: "a Chapter 11 petition is subject to dismissal for 'cause' under 11 U.S.C. § 1112(b) unless it is filed in good faith."[104] The Bankruptcy Court noted that the purpose of requiring "good faith" is to ensure that the "Code's careful balancing of interests is not undermined by petitioners whose aims are antithetical to the basic purposes of bankruptcy."[105] Once the issue of good faith is raised, the "debtor bears the burden of proving that a petition was filed in good faith."[106] A court's investigation into good faith requires an examination of the totality of the circumstances and is considered a "fact intensive inquiry."[107] The general focus of such inquiry, as applied by the Bankruptcy Court, must be "(1) whether the petition serves a valid bankruptcy purpose and (2) whether the petition is filed merely to obtain a tactical litigation advantage."[108] In addition, the Bankruptcy Court noted that the choice of judicial system and its service in ensuring the best interests of the bankruptcy estate, including the current and future talc-claimants, is a vital consideration.[109] Upon application of the presented circumstances to this standard, the Bankruptcy Court denied the motion to dismiss for lack of good faith, as it found both a valid bankruptcy purpose and no tactical litigation advantage.[110]

First, the Bankruptcy Court found a valid purpose underlying LTL's decision to file Chapter 11 bankruptcy. Citing to the Supreme Court's decision in *In re Integrated Express, Inc.*, the Bankruptcy Court noted that bankruptcy serves two basic purposes: (1) "preserving going concerns" and (2) "maximizing property available to satisfy creditors."[111]

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103 *Id.*
104 *Id.* (quoting *In re* SGL Carbon Corp., 200 F.3d 154, 162 (3d Cir. 1999)).
105 *Id.*
106 *Id.* at 405 (citing *In re* GVS Portfolio I B, LLC, No. 21-10690, 2021 WL 2285285, at *5 (Bankr. D. Del. June 4, 2021)).
107 *Id.* (citing NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 118 (3d Cir. 2004)).
108 *See In re* LTL Mgmt., LLC, 637 B.R. 396, 406 (Bankr. D.N.J. 2022) (quoting 15375 Mem'l Corp. v. BEPCO, L.P. (*In re* 15375 Mem'l Corp.), 589 F.3d 605, 618 (3d Cir. 2009)).
109 *Id.*
110 *Id.*
111 *Id.* at 407 (citing *In re* Integrated Telecom Express, Inc., 384 F.3d at 119).

Considering the totality of the circumstances and the "financial risks and burdens facing both [Old Consumer] and [LTL]," the Bankruptcy Court found that the Chapter 11 filing "serves to maximize the property available to satisfy creditors by employing the tools available under the Bankruptcy Code to ensure that all present and future tort claimants will share distributions through the court-administered claims assessment process."[112] Citing to *In re Bestwall LLC*, the Bankruptcy Court held 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."[113]

In addition to finding a valid purpose through the preservation of corporate value, the Bankruptcy Court found that bankruptcy is the proper, more efficient vehicle by which to reach an equitable result for all parties for mass tort claims. The Bankruptcy Court strongly rejected the "premise that continued litigation in state and federal courts serves best the interests" of the claimants, as many of the subject cases have experienced substantial delay and will face the "inevitable appeals process."[114] Noting that class action suits have fallen out of favor with the Supreme Court and often are ill-suited for reaching a settlement due to the variation in injuries, illnesses, and related losses, the Bankruptcy Court argued that the "[p]resent and future talc claimants should not have to bear the sluggish pace and substantial risk" of the tort system.[115] The court made note of the following successful uses of § 524(g) trusts as a means of mediating mass claims:

> In recent weeks and months, we have seen comprehensive and productive mediated settlements, producing hundreds of millions of dollars in funding of settlement trusts. Indeed, we need look only at the USA Gymnastics settlement approaching $400 million, the proposed Mallinckrodt $1.7 billion trust and the Boy Scouts proposed settlement nearing $3 billion as examples. Likewise, settlement trusts are in some stage of negotiation in over thirty Catholic Church diocese cases across the country. The Court places these positive results against a backdrop of dozens of successful asbestos trust cases created over the years pursuant to § 524(g), which continue to fund payments to asbestos victims. Claims

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112 *Id.*
113 *Id.* at 407-08 (citing *In re* Bestwall LLC, 605 B.R. 43, 49 (Bankr. W.D.N.C. 2019)).
114 *In re* LTL Mgmt., LLC, 637 B.R. 396, 410 (Bankr. D.N.J. 2022).
115 *Id*. at 414.

> reconciliation through these bankruptcy trusts place reduced evidentiary and causation burdens on the injured and their families, and resolution of claims and payments to victims can be achieved at a far more expeditious pace than through uncertain litigation in the tort system. A trust would establish a far simpler and streamlined process—both for present and future cosmetic talc claimants—than currently available in the tort system.[116]

The court attempted to dissuade the fear of a "migration of tort litigation out of the tort system and into the bankruptcy system" by noting that Congress developed the "structure of the asbestos trusts under § 524(g)" as a "meaningful opportunity for justice," rather than a method of escaping liability for corporations.[117]

Continuing its harsh rebuke of the challenges and inefficiencies of multi-district litigation, the Bankruptcy Court held that to return the nearly 40,000 existing cases to an ill-equipped, overwhelmed tort system would not only force present claimants to relitigate causation and damages but would also significantly hamper the ability of the courts to provide for future claims, as the liable entities would likely be without funding or assets.[118] Rather than litigate these claims in isolation and risk unequal treatment of claimants, the court argued that bankruptcy proceedings offer a "unique opportunity to compel the participation of all parties in interest . . . in a single forum with an aim of reaching a viable and fair settlement."[119] In addition to presenting its strong rebuke of the tort system, the court notes that § 524(g) trusts consolidate claims, reduce evidentiary and causation burdens on the injured parties, and resolve and compensate claimants without the delays of the traditional tort system.[120]

As a final pillar of support in finding a valid bankruptcy purpose, the Bankruptcy Court noted that LTL was in severe financial distress. Although insolvency based on an entity's balance sheet or liquidity can indicate financial distress, the court noted that a business need not wait "until its viable business operations [are] threatened past the breaking point" in order to file for bankruptcy.[121] Rather, financial distress can be patently obvious through existing and future claims that have already and can, in the future, result in significant liabilities. Because LTL had

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116 *Id.* at 415.
117 *Id.* at 414.
118 *Id.* at 416 (noting that § 524(g) trusts ensure that current claimants fail to deplete the debtor's assets prior to the occurrence of injuries by future claimants).
119 *Id.* at 414.
120 *In re* LTL Mgmt., LLC, 637 B.R. 396, 415 (2022).
121 *Id.* at 420.

assumed liability for the talc-based products from Old Consumer at the time of its Chapter 11 filing, LTL "had contingent liabilities in the billions of dollars and likely would be expending annually sums ranging $100-200 million in its defense of the tens of thousands of talc personal injury cases for decades to come."[122] Additionally, "the prospects of continued monthly $10-20 million defense expenditures, with rapidly increasing numbers of new claims being filed, warranted seeking action in this Court."[123]

Despite these factors, Movants argued that LTL's ability to access the Funding Agreement should prevent a finding of financial distress.[124] However, the Bankruptcy Court rejected this argument, holding that while a forced liquidation of New Consumer could occur, "such actions would have a horrific impact on these companies, with attendant commercial disruptions and economic harm to thousands of employees, customers, vendors, and shareholders, and threaten" the continued viability of both New Consumer and J&J.[125] Generally, while LTL, New Consumer, and J&J were not insolvent, the realistic and accumulating threat of liabilities from claimants provided for a strong finding of financial distress for the ultimately responsible entity, LTL, according to the Bankruptcy Court.

In addition to finding a valid bankruptcy purpose, the court held that LTL's Chapter 11 filing was not undertaken to secure an unfair tactical advantage against Movants and other interested parties. Movants contended that the corporate restructuring under the Texas divisive merger statute left LTL undercapitalized from its initial creation, which placed the talc creditor at significant risk.[126] In support, Movants noted the following three issues with the divisive merger and subsequent Funding Agreement: (1) J&J and New Consumer may refuse to actually fund any subsequent trust under § 524(g); (2) the division and allocation of assets artificially caps the value of the settlement trust via bankruptcy; and (3) enforcement of the Funding Agreement rests with LTL, which is under the same management as New Consumer and J&J.[127] The court dismissed these concerns, pointing to the fact that the resources of the "Funding Agreement will be available upon confirmation of a plan . . . and whether or not the plan offers payors protections under § 524(g)."[128]

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122 *Id.* at 417.

123 *Id.* at 419.

124 *In re* LTL Mgmt., LLC, 64 F.4th 84, 96 (3rd Cir. 2023). As previously stated, the Funding Agreement between LTL, New Consumer, and J&J would enable LTL to fund current and future talc liabilities up to $61 billion, the value of New Consumer.

125 *Id.* at 418.

126 *In re* LTL Mgmt., LLC, 637 B.R. 396, 422 (2022).

127 *Id.*

128 *Id.* at 423-24.

As a secondary argument, Movants noted that LTL was created for the sole purpose of allocating liabilities from the pre-existing Old Consumer in order to place those liabilities under bankruptcy.[129] However, in quick succession, the Bankruptcy Court rejected this argument as bankruptcy filings by either J&J or Old Consumer would result in "behemoth bankruptcies, extraordinary administrative costs and burdens, significant delays and unmanageable dockets."[130] For similar reasons as to why it defended the bankruptcy system as a better alternative to the traditional tort system, the court commented that the use of the Texas Two-Step prevents the wasting of value, which "could be better used to achieve some semblance of justice for existing and future talc victims."[131] In defense of any potential risk associated with the Texas Two-Step, the court highlighted that the "Code requires full transparency of all assets, liabilities and financial conduct," and "burdens a debtor with the need to reach a consensus with its creditor base through the plan process and voting requirements."[132] The Bankruptcy Court assumed that the cooperation of the J&J corporate family in funding the planned § 524(g) trust is in its best interest. Although the use of the Texas divisional merger statute in connection with a § 524(g) trust under Chapter 11 does provide advantages to LTL and related entities, the Bankruptcy Court found that such actions were not taken "solely to gain a litigation advantage or hinder a plaintiff in any of the thousands of pending tort actions."[133]

2. Motion to Apply Automatic Stay, or in Alternative Enjoin Further Action

In addition to opposing Movants' motion to dismiss for lack of good faith, LTL supplemented its original arguments made pre-transfer that the automatic stay under § 362 prohibits the prosecution of further claims against itself and the Protected Parties, and, in the alternative, that the Bankruptcy Court should exercise its discretion under § 105(a) to enjoin either the continuation or commencement of such actions.

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129 *See id.*

130 *Id.* at 425 (arguing that this is not a case "of too big to fail" but rather, "a case of too much value to be wasted, which value could be better used to achieve some semblance of justice for existing and future talc victims." In its decision to find that the use of a divisional merger was valid, the court took into consideration that requiring J&J to file bankruptcy would significantly hinder a "profitable supplier of health, consumer product and pharmaceuticals that employs over 130,00 individuals globally, whose families are dependent upon continued successful operations").

131 *Id.*

132 *In re* LTL Mgmt., LLC, 637 B.R. 396, 425 (2022).

133 *Id.* at 426.

In support of its request, LTL argued that although "talc claims are asserted against these other entities [J&J, Old Consumer, etc.], [LTL] is the true defendant;" therefore, the automatic stay should be extended to all of the Protected Parties.[134] LTL cited to Third Circuit precedent that permits a court to consider the unusual circumstances by which a third-party defendant and the debtor essentially share an identity such that a judgment against the third-party is a judgment against the debtor.[135] In opposition, Movants argued that it "would be inequitable—and produce an 'absurd result' if the courts were to permit nondebtors to 'avail themselves of the automatic stay simply by unilaterally allocating to the debtor indemnity and other obligations on the eve of the bankruptcy filing.'"[136] As similarly argued in its motion to dismiss for lack of good faith, Movants criticized the use of the Texas Two-Step to create a special purpose vehicle by which J&J could accomplish its goal of separating its significant liabilities from the business as a going concern, so J&J should not be benefited by the protections of "usual circumstances" when such circumstances were purposely created by the filing party.[137]

In review of these arguments, the Bankruptcy Court considered the totality of the circumstances and held that the concerns regarding the Texas Two-Step did not establish bad faith or delegitimize the purpose of the bankruptcy proceeding. As a result, there was no reason, on those grounds of alleged potential "gamesmanship or inequity," to decline an extension of the injunction to the Protected Parties.[138] In support of this decision, the Bankruptcy Court noted that the "talc claims against the Protected Parties involve the same products, same time periods, same alleged injuries, and same evidence as claims against Debtor."[139] Additionally, LTL's indemnification obligations and assumption of liabilities in connection with the talc-based products ensures that it is ultimately the responsible party, according to the court.[140] Based on this analysis, the Bankruptcy Court upheld the automatic stay against the Protected Parties.

In addition to maintaining the automatic stay against the Protected Parties, this court also determined that "a preliminary injunction pursuant to § 105(a) that extends the stay to the Protected Parties is appropriate given the circumstances of this case."[141] In reaching this conclusion, the

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134 *In re* LTL Mgmt., LLC, 638 B.R. 291, 304 (2022).
135 *Id.* (citing McCartney v. Integra Nat. Bank N., 106 F.3d 506, 510 (3d Cir. 1997)).
136 *Id.* (citing *Objection of Original TCC* 53, ECF No. 142).
137 *See id.*
138 *In re LTL Mgmt., LLC*, 638 B.R. at 305.
139 *Id.* at 306.
140 *Id.*
141 *Id.* at 322.

Bankruptcy Court evaluated the following four factors: (1) litigant's likelihood of success on the merits; (2) suffering irreparable harm if denied an injunction; (3) granting an injunction will not result in greater harm to non-movant; and (4) public interest favors relief.[142] Finding that each factor was satisfied by the evidence presented, the Bankruptcy Court granted, in the alternative, the injunction against both LTL and the Protected Parties.

D. Appeal and Reversal by Third Circuit

Reviewing the Bankruptcy Court's denial of the motion to dismiss for abuse of discretion, the Third Circuit held that because "LTL was not in financial distress, it cannot show its petition served a valid bankruptcy purpose and was filed in good faith under Code § 1112(b)."[143] Noting that § 1112(b) provides for dismissal for "cause" without explicitly classifying "bad faith," the court held that a requirement of good faith is "grounded in the 'equitable nature of bankruptcy' and the 'purposes underlying Chapter 11.[144] As discussed by the Bankruptcy Court, the court, here, noted that two inquiries are relevant for a determination of good faith: (1) "whether the petition serves a valid bankruptcy purpose[;] and (2) whether [it] is filed merely to obtain a tactical litigation advantage."[145] In addition to these general inquiries, the court found that a valid bankruptcy purpose could include the preservation of a business as a going concern or maximizing the debtor's estate.[146]

Although either factor may be shown, the court held that the debtor must first be in financial distress in order to support any valid bankruptcy petition, for "absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose."[147] While the court commented that there is not an explicit list of factors that support a finding of financial distress, the "debtor's balance-sheet insolvency or insufficient cash flows to pay liabilities" cannot be ignored and are crucial to the determination.[148] While the court noted that all forms of financial difficulties cannot be predicted, "uncertain and unliquidated future liabilities could pose an obstacle to a debtor efficiently obtaining financing and investment."[149] The

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142 *Id.* at 320 (citing McTernan v. City of York, 577 F.3d 521, 527 (3d Cir. 2009)).
143 *In re* LTL Mgmt., LLC, 64 F.4th 84, 110 (3rd Cir. 2023).
144 *Id.* at 100.
145 *Id.* at 100-01 (citing *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 118 (3d Cir. 2004)).
146 *Id.* at 101 (citing *In re Integrated Telecom Express, Inc.*, 384 F.3d at 128).
147 *Id.* at 101.
148 *Id.* at 102.
149 *Id.*

totality of the circumstances and the "many spokes" that can lead to financial distress can neither be predicted or divined by the court.[150]

However, the court strongly rebuked the use of bankruptcy prematurely, especially within the context of mass tort bankruptcy. In its criticism, the court commented that the use of bankruptcy to resolve mass tort liability introduces the "possibility of undervaluing future claims . . . and the difficulty of fairly compensating claimants with wide-ranging degrees of exposure and injury."[151] Additionally, the court noted that "a longer history of litigation outside of bankruptcy may provide a court with better guideposts when tackling these issues."[152] The court focused on the use of bankruptcy for rehabilitation and reorganization, and not as a means by which "to give profitable enterprises an opportunity to evade contractual or other liability."[153] As a conclusive statement, the court held that while "mass tort liability can push a debtor to the brink," courts must "measure the debtor's distance to it," which requires weighing not only the "scope of liabilities the debtor faces, but also the capacity it has to meet them."[154]

In its evaluation of the totality of the circumstances presented by LTL's financial condition, the court held that while evaluating the pre-restructuring entities, such as Old Consumer and J&J, would help contribute to a complete analysis of the financial burdens of the debtor, here, the analysis should "not underappreciate the financial reality of LTL."[155] Distinguishing itself from the Bankruptcy Court, the Third Circuit focused its ruling on the assets and liabilities of LTL, and most critically, on the funding backstop provided by the Funding Agreement. Acknowledging that past verdicts, present claims, and potential future liabilities existed against LTL, the court found that Old Consumer had enjoyed relatively high rates of success in litigating these claims, noting that Old Consumer had settled "about 6,800 talc-related claims for under $1 billion and obtained dismissals of about 1,300 ovarian cancer and over 250 mesothelioma claims without payment."[156] The court strongly rebuked the Bankruptcy Court's estimation that a defense of all claims would "cost up to $190 billion," as the projections ignore the "possibility

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150 *Id.*
151 *Id.* at 103.
152 *Id.* (citing *Report of the National Bankruptcy Review Commission* 328 n.813, 344-45 (Oct. 20, 1997)).
153 *Id.*
154 *Id.* at 104.
155 *In re* LTL Mgmt., LLC, 64 F.4th 84, 105 (3rd Cir. 2023).
156 *Id.* at 107.

of meaningful settlement, as well as successful defense and dismissal" of claims if they proceeded to trial.[157]

In addition to minimizing the threat of current and future liabilities stemming from the talc-based claims, the Third Circuit found that the "roughly \$61.5 billion payment right against J&J and New Consumer" made untenable a finding that LTL was in financial distress at the time of filing.[158] While the Bankruptcy Court found the Funding Agreement to be a critical factor in supporting the bankruptcy petition, as it served as a vehicle to fund a § 524(g) trust, the Third Circuit found that the Funding Agreement made LTL "highly solvent" due to its "access to cash to meet comfortably its liabilities as they came due for the foreseeable future."[159] Acknowledging that the ability to draw on the Funding Agreement might someday threaten New Consumer's capability to "sustain its operational costs," the court held that "those risks do not affect LTL, for J&J remains its ultimate safeguard," as J&J "had well over \$400 billion in equity value with a AAA credit rating and \$31 billion just in cash and marketable securities."[160] Due to the significant assets on LTL's balance sheet, a funding backstop available from two highly solvent entities, and a lack of foundation for assuming significant costs of settling or litigating claims, the Third Circuit concluded that LTL was not financially distressed and dismissed the bankruptcy petition.

Taking "guidance from the Third Circuit" and the aforementioned discussion, the Bankruptcy Court found cause to dismiss LTL's bankruptcy petition "due to LTL's lack of imminent and immediate financial distress."[161] Prior to complying with the instruction from the Third Circuit regarding the financial distress of LTL, the Bankruptcy Court felt "compelled to address the possibility of continuing this chapter 11 bankruptcy in the best interests of the creditors."[162] Although it remained "unconvinced that the procedural mechanisms and notice programs offered in the tort system can protect future claimants' rights in the same manner as the available tools in the bankruptcy system," the Bankruptcy Court did not find that LTL met the statutory elements for an exception to dismissal under § 1112(b)(2) of the Code.[163] As a result, LTL's bankruptcy petition was firmly dismissed.[164]

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157 *Id.* (arguing that the verdict in *Ingham* is the rare exception and not the expected trend for claims.).
158 *Id.* at 106
159 *Id.* at 108.
160 *Id.* at 106.
161 *In re LTL Mgmt., LLC*, 652 B.R. 433, 456 (Bankr. D.N.J. 2023).
162 *Id.* at 449.
163 *Id.* at 451.
164 *See id.* at 456.

CONCLUSION

The Texas Two-Step is a truly innovative tool. However, courts, corporations, and claimants are all engaged in a wide debate regarding its use within the arena of mass tort resolution. Previously, mass tort liability had been resolved within the traditional tort system of multi-district litigation. However, with the development and implementation of divisive mergers under the popularized Texas Two-Step, sizable corporations have taken advantage of the opportunity to utilize the bankruptcy system as a new venue for resolving their liabilities en masse. Rather than face the uncertainty of prolonged litigation, these corporations have found that it is easier to amputate the infected portion of their business through a divisive merger and preserve the central business as a going concern within a newly created entity. As reflected in the presented judicial opinions and scholarly criticisms, the central issue regarding the shifting of liabilities into a special purpose vehicle that files for bankruptcy is whether this action is in line with the judicially created standards of good faith under the Code.

From the perspective of the corporate-debtor, the Texas Two-Step allows them, in theory, to create an equitable resolution for both current and future claimants by allocating certain assets to the filing entity and creating a financial backstop through a funding agreement. Additionally, the corporate entity would be allowed to more efficiently reach a resolution of all current and future claims as they would be bundled together and compensated through the agreed upon § 524(g) trust. This process would avoid the inconsistency of jury decisions and the necessity of appeals. However, critics and claimants have argued that this corporate restructuring has resulted in an imbalance of bargaining power between the debtor and claimants, which leads to an artificially created cap on compensation through a termed "bankruptcy discount." Additionally, critics argue that such restructuring and petitions are against the purposes of the Code, as the truly liable parent entities are not in financial distress, which is a requirement for bankruptcy.

As reflected by the decisions in *In re Bestwall LLC* and *In re LTL Management LLC*, bankruptcy courts are in strong favor of utilizing the bankruptcy system as the most efficient means by which to resolve mass tort liability for corporate entities. These courts view bankruptcy as the only means by which to sufficiently address and fairly adjudicate all claims, as the already overwhelmed state and federal tort systems risk unfair and unequal treatment of those claims. Additionally, those courts believe that the prosecution of claims within the tort system would significantly delay the compensation of claimants. As a final supporting note for the use of the bankruptcy system in this manner, these courts highlight that confirmation of a § 524(g) trust requires both full transparency of the debtor and compliance with the procedures and supervision of the Code and its courts. In addressing the concerns that this is in actuality self-interested maneuvering through the creation of a special purpose vehicle, the bankruptcy court in *In re LTL Management LLC* highlighted that forcing the original pre-existing entity to file for bankruptcy would result in such disruption to behemoth companies that it would be better for all interested parties and the public at-large to pursue resolution via the Texas Two-Step.

As reflected in the Third Circuit's opinion, there still continues to be a sharp divide as to whether the Texas Two-Step reflects the purpose of the Code. While the § 524(g) trust was developed as a means for companies to resolve mass-tort liability within the context of asbestos claims, Congress did not necessarily envision the use of trusts in this manner. Rather than view funding agreements between filing debtors and their asset-rich related entities as a reason to support the utilization of Chapter 11 and a § 524(g) trust, the Third Circuit currently holds that such funding agreements are assets in themselves that make the filing debtor asset-rich.

In essence, the Third Circuit has rejected the use of the Texas Two-Step within their jurisdiction as a means by which corporate entities can circumvent the long-used arenas for mass-tort liability: state and federal courts. Bankruptcy, according to the Third Circuit, is reserved for truly financially distressed entities, and not for corporations attempting to avoid the realities of products liability litigation. While the decision of the Third Circuit may be the strongest challenge to the utilization of the Texas Two-Step to-date, there is no indication yet as to whether this will be adopted by other circuits or bankruptcy courts outside its jurisdiction. Despite this uncertainty, this presented case study reveals that the debate surrounding the ethical and judicial standing of the Texas Two-Step is being drawn into further question and will likely be discussed and argued until clearer guidance and boundaries are provided.