Court Rejects Johnson & Johnson's Use of the "Texas Two-Step" to Tackle Baby Power Liability

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Overview

The Third Circuit recently dismissed the chapter 11 bankruptcy filing of LTL Management, LLC, which is a subsidiary of Johnson & Johnson ("Johnson").[1] This ruling undermines a common practice employed by corporations to evade liability for mass torts.

Johnson's subsidiary, J&J Consumer Inc. ("Old Consumer"), produced Johnson's famous Baby Powder, which contained talc, a mineral mined and milled into a fine powder.[2] Lawsuits against Old Consumer began in 2010 when concerns arose that the talc in Johnson's Baby Powder contained traces of asbestos and could cause ovarian cancer and mesothelioma.[3] In 2020, the Missouri Court of Appeals awarded $2.24 billion to a class of 22 plaintiffs who developed ovarian cancer after their continued use of Johnson's Baby Powder.[4] By the end of 2021, Old Consumer and Johnson were facing over 38,000 ovarian cancer lawsuits and over 400 mesothelioma lawsuits.[5]

In October 2021, Johnson underwent a restructuring and formed two new entities, LTL Management, and "New Consumer." Johnson assigned all of Old Consumer's talc liabilities to LTL, while New Consumer retained all of Old Consumer's operating assets. Johnson also entered a funding agreement with LTL, promising to cover any talc and bankruptcy-related expenses up to $61.5 billion. Two days later, LTL filed for Chapter 11 bankruptcy in North Carolina. However, the most recent decision dismissed this bankruptcy filing because the court determined that LTL Management wasn't in financial distress.[6]

This strategy for avoiding mass tort liability has been widely known as the "Texas Two-Step," wherein the corporation creates a subsidiary, transfers all tort lawsuits to the new subsidiary, and then the subsidiary files for bankruptcy. By dismissing this bankruptcy case, the numerous alleged victims of the Baby Powder products preserved their right to sue LTL.[7]

Good Faith or Patently Abusive?

Modern U.S. bankruptcy law is designed to give a "fresh start" to honest but unfortunate debtors by providing them with an opportunity to reorganize their affairs, make amends with their creditors, and "enjoy a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[8] It's no secret that most businesses fail, and when they do, they are often saddled with debts and lawsuits that spiral out of control. Some companies

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[1] *See In re LTL Mgmt., LLC*, No. 22-2003, 2023 WL 1098189 (3d Cir. Jan. 30, 2023).
[2] *Id.* at *1.
[3] *Id.* at *2.
[4] Ingham v. Johnson & Johnson, 608 S.W.3d 663 (Mo. Ct. App. 2020)
[5] LTL Mgmt., at *2.
[6] *Id.*, at *3-4
[7] Samantha Goldstein, *The Texas Two-Step: A Controversial Bankruptcy Dance*, University of Miami Law Review, https://lawreview.law.miami.edu/the-texas-two-step-a-controversial-bankruptcy-dance/
[8] Grogan v. Garner, 111 S.Ct. 654 (1991)

find themselves in "economic distress," meaning that their business is no longer valuable and that the cost of running it exceeds the benefit it generates. For example, horse buggy companies were economically distressed once modern automobiles became popular. Other businesses find themselves in "financial distress," meaning they face liquidity issues. The company might make a $10 million profit if it invests $2 million. However, since the company owes $100 million to its current creditors, no one is willing to lend the company $2 million. The purpose of bankruptcy law is to preserve the value of companies in the latter category, saving their "going concern value" from the "common pool" or "collective action" problem where near-sighted creditors rush to the assets and destroy the going concern value without considering the business's long-term value. At the same time, the bankruptcy process resolves the "debt overhang" issue so that new lenders are willing to lend new money to the business in temporary financial distress.

Due to the significant benefits of bankruptcy law, struggling businesses sometimes file for bankruptcy solely to take advantage of the bankruptcy process, during which all old financial claims and lawsuits against the debtor are dismissed, and the debtor comes out of the process paying a fraction of their old debt. To prevent this, Chapter 11 bankruptcy petitions are subject to dismissal under 11 U.S.C. § 1112(b) unless they are filed in "good faith."[9] This requires the court to "examine the totality of facts and circumstances and determine where a petition falls along the spectrum ranging from the clearly acceptable to the patently abusive."[10] In examining the facts, two inquiries are relevant to the court, namely whether the petition serves a valid bankruptcy purpose and whether it is filed merely to obtain a tactical litigation advantage. The Third Circuit in *Integrated Telecom* opined that valid bankruptcy purposes include "preserving a going concern" or "maximizing the value of the debtor's estate."[11]

The *LTL* court did not abide by the framework outlined in *Integrated Telecom*. Instead, the court created a relatively new "financial distress" standard for good faith. To create this new standard, the court relied in part on dicta from *Integrated Telecom*, which states that "a valid bankruptcy purpose assumes a debtor in financial distress." The *LTL* court interpreted this language to mean that a debtor who does not suffer from financial distress cannot demonstrate valid bankruptcy purpose supporting good faith. Because LTL Management had a funding agreement that allowed it payment rights to up to $61 billion, the court held that LTL was not in financial distress and thus could not satisfy the good faith requirements. This decision is most likely misguided. As most scholars and courts have pointed out, the black-letter law emerging from *Integrated Telecom* is that the focus for good-faith filing is on whether the petition serves a valid bankruptcy purpose of either preserving the going concern or maximizing the value of the estate,[12] not whether the debtor is in financial distress.

Did the Court Get it Right, Normatively?

While the mundane concerns of lawyers and judges are to navigate the line-drawing issues and the technicalities behind the definition of "good faith," the public is rightfully concerned about

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[9] *In re 15375 Mem'l Corp. v. BEPCO, L.P.*, 589 F.3d 605, 618 (3d Cir. 2009) (*citing NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)*, 384 F.3d 108, 118 (3d Cir. 2004)).
[10] *Integrated Telecom*, 384 F. 3d at 118.
[11] *Id.* at 119-20.
[12] *See e.g.* Douglas G. Baird, Anthony J. Casey, Bankruptcy Step Zero, 2012 Sup. Ct. Rev. 203, 231 (2012); 30 Melb. U. L. Rev. 300, 310; In re Am. Cap. Equip., LLC, 296 F. App'x 270, 273 (3d Cir. 2008)

the use of the Texas Two-Step by massively profitable corporations to avoid taking responsibility for mass torts. Victims of diseases such as ovarian cancer and mesothelioma often feel that the bankruptcy process allows corporations to swiftly resolve their cases and potentially receive a "bankruptcy discount" on the amount owed to victims.[13] As attorney Jon Ruckdeschel has pointed out, the bankruptcy code was never intended to be used by profitable corporations to delay or prevent cancer victims from having their day in court.[14] These concerns are valid, especially in light of Johnson's use of the Texas Business Organizations Code § 1.002(55)(A) to artificially create financial distress for LTL Management in order to meet the good faith requirement for bankruptcy.

On the other side of the dance floor, there is a strong argument in favor of Johnson's use of bankruptcy as a means to resolve the overwhelming litigation they face. Prior to the Texas Two-Step maneuver, Johnson was only able to litigate about ten cases per year, while facing over 40,000 lawsuits by victims of Johnson's Baby Power product. Bankruptcy provides an alternative to the traditional state tort system, in which the lucky victims, like the ones in Missouri, win a large lump sum, while the others face a strikeout. Hence, bankruptcy may be the only realistic solution that is more comprehensive and streamlined for both Johnson and the victims. Indeed, the lower bankruptcy court bought this argument.[15] They ruled that the bankruptcy was filed in good faith because it sought to resolve talc liability by creating a trust for the benefit of claimants under § 524(g)(2)(B)(i)(I) of the Bankruptcy Code, which specifically allows a debtor to establish a trust for the benefit of current and future asbestos claimants. The court also noted that "[a] section 524(g) trust will provide all claimants—including future claimants who have yet to institute litigation—with an efficient means through which to equitably resolve their claims."[16]

But is using the bankruptcy system as a means to reform the mass torts process a proper use of the system? The argument for efficiency can only go so far because reform of the judicial system should be left to the legislators.[17] The litigants have a constitutional right to have their day in court, yet they are now forced into bankruptcy court because Johnson created a shell company to assume all talc liabilities and then filed for bankruptcy. The Third Circuit is likely acknowledging that the US judicial system has established procedures for mass torts, with its own jurisdiction and venue rules, theories of liabilities and defenses, and standard mechanisms courts use to manage these cases. While complicated and sometimes laborious, it follows a set of rules around discovery, experts, and settlement. The Third Circuit is not ready to replace this system with bankruptcy law just yet.

Numerous large corporations have attempted to use the Texas Two-Step to resolve mass tort lawsuits. For instance, in 2017, Georgia-Pacific spun off Bestwall after facing approximately 64,000 asbestos-related claims.[18] Similarly, in 2019, CertainTeed created DBMP to deal with its asbestos liabilities, and in 2020, Trane Technologies transferred all its asbestos liabilities to Aldrich Pump while keeping the operating assets. All three companies filed for bankruptcy in the Western

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13 Samantha Goldstein, *The Texas Two-Step: A Controversial Bankruptcy Dance*, https://lawreview.law.miami.edu/the-texas-two-step-a-controversial-bankruptcy-dance.
14 *Id.*
15 In re LTL Mgmt., LLC, 637 B.R. 396, 400 (Bankr. D.N.J. 2022), rev'd and remanded, No. 22-2003, 2023 WL 1098189 (3d Cir. Jan. 30, 2023)
16 In re LTL Mgmt., LLC, 637 B.R. 396, 415 (citing In re Bestwall LLC, 606 B.R. at 257).
17 Paige Sutherland, *The Texas Two-Step: A Controversial Legal Strategy to Avoid Corporate Liability*, WBUR, https://www.wbur.org/onpoint/2022/10/20/the-texas-two-step-a-new-bankruptcy-strategy-to-avoid-corporate-liability.
18 *In re Bestwall,* 605 B.R. 43, 46 (Bankr. W.D. N.C. 2019).

District of North Carolina.[19] While these cases are currently pending, it would not be surprising if they are also dismissed on the same grounds as LTL Management's bankruptcy.

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[19] Dan Levine, *How a Bankruptcy Innovation Halted Thousands of Lawsuits from Sick Plaintiffs*, Reuters, https://www.reuters.com/investigates/special-report/bankruptcy-tactics-two-step.