ALERT

Flames, Not Smoke: LTL Management LLC's Second Chapter 11 Filing Dismissed by the Bankruptcy Court for the District of New Jersey for Lack of Imminent and Immediate Financial Distress

August 14, 2023

SCHULTE ROTH + ZABEL

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On July 28, 2023, Judge Michael Kaplan of the Bankruptcy Court for the District of New Jersey issued an opinion granting motions to dismiss LTL Management LLC’s second chapter 11 case, finding that it was filed in bad faith due to a lack of imminent and immediate financial distress. See *In re LTL Mgmt., LLC*, No. 23-12825 (MBK), 2023 WL 4851759 (Bankr. D.N.J. July 28, 2023). Judge Kaplan’s decision follows the U.S. Court of Appeals for the Third Circuit’s dismissal of LTL’s first chapter 11 bankruptcy case in January 2023. Read our *Alert* on the Third Circuit’s dismissal of LTL’s first chapter 11 bankruptcy case here. In this latest opinion, Judge Kaplan referenced the fact that, though he had failed to dismiss the original bankruptcy, the facts supporting the Third Circuit’s decision to require dismissal – specifically, the Debtor’s lack of “financial distress” remained largely unchanged and thus mandated dismissal under current Third Circuit law. The Court’s decision to dismiss highlights difficulties that corporations with mounting mass tort liabilities face under the Third Circuit’s precedent.

A potential circuit split may emerge. In June, the U.S. Court of Appeals for the Fourth Circuit issued a 2-1 decision upholding a bankruptcy court-issued preliminary injunction prohibiting asbestos-related actions against Georgia-Pacific, a non-debtor predecessor of Bestwall. *In re Bestwall LLC*, 71 F.4th 168 (4th Cir. 2023), *reh’g en banc denied*. The Fourth Circuit in *Bestwall* noted the Third Circuit’s *LTL* decision, recognizing that the two circuits adopt different approaches with respect to the requirements that debtors must satisfy to avoid dismissal of their bankruptcy case under Section 1112(b) of the Bankruptcy Code. The emerging circuit split presents an opportunity for the Supreme Court to decide the issue. A Supreme Court ruling could have significant ramifications for those looking to engage in the controversial Texas two-step maneuver – which both of LTL Management and Bestwall engaged in prior to their bankruptcy filings.

Background

In our previous *Alert*, “Third Circuit Dismisses J&J Bankruptcy Case for Lack of Good Faith,” we analyzed the Third Circuit’s dismissal of LTL’s chapter 11 first bankruptcy case. The Third Circuit dismissed the case as a bad faith filing based on a lack of imminent and apparent financial distress. The decision reversed rulings by Judge Kaplan, created uncertainty around whether strategies like the “Texas two-step” will remain a tool for large corporations to cabin off legacy liabilities, and, as we discuss below, contributes to what appears to be an emerging circuit split between the Third and Fourth circuits.

LTL’s Second Bankruptcy Filing

Just hours after the Bankruptcy Court officially dismissed LTL’s first bankruptcy case on April 4, 2023, LTL filed for chapter 11 protection once more. LTL announced in a press release that it “filed [its first chapter 11 case] in good faith, and, heeding the Third Circuit’s guidance, [has] filed this new case to effectuate that intent.” LTL entered its second bankruptcy with a funding backstop from parent Johnson &

Johnson worth ~$30 billion, roughly half of the $61.5 billion backstop LTL had from its parent when it filed its previous case.

Various parties, including the Official Committee of Talc Claimants, the U.S. Trustee, the ad hoc committee of states holding consumer protection claims, New Mexico, Mississippi and other talc claimant representatives, filed motions to dismiss LTL's second case. In their pleadings, they argued that, much like the first case, LTL's new case was not filed in good faith. The Bankruptcy Court held a four-day trial on the motions to dismiss in June.

Judge Kaplan's Opinion in the Second LTL Management Bankruptcy

On July 28, 2023, Judge Kaplan issued an opinion granting the motions to dismiss, finding that LTL filed its second chapter 11 case in bad faith due to a lack of imminent and immediate financial distress.

In the Third Circuit, a chapter 11 bankruptcy petition is subject to dismissal for 'cause' under Section 1112(b) of the Bankruptcy Code unless it is filed in good faith. A debtor files a petition in good faith if the bankruptcy (i) serves a valid bankruptcy purpose and (ii) is not filed merely to obtain a tactical litigation advantage. Judge Kaplan made it clear in his opinion that, under the Third Circuit's guidance from the first LTL Management bankruptcy, a bankruptcy court must start its analysis of whether a bankruptcy petition is filed in good faith with an assessment of "financial distress."

Grappling with precedential constraints, Judge Kaplan noted that the Third Circuit has not "set out a specific test to apply rigidly when evaluating financial distress." However, the Third Circuit *has* articulated that "[f]inancial distress must not only be apparent, but it must be immediate enough to justify a filing" and that "an attenuated possibility standing alone" regarding a bankruptcy filing is insufficient for purposes of establishing good faith.

Although LTL (i) faces a mounting wave of future liabilities stemming from legacy talc-related tort claims and (ii) has already incurred billions of dollars in judgments, settlements and litigation costs, Judge Kaplan acknowledged that LTL has significant assets, including a funding backstop with parent Johnson & Johnson. Pursuant to the funding backstop agreement, LTL "was contractually entitled to . . . access the value of HoldCo's significant cash holdings, anticipated annual dividends, and equity interests having a value approaching $30 billion." Based on expert valuations presented by LTL and certain parties seeking dismissal of the case, Judge Kaplan found that LTL was solvent – with the assistance of its parent – because its assets exceed "projected near term and aggregate talc liability."

Judge Kaplan recognized that the Bankruptcy Court faced nearly the same record as the Third Circuit faced in dismissing the original LTL Management bankruptcy. Thus, under the approach articulated by the Third Circuit earlier this year, "[g]iven LTL's assets – including the [funding] backstop – the record demonstrates that LTL can satisfy these costs; accordingly, there is no imminent financial distress."

Judge Kaplan also held that LTL failed to satisfy the requirements of Section 1112(b)(2), which states that the court shall not dismiss a case if the court finds the presence of "unusual circumstances establishing that . . . dismissing the case is not in the best interests of creditors . . ." Judge Kaplan explained that this exception arises "where 'cause' for dismissal is based on 'technical mistakes' or other procedural and ministerial failings." Similarly, Judge Kaplan declined to appoint an examiner or chapter 11 trustee, finding that it would not be in the best interests of creditors.

Judge Kaplan wrote that "[o]ne can view the Third Circuit's ruling as being somewhat at odds with a pro-active approach to trouble. When one smells smoke, the wise course of action is to get out of the house

and call for help. However, as it stands now, in gauging financial distress, observing smoke may not be enough – one must see flames."

Potential Circuit Split Between the Third and Fourth Circuits

In June, the U.S. Court of Appeals for the Fourth Circuit issued a decision in *In re Bestwall LLC* upholding a bankruptcy court-issued preliminary injunction prohibiting asbestos-related actions against Georgia-Pacific, a non-debtor predecessor of Bestwall.

The Fourth Circuit cited to the Third Circuit's *LTL* opinion. While the Fourth Circuit recognized that the issues presented in the two cases were different – the Fourth Circuit's *Bestwall* opinion dealt with jurisdictional questions rather than the requirements of a good faith filing – it also acknowledged that the overall standard applied by each circuit in determining whether a bankruptcy petition lacks good faith differs markedly. The Fourth Circuit employs a "more stringent standard for dismissal of a case for lacking good faith." Under Fourth Circuit precedent "the complaining party must show both 'subjective bad faith' and the 'objective futility of any possible reorganization.'"

Comparatively, pursuant to Third Circuit's approach, it is the debtor, not the movant, that bears the burden of proving that its filing was in good faith – and of showing "financial distress." These holdings conflict, and reflect an increasingly pertinent circuit split – which could prompt the Supreme Court to weigh in on the issue. The likelihood of the Supreme Court weighing in is bolstered by the fact that, as the dissent in *Bestwall* articulates, "in recent years, major and fully solvent business corporations have managed to skirt [the] debtor-centric objective [of the Bankruptcy Code] and obtain shelter from sweeping tort litigation without having to file for bankruptcy themselves." This type of "manipulation of the Bankruptcy Code" is seemingly antithetical to the Supreme Court's long standing recognition "that Congress's central purpose in enacting the Bankruptcy Code was to provide a procedure by which certain *insolvent debtors* can reorder their affairs, make peace with their creditors, and enjoy a new opportunity in life with a clear field for future effort."

Takeaways

This ruling could impact bankruptcies in the Third Circuit (and beyond) significantly.

- Judge Kaplan wrote that the "chief difference" between the Bankruptcy Court's decision not to dismiss LTL's first case and the Third Circuit's subsequent logic in reversing that decision was the perceived lack of "immediacy" of financial stress. Judge Kaplan's decision to dismiss the second LTL case follows directly from the Third Circuit's guidance. The requirement of imminent and immediate financial distress poses a challenge for companies who, keenly aware of sure-to-come mass tort liability, seek a proactive approach to the issue.
- Judge Kaplan expressed doubt 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." However, he conceded that the "Court's beliefs as to the benefits and advantages of bankruptcy, or the appropriateness of employing a chapter 11 filing to resolve mass tort liability are of no moment" because, under the Third Circuit's guidance, the analysis must "'start, and stay, with good faith' and the requirement of financial distress." The focus on financial distress under Third Circuit jurisprudence over the bankruptcy court's equitable powers to facilitate orderly resolution of mass tort litigation through bankruptcy systems may lead corporations dealing with mounting mass tort liability to reconsider the merits of filing for chapter

11 in the Third Circuit (which includes Delaware). Notably, LTL Management originally filed the first case in the Fourth Circuit (in North Carolina). The judge there transferred venue to New Jersey.

- Lastly, two-stepping companies must contend with a new dilemma – (1) severely curtail backstop funding arrangements with parent or holdco entities, which could expose the company to fraudulent transfer claims or (2) limit fraudulent transfer exposure through adequate funding, but risk wholesale dismissal of its bankruptcy case.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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