ALERTS

Third Circuit Dismisses J&J Bankruptcy Case for Lack of Good Faith

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"The theme is clear: absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose."

On Jan. 30, 2023, the U.S. Court of Appeals for the Third Circuit dismissed the Chapter 11 bankruptcy case of LTL Management LLC, a Johnson & Johnson entity created to hold billions in liabilities stemming from J&J's talc products, after finding that the case was not filed in good faith. *See In re LTL Management, LLC*, No. 22-2003, 2023 BL 28442 (3d. Cir. Jan. 30, 2023). The decision reversed rulings of the Bankruptcy Court for the District of New Jersey noting that the bankruptcy court erred by focusing its analysis on the financial wellbeing of LTL's predecessor instead of LTL itself.

As the Court explained, "[w]e start, and stay, with good faith . . . What counts to access the Bankruptcy Code's safe harbor is to meet its intended purpose. Only a putative debtor in financial distress can do so. LTL was not." This case could potentially impact certain companies' ability to file for bankruptcy in the Third Circuit (which includes the Delaware Bankruptcy Court) – and certainly creates uncertainty around eligibility. It also strikes a blow against large companies using strategies like the so-called "Texas two-step" merger to cabin off liabilities – exposing the larger corporate entities to those broader liabilities.

The Good Faith Requirement

Section 1112(b) of the Bankruptcy Code requires a bankruptcy court to dismiss a Chapter 11 case for "cause," which can include a finding that the case was not filed in good faith. Courts consider the totality of the circumstances, but one particularly important inquiry is whether the petition serves a valid bankruptcy purpose. "[A] debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith."

The "Texas Two-Step" & LTL's Funding Agreement

J&J formed LTL two days prior to LTL's Chapter 11 filing through a form of divisional merger allowed under Texas law. Under the transaction, an existing subsidiary of J&J named Johnson and Johnson Consumer Inc. ("Old Consumer") allocated essentially all of its talc-related tort liabilities to a new entity named LTL Management LLC. Concurrently, Old Consumer assigned its operating assets to a different new entity also named Johnson & Johnson Consumer Inc. ("New Consumer") – effectively severing the assets from the liabilities. LTL's assumption of Old Consumer's liabilities meant that LTL "would take the place of Old Consumer in current and future talc lawsuits and be responsible for their defense." At the same time the actual assets from which those liabilities derived had been moved to New Consumer which would continue operating. To effectuate this strategy for ring-fencing liabilities, J&J relied on provisions of Texas state law that "splits a legal entity in two, divides its assets and liabilities between two new entities, and terminates the original entity." People have commonly called this transaction, a "Texas two-step" divisional merger.

As part of the transaction, LTL also entered into a multi-billion-dollar funding agreement with J&J and New Consumer. Under the funding agreement, J&J and New Consumer agreed, jointly and severally, to pay LTL cash up to the value of New Consumer ($61.5 billion at the time of the merger) for purposes of satisfying talc-related costs and LTL's normal course expenses.

The Bankruptcy Court Finds a Good Faith Bankruptcy Filing

Shortly after LTL filed its Chapter 11 petition in New Jersey, certain talc claimants moved to dismiss the case under § 1112(b) by arguing that it was not filed in good faith. Judge Kaplan, the Chief Judge of the Bankruptcy Court for the District of New Jersey, found that LTL's case was filed in good faith and denied the motions to dismiss. Judge Kaplan based his opinion, in part, on a finding that LTL was in financial distress due to the scope of litigation against Old Consumer, the costs Old Consumer incurred in defending such litigation and the effect of those lawsuits on Old Consumer's business. The talc claimants appealed the ruling directly to the Third Circuit.

The Third Circuit Reverses the Bankruptcy Court

The Third Circuit disagreed with Judge Kaplan's approach, finding that LTL was not in financial distress at the time of filing and that its Chapter 11 case was therefore not filed in good faith. The Court wrote that Judge Kaplan erred by focusing on Old Consumer's liabilities and litigation costs instead of testing the financial wellbeing of the debtor LTL, "independent of any other entity." The Court explained that the correct analysis should have focused "on [LTL's] assets, liabilities, and, critically, the funding backstop it has in place to pay those liabilities." Old Consumer should be considered only to the extent it "informs [the court's] view of the financial condition of LTL itself."

LTL's multi-billion-dollar funding agreement with New Consumer and J&J was particularly significant. The Court wrote that the "[a]greement provided LTL a right to cash that was very valuable, likely to grow, and minimally conditional. And this right was reliable, as J&J and New Consumer were highly creditworthy counterparties (an understatement) with the capacity to satisfy it." Given LTL's "$61.5 billion payment right against J&J and New Consumer," the Court "[could not] agree LTL was in financial distress when it filed its Chapter 11 petition."

The Court stopped short of laying out a specific test for evaluating financial distress, writing instead that "[t]hough insolvency is not strictly required...we cannot ignore that a debtor's balance-sheet insolvency or insufficient cash flows to pay liabilities (or the future likelihood of these issues occurring) are likely always relevant."

The Court's opinion instructs Judge Kaplan to dismiss the case.

Takeaways

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

- While the Bankruptcy Code has never required a showing of insolvency to file for bankruptcy, the Third Circuit has now added a requirement that a debtor be in "financial distress." Congress does not require such distress – though Court rulings on “good faith” have often considered the Debtor’s financial state.

- The Court noted that consideration of “financial distress” and good faith should focus on the Debtor’s financial well-being – not the well-being of other non-filing entities.

- While the Third Circuit does not rule as to the propriety of the “Texas two-step” divisional merger *per se*, surely Debtors will need to think carefully before utilizing such strategies prior to filing for bankruptcy in the Third Circuit. Companies looking to isolate mass tort claims via a separate entity in bankruptcy must carefully structure the bifurcation of assets and liabilities between the parent and bankruptcy-bound subsidiaries. As the Court put it, “the bigger a backstop a parent company provides a subsidiary, the less fit that subsidiary is to file.”

- This is part of a recent series of cases in which creditors have questioned the fairness of bankruptcies designed to limit parental liabilities for potential tort or other mass liabilities. The victim claimants in the *Purdue Pharma L.P.* bankruptcy challenged potential non-debtor releases for the owners of officers of the debtors – before settling on appeal. And tort claimants in the *Aearo Technologies LLC* bankruptcy are seeking dismissal of the case as also filed in bad faith. In *Aearo* the victims recently argued that the Bankruptcy Court for the Southern District of Indiana should consider the Third Circuit’s ruling in *LTL* and dismiss the case. However the debtors in *Aearo* will assert the facts there vary from the facts here – *Aearo* was a long-existing subsidiary of 3M that recently filed for bankruptcy.

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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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