

## insights

# Put down your fiddle: Third Circuit halts Johnson & Johnson's Texas two-step

On January 30, 2023, the [Third Circuit Court of Appeals dismissed](#) the bankruptcy filing by Johnson & Johnson's subsidiary, LTL Management, LLC ("LTL"). The Circuit Court reversed the New Jersey Bankruptcy Court and held that LTL did not file the bankruptcy case in good faith and therefore was ineligible to petition the bankruptcy court for relief.

### Background [1]

Johnson & Johnson Consumer Inc. ("Old Consumer"), a wholly-owned subsidiary of Johnson & Johnson ("J&J"), sold iconic health care products, including Band-Aid, Tylenol, Aveeno, and Listerine. It also produced Johnson's Baby Powder. Concerns that the talc base in the Baby Powder contained traces of asbestos led to a torrent of lawsuits against Old Consumer and J&J, alleging Johnson's Baby Powder caused ovarian cancer and mesothelioma. Some of those suits resulted in verdicts against the defendants, some failed (outright or on appeal), and others settled.

But by 2021, more than 38,000 talc lawsuits were pending. With payouts mounting and litigation costs soaring, Old Consumer, through a series of intercompany transactions primarily under Texas state law, split into two new entities: LTL, holding principally Old Consumer's liabilities relating to talc litigation and a funding support agreement from LTL's corporate parents; and Johnson & Johnson Consumer Inc. ("New Consumer"), holding virtually all the productive business assets previously held by Old Consumer. J&J's stated goal was to isolate the talc liabilities in a new subsidiary so that the entity could file for Chapter 11 without subjecting Old Consumer's entire operating enterprise to bankruptcy proceedings. Two days later, LTL filed a petition for Chapter 11 relief in the Bankruptcy Court for the Western District of North Carolina. That Court, however, transferred the case to the Bankruptcy Court for the District of New Jersey. Additional information regarding the details behind this two-step divisional merger, known colloquially as a Texas Two Step, is detailed in this prior [blog post](#).

A group of talc claimants filed a motion to dismiss LTL's bankruptcy filing as having been filed in bad faith. The [Bankruptcy Court denied the motion to dismiss](#) and the claimants appealed directly to the Third Circuit.

### Third Circuit standard

As an initial matter, the Third Circuit set forth its standard[2] to determine whether bankruptcy petitions are filed in good faith.

Chapter 11 bankruptcy petitions are "subject to dismissal under 11 U.S.C. § 1112(b) unless filed in good faith." Section 1112(b) provides for dismissal for "cause." A lack of good faith constitutes "cause," though it does not fall into one of the examples of cause specifically listed in the statute. Because the Code's text neither sets nor bars explicitly a good-faith requirement, we have grounded it in the "equitable nature of bankruptcy" and the "purposes underlying Chapter 11." Once at issue, the burden to establish good faith is on the debtor.... "[T]wo inquiries . . . are particularly relevant": "(1) whether the petition serves a valid bankruptcy purpose[;] and (2) whether [it] is filed merely to obtain a tactical litigation advantage." [3]

After evaluating the standard in light of the facts of LTL's case, the Third Circuit concluded "a debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith." "Good faith," the Court held, "necessarily requires some degree of financial distress on the part of a debtor." "Absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose."

### LTL's lack of financial distress

The Third Circuit Court found that LTL was not in financial distress. The Court noted that LTL's assets included the right to receive about \$61.5 billion from J&J and New Consumer under a funding agreement executed at the time of the divisional merger. By contrast, in the five years preceding the bankruptcy filing, the aggregate costs of the talc

litigation were approximately \$4.5 billion, or less than 7.5% of LTL's assets, on the petition date. Likewise, J&J reported a GAAP calculation of its talc liability as of October 2021 at only \$2.4 billion over the next 24 months and had entered settlement discussions seeking to resolve its talc liability in multi-district litigation in the \$4 to \$5 billion range. Given that its assets far outweighed its potential liability as of the petition date, the Circuit Court held that LTL was not in "financial distress." The Court, however, did not rule out the possibility of changing circumstances that might necessitate a future filing and specifically stated that additional time for litigation claims to get resolved would assist future fact finders in painting a clearer picture of LTL's actual talc claim exposure.

### **The Catch-22**

J&J's carefully crafted bankruptcy plan for its legacy talc liabilities was ultimately undone by its attempt to comply with fraudulent transfer laws. Specifically, at the time of the divisional merger, JJ gave a \$61.5 billion funding agreement to LTL. As a result, the Circuit Court noted, LTL held "assets having a value at least equal to its liabilities and had financial capacity sufficient to satisfy its obligations as they become due in the ordinary course of business, including any [t]alc [r]elated [l]iabilities."

Perhaps to discourage practitioners from trying to avoid LTL's fate by creating divisive mergers without a sufficient funding agreement or other adequate backstop, the Third Circuit warned that "interested parties may seek to 'avoid any transfer' made within two years of any bankruptcy filing by a debtor who 'receive[s] less than a reasonably equivalent value in exchange for such transfer' and 'became insolvent as a result of [it].'" 11 U.S.C. § 548(a).<sup>[4]</sup> Put differently, the Texas Two Step strategy is subject to a Catch-22: either the divisional merger results in the new entity holding assets worth at least as much as its liabilities, in which case there is no "financial distress" or the divisional merger leaves the entity insolvent or inadequately capitalized and vulnerable to fraudulent transfer attack.

LTL's bankruptcy path was undone because LTL was solvent after the division merger and therefore not in financial distress. Had LTL been insolvent or inadequately capitalized, the Third Circuit probably would not have dismissed the case but the bankruptcy court could have unwound the divisive merger, leaving J&J in the same position as before the divisive merger.

### **Conclusion**

While the Circuit Court noted the "apparent irony" of the situation, namely that J&J's unquestioned ability to backstop LTL's liability for the talc claims led to the finding that LTL was not entitled to bankruptcy protection, the Court at the same time encouraged lawyers to be "inventive" and for management to experiment "with novel solutions." Lawyers will likely do just that, and while the music may have stopped for LTL, another company may be preparing to strike up the band with a twist that can pass judicial scrutiny.

[1] All facts described herein come directly from the Circuit Court Opinion.

[2] As detailed in the prior blog post, the Fourth Circuit standard is more permissive and may have been why LTL initially filed in North Carolina.

[3] Opinion at 35-36. Internal citations have been omitted.

[4] Id. at 55 n.18

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