Tide May Be Turning On Texas Two-Step Bankruptcy Strategy

By **Stuart Gordon, Matthew Spero and Alexandria Tomanelli** (July 19, 2023)

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Companies facing multidistrict litigation mass tort exposure have been utilizing a new technique to protect themselves and their related entities from mass tort claims.

Known as the Texas Two-Step, this creative use of the U.S. Bankruptcy Code gives related entities the benefit of the automatic stay without those companies having to file for Chapter 11 bankruptcy protection themselves.

Two recent court decisions, however, have eroded the ability to use the Texas Two-Step to shield companies from multidistrict litigation, while a third has upheld the technique as viable.

These are emotionally charged cases, requiring courts to balance the interests of terminally ill plaintiffs against well-heeled corporations seemingly capable of defending these claims and paying any judgments.

Considering recent decisions, the tide may be turning against tort debtors who employ this creative strategy in favor of plaintiffs alleging terminal illnesses caused by the debtors and their affiliates.

Many of these plaintiffs are in the late stages of disease or on the eve of trial. They argue that they seek justice for themselves and their survivors before dying.

They also believe that using the bankruptcy process to protect nondebtors from litigating the claims case-by-case, capping defense costs, and avoiding the risks of adverse rulings in multiple jurisdictions is an unjust tactic and is contrary to the intent and purpose of the Bankruptcy Code.

In the Texas Two-Step, a defendant corporation will assign its liabilities to a newly formed subsidiary under Texas law, which allows this type of divisive merger.

The subsidiary with the liabilities will then file for bankruptcy, which stays the lawsuits, and seek to extend the automatic stay to its affiliated entities with the goal of resolving all MDL through the bankruptcy system. Doing so allows companies to utilize the bankruptcy system's expedited timeline and avoid defending claims case by case.

Nondebtors seek to obtain the benefit of the automatic stay by entering into funding agreements through a Chapter 11 reorganization plan, which provides funds to be administered by a trust for the benefit of the debtor's tort claimants.

Debtors can then argue they need to protect nondebtors because there will be sufficient assets to pay torts claimants. Debtors also argue that allowing the litigation to proceed against these nondebtors would distract the debtor from its reorganization efforts.

These creative efforts by debtors to protect their affiliates are controversial since the nondebtor affiliates obtain the automatic stay protections without having to file for Chapter 11.

Thus, nondebtor affiliates avoid the fiduciary responsibilities of Chapter 11 and do not have to disclose their assets and liabilities, permit investigations by creditors, or provide transparency of their business operations as normally required under the Bankruptcy Code.

In re: LTL Management LLC is one of the latest examples of using the Chapter 11 process to protect otherwise solvent entities. In this case, some consumers of Johnson & Johnson baby powder alleged that they were diagnosed with cancer caused by talc, one of the powder's ingredients.

J&J faces over 38,000 lawsuits alleging ovarian cancer and mesothelioma caused by exposure to talc. After many years of litigation and mixed verdicts, J&J turned to the U.S. Bankruptcy Court for the District of New Jersey for relief — not for itself, but for its affiliated entity, LTL.

In 2021, J&J formed two subsidiaries. It moved its assets into one entity and transferred certain assets and its talc liabilities into the other, LTL.

Shortly thereafter, LTL filed for bankruptcy, which stayed the pending talc cases against LTL, but not against J&J and its other nondebtor affiliates. J&J and LTL then established a funding agreement for talc claim liabilities as part of the bankruptcy process.

The Talc Claimants Committee sought dismissal of the bankruptcy petition for bad faith.

In 2022, the bankruptcy court denied the motion to dismiss the LTL bankruptcy case, holding that the proceeding would address the talc claims and that LTL was in financial distress and not seeking to restructure to secure a tactical advantage. LTL's request for continued injunctive relief was also granted.

The Talc Claimants Committee appealed, and the U.S. Court of Appeals for the Third Circuit accepted a direct appeal from the bankruptcy court.

The Third Circuit reversed and found that LTL did not file its bankruptcy petition in good faith as LTL was not in financial distress and had the benefit of the J&J funding agreement. This holding would have allowed the talc claimants to continue to pursue their claims through the tort system against LTL, J&J, and their related entities.

The Third Circuit denied LTL's motion for a rehearing. Subsequently, LTL filed a motion for a stay pending LTL's petition for certiorari to the U.S. Supreme Court.

The Third Circuit denied the motion and directed the bankruptcy court to dismiss LTL's bankruptcy case. Any appeal relating to continued injunctive relief was moot because the case was ordered to be dismissed.

Within hours of the bankruptcy court's dismissal order, LTL filed for Chapter 11 protection a second time in In re: LTL Management LLC. This time, J&J also agreed to contribute up to establish a funding agreement to resolve all current and future talc claims. The LTL II bankruptcy case is pending and the subject of several motions to dismiss.

On June 30, the Third Circuit concluded the trial on the motions to dismiss but has yet to

render a decision.

Other bankruptcy courts have seized on the LTL dismissal holding, including In re: Aearo Technologies LLC in the U.S. Bankruptcy Court for the Southern District of Indiana.

In 2008, 3M Co., a multinational conglomerate that manufactures industrial, safety and consumer products, acquired Aearo Technologies, a designer and manufacturer of personal protection and energy-absorbing products.

In July 2022, Aearo filed for Chapter 11 protection in the Southern District of Indiana bankruptcy court. 3M placed its subsidiary into bankruptcy after it spent over $300 million in legal fees defending personal injury lawsuits involving allegedly faulty earplugs that Aearo sold to the U.S. military.

Before filing for bankruptcy, 3M earmarked more than $1 billion under a funding agreement to pay for the claims. At that time, the chair and CEO of 3M Mike Roman announced that "this decisive action now will allow 3M and Aearo Technologies to address these claims in a way that is more efficient and equitable than the current litigation."

Aearo's bankruptcy filing automatically stayed the personal injury lawsuits filed against Aearo but not against 3M, and Aearo requested that the bankruptcy court extend the automatic stay to those claims.

In August 2022, the bankruptcy court denied Aearo's request to extend the automatic stay and grant injunctive relief to 3M, forcing 3M to continue to defend itself in the personal injury litigations. Aearo immediately appealed the decision, and the U.S. Court of Appeals for the Seventh Circuit agreed to take a direct appeal from the bankruptcy court.

The appeal was argued in April.

Invoking the Third Circuit's dismissal of the LTL case, the Tort Claimants Committee in the Aearo case and over 200,000 claimants, veterans, active-duty service members, civilian contractors and consumers jointly moved to dismiss the Aearo bankruptcy cases for cause.

They argued that, like in LTL, the Aearo debtors were not in any financial distress when they sought bankruptcy protection and that Aearo's current and future tort liabilities to claimants were fully backstopped by 3M under a funding agreement, obviating any need for reorganization.

On June 9, the bankruptcy court dismissed Aearo's bankruptcy filing. Citing LTL, the bankruptcy court held that Aearo was financially healthy and possessed a "greater deal of financial security than warrants bankruptcy protection." The bankruptcy court found no evidence that the impending MDL had, or will have, any substantial effect on Aearo financially.

This reflects a possibly evolving stance that courts should only extend bankruptcy protections to financially troubled companies. LTL was somewhat distinguished, as the court noted that, unlike LTL, Aearo was at least an actual company with debts.

However, those debts were not sufficient to merit bankruptcy protection. Aearo appealed this decision directly to the Seventh Circuit.

Separately, claimants in other unrelated bankruptcy cases have sought similar relief in

response to the Texas Two-Step.

For example, in yet another case, Georgia-Pacific LLC formed Bestwall LLC to seek to channel its present and future asbestos-related liabilities to Bestwall's bankruptcy case.[1] Through the same Texas Two-Step, Georgia Pacific placed the vast majority of its asbestos liabilities with Bestwall and the vast majority of its assets into a new Georgia Pacific entity.

In December 2022, the U.S. Court of Appeals for the Fourth Circuit heard oral argument on an appeal as to whether the U.S. Bankruptcy Court for the Western District of North Carolina had jurisdiction to enjoin asbestos victims' claims against nondebtors such as Georgia Pacific.

This was the third time that a court of appeals had the opportunity to address attempts of nondebtors to utilize the bankruptcy protections of their bankrupt affiliates to avoid their own bankruptcy filing.

As in LTL and Aearo, a prebankruptcy funding agreement and indemnification agreement were in place. The Asbestos Claimants Committee asserted that claims against Georgia Pacific would not affect Bestwall's bankruptcy and that enjoining them would interfere with victims' rights to pursue claims against nondebtor tortfeasors in the state or federal judicial systems.

In February, the claimants in the Bestwall case asked the bankruptcy court to dismiss the case, arguing that the purpose of the bankruptcy filing was to prevent asbestos-related lawsuits from proceeding in the tort system. Attorneys for tort claimants argued that the Texas Two-Step used by Bestwall was identical to that used by LTL.

In June, the claimants filed a notice of supplemental authority in support of its motion to dismiss citing to the results of the LTL and Aearo cases.

On June 20, the Fourth Circuit affirmed the district court. It extended the automatic stay in the Bestwall case, protecting Georgia-Pacific from the pending asbestos litigation while Bestwall remains in bankruptcy.

The court reasoned that the decades-long litigation impeded the timely resolution of Bestwall's bankruptcy proceeding, and the automatic stay would allow Bestwall to reorganize effectively. This outcome differs from the J&J and 3M decisions, which may result in a circuit split.

Conclusion

The path forward is still not clear for all these cases.

However, the decision by the Third Circuit in LTL, the appeal of the Aearo case dismissal and the opinion by the Fourth Circuit in Bestwall shed further light on the ability of otherwise solvent companies to utilize these creative bankruptcy strategies.

Most prognosticators expect the Supreme Court to hear at least one of these cases. Until then, divisive mergers as a bankruptcy strategy will continue to be precisely that, divisive and the subject of increased scrutiny.

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[1] In re Bestwall LLC, case no. 17-31795.