

Introduction to LTL Management's Bankruptcy

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Judge Kaplan's (U.S. Bankruptcy Court for the District of New Jersey) recent refusal to dismiss the LTL Management/Johnson & Johnson bankruptcy has further stirred controversy about the hotly debated Texas Two-Step Maneuver.

The "Texas Two-Step" refers to series of transactions in which a company executes a divisional merger under Texas or Delaware law, and then causes one of the resulting companies to file for bankruptcy while the other remains outside of bankruptcy and maintains its normal operations.

Mass tort debtors have utilized this maneuver to isolate their tort liability in a separate entity from their primary business. The new entity then files for bankruptcy while the original business continues operating outside of bankruptcy. The Two-Step has sparked concern in a variety of sectors, including even from the Texas [lawmakers who drafted the statute](#) that makes the Two-Step possible. The technique has also recently received [scrutiny](#) from [Congress](#).

Johnson & Johnson (J&J) has employed the Two-Step to isolate tort claims arising from allegations that its talc baby powder product contained asbestos, thereby causing some of its customers to develop mesothelioma and ovarian cancer. In its Two-Step transaction, J&J executed a divisional merger of its consumer division subsidiary, Johnson & Johnson Consumer Inc. (Old JJCI), under Texas law. This divisional merger created a separate entity, LTL Management (LTL) alongside a new JJCI (New JJCI). LTL took on Old JJCI's tort liabilities and limited assets, primarily in the form of a funding agreement with J&J and New JJCI. In this agreement, J&J and New JJCI agreed to cover LTL's talc liabilities, up to New JJCI's value. LTL then filed for Chapter 11 bankruptcy relief in the Western District of North Carolina, hoping to take advantage of favorable legal precedent in that court.

Following initial legal maneuvering, which saw the case transferred to the District of New Jersey, tort claimants challenged LTL's filing as violating Section 1112(b) of the Bankruptcy Code and/or a separate requirement that bankruptcy petitions be filed in good faith.¹ The claimants argued that the filing was made in bad faith because J&J intended to use it to obtain a strategic advantage in litigation, thereby forcing talc claimants to accept a "bankruptcy discount" on their claims against LTL.

The court rejected these arguments, holding that LTL's Chapter 11 filing was an appropriate use of Chapter 11 because it would maximize the property available to creditors by using the Bankruptcy Code's tools. The court viewed J&J's compliance with the statutory requirements for divisional mergers as evidence that the filing was not for the purpose of securing an unfair tactical advantage in order to hinder creditors. The opinion also highlighted that a debtor need not be insolvent to make a good faith Chapter 11 filing.

Judge Kaplan emphasized that a successful reorganization and implementation of a settlement trust pursuant to Section 524(g) of the Bankruptcy Code would "dramatically reduce

¹ Collier's states that "[i]n general, a court may dismiss any case for a lack of good faith in order to prevent abuse of the chapter 11 process," and distinguishes this doctrine from the "cause" requirements under Section 1112(b)(4). 7 Collier on Bankruptcy ¶ 1112.07; *see also* In re Gen. Growth Props., 409 B.R. 43, 56 (2009) (bad faith dismissal is a "judge-made doctrine"). The principle behind this doctrine is that bankruptcy filings should only be available to the "honest but unfortunate debtor." 7 Collier on Bankruptcy ¶ 1112.07[3].

costs and ensure balanced recoveries for present and future claimants.”² He also rejected the claimants’ arguments that J&J left LTL undercapitalized from the outset, holding that the claimants were not worse off as a result of the Two-Step because of the funding agreement among J&J, New JJCI, and LTL, which would require “extraordinarily large” contributions from J&J and/or New JJCI to fund the trust, with oversight from the Bankruptcy Court to ensure compliance. As such, Judge Kaplan viewed the bankruptcy court as the “optimal venue” for offering redress to present and future talc claimants.

While he acknowledged that some plaintiffs seek to remain in the tort system and have their cases tried before a jury, Judge Kaplan stated that the tort system has “struggled to meet the needs of present claimants in a timely and fair manner,” and that “[t]he system is ill-equipped to provide for future claimants.” He thus viewed it as “folly” to contend that “the tort system offers the *only fair and just pathway* of redress.” (emphasis in original). He noted that although tort creditors rarely choose to pursue their rights in the bankruptcy courts, there have been numerous asbestos trusts implemented under Section 524(g), which have produced “uniform treatment for all claimants.” The Judge thus characterized the Chapter 11 process, including the opportunity to establish Section 524(g) trusts, “as [providing] a meaningful opportunity for justice, which can produce comprehensive, equitable, and timely recoveries for injured parties.”

This decision has put an end to speculation about whether the bankruptcy court would allow LTL’s bankruptcy filing to proceed, though the Third Circuit is currently reviewing the case on direct appeal from the bankruptcy court. Some commentators had argued that bankruptcy judges can police the use of the Two-Step through the application of the good faith filing requirement (and its flip side, bad faith dismissal), thus making legislative action unnecessary. However, this decision indicates that the court did not view J&J’s [widely criticized](#) use of the Two-Step as prima facie abusive. Any policing of J&J’s Two-Step tactics will therefore have to come at a later stage in the proceeding. The case may provide motivation for legislative action if Congress views the decision as a failure to appropriately limit the use of the Two-Step. The decision also provides an additional lens through which to examine [venue reform](#), another controversial bankruptcy topic that has attracted criticism,³ and instigated [Congressional inquiry](#) into whether to restrict access to the Texas Two Step.

² Trusts implemented under Section 524(g) often provide tort victims with a choice between receiving guaranteed compensation from a trust established under that section or pursuing recovery against the trust through jury trials.

³ Judge Kaplan was skeptical that venue transfer does much to change the applicable standard for a bad faith dismissal or the analysis in this case: “The Court cannot help but ponder how a bankruptcy filing, which took place in North Carolina and most likely satisfied the good faith standards in that jurisdiction, suddenly morphs post-petition into a bad faith filing simply because the case travels 400 miles up I-95 to Trenton, New Jersey.” *In re LTL Mgmt., LLC*, 2022 Bankr. LEXIS 510, at *19 (Bankr. D.N.J. Feb. 25, 2022).