Waltz Across Texas: The Texas Three-Step

Edward J. Janger[*] and John Pottow[+]

Judge Ambro's opinion on behalf of the Third Circuit in *In re. LTL Management* offers a master class in judicial statesmanship. It manages to dismiss a bankruptcy case as filed in bad faith while insulting no-one and impugning nobody's motives. This is quite an accomplishment, but the diplomacy comes at some cost. As Billy Organek's excellent summary points out, statesmanship's gain is precision and predictability's loss. While with one hand, Ambro implies that the Two-Step has danced its last jig, with the other, he invites the bankruptcy bar to keep trying—to continue to "innovate." These signals are mixed, to say the least. But, in good faith (if we may), we take this opportunity to accept Judge Ambro's invitation to keep trying seriously, while offering a path to how that innovation might be accomplished consistent with bankruptcy law's mission.

Distilled to its essence, the Third Circuit's opinion states that a good faith filing requires a valid bankruptcy purpose. The purpose of bankruptcy is to address financial distress. LTL was not in distress, because the funding agreement provided by J&J and J&J Consumer provided LTL with ample resources to satisfy its mass-tort liability. Ergo, there was no valid bankruptcy purpose.

This outcome has led some to speculate that the mistake made by J&J's lawyers was to provide too generous funding. We think, however, this reading of the opinion underappreciates and misunderstands a crucial subtext. The Bankruptcy Code's superpowers, such as the power to discharge claims, can only be enlisted in favor of a legitimate bankruptcy purpose: to help resolve genuine (not contrived) financial distress.

In this regard, the LTL opinion and its statesmanship create a seemingly difficult task for debtors (which one of us likens to a Möbius strip). Lack of financial distress demonstrates lack of legitimate bankruptcy purpose. But manufactured financial distress, created solely for the purpose of obtaining bankruptcy relief, also would ground bad faith. Just how is one to "innovate" into the sweet spot? And, once one has gained access to bankruptcy, what are the prerequisites for relief? We think there is a path forward, but it requires plunging more into bankruptcy law and its purposes than the opinion had occasion to do.

Judge Ambro's opinion is exemplary in its tact. By focusing solely on LTL and its absence of financial distress, the decision did not have to examine the transaction by which that distress was created, let alone the motives of J&J and Old Consumer when they chose to spin their liabilities into LTL. The lawyers and officers and directors involved should count themselves lucky. They were taken at their word in their assertions that the Funding Agreement provided ample resources to cover any talc liability that might arise. Therefore, Ambro was able to avoid discussing the uglier topic of whether the filing was a bad faith litigation tactic as a naked attempt to stymie adversary litigation. As the other contributors to this discussion have demonstrated,

[*] David M. Barse Professor of Law, Brooklyn Law School.
[+] John Philip Dawson Collegiate Professor of Law, University of Michigan Law School.

that would have raised issues of, inter alia, fraudulent conveyance, breach of fiduciary duty, veil piercing, and abuse of process. Sanctions might have been on the table. By taking the Debtors' attorneys at their word about the sufficiency of the Funding Agreement, Ambro did not have to look beyond the balance sheet of LTL or scrutinize the motives behind its creation.

But this narrowness of judicial focus makes the invitation to continued creativity seem puzzling. Certainly, Judge Ambro would not have been inviting dishonesty and strategery. So, the deeper questions raised by his invitation, if one is to take it seriously, is: what are the proper uses of bankruptcy courts powers in resolving mass tort cases, and can they be invoked in the absence of financial distress? What is the scope of the court's power? And what are the procedural prerequisites for their exercise?

Financial distress may be a prerequisite, but answering these broader questions requires considering the proper relationship between bankruptcy courts and the MDL and class-action process—what it is that bankruptcy courts can offer that ordinary litigation and Rule 23 cannot? But more importantly, it also requires asking *why*? What is it about financial distress that justifies the bankruptcy superpowers that distinguish bankruptcy courts from their MDL counterparts? And what are the limits of those powers, and what process is required to police their use?

Let's tackle those questions in order. First, what is it that J&J was trying to do when it undertook the Texas Two-Step? By all accounts, it was seeking global peace: resolution of its talc liability—past, present, and future—so that the operating businesses of J&J and J&J Consumer could close the books on their talc liability free from "tort overhang." Further, it was seeking global peace at a price it could afford. If this was the goal, then the term Texas Two-Step is really a misnomer. Achieving the ultimate goal was really always going to require a "Three-step"—a "Waltz Across Texas," if you will, proceeding as follows. Step 1: the divisive merger that split Old J & J Cosmetics into a good half (new J&J Consumer) and a bad half (LTL); Step 2: the marshalling of all the various lawsuits together in one place by putting LTL into bankruptcy and getting the benefit of an automatic and supplemental stay; and Step 3: the deployment of bankruptcy law superpowers to obtain global peace in the form of a discharge of not just LTL, but also J&J Consumer, and J&J, from their past and future talc liability.

It is really the third step that matters, which Ambro never got to, and which is the source of the greatest controversy. Without the last step—debtor discharge and third-party release—none of the rest would have mattered. Bankruptcy law is unnecessary to bring all of the disputes together; multi-district litigation and class actions can do that just fine. Only bankruptcy law, however, can discharge the debtor's present and future claims, and it is currently before the Second Circuit in the *Purdue Pharma* case whether a bankruptcy court can (under current law) grant a release of third-party claims over the objection of unwilling creditors in exercising that superpower.

Second, if the "why" is the discharge, what justifies the discharge of present and future claims against the debtor in bankruptcy? The answer, again, per Judge Ambro, is the need to provide comprehensive and final relief for good faith financial distress. The same is true, incidentally, for

a non-opt out class under Rule 23(b)(1)(B), after the Supreme Court's decision in *Ortiz v. Fibreboard Corp.,* 527 U.S 815 (1999). [Edward J. Janger, *Aggregation and Abuse: Mass Torts in Bankruptcy*, 91 FORDHAM L. REV. 361 (2022).]

If a business liquidates in bankruptcy, it does not receive a discharge [11 U.S.C. 727(1), 1141(d)(3)]. That is because there is nothing left to distribute. Tort claimants who don't participate in the distribution are left out in the cold. For those who do, however, the Code assures an equitable distribution of value. By contrast, if an entity reorganizes and continues in business in Chapter 11, it does receive a discharge, *but only if the claimants do better than they would have in a liquidation*. [11 U.S.C. 1129(a)(7).] Thus, Chapter 11 discharge can be justified via the principles of loss allocation and value maximization. Continuation of the business must be shown to be better for the tort claimants than liquidation. In other words, by allowing the debtor to continue in business, there is more available to distribute to both present and future tort claimants. If the entity is solvent and can afford to pay its tort claims while remaining in business, no such extraordinary relief is necessary.

Third, what is the price of a discharge, and what process is required to assure that fair value is received and that the value is equitably distributed? The debtor must commit all its assets to the reorganization, make sufficient disclosures, and comply with the plan process for allocating that value either through a deal supported by statutory majorities or crammed down.

The very shorthand discussion above illustrates the centrality of debtor financial distress in justifying the first part of the third step—the discharge of mass-tort claims against the debtor in Chapter 11—here LTL. It does not, however, justify the mandatory third-party release of related entities—here J&J and J&J Consumer—necessary to obtain global peace. This issue has been front and center in the opioid bankruptcies of *Purdue Pharma* and *Mallinckrodt.* In those cases, related parties contributed to the bankruptcy distribution in return for receiving their own discharge. As others have discussed elsewhere, however, and as the Second Circuit may soon decide, it is not obvious that such releases are authorized by statute. But if they are, they should only be justified by a showing of the third party's financial distress for normative coherence with the debtor's justification. And if distress is the justification, then presumably, the granting of the release will require adherence to the bankruptcy bargain of committing all assets to the restructuring and adherence to the plan confirmation process to assure fair value allocation.

The genius of Ambro's seemingly narrow focus on financial distress and the single LTL entity is how the justification of financial distress folds back on itself to cabin the innovation he nominally invites. (The Möbius strip.) The opinion may seem narrow, but if one takes Ambro's invitation seriously, and understands that the two-step is really a waltz (three-step), then achieving the third step—global discharge—requires a third-party release. But any such release that discharges all of the members of the group should be justified by the same rationale as the debtor's own discharge. That is, it can be justified only if all of the group members demonstrate good faith financial distress (alongside adherence to process sufficient to assure compliance with bankruptcy law's mission). It may not be necessary for each entity to actually file for bankruptcy,

but they must submit themselves fully to participation in the case and demonstrate that they are fulfilling a legitimate bankruptcy purpose.

In conclusion, Judge Ambro's opinion is elegant. By focusing on financial distress and a single entity, it can be critical without criticizing. By suggesting innovation, it directs our focus to the future, but by its own reasoning prompts us to consider what that means in a world where innovation cannot just be manufactured ad hoc. And that in turn, we argue, means tying any discharge to the bankruptcy purpose of addressing financial distress—the very justification of the discharge's superpower (and reason to exclude regular MDL and class action courts) in the first place.