The Third Circuit's New One-Step: Good Faith as Purpose in *LTL*

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The Third Circuit's recent opinion in *LTL*—the so-called "Texas Two-Step" case—might surprise some bankruptcy watchers. Until then, one might have thought that a chapter 11 debtor could defeat a motion to dismiss a case as having been filed in "bad faith" by showing *either* that the debtor: (1) was in financial trouble; *or* (2) had many creditors.

Thus, the leading cases (*Integrated Telecom, SGL Carbon*, and *BEPCO*) were dismissed because the debtors were not broke *and* because they sought to use bankruptcy to defeat a bilateral dispute "opportunistically." By contrast, cases like *Energy Resources Holdings*—and dozens of asbestos prepacks that hustled through Delaware—suggested that numerosity, by itself, would permit a solvent debtor to reorganize in the face of grim long-term asbestos liability.

LTL, by contrast, suggests that the Third Circuit may be choreographing a new dance—a "one-step"?—that focuses on the underlying policy goals of chapter 11 despite numerosity and future threats to enterprise solvency due to alleged asbestos exposure.

In *LTL,* consumer-products giant Johnson & Johnson was defending about 38,000 lawsuits arising from allegations that its talc products contained asbestos. Although talc liability "put financial pressure" on J&J, including an eye-popping $2.24 billion verdict in the *Ingham* case, it had won or settled many cases. Still, J&J tried to contain its projected liability in a new subsidiary (LTL) formed pursuant to a "divisional merger" under Texas law, which then became the debtor in the *LTL* chapter 11.

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To avoid the very plausible claim that this was little more than a fancied-up fraudulent transfer, corporate parent J&J entered into a "funding agreement" with LTL, under which J&J committed the full value of its now-liability-free consumer products subsidiary—$61.5 billion—to pay talc claims as and when allowed under a plan of reorganization for LTL. This, LTL argued, would surely pay more tort creditors more through a chapter 11 plan than they would recover in the much-maligned "tort system" outside bankruptcy. This, in turn, showed its good faith in commencing its chapter 11 case.

Bankruptcy Judge Michael Kaplan bought it, but the Third Circuit did not. "Good intentions," Judge Ambro wrote, "such as to protect the J&J brand or comprehensively resolve litigation do not suffice alone. What counts to access the Bankruptcy Code's safe harbor is to meet its intended purposes. Only a putative debtor in financial distress can do so. LTL was not. Thus we dismiss its petition."

Most analysis will focus on the solvency leg of the Third Circuit's analysis. Judge Ambro took LTL at its word when it said, in a prior court filing, that there was not "'any imminent or even likely need of [it] to invoke the Funding Agreement to its maximum amount or anything close to it.'" He likened J&J's funding commitment to an "ATM disguised as a contract" from which it could make withdrawals "without any disruption to its business or threat to its financial viability." If things got worse—if *Ingham* foretold a future of severe losses—J&J could come back to bankruptcy court and try again.

But the case may have broader implications for how we think about the purpose of chapter 11. One can imagine that LTL sought to use bankruptcy not merely to provide a more efficient (and perhaps distributively fairer) resolution to its talc liability. Instead, or in addition, my hunch is that an unstated purpose in *LTL* was to enable J&J to control the process by which liability would

be determined, all while keeping the consumer products giant free from the scrutiny, risk, and hassle of chapter 11.

Like most chapter 11 tortfeasors, LTL would probably have used a plan of reorganization to force creditors into expedited claim allowance processes and to forsake the right to a jury trial before a district court. This can be more "efficient" than the "tort system," but would come at the expense of individual protections created by Congress and long-recognized by the Supreme Court. Meanwhile, J&J's other operations would be largely immune from creditor scrutiny. It would "borrow" its subsidiary's bankruptcy to get the benefits of chapter 11, without its burdens.

Until *LTL,* the Third Circuit seemed to take a contractualist approach to good faith, with a strong efficiency backbeat. Using bankruptcy solely to address bilateral disputes—to vanquish a litigation adversary, without an apparent collective action problem—was opportunistic, and thus bad faith. Significant problems of aggregation, by contrast, would suffice. I have long believed that it is difficult to map a bilateral understanding of good faith onto the multilateral problems of chapter 11. Perhaps *LTL* signals a recognition that chapter 11 is about more than just solving problems of "incomplete contracting," as some would have it.

On this view, a number of controversial cases (notably *Purdue Pharma*) might warrant closer scrutiny. Like J&J, Purdue Pharma faced no immediate financial crisis—it had no funded debt. Like J&J, the debtors' owners, the Sacklers, apparently undertook prebankruptcy "defensive maneuvers" to protect their fortune and their brand (their philanthropic reputation). Unlike J&J, the Sacklers had apparently suffered no verdicts at all before bankruptcy—a problem because there is a plausible view that the Sacklers "borrowed" Purdue Pharma's bankruptcy to halt efforts to determine their direct liability.

Of course, the obvious response is that the *Purdue Pharma* case is nearly three-and-a-half years old, and in a different Circuit. Surely, if creditors had wanted to challenge the good faith of Purdue Pharma's bankruptcy, they had plenty of time to do so.

Perhaps. But, as I explain here, efforts to fight the deal Purdue Pharma and the Sacklers sought to implement in bankruptcy met strong resistance from the bankruptcy judge, the debtors and, ultimately, most creditor groups. A motion to dismiss would surely have been treated with similar skepticism.

"Good faith" is a composite impression, akin to a policy judgment, so it is difficult to say that either the Bankruptcy Court or the Third Circuit in *LTL* was "wrong." Instead, *LTL* may signal growing concern by Article III courts that chapter 11's reach exceeds its grasp. The Third Circuit's opinion in *LTL* echoes the skepticism of District Courts in *Ascena* and *3M* about the use of bespoke concoctions such as nondebtor releases and sweeping preliminary injunctions to displace other courts and other legal processes.

Whether the Second Circuit will continue this trend in *Purdue Pharma*, where its nondebtor releases are sub judice, remains to be seen.

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