CADWALADER

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Clients&FriendsMemo

Third Circuit Dismisses J&J Affiliate LTL's Talc Liability Chapter 11 Filing; "Good Faith" Under 1112(b) Requires Financial Distress

February 9, 2023

Executive Summary:

On January 30, 2023, the U.S. Court of Appeals for the Third Circuit (the "Court") issued an opinion in In re LTL Management, LLC, No. 22-2003, 2023 WL 1098189, at *1 (3d Cir. Jan. 30, 2023) ("LTL Management"),[1] in which Judge Thomas L. Ambro reversed the prior ruling of the U.S. Bankruptcy Court for the District of New Jersey and dismissed Johnson & Johnson, Inc. ("J&J") affiliate LTL's chapter 11 petition. Specifically, the Court ruled that because the chapter 11 debtor (LTL) "was not in financial distress, it cannot show its petition served a valid bankruptcy purpose and was filed in good faith under Code § 1112(b)."[2] In determining that LTL's attempt to compartmentalize its parent company's (J&J) talc liability ran afoul of Bankruptcy Code section 1112(b)'s good-faith standard, the Third Circuit creates a question as to the ability of prospective debtors to use the chapter 11 process to manage mass tort litigation risk — particularly in cases involving a well-capitalized parent.

Factual and Procedural Background:

LTL Management, LLC ("LTL") is a subsidiary of J&J. J&J is a global healthcare giant that owns a diverse portfolio of global healthcare brands and product lines, including Band-Aid and Tylenol. At the time of LTL's bankruptcy filing in October 2021, J&J had a market capitalization in excess of $400 billion and held $31 billion in cash and marketable securities, which contributed to its perfect AAA credit rating.

Johnson & Johnson Consumer Inc. ("Old Consumer") was a wholly owned subsidiary of J&J that produced and sold Johnson's Baby Powder, a skincare product manufactured from talcum powder or "talc" — a mineral that is mined and then milled into a fine powder. Baby Powder was first sold by J&J in 1894 and became one of the company's best-selling products. Although Baby Powder

[1] In re LTL Mgmt., LLC, No. 22-2003, 2023 WL 1098189, at *1 (3d Cir. Jan. 30, 2023) ("LTL Management").

[2] LTL Management, 2023 WL 1098189, at *16.

This memorandum has been prepared by Cadwalader, Wickersham & Taft LLP (Cadwalader) for informational purposes only and does not constitute advertising or solicitation and should not be used or taken as legal advice. Those seeking legal advice should contact a member of the Firm or legal counsel licensed in their jurisdiction. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. Confidential information should not be sent to Cadwalader without first communicating directly with a member of the Firm about establishing an attorney-client relationship. ©2023 Cadwalader, Wickersham & Taft LLP. All rights reserved.

was sold directly by J&J for most of its product life, in 1979 J&J transferred the Baby Powder business to Old Consumer, which continued to sell talc-based Baby Powder until the product was discontinued in the U.S. and Canada.

Recently, customers and users of Baby Powder have filed a flurry of lawsuits across numerous jurisdictions[3] against Old Consumer and J&J alleging that the talc contained in Baby Powder caused ovarian cancer and mesothelioma. Beginning in 2013, a series of lawsuits resulted in jury verdicts for plaintiffs who alleged that Baby Powder contained trace amounts of asbestos and caused ovarian cancer and mesothelioma. At the time of LTL's bankruptcy filing in 2021, over 38,000 ovarian cancer actions and over 400 mesothelioma actions were pending against Old Consumer and J&J. Before the Petition Date, J&J and Old Consumer had already paid out approximately $3.5 billion for talc-related verdicts and settlements, in addition to nearly $1 billion in defense costs.

The "Texas Two-Step":

In October 2021 J&J undertook a pre-bankruptcy, multi-step divisional merger transaction (under Texas law) in order to capture all of the company's asbestos liability in a newly-created subsidiary (LTL). Specifically, J&J deployed a legal maneuver colloquially known as the "Texas two-step" transaction, in which Old Consumer, through a series of intercompany transactions, split itself into two new entities: (1) LTL, which would principally hold Old Consumer's liabilities relating to the talc litigation; and (2) Johnson & Johnson Consumer Inc. ("New Consumer"), which would hold the productive business assets previously held by Old Consumer. LTL then filed for chapter 11 bankruptcy.

As summarized by Judge Ambro, the "stated goal was to isolate the talc liabilities in a new subsidiary so that entity could file for Chapter 11 without subjecting Old Consumer's entire operating enterprise to bankruptcy proceedings."[4]

Relatedly, J&J, New Consumer, and LTL executed a Funding Agreement, pursuant to which LTL had the right to cause J&J and New Consumer, jointly and severally, to pay it cash up to the value of New Consumer (estimated at $61.5 billion) to satisfy any talc-related costs and normal course expenses. LTL's payment right under the Funding Agreement "gave LTL direct access to J&J's exceptionally strong balance sheet."[5] The Court characterized LTL's rights under the Funding

[3] Many of these actions were consolidated in federal multi-district litigation in New Jersey.

[4] LTL Management, 2023 WL 1098189, at *1.

[5] LTL Management, 2023 WL 1098189, at *13. The Court further explained that "[a]t the time of LTL's filing, J&J had well over $400 billion in equity value with a AAA credit rating and $31 billion just in cash and marketable securities. It distributed over $13 billion to shareholders in each of 2020 and 2021. It is hard to imagine a scenario where J&J and New Consumer would be unable to satisfy their joint obligations under the Funding Agreement." Id.

Agreement as "a funding backstop, not unlike an ATM disguised as a contract," that LTL had the ability to draw upon to satisfy its future talc liabilities.[6]

LTL's bankruptcy filing and subsequent bankruptcy court litigation:

On October 14, 2021 (the "Petition Date"), LTL filed a chapter 11 petition in the U.S. Bankruptcy Court for the Western District of North Carolina. Shortly thereafter, the case was transferred to the U.S. Bankruptcy Court for the District of New Jersey (the "Bankruptcy Court"), where the case was assigned to Judge Michael B. Kaplan.[7]

During the Bankruptcy Court proceedings, the Official Committee of Talc Claimants, together with certain other talc personal injury claimants (collectively, the "Talc Claimants") moved to dismiss LTL's bankruptcy case on the basis that it was not filed in good faith.[8] In an opinion issued February 25, 2022, the Bankruptcy Court denied the motions.[9] First, the Bankruptcy Court (applying Third Circuit case law) held that LTL had filed its bankruptcy petition in good faith for purposes of section 1112(b). The Bankruptcy Court ruled that LTL's bankruptcy filing served a valid bankruptcy purpose that was consistent with Bankruptcy Code section 524(g) because, through its chapter 11 filing, LTL sought to resolve asbestos-related talc liability by creating a trust for the benefit of the Talc Claimants.[10] The Bankruptcy Court also held that LTL was in "financial distress" for purposes of section 1112(b) due to the significant financial burdens LTL faced as a result of defending itself against thousands of separate talc lawsuits. Second, the Bankruptcy Court determined that LTL's Texas two-step transaction and bankruptcy petition were not undertaken to secure an unfair tactical litigation advantage, but instead constituted "a single integrated transaction" that did not prejudice creditors.[11]

---

[6] LTL Management, 2023 WL 1098189, at *16.

[7] Concurrent with its chapter 11 filing, LTL also asked the Bankruptcy Court to issue an injunction shielding J&J and numerous other affiliates from all ongoing talc-related litigation.

[8] The Talc Claimants also opposed the issuance of the third-party injunction.

[9] See In re LTL Management LLC, 637 B.R. 396 (Bankr. D.N.J. 2022).

[10] In re LTL Management LLC, 637 B.R. at 416. Bankruptcy Code section 524(g) provides for the establishment of a trust to assume, and pay, present and future asbestos claims and a channeling injunction directing all future claims to the trust.

[11] In re LTL Management LLC, 637 B.R. at 422-424. The Bankruptcy Court also granted the debtor's motion to extend the automatic stay against more than 600 non-debtor entities, including J&J and numerous LTL affiliates.

The Talc Claimants appealed the Bankruptcy Court's rulings directly to the Third Circuit.

Third Circuit: Ruling and Analysis:

On January 30, 2023, the Third Circuit issued its ruling and reversed the Bankruptcy Court, remanding the case with instructions to dismiss LTL's chapter 11 petition. As the Third Circuit explained at the beginning of its decision:

> "We start, and stay, with good faith. Good intentions—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."[12]

The crux of the analysis focuses on section 1112(b) of the Bankruptcy Code, which establishes the conditions under which a chapter 11 case may be dismissed for "cause." Courts across jurisdictions (including those in the Third Circuit) have found that a debtor's lack of good faith constitutes "cause" for purposes of section 1112(b).[13] Once at issue, the burden to establish good faith is on the debtor.[14] In the Third Circuit, demonstrating a debtor's good faith requires a showing that the chapter 11 filing itself is consistent with the "equitable nature of bankruptcy" and the "purposes underlying Chapter 11."[15]

In examining a debtor's good faith under section 1112(b), two inquiries are especially relevant: "(1) whether the petition serves a valid bankruptcy purpose[;] and (2) whether [it] is filed merely to obtain a tactical litigation advantage."[16]

Under the first prong, a valid bankruptcy purpose includes "preserv[ing] a going concern" or "maximiz[ing] the value of the debtor's estate."[17] Significantly for purposes of the LTL Management decision, a valid bankruptcy purpose "assumes a debtor in financial distress."[18]

---

[12][12] LTL Management, 2023 WL 1098189, at *1.

[13] See In re SGL Carbon Corp., 200 F.3d 154, 159-62 (3d Cir. 1999) ("SGL Carbon").

[14] See In re 15375 Mem'l Corp. v. Bepco, L.P., 589 F.3d 605, 618 (3d Cir. 2009) ("Bepco"); In re Integrated Telecom Express, Inc., 384 F.3d 108, 118 (3d Cir. 2004) ("Integrated Telecom").

[15] SGL Carbon, 200 F.3d at 161-62 ("A debtor who attempts to garner shelter under the Bankruptcy Code . . . must act in conformity with the Code's underlying principles.").

[16] LTL Management, 2023 WL 1098189, at *1 (citing Bepco, 589 F.3d at 618 (internal quotation marks omitted)).

[17] BEPCO, 589 F.3d at 619.

[18] Integrated Telecom, 384 F.3d at 128.

Under the second prong, courts within the Third Circuit (and in other jurisdictions) have dismissed chapter 11 filings as not being made in good faith where the bankruptcy filing itself is used as a strategic mechanism to "orchestrate pending litigation."[19]

A. *Good Faith under 1112(b) Requires Financial Distress*.

Relying upon Third Circuit precedent in both SGL Carbon and Integrated Telecom — in which the Court dismissed bankruptcy filings by well-capitalized debtors facing significant litigation liabilities — the Court explained that under established Third Circuit precedent, "a debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith."[20] The Court stated:

> "The theme is clear: absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose. Courts, therefore, have consistently dismissed . . . petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11. . . . [I]f a petitioner has no need to rehabilitate or reorganize, its petition cannot serve the rehabilitative purpose for which Chapter 11 was designed."[21]

The Third Circuit concluded that only the chapter 11 debtor's (i.e., LTL's) financial condition was determinative in evaluating the presence (or absence) of financial distress.[22] In other words, the Court would not consider the financial condition of the Old Consumer entity (LTL's non-debtor, affiliate entity) in determining LTL's financial distress.[23]

B. *LTL (the Chapter 11 Debtor) was not in Financial Distress*.

The Third Circuit found that the Bankruptcy Court had erred in its finding that LTL was in financial distress. Specifically, the Bankruptcy Court erred by "overemphasizing the relevance of Old Consumer's financial condition" to its analysis of LTL's financial condition.[24] Contrary to the Bankruptcy Court's analysis, the Third Circuit concluded that LTL was not in financial distress on the Petition Date for purposes of Bankruptcy Code section 1112(b).

---

[19] See In re SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999) (internal citations omitted).

[20] LTL Management, 2023 WL 1098189, at *8.

[21] LTL Management, 2023 WL 1098189, at *9 (internal citations omitted).

[22] LTL Management, 2023 WL 1098189, at *12-13.

[23] LTL Management, 2023 WL 1098189, at *12. Later on in its opinion, the Court wrote that "the financial condition of Old Consumer is relevant only to the extent it informs our view of the financial condition of LTL itself." LTL Management, 2023 WL 1098189, at *13.

[24] LTL Management, 2023 WL 1098189, at *13.

Central to the Court's conclusion that LTL did not exhibit financial distress was LTL's $61.5 billion payment right against J&J and New Consumer under the Funding Agreement — which meant that the value of LTL's assets greatly exceeded the likely amount of its talc liabilities. A simple comparison of LTL's payment right under the Funding Agreement ($61.5 billion) with the aggregate costs of the talc litigation over the five years prior to the Petition Date ($4.5 billion) meant that, in the Third Circuit's view, LTL was not facing financial distress as of the Petition Date.[25] As the Court explained:

> "[W]e cannot agree LTL was in financial distress when it filed its Chapter 11 petition. The value and quality of its assets, which include a roughly $61.5 billion payment right against J&J and New Consumer, make this holding untenable."[26]

The Court found that the Bankruptcy Court erred in finding that LTL was in financial distress as of the Petition Date because it erroneously focused its financial-distress analysis on how talc litigation affected Old Consumer (the non-debtor entity) as opposed to LTL (the chapter 11 debtor), but it "hardly considered the value of LTL's payment right to its financial condition."[27] As the Third Circuit went on to explain:

> "Directing its sight to Old Consumer and away from the Funding Agreement's benefit to LTL essentially made the financial means of Old Consumer, and not LTL, the lodestar of the Court's financial-distress analysis. This misdirection was legal error."[28]

In sum, because LTL was not in financial distress on the Petition Date, the Third Circuit concluded that LTL's chapter 11 petition had no valid bankruptcy purpose and, accordingly, was not filed in good faith as is required under Bankruptcy Code section 1112(b).[29]

---

[25] LTL Management, 2023 WL 1098189, at *15.

[2626] LTL Management, 2023 WL 1098189, at *13.

[27] LTL Management, 2023 WL 1098189, at *14.

[28] LTL Management, 2023 WL 1098189, at *14.

[2929] LTL Management, 2023 WL 1098189, at *16. Because the Court found that LTL's chapter 11 petition did not serve a valid bankruptcy purpose, the Court did not address the question whether the petition was filed "merely to obtain a tactical litigation advantage." LTL Management, 2023 WL 1098189, at *16 n.19.

C. *"Unusual Circumstances" Did Not Otherwise Preclude Dismissal under section 1112(b)(2)*.

In a separate part of its opinion, the Third Circuit ruled that because LTL was not in financial distress on the Petition Date, its chapter 11 filing could not be saved by the "unusual circumstances" language set forth in Bankruptcy Code section 1112(b)(2).[30]

Specifically, in order for a chapter 11 petition to be saved from dismissal under the "unusual circumstances" exception, section 1112(b)(2) requires "unusual circumstances establishing that . . . [dismissal] is not in the best interests of creditors and the estate."[31] The debtor (or any other party in interest) must also establish that "the grounds for . . . [dismissal] include an act or omission" (1) "for which there exists a reasonable justification" and (2) "that will be cured within a reasonable period of time."[32]

During the Bankruptcy Court litigation, Judge Kaplan ruled as a secondary matter that even if LTL's petition was not filed in good faith, section 1112(b)(2) would nonetheless operate to deny dismissal of LTL's case because "the interests of current tort creditors and the absence of viable protections for future tort claimants outside of bankruptcy . . . constitute such 'unusual circumstances' as to preclude . . . dismissal."[33]

The Third Circuit ultimately found that the Bankruptcy Court had erred in its section 1112(b)(2) "unusual circumstances" analysis, because LTL's lack of financial distress was not an "act or omission" for which "there exists a reasonable justification," nor could the Court "currently see" how LTL's lack of financial distress could be cured.[34] Therefore, the Court held that no relevant "unusual circumstances" existed to save the chapter 11 cases from dismissal.[35]

Key Considerations & Practical Implications:

The Third Circuit's LTL Management decision is particularly important for corporations that are considering the chapter 11 process as a means to deal with mass tort and other large-scale

[30] LTL Management, 2023 WL 1098189, at *17.

[31] 11 U.S.C. § 1112(b)(2).

[32] 11 U.S.C. § 1112(b)(2).

[33] In re LTL Management LLC, 637 B.R. at 406 n.8.

[34] See 11 U.S.C. § 1112(b)(2)(B).

[35] LTL Management, 2023 WL 1098189, at *17.

litigation risk. Below, we examine a handful of open questions and key considerations to keep top of mind in the aftermath of this decision.

A. Does LTL Management invalidate the "Texas two-step transaction" (or similar divisional merger transactions) in the Third Circuit?

LTL is not the first chapter 11 debtor to employ the "Texas two-step" transaction in an effort to compartmentalize mass tort liabilities for the benefit of a corporate parent. In recent years, this and similar transactions have been employed by a variety of other companies, including 3M, Georgia-Pacific (a subsidiary of Koch Industries), and Trane Technologies, to name a few recent examples. The Third Circuit's LTL Management decision raises questions concerning the continued viability of these types of transactions, at least within the Third Circuit.

While it is still too early to tell, Judge Ambro included language in the LTL Management decision that can be fairly read to suggest that the Texas two-step (and similar divisional merger transactions) may retain some viability in the Third Circuit — at least for now — provided that the debtor can make a stronger showing of financial distress, for example because mass tort litigation outside of bankruptcy has proceeded to a point that the debtor's potential liabilities more clearly exceed its ability to pay. Indeed, at the end of the opinion, the Third Circuit expressly states that "we need not lay down a rule that no nontraditional debtor could ever satisfy the Code's good-faith requirement."[36] The Court also made clear that the decision should *not* be read for the proposition that any "divisional merger" transaction (such as the Texas two-step) "contradicts the principles and purposes of the Bankruptcy Code."[37] Rather, the Court said that answering that particular question "is a call that awaits another day and another case."[38]

B. Does "financial distress" under section 1112(b) mean the same thing as insolvency?

The Third Circuit repeatedly emphasized that under Third Circuit precedent, financial distress is a requirement of a good faith showing under section 1112(b). Importantly, however, financial distress (for purposes of section 1112(b)) appears to mean something short of insolvency. Although the Court did not quantify exactly how much financial distress must be demonstrated for purposes of 1112(b), it did say that the financial distress must be "apparent" and "immediate enough to justify a filing."[39] By way of illustration, Judge Ambro wrote that the bankruptcies of A.H. Robins Company, Johns-Manville Corp., and Dow Corning — all of which were spawned by mass tort liabilities —

---

[36] LTL Management, 2023 WL 1098189, at *17.

[37] LTL Management, 2023 WL 1098189, at *17.

[38] LTL Management, 2023 WL 1098189, at *17.

[39] LTL Management, 2023 WL 1098189, at *9.

adequately demonstrated financial distress because these debtors were "push[ed] . . . to the brink" by their mass tort liabilities.[40]

C. A potential unintended consequence of LTL Management: should parent companies simply not provide litigation funding to their "bad debt" mass tort subsidiaries in bankruptcy?

One potentially problematic consequence of the Third Circuit's decision in LTL Management may be its impact on a corporate parent's willingness to provide funding to a "bad debt" subsidiary that has been strategically placed into bankruptcy. As discussed above, one of the key factors relied upon by the Third Circuit in finding that LTL was not in "financial distress" was the multi-billion dollar backstop that J&J provided to LTL (under the Funding Agreement) — which, it is important to note, J&J was under no obligation to provide. As a result, the question must be asked: Would J&J have been better off (in terms of avoiding dismissal of LTL's chapter 11 case) if it had never entered into the Funding Agreement in the first place? Indeed, in a recent editorial, *The Wall Street Journal* opined that LTL's case was dismissed because "[t]he fund the company created to pay talc claimants had too much money."[41]

The Third Circuit itself appeared to grapple with this "apparent irony" by observing the following:

> "We do not duck an apparent irony: that J&J's triple A-rated payment obligation for LTL's liabilities, which it views as a generous protection it was never required to provide to claimants, weakened LTL's case to be in bankruptcy. Put another way, the bigger a backstop a parent company provides a subsidiary, the less fit that subsidiary is to file. But when the backstop provides ample financial support to a debtor who then seeks shelter in a system designed to protect those without it, we see this perceived incongruity dispelled."[42]

Going forward, corporate parent entities will have to think through these potential ramifications before backstopping liabilities at their bankrupt mass tort subsidiaries. In the wake of LTL Management, it can certainly be argued that a "bad debt" mass tort subsidiary is more likely to satisfy the "financial distress" requirement of section 1112(b) — and remain a chapter 11 debtor — if it does not have robust financial support to rely upon from its corporate parent.

While deliberately under-funding a "bad debt" subsidiary placed into bankruptcy may look like a viable strategy following this decision, however, the Third Circuit observed in a footnote that *some*

[40] LTL Management, 2023 WL 1098189, at *11-12.

[41] See "The Looting of Johnson & Johnson," THE WALL STREET JOURNAL (Feb. 2, 2023).

[42] LTL Management, 2023 WL 1098189, at *17.

level of parent funding may be required in order to avoid a new obstacle — specifically, a fraudulent transfer challenge under Bankruptcy Code section 548(a). As the Court explained:

> "Some might read our logic to suggest LTL need only part with its funding backstop to render itself fit for a renewed filing. While this question is also premature, we note 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].' So if the question becomes ripe, the next one might be: Did LTL receive reasonably equivalent value in exchange for forgoing its rights under the Funding Agreement?"[43]

Herein lies a dilemma for corporations looking to use the Bankruptcy Code to manage liabilities. Fund too much, and risk dismissal as being filed not in good faith. Fund too little, and the risk becomes fraudulent transfer challenges. This is a tightrope to walk that appears very difficult to measure predictably.

Accordingly, even in the wake of LTL Management, "bad debt" subsidiaries strategically placed into bankruptcy to administer a parent's mass tort liabilities may be required, at a minimum, to receive "reasonably equivalent value" (in terms of the amount of litigation funding provided by the parent) commensurate with the liabilities being assumed by the debtor-subsidiary. The precise amount of litigation funding that will escape a fraudulent transfer challenge under Bankruptcy Code section 548(a) may, of course, depend upon the unique facts and circumstances of each individual case.

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Ingrid Bagby +1 212 504 6894 ingrid.bagby@cwt.com

Michele Maman +1 212 504 6975 michele.maman@cwt.com

Casey Servais +1 212 504 6193 casey.servais@cwt.com

Christopher Floyd +1 212 504 6080 christopher.floyd@cwt.com

[43] LTL Management, 2023 WL 1098189, at *16 n.18 (internal citations omitted).