Lawyer Insights

2 Takeaways From 3rd Circ.'s J&J Bankruptcy Ruling

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Body On Jan. 30, in In re: LTL Management LLC, the U.S. Court of Appeals for the Third Circuit ordered LTL's Chapter 11 bankruptcy petition dismissed, concluding the petition was not filed in good faith because LTL was not in financial distress at the time of the filing.[1]

Critically — and contrary to much of the immediate news coverage — the Third Circuit's decision did not disapprove of the Texas divisive merger transaction that constituted the first step of the so-called Texas two-step transactions, but instead focused on whether LTL was in financial distress at the time of bankruptcy petition filing.

While the Third Circuit's opinion should not have significant consequences for divisive mergers for entities under Texas law, it is noteworthy for two reasons:

- Practitioners in the Third Circuit will have to grapple with this amorphous financial distress standard.
- The Third Circuit's dismissal of LTL's bankruptcy will, barring appellate remedies, result in the termination of a preliminary injunction currently staying a myriad of lawsuits against third parties, including suits against nondebtor affiliates, retailers and distributors, and insurance companies being sued regarding allegedly contaminated products.

By way of background, and as discussed in more detail below, what follows are the relevant entities and their relationships: (1) Johnson & Johnson is the ultimate parent company of both the old Johnson & Johnson Consumer Inc. — which ceased to exist following the divisive merger discussed below — and the new Johnson & Johnson Consumer Inc.; (2) the old Johnson & Johnson Consumer was divided into the new Johnson & Johnson Consumer and LTL — asset and liability divisions are addressed below; and (3) the new Johnson & Johnson Consumer is the direct parent of LTL.

Against that backdrop, the LTL bankruptcy was predicated by numerous products liability lawsuits stemming from allegations that talc used in certain of the old Johnson & Johnson Consumer products were contaminated with asbestos causing ovarian cancer and mesothelioma.[2]

The products liability claims had already resulted in adverse damage judgments and litigation costs cumulating into the billions of dollars.[3] In an effort to address these mounting liabilities, Johnson & Johnson effected a series of reorganizational transactions with the stated goal of isolating the products liability claims in a newly formed entity for the purpose of adjudicating and resolving all products liability claims through a single organized and fair bankruptcy proceeding, rather than through thousands of

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individual lawsuits.[4]

The reorganization transactions undertaken by J&J first involved the old Johnson & Johnson Consumer merging into a new Texas limited liability company, which survived the merger and became an indirect, wholly owned subsidiary of J&J.[5] That limited liability company then effected a divisive merger under Texas law by which two new Texas limited liability companies were created, and the original Texas limited liability company ceased to exist.[6]

One LLC was then converted into a North Carolina limited liability company with the name of LTL Management LLC.[7] The second new Texas limited liability company was merged into the direct parent corporation of LTL, which survived and changed its name to Johnson & Johnson Consumer.[8]

In the Texas divisive merger, the first LLC that was the predecessor of LTL was allocated all of the liabilities arising from any products liability claims and certain assets, including a newly executed funding agreement with J&J and the predecessor of the new Johnson & Johnson Consumer, $6 million in cash and a portfolio of royalty streams valued by LTL at approximately $367 million, and the second LLC that was the predecessor of new Johnson & Johnson Consumer was allocated the remaining assets and liabilities of the old Johnson & Johnson Consumer.[9]

Following the divisive merger, which was the first step of transactions colloquially referred to as the Texas two-step, LTL filed for a Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Western District of North Carolina, as the second step of the Texas two-step.[10]

In connection with the filing, LTL sought an extension of the automatic stay, which is a widespread injunction against any action taken against property of the debtor automatically put in place upon filing for bankruptcy, to enjoin the products liability claims being asserted against the protected parties.[11]

The North Carolina bankruptcy court granted the request extending the automatic stay to the product liability claims being asserted against the protected parties for 60 days.[12]

The North Carolina bankruptcy court, however, also transferred LTL's case to the U.S. Bankruptcy Court for the District of New Jersey due to LTL's inability to demonstrate that venue was proper in the Western District of North Carolina.[13]

Following the venue transfer, numerous talc claimants, among others, challenged LTL's bankruptcy and moved to dismiss LTL's bankruptcy case as not filed in good faith.[14]

Simultaneously, LTL urged the New Jersey bankruptcy court to extend the soon-to-expire third-party injunction, and, after a five-day trial on both issues, the New Jersey bankruptcy court denied the motion to dismiss and granted LTL's request to extend the third-party injunction.[15]

Both decisions were appealed, and the Third Circuit reversed.[16] As previously mentioned, the Third Circuit's opinion declined to address the argument that the Texas divisive merger contradicted the principles and purpose of the U.S. Bankruptcy Code. In fact, the Third Circuit explicitly noted:

Some may argue any divisional merger to excise the liability and stigma of a product gone bad contradicts the principles and purposes of the [Bankruptcy Code, but] even that is a call that awaits another day and another case.[17]

Instead, the Third Circuit's decision was predicated, after an extensive analysis, on its conclusion that LTL was not filed in good faith because LTL simply was not in financial distress at the time of the filing.[18]

In deciding to reverse the New Jersey bankruptcy court, the Third Circuit applied existing precedent requiring a showing of financial distress for a debtor's filing to be in good faith under the Bankruptcy Code.[19] [20]

Applying that precedent, the Third Circuit reasoned that the New Jersey bankruptcy court erred in determining that LTL was in financial distress because it overestimated the liability stemming from the products liability claims and because the New Jersey bankruptcy court erred in disregarding the value of the funding agreement under which both J&J and the new Johnson & Johnson Consumer, jointly and severally, were required to pay LTL up to the enterprise value of the new Johnson & Johnson Consumer for the purposes of satisfying any costs of LTL arising from the product liability claims.[21]

The funding agreement had few conditions to funding and no obligation on the part of LTL to repay any amounts that it received.[22] The payment right under the funding agreement could not drop below a floor defined as the value of the new Johnson & Johnson Consumer measured on the date of the divisive merger, which was estimated by LTL to be $61.5 billion, and was subject to increase as the value of the new Johnson & Johnson Consumer increased after the reorganization.[23]

Importantly, the Third Circuit, in discussing the financial distress standard, pointed to previous decisions where bankruptcy petitions filed by other well-capitalized debtors confronted with litigation liabilities were dismissed.[24] The Third Circuit contrasted those debtors with other debtors — whose petitions were not dismissed — whose litigation liability, by contrast, "show[ed] that mass tort liability can push a debtor to the brink."[25]

The Third Circuit also rejected the New Jersey bankruptcy court's independent basis for its holding that unusual circumstances precluded dismissal, stating that the only unusual circumstance was "that a debtor comes to bankruptcy with the insurance [i.e., the funding agreement] accorded LTL."[26]

It is counterintuitive, to say the least, to think that a would-be debtor confronted with tens of thousands of lawsuits, some of which had already resulted in judgments for billions of dollars, could not be in financial distress.

Unfortunately, practitioners in the Third Circuit will have the difficult task of navigating this conundrum and will have to grapple with difficult questions like whether, and, if so, how much, parent companies should provide funding for the so-called bad company being placed in a strategic bankruptcy.

That said, given the highly fact-intensive nature of the financial distress analysis, whether the Third Circuit's decision will have a broad impact on future debtors, or be frequently, and easily, distinguished on LTL's unusual facts, remains to be seen.

The other significant result of the Third Circuit's decision is that the third-party injunction is set to be terminated — meaning the protected parties may soon be forced to resume litigation.

Potential claims of fraudulent transfer under state law were not directly addressed by the Third Circuit.

However, in one footnote, the Third Circuit noted that if LTL were to terminate the funding agreement with

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its parent entities so as to render itself insolvent, interested parties may seek to avoid any transfer made within two years of the bankruptcy filing if the transfer was made in exchange for less than a reasonably equivalent value or a party has become insolvent as a result of the transfer.[27]

Undoubtedly, the Third Circuit's decision comes as a surprise to many and upends J&J's creative attempt to cabin exposure from the products liability claims.

That said, the Third Circuit's decision, while significant for the reasons mentioned above, should not be read as an indictment of divisive mergers under Texas law. That decision, if it ever comes, is one for another day.[28]

Another day, however, may come a bit sooner as, on Feb. 13, LTL filed a petition for rehearing and a petition for rehearing en banc, claiming the Third Circuit's decision was:

- Contrary to the Third Circuit's decisions in In re: SGL,[29] In re: Integrated Telecom,[30] In re: 15375 Memorial Corp.,[31] and In re: Fiber-Span;[32]

- Contrary to the U.S. Court of Appeals for the Fourth Circuit's decisions regarding the good faith standard; and

- In error in failing to defer to the bankruptcy court's findings of fact about LTL's financial distress.

Whether the Third Circuit will be persuaded by LTL's plea remains to be seen.

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Notes

1. In re LTL Mgmt., LLC, 58 F.4th 738, 2023 WL 1098189, at *1 (3d Cir. 2023).

2. Id. at *3.

3. Id. at *4.

4. Id. at *3-4.

5. Id. at *4.

6. Id.

7. Id. at *4 n.3.

8. Id.

9. Id. at *4-5.

10. Id.

11. Id. at *5.

12. Id.

13. Id.

14. Id. at *6.

15. Id. at *6

16. Id. at *7.

17. Id. at *17.

18. Id. ("For here the debtor was in no financial distress when it sought Chapter 11 protection.").

19. Id.

20. The Third Circuit requires a showing of "financial distress" as part of its inquiry into good-faith under section 1112(b) of the Bankruptcy Code. See In re SGL Carbon Corp., 200 F.3d 154, 159-62 (3d Cir. 1999). While many of the circuits agree that 1112(b) requires a good-faith filing, the Third Circuit's financial distress requirement is unique. See Carolin Corp v. Miller, 886 F.2d 693, 694 (4th Cir. 1989) (a court can only dismiss a bankruptcy petition for lack of good faith on a showing of the debtor's

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"subjective bad faith" and the "objective futility of any possible reorganization."); Matter of Little Creek Dev. Co., 779 F.2d 1068, 1072 (5th Cir. 1986) (determination of whether a debtor filed in bad faith is "predicated on certain recurring but non-exclusive patterns, and they are based on a conglomerate of factors rather than any single datum.").

21. In re LTL Mgmt., LLC, at *13-16.

22. Id.

23. Id.

24. Id. at *8-9.

25. Id. at *12.

26. Id. at *17.

27. Id. at *16 n.18.

28. Id. at *17.

29. In re SGL Carbon Corp., 200 F.3d 154 (3d Cir. 1999).

30. In re Integrated Telecom Express, Inc., 384 F.3d 108 (3d Cir. 2004).

31. In re 15375 Mem'l Corp. v. BEPCO, L.P., 589 F.3d 605 (3d Cir. 2009).

32. In re Fiber-Span, Inc., 40 F.4th 79 (3d Cir. 2022).

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