Good Faith, Not Good Intentions,

REQUIRED FOR CHAPTER 11 IN THE 3RD CIRCUIT

BY SHERYL P. GIUGLIANO, PARTNER,
RUSKIN MOSCOU FALTISCHEK PC

On January 30, 2023, the 3rd U.S. Circuit Court of Appeals issued a precedential opinion reversing a decision by the U.S. Bankruptcy Court for the District of New Jersey and dismissing the Chapter 11 case filed by LTL Management LLC. LTL is the "Bad Co" Johnson & Johnson entity formed through a "Texas two-step" series of prebankruptcy filing corporate transactions to address the onslaught of tort claims allegedly caused by certain of its talc-based products. *In re LTL Mgmt., LLC*, No. 22-2003, 2023 WL 1098189 (3d Cir. Jan. 30, 2023).

The focus of this article is the seemingly new requirement that a Chapter 11 debtor hoping to establish good faith and defeat a motion to dismiss in the

3rd Circuit must now establish sufficient financial distress. *In re LTL Mgmt., LLC,* No. 22-2003, 2023 WL 1098189 *1 (3d Cir. Jan. 30, 2023) (3d Cir. Jan. 30, 2023) ("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.").

J&J's Texas Two-Step

Johnson & Johnson Consumer Inc. (Old Consumer), a wholly owned subsidiary of Johnson & Johnson, sold certain healthcare products, notably its well-known Johnson's Baby Powder. *In re LTL Mgmt., LLC*, No. 22-2003, 2023 WL 1098189 *1-2 (3d Cir. Jan. 30, 2023). Johnson's Baby Powder was talc-based. Claims have been raised that the talc contained traces of asbestos, causing ovarian cancer and mesothelioma in some users.

continued on page 28

Few restrictions were imposed on LTL under the funding agreement, and LTL had no obligation to repay J&J or New Consumer.

continued from page 27

In October 2021, facing tens of thousands of ovarian cancer and mesothelioma actions, Old Consumer executed what is known as a "Texas two-step" series of restructuring transactions under Texas Law. *Id.* *1 (citations omitted). Essentially, Old Consumer was divided in two: (i) LTL (often referred to as "Bad Co"), which held substantially all of Old Consumer's liabilities relating to talc litigation and obtained the rights to a funding support agreement from LTL's corporate parents; and (ii) New Consumer (often referred to as "Good Co"), which held substantially all of Old Consumer's productive operating assets. Old Consumer then ceased to exist.

As noted, Old Consumer transferred to LTL (Bad Co) Old Consumer's rights under a certain funding agreement with J&J and New Consumer. *Id.* Under the funding agreement, LTL could cause New Consumer and J&J to pay it cash up to the value of New Consumer (not to fall below approximately $61.5 billion) to satisfy administrative costs in the bankruptcy and to fund a trust to be created in a plan of reorganization for the benefit of existing and future talc claimants. *Id.* Few restrictions were imposed on LTL under the funding agreement, and LTL had no obligation to repay J&J or New Consumer. *Id.*

LTL's Bankruptcy Filing

Immediately after consummating the Texas two-step transaction, LTL filed a petition for relief under Chapter 11 in the U.S. Bankruptcy Court for the Western District of North Carolina (in the 4th Circuit). There was no secret behind LTL's creation, purpose, and the reason for filing for bankruptcy protection. *In re LTL Mgmt., LLC*, No. 22-2003, 2023 WL 1098189 *5 (3d Cir. Jan. 30, 2023) ("LTL's first-day filings described the bankruptcy as an effort to 'equitably and permanently resolve all

current and future talc-related claims against it through the consummation of a plan of reorganization that includes the establishment of a [funding] trust.'") (quoting App. 3799 (LTL's Compl. For Decl. and Inj. Relief 2); App. 316 (LTL's Info. Br. 1)).

As noted by the 3rd Circuit, LTL's choice of venue was part of its intentional plan in light of the 4th Circuit's more "stringent test of justification" for dismissing a Chapter 11 case at such an early stage. *See Id.*, *5, n8 ("Perhaps not by coincidence then, debtors formed by divisional mergers and bearing substantial asbestos liability seem to prefer filing in the Fourth Circuit, with four such cases being filed in the Western District of North Carolina in the years before LTL's filing.") (citing *In re Bestwall LLC*, Case No. 17-31795 (Bankr. W.D.N.C.); *In re DBMP LLC,* Case No. 20-30080 (Bankr. W.D.N.C.); *In re Aldrich Pump LLC*, Case No. 20-30608 (Bankr. W.D.N.C.); *In re Murray Boiler LLC,* Case No. 20-30609 (Bankr. W.D.N.C.)). *See also Id.* (citing *Carolin Corp. v. Miller,* 886 F.2d 693, 700 - 01 (4th Cir. 1989) ("[W]e agree with those courts that require *both* objective futility and subjective bad faith be shown in order to warrant dismissals for want of good faith in filing. . . . This, we think, is the only sufficiently stringent test of justification for threshold denials of Chapter 11 relief. . . . [I]t contemplates that it is better to risk the wastefulness of a probably futile but good faith effort to reorganize than it is to risk error in prejudging its futility at the threshold.").

LTL moved the North Carolina Bankruptcy Court to extend the automatic stay to talc claims arising from Johnson's Baby Powder against hundreds of non-debtors, including J&J and New Consumer, or for a preliminary injunction enjoining those claims. The North Carolina Bankruptcy Court issued an order enjoining certain third-party claims against non-debtors, including J&J and New Consumer for a period of 60 days, and then granted motions by talc claimants and others and transferring LTL's case to the District of New Jersey under 28 U.S.C. § 1412. *Id.*

The New Jersey Bankruptcy Court denied motions to dismiss LTL's bankruptcy case by the talc claimants as not filed in good faith and granted LTL's motion to extend the automatic stay to non-debtors, including J&J and New Consumer. The New Jersey Bankruptcy Court held that: (i) LTL's bankruptcy petition was filed in good faith and served a valid bankruptcy purpose, because LTL was using the bankruptcy process to create a trust for the benefit of talc claimants under Bankruptcy Code Section 524(g); and (ii) LTL was in financial distress based on the amount of litigation it would face.

The New Jersey Bankruptcy Court was convinced that it was the appropriate forum, rather than state court litigation, because "it could resolve claims more efficiently (from both a cost and time perspective), ensure more balanced recoveries among claimants, and preserve funds for future claimants." *In re LTL Mgmt., LLC,* No. 22-2003, 2023 WL 1098189 *6 (3d Cir. Jan. 30, 2023) (referring to lower court's opinion).

continued on page 30

continued from page 29

The 3rd Circuit, less convinced on the issues of LTL's financial distress and whether LTL's filing was for an unfair tactical litigation advantage, reversed, dismissing LTL's bankruptcy case. Addressing the standard of review on the appeal from the Bankruptcy Court, the 3rd Circuit stated: "A conclusion of financial distress, like the broader good-faith inquiry of which it is a part, likewise is subject to mixed review. Whether financial distress exists depends on the underlying basic facts, such as the debtor's ability to pay its current debts, and inferred facts, such as projections of how much pending and future liabilities (like litigation) could cost it in the future." *Id*. *7.

Good Faith Filing Requires 'Financial Distress'

Bankruptcy Code Section 1112(b)(1) allows a court to convert a Chapter 11 case to one under Chapter 7 of the Bankruptcy Code, or dismiss the case, "whichever is in the best interests of creditors and the estate, for cause . . . ." 11 U.S.C. § 1112(b). Bankruptcy Code Section 1112(b)(4) provides a non-exhaustive list of what is considered "cause" under (b)(1). Neither good faith nor financial distress are on the list. *Id*. Bankruptcy Code Section 1112(b)(2) provides an exception to conversion or dismissal "if the court finds and specifically identifies unusual circumstances establishing that converting or dismissing the case is not in the best interests of creditors and the estate." 11 U.S.C. § 1112(b)(2).

A court may only find such "unusual circumstances" exist if the debtor (or any party in interest) can show "there is a reasonable likelihood that a plan will be confirmed" within certain statutory time frames or a "reasonable period of time," and that the grounds for conversion or dismissal "include an act or omission of the debtor . . . (i) for which there exists a reasonable justification for the act; and (ii) that will be cured within a reasonable period of time fixed by the court." 11 U.S.C. § 1112(b)(2)(B). The 3rd Circuit dismissed entirely the New Jersey Bankruptcy Court's conclusion that "unusual circumstances" did exist in LTL's case. *In re LTL Mgmt., LLC,* No. 22-2003, 2023 WL 1098189 *17-18 (3d Cir. Jan. 30, 2023) ("No 'reasonable justification' validates" a lack of financial distress.").

The 3rd Circuit stated that the inquiry as to whether a Chapter 11 case was filed in bad faith and, therefore, should be dismissed is not black and white. ("We 'examine the totality of facts and circumstances and determine where a petition falls along the spectrum ranging from the clearly acceptable to the patently abusive.'" *Id*. *8 (quoting *In re 15375 Mem'l Corp. v. BEPCO, L.P.*, 589 F.3d 606, 618 (3d Cir. 2009) (internal quotation marks omitted) citing *Integrated Telecom,* 384 F.3d at 118)). Prior 3rd Circuit decisions provided a basis for that holistic approach. *See, e.g., In re SGL Carbon Corp.,* 200 F.3d 154 (3d Cir. 1999) (holding a debtor does not have a good faith purpose for reorganization if it files its petition to gain a tactical advantage with respect to other, pending litigation).

Notwithstanding the 3rd Circuit's endorsement of a "spectrum" of a lack of good faith, the *LTL* decision seems to inject a new requirement of financial distress into the good faith analysis, at the expense of other considerations. In other words, absent financial distress, a Chapter 11 case will be dismissed for lack of good faith in the 3rd Circuit. *In re LTL Mgmt., LLC,* No. 22-2003, 2023 WL 1098189 *9 (3d Cir. Jan. 30, 2023) ("The theme is clear: absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose.")

Although the proper analysis in the 3rd Circuit is whether: (a) "the petition serves a valid bankruptcy purpose"; and (b) the petition was filed "'merely to obtain a tactical litigation advantage,'" *id*. (quoting *BEPCO* at 618 (internal quotation marks omitted) (citing *Integrated Telecom,* 384 F.3d at 119-20)), any such valid bankruptcy purpose "'assumes a debtor in financial distress.'" *Id*. (quoting *Integrated Telecom*, 384 F.3d at 128)).

The 3rd Circuit relied upon decisions from other Courts of Appeals in reaching its conclusion that financial distress is an absolute requirement to survive a motion to dismiss and establish good faith. *In re LTL Mgmt., LLC,* No. 22-2003, 2023 WL 1098189 *11, n14 (3d Cir. Jan. 30, 2023) ("Our confidence in the conclusion that financial distress is vital to good faith is reinforced by the central role it plays in other courts' inquiries.") (citing *Little Creek Dev. Co. v. Commonw. Mortg. Corp. (In re Little Creek Dev. Co.)*, 779 F.2d 1068, 1072 (5th Cir. 1986); *Cedar Shore Resort, Inc. v. Mueller (In re Cedar Shore Resort, Inc.)*, 235 F.3d 375 (8th Cir. 2000); *In re James Wilson Assocs.*, 965 F.2d 160, 170 (7th Cir. 1992); *Baker v. Latham Sparrowbush Associates (In re Cohoes Industrial Terminal, Inc.)*, 931 F.2d 222 (2d Cir. 1991); *Barclays-Am./ Bus. Crdit, Inc. v. Radio WBHP, In. (In re Dixie Broad., Inc.)*, 871 F.2d 1023, 1027-28 (11th Cir. 1989); *Carolin Corp. v. Miller,* 886 F.2d 693, 701 (4th Cir. 1989)).

But those decisions are not as analogous as one might hope in terms of underlying facts or the inquiry on appeal. For example, in *Cohoes Industrial Terminal, Inc.*, the 2nd Circuit analyzed whether a bankruptcy filing was frivolous and whether sanctions were appropriate under Bankruptcy Rule 9011. The 2nd Circuit was not ruling on a dismissal motion under Bankruptcy Code Section 1112(b). *Cohoes Industrial Terminal, Inc.,* 931 F.2d 222 (2d Cir. 1991) (reversing the District Court and vacating the Bankruptcy Court's order, holding it was not frivolous for a corporation in financial distress to file Chapter 11, even where one of the stated reasons for doing so was to attack collaterally a state court default judgment).

In *Dixie Broadcasting,* the 11th Circuit analyzed whether the automatic stay should be lifted in light of alleged bad faith by the debtor. *Dixie Broadcasting*, 871 F.2d at 1027 (identifying financial distress as one of many factors in the test for bad faith when considering a motion for relief from the automatic stay).

Perhaps most notable is the decision cited in which the 4th Circuit seemed to endorse allowing a bankruptcy to proceed (not the one at issue in that case, of course) where the good faith of the filing debtor was questionable, stating: "[I]t is better to risk proceeding with a wrongly motivated invocation of Chapter 11 protections whose futility is not immediately manifest than to risk cutting off even a remote chance that a reorganization effort so motivated might nevertheless yield a successful rehabilitation. . . . ." *Carolin Corp.*, 886 F.2d at 701.

Funding Agreement Belied Financial Distress

The 3rd Circuit decided that solely LTL's financial condition, not the entities supporting the funding agreement as noted by the New Jersey Bankruptcy Court, is relevant for the analysis of whether the case was filed in good faith. *In re LTL Mgmt., LLC,* No. 22-

2003, 2023 WL 1098189 *12-13 (3d Cir. Jan. 30, 2023). And with respect to LTL's financial condition, the court held that LTL was not in financial distress when it filed bankruptcy, due to the $61.5 billion payment rights under the funding agreement. *Id.* *15.

One could argue that although the 3rd Circuit held that only LTL's financial condition is relevant, its decision is premised upon the financial viability of J&J and New Consumer, the entities responsible for providing the funding under the funding agreement. *Id.* *13 ("Most important, though the payment right gave LTL direct access to J&J's exceptionally strong balance sheet. At 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.").

With respect to LTL's projections of future liability, the 3rd Circuit essentially held that they were surface level and failed to consider that many of the potential talc claimants might settle, fail at trial, or be dismissed, as history had allegedly demonstrated in prior litigation. *Id.* *14 - 15. ("[W]e cannot help noting that the casualness of the calculations supporting the [New Jersey Bankruptcy] Court's projections engenders doubt as to whether they were factual findings at all, but instead back-of-the-envelope forecasts of hypothetical worst-case scenarios.").

Texas Two-Step May Remain Viable

Notwithstanding the dismissal of LTL's Chapter 11 case in this precedential opinion, all hope is not lost for the Texas two-step. *In re LTL Mgmt., LLC,* No. 22-2003, 2023 WL 1098189 *16, n17 (3d Cir. Jan. 30, 2023) ("In saying the nature of the payment right and lack of meaningful operations show that LTL did not suffer from sufficient kinds of financial distress, we focus on the special circumstances here and do not suggest the presence of these characteristics would preclude a finding of financial distress in every case."). The 3rd Circuit was less focused on the prefiling corporate restructuring, and more so on the financial health, stability, and future of LTL. *Id.* *17 ("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.").

Sheryl P. Giugliano is a partner at Ruskin Moscou Faltischek P.C. and a member of the Corporate Restructuring & Bankruptcy Practice Group and the Corporate and Securities Department. Her experience includes restructuring, bankruptcy, and litigation. She works with companies facing solvency issues to identify a solution and implement a strategic response, which includes negotiating with interested parties, creditors, and shareholders, and may also include filing for bankruptcy protection or facilitating an out-of-court wind down.

The 3rd Circuit stated that the inquiry as to whether a Chapter 11 case was filed in bad faith and, therefore, should be dismissed is not black and white.

Indeed, the 3rd Circuit accepted the validity of the Texas two-step maneuver and looked only to the effect of those transactions resulting in: "the creation of a new entity with a unique set of assets and liabilities, and the elimination of another. Only the former is in bankruptcy and subject to its good-faith requirement." *Id.* *12 (citations omitted). Ironically, as noted by the 3rd Circuit, the professionals implementing the transaction may need to simply temper the funding available to the filing entity. *Id.* *17 ("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.").

Conclusion

At least for now, a lack of financial distress is essentially a death knell for a debtor's Chapter 11 case in the 3rd Circuit, and possibly the 7th Circuit as well. Just five days after the LTL opinion was issued, the Official Committee of Unsecured Creditors for Tort Claimants – Related to Use of Combat Arms Version 2 Earplugs and others, filed a joint motion to dismiss the *Aearo Technologies LLC* Chapter 11 cases due to, among other things, a lack of financial distress and, therefore, good faith. (ECF Doc. No. 1068, Case No. 22-02890 (JJG), U.S.B.C. S.D. Indiana) ("The decision in *LTL*—reversing the lower court rules on which the Debtors [in *Aearo*] so heavily rely and remanding with instructions to dismiss LTL's bankruptcy—knocks the props out from under these cases and requires their dismissal.").

Turnaround professionals will be watching the 7th Circuit and likely the U.S. Supreme Court dockets closely and might even pause before implementing a Texas two-step transaction which culminates in a bankruptcy filing with a well-funded backstop.

On February 13, 2023, LTL filed a Petition for Rehearing and Rehearing En Banc. The 3rd Circuit had not responded before the publication date of this article.