

**ABUSING CHAPTER 11: CORPORATE
EFFORTS TO SIDE-STEP
ACCOUNTABILITY THROUGH BANKRUPTCY**

HEARING
BEFORE THE
SUBCOMMITTEE ON FEDERAL COURTS,
OVERSIGHT, AGENCY ACTION AND
FEDERAL RIGHTS
OF THE
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**ABUSING CHAPTER 11: CORPORATE
EFFORTS TO SIDE-STEP
ACCOUNTABILITY THROUGH BANKRUPTCY**

TUESDAY, FEBRUARY 8, 2022

UNITED STATES SENATE,
SUBCOMMITTEE ON FEDERAL COURTS, OVERSIGHT,
AGENCY ACTION, AND FEDERAL RIGHTS,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice at 3:06 p.m., in Room 226, Dirksen Senate Office Building, Hon. Sheldon Whitehouse, Chairman of the Subcommittee, presiding.

Present: Senators Whitehouse [presiding], Hirono, Ossoff, Kennedy, and Tillis.

Also present: Senators Durbin and Blumenthal.

**OPENING STATEMENT OF HON. SHELDON WHITEHOUSE,
A U.S. SENATOR FROM THE STATE OF RHODE ISLAND**

Chair WHITEHOUSE. The hearing will come to order. I thank all of our witnesses for being here. We are in the middle of a vote sequence over in the Senate, and so you'll see people appear and disappear, as they have to come from and return for votes. I thank Senator Kennedy for allowing us to get underway as he is on his way over here, and I will take the time to do a little bit of house-keeping, particularly with respect hearing exhibits. With consent, I will ask for the Reuters article, "Special Report: Inside J&J's secret plan to cap litigation payouts to cancer victims" to be made an exhibit in this hearing.

I will, with consent, get this Wall Street Journal article behind me also entered as an exhibit.

I have two constituent letters from John "Jay" Erickson, Jr., of Newport, Rhode Island, whose late wife Geralyn passed away after a difficult battle against ovarian cancer, and John Tassone of Narragansett, Rhode Island, who has been diagnosed with mesothelioma and has undergone a major lung surgery. I will ask that both of those letters be made a part of the record of this hearing.

We also have a letter of support from seven bankruptcy professors submitted to our Subcommittee for this hearing. The professors are Professors Ellias, Ayotte, Block-Lieb, Dick, Markell, Rasmussen, and Yadav, and their letter will be made part of the record.

Finally, there is a brief in the United States Bankruptcy Court for the District of New Jersey filed by Dean Erwin Chemerinsky

of the University California Berkeley School of Law, the dean of that school of law, and I will make his amicus curiae brief a part of the record here.

I'll do some opening remarks. When he gets here, Senator Kennedy will then provide opening remarks. If Senator Durbin gets here first, he's the Chairman of the Full Committee and he may seek to offer some opening remarks. We'll have three rounds of opening remarks, with any luck, and then I'll introduce the panel, and you proceed with your testimony. Then we'll go on to questions. I will be pretty rigorous about the 5-minute rule. I know you've all put a lot of work into your statements. They can be made a part of the record so we have the full benefit of your full statement, but Senators who come to a hearing are eager to ask questions and engage with the panel, and moving to that quickly is a good thing for a Chairman to do. I will be a strict policeman of the 5-minute rule.

We are here to address a novel and rather troubling circumstance that is emerging in bankruptcy law.

Imagine that a big corporation wreaks serious harm on you and your family. You sue for damages to cover hospital bills or to care for a family member. When you do, you discover that your claim against the company, a company that is out there operating, apparently thriving, in the marketplace—your claim is somehow in bankruptcy court that may not be heard for months or years, and it may never be paid. Sadly, this situation is not imaginary. The so-called “Texas Two-Step” has mired tens of thousands of claims in bankruptcy proceedings.

It's bankruptcy's aim to grant honest but unfortunate debtors a fresh start while doing the utmost to make creditors whole. In recent years, large corporations on solid financial footing have found a bankruptcy trick to shirk responsibility for hurting Americans.

Here's how it works. First, a corporation with claims against it from people that have been harmed transforms into a Texas corporate entity. Second, that new entity exploits a Texas law allowing something called a “divisive merger,” splitting the corporation into two corporations. Company one is saddled with the claims; company two takes the corporate assets.

The company saddled with the claims then files for bankruptcy, perhaps in North Carolina where the Fourth Circuit makes it nearly impossible for victims to have the company's filing dismissed for bad faith. Victims harmed by the corporation are left in bankruptcy proceedings that can take years to resolve, condemned to receive only a fraction of what they're owed.

Meanwhile, the company with the corporate assets continues business as usual, shed of the claims. That's the Texas Two-Step. Although, to be fair, the same thing can potentially be done under Delaware law.

The originator of this move is perhaps the most prolific industrial polluter in American history, Koch Industries. In 2017, it used the Texas Two-Step to dump its subsidiary's asbestos liabilities. Victims are still tied up in the bankruptcy process, as are asbestos claimants in ensuing copycat cases.

Johnson & Johnson, one of the biggest and richest companies in the world, last year faced over 38,000 lawsuits alleging that its

talc-based baby powder contained asbestos and caused ovarian cancer and mesothelioma. Johnson & Johnson followed the Koch Industries model and hatched a shell company that took on the talc liability and filed for bankruptcy. Johnson & Johnson now seeks a stay of all those claims, pending bankruptcy proceedings.

This move presents four big concerns. First, it violates the fundamental principle of bankruptcy that a company is forgiven its debts, but it must offer up all its assets to creditors. Then it gets a fresh start. The Texas Two-Step separates the assets from the liabilities in violation of this basic principle.

Second, it denies people their day in court. The civil jury has been a bastion of individual rights throughout our history, allowing people a vital check on the most powerful forces arrayed against them. The Texas Two-Step denies victims a jury of their peers, defeating the 7th Amendment in our Bill of Rights.

Third, it encourages forum shopping. Johnson & Johnson had no particular reason to file for bankruptcy in North Carolina; in fact, Johnson & Johnson's Texan liability shell only existed for 2 days before it filed bankruptcy. Outcomes in court should not be determined by strategic forum shopping.

Finally, the Texas Two-Step mires victims in protracted proceedings, robbing them of precious time. Asbestos victims can die of mesothelioma and other types of cancers before their claims are heard. That is a blot on our legal system.

So far, this trick has hit asbestos victims, but once the Two-Step strategy catches on, it could deprive all sorts of victims of the compensation they're due and undermine the integrity of other creditor-debtor relationships. Hiding assets in a bankruptcy is a serious wrong. The Texas Two-Step uses a trick of corporate law to hide assets in plain view with courts' connivance.

I thank Senator Kennedy for his bipartisan approach to this hearing. I hope that we can continue to work in bipartisan fashion to address this abuse of our bankruptcy process and to make sure that injured victims get their day in court as our Constitution entitles them to.

Senator Kennedy, you are recognized for your opening remarks.

**OPENING STATEMENT OF HON. JOHN KENNEDY,
A U.S. SENATOR FROM THE STATE OF LOUISIANA**

Senator KENNEDY. Mr. Chairman, thank you for calling this hearing. Thanks to all of our witnesses for being here today. I look forward to their testimony, and I plan to listen and to learn. Thank you, Mr. Chairman.

Chair WHITEHOUSE. All right. Let us begin then with Judge Fitzgerald, a retired United States bankruptcy judge who served in the Western District of Pennsylvania from 1987 to 2013, including 5 years as the Chief Judge. While on the bench, she presided over more asbestos mass tort bankruptcy cases than any other bankruptcy judge. She's now a shareholder at the Pittsburgh-based law firm of Tucker Arensberg and a professor in the practice of law at the University of Pittsburgh School of Law, where she teaches courses in bankruptcy and advanced bankruptcy. Your Honor, thank you for being here. Please proceed with your statement.

**STATEMENT OF HON. JUDITH K. FITZGERALD,
SHAREHOLDER, TUCKER ARENSBERG, P.C.,
PITTSBURGH, PENNSYLVANIA**

Judge FITZGERALD. Thank you, Chairman Whitehouse, Ranking Member Kennedy, and all of the Members of the Subcommittee. I appreciate the opportunity to be here today to testify as you continue to work on issues related to abuse of bankruptcy and the impact of divisive mergers, and I appreciate the efforts that you are putting forth.

I want to begin by noting that I see nothing improper with the State of Texas enacting a law authorizing a particular form of merger between companies or permitting the division of one company into two or more. Implementation of corporate law in policy customarily is a matter of State law. It is only when the corporate division separates out all of the troublesome liabilities into one company, that I refer to as BadCo, and puts the vast majority of the valuable assets into another company that I call GoodCo, and then BadCo files bankruptcy but GoodCo does not, that the problems and possible abuse arise.

I want to emphasize three points today that deal the very essence of bankruptcy law. They are: first, bankruptcy relies on the good faith of the debtor to undergo a valid reorganization and to maximize the value of its assets and pay back value to creditors; two, bankruptcy relies on the debtor's complete disclosure of all assets and liabilities; and three, bankruptcy involves burdens and benefits which are intended to compensate creditors for what the debtor owes, in exchange for which the debtor can channel payments to a trust, discharge unpaid claims, and go about its business.

First, the bankruptcy system relies on the good faith of debtors and requires that they utilize bankruptcy for valid reorganizational purposes and to maximize the returns they pay to their creditors. There is considerable concern today about the bona fides of solvent companies engaging in the Texas Two-Step for the sole purpose of sheltering their assets by putting BadCo into bankruptcy. It's important to note that a BadCo has no business to reorganize, and it is vested with insufficient assets to pay liabilities. Thus, the purposes of bankruptcy are not well served and the good faith of a BadCo bankruptcy is called into question.

Second, the bankruptcy system relies on full and complete disclosure so that all transactions take place subject to court and public scrutiny. Yet there is nothing in the bankruptcy code that requires GoodCo to disclose the assets it acquired through the divisive merger. Only BadCo, the debtor that absorbed the troublesome liabilities with insufficient assets to pay them, must disclose.

Nonetheless, when BadCo files bankruptcy, it invokes the full panoply of benefits that it enjoys as a debtor and takes every effort it can to extend those benefits to its entire corporate chain and others, even though those non-debtors have not subjected themselves to court oversight. This enables the original tortfeasors to avoid accountability for the harms they cause.

Third, there is another harmful impact, particularly on tort victims, when, in the bankruptcy process, they are left with recovering only from BadCo. This harm would not exist but for the divi-

sive merger because without the merger, if the original company filed bankruptcy, all of those assets and liabilities would be within the bankruptcy court's purview.

The only purpose for which a BadCo bankruptcy is filed is to enable a solvent company allegedly responsible for injuring thousands of people to avoid litigating and proving its defenses in courts of law. The original solvent company uses BadCo as a shield from disclosure and then uses BadCo's bankruptcy as a sword against tort victims who are denied billions of dollars in assets that otherwise would be available to pay valid claims.

A BadCo bankruptcy is not like other mass tort cases where, for example, the asbestos manufacturer itself goes into bankruptcy, accepts responsibility, and negotiates a plan to pay tort victims. BadCo bankruptcies are exactly the opposite. For example, J&J denies that its talc products were dangerous and caused thousands of women to develop ovarian cancer and mesothelioma, yet it formed LTL to act as its shield.

In conclusion, I submit that Congress could find abuse of the bankruptcy system when the full benefits of bankruptcy are granted to a nondebtor, well-capitalized, solvent company which, to avoid responsibility for its harmful conduct, manufactures BadCo as a new company for the sole purpose of transferring the troublesome liabilities into it and then hides behind BadCo when it files bankruptcy.

I thank you for this opportunity.

[The prepared statement of Judge Fitzgerald appears as a submission for the record.]

Chair WHITEHOUSE. Thank you very much, Judge Fitzgerald. I appreciate it, and well done on the 5-minutes. I'm grateful to you.

Our next witness is Professor David Skeel, the Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Carey Law School. We will get beyond Pennsylvania with other witnesses, I promise you. He is the author of numerous articles on bankruptcy and financial distress, corporate law, Christianity and law, law and literature, and other topics. Since August 2016, he has served on the Financial Oversight and Management Board for Puerto Rico, which he currently chairs. Professor Skeel.

**STATEMENT OF DAVID A. SKEEL, JR.,
S. SAMUEL ARSHT PROFESSOR OF CORPORATE
LAW, UNIVERSITY OF PENNSYLVANIA SCHOOL
OF LAW, PHILADELPHIA, PENNSYLVANIA**

Professor SKEEL. Thank you very much. Thank you for the opportunity to testify today in this very, very important hearing that y'all are holding. It's needless to say a great honor to appear before you.

The issue that we're focusing on today, the potential abuse of so-called Texas Two-Step transactions and other divisive mergers, is, in my view, one of the principal reasons for a growing backlash against perceived abuses in the Chapter 11 reorganization process.

The term divisive or divisional merger is an oxymoron. Rather than combining firms, divisive merger divides a firm's assets and/or its liabilities into two entities. In Texas Two-Step transactions, as in the controversial Johnson & Johnson case, the liabilities are

shunted off into a new entity, and that new entity then files for bankruptcy. What this strategy is designed to do is to turn a company like Johnson & Johnson's consumer products business that would otherwise be liable into a third party, in a sense, and to obtain a giant third-party release, or what's sometimes called a non-debtor release.

In a sense, what this is doing is manufacturing an opportunity for a nondebtor release. The opportunity for abuse and for undercutting the rights of victims and other creditors is obvious. One response to this is to rely on bankruptcy courts and bankruptcy judges to police abuses. Courts can dismiss a case if it was filed in bad faith and, in fact, a motion to do that is pending right now in the Johnson & Johnson transaction. Victims or other creditors can challenge the divisive merger as a fraudulent conveyance.

Legislation was recently introduced in the House that would take a much more sweeping approach. The legislation would essentially bar the doors to bankruptcy for any divisive merger, whether or not it's abusive. I believe the better approach is to rely on the bankruptcy remedies rather than completely outlawing divisive mergers. Although the bankruptcy remedies are far from perfect, and I talk about some of the obstacles in my written testimony, in my view, they're adequate to the task.

I could be wrong about this. Courts may fail to adequately police divisive mergers. If they do, legislative intervention can and would be warranted, but at this point, I don't think legislation is currently warranted, and I worry that any legislation might have unfortunate unintended consequences. I guess my conclusion is divisive mergers really do create a danger of abuse. They should be scrutinized carefully and, in appropriate cases, kicked out of bankruptcy, but in the first instance, I would rely on the courts to do that policing. Thank you.

[The prepared statement of Professor Skeel appears as a submission for the record.]

Chair WHITEHOUSE. Thank you, Professor. Our next witness is Ms. Kimberly Naranjo, who comes to us from Sandy, Utah. She is a mom of seven—bravo—and prior to her mesothelioma diagnosis, she was a substance use disorder counselor with the Salt Lake County Sheriff's Department. Ms. Naranjo was also studying for a bachelor of science in marriage and family studies from Brigham Young University-Idaho prior to her diagnosis. She is a plaintiff in a talc lawsuit against Johnson & Johnson, and her claims have been stayed as part of Johnson & Johnson's bankruptcy filing. Ms. Naranjo, I'm very grateful that you took the trouble to travel here for this hearing in the situation which you find yourself, so thank you. Please proceed.

**STATEMENT OF KIMBERLY ANN NARANJO,
SANDY, UTAH**

Ms. NARANJO. Thank you, Chairman Whitehouse, Ranking Member Kennedy, and Members of the Subcommittee. My name is Kimberly Naranjo and I'm here to ask you for your help in preserving my constitutional right and the rights of so many others to pursue accountability in our courts.

I have been diagnosed with mesothelioma, which is a terminal cancer that's caused by one thing and one thing only, exposure to asbestos. I was given 12 to 16 months of life, which puts my expiration date at March 2023, 1 month before my 50th birthday. I'm a single mother with two of my seven children still under the age of 18: Angelica, who is 14 and lives with a diagnosis of autism, and my son Jayce, who's only 9. I would like to share my story with you.

I was born into dysfunction. My biological mother was deep in her disease of addiction, and I experienced horrific abuse. I was in and out of foster care, passed around from family members, and on my own since I was 15.

As a result of the trauma and abuse I experienced in my early years, family, being a good mother, and having stability was all I dreamed about. At the age of 19, I became pregnant with my oldest daughter, Maria, and then gave birth to four additional daughters, Adrianna, Monaliza, Faviola, and Karina, within the next 6 years. I wanted to be a good mom, something that I didn't have until my Aunt Cathy, who never gave up on me, took me in, and later adopted me as an adult. She has supported me my whole life and is right here behind me supporting me now.

Although I did my best at being a good mother, the unhealthy behavior patterns that I had been exposed to in my early years started to manifest in my life. I needed to do something to stop the cycle. My adopted mom permanently took over caring for my five children, and I attended a residential treatment program where I lived for 13 months. I'm proud to say that next month I will celebrate 15 years of sobriety.

After completing treatment, I gained enough skills to become a productive member of society. I decided that I wanted to get an education and dedicate the rest of my life helping others overcome their hardships. I graduated with highest honors with my associate's degree in alcohol and drug counseling and I started working as an addiction counselor. I've dedicated the last 7 years of my life helping and advocating for others. I didn't want to stop there; I continued my education at BYU-Idaho working toward a bachelor's degree in marriage and family studies. My goal was to get my master's degree in social work.

I've worked very hard to break the cycle for my children, who I am blessed to have a wonderful relationship with today. Since my disease of addiction has been in remission, I have been an active and supporting participant in all their lives.

Throughout my life, I have never lived in one residence longer than 2 years, and I wanted that to change. Last year, I purchased my first home, my forever home. I was also hired at my dream job, working for the Salt Lake County Sheriff's Office as an addiction counselor.

Three days into working at the sheriff's department, I felt a pain in my side. The next week, I was diagnosed with mesothelioma. It all happened so fast. One week, I was enjoying my forever home, surrounded and celebrating life with my family. The next week, I was given an aggressive treatment plan in hopes to extend my life by a few months.

Unfortunately, I was no longer able to work. With no income, I was unable to pay my mortgage and forced to sell my forever home. I then had to sit down with my children and grandchildren to let them know that I'm going to be leaving my body. It was a really hard day. My oldest daughter, Maria, is only 28 and a single mother, and she is going to raise my two children after my death.

After spending hours going over every place I've ever lived or worked, it was determined that the only way I was exposed to asbestos was from Johnson & Johnson's baby powder. Instead of protecting my children as advertised by Johnson & Johnson, I had no idea I was exposing them and myself to the deadly asbestos in that white plastic bottle I associated with motherly love.

When I learned that I could file a lawsuit and have it decided by a jury, I saw a path forward for my family. There was a way that my children could be taken care of monetarily as if I had lived. I was less scared knowing that even though I can't control the fact that I'm dying, I could use my constitutional right and be heard in a court of law. I knew that justice would take care of my family. I was filled with hope.

That hope was also taken from me. I learned that Johnson & Johnson filed for bankruptcy and that I would not receive a court date. I didn't understand. Johnson & Johnson is a really big and thriving company. How can they be bankrupt? I learned that they took advantage of a loophole where they made a new company and put all their responsibilities related to Johnson & Johnson's baby powder into that company, then filed bankruptcy, and now everything's stopped except for the progression of my cancer.

I have accepted the fact that I do not have much time left. I even held a living memorial where I gave all my friends an opportunity to say goodbye. I made parting gifts. When I graduated from residential treatment, I was given a poem that you can see right there—it's framed—don't quit. That's my motto. I made copies of that picture, little wallet-sized, and handed them out to all of my friends and everybody who came and celebrated my life with me.

I don't have much time left, but I will not quit. Even though I'm in pain every day, I get up and do my best to make a difference in the world. I've even made myself a stickers chore chart, and I give myself a star for getting up, taking a shower, walking my son to the bus stop, and cooking. I will not quit, no matter how tough this gets. It took every ounce of strength for me to be here before you today, but I am here today because I am a voice for the thousands of people that Johnson & Johnson has harmed, and we have a right to be heard.

I'm so grateful that you've listened to me. I wish that Johnson & Johnson would listen too, but they took away that right from me and thousands of other people who have their own stories, families, and lives that also deserve a right to be heard by a jury.

Thank you again for your time and attention. I'm truly grateful.
[The prepared statement of Ms. Naranjo appears as a submission for the record.]

Chair WHITEHOUSE. Thank you, Ms. Naranjo. We do hear you, and we will remember.

Paul Zumbro is a partner at Cravath, Swaine, & Moore, and the head of Cravath's financial restructuring and reorganization practice.

Mr. Zumbro's practice focuses on restructuring transactions and related financings, both in and out of court, as well as bankruptcy, merger, and acquisition transaction. His restructuring experiences includes both debtor and creditor side representations and includes work in the field of municipal and sovereign debt restructuring as well as insolvency-related litigation matters. Mr. Zumbro.

**STATEMENT OF PAUL H. ZUMBRO, CRAVATH,
SWAINE & MOORE LLP, NEW YORK, NEW YORK**

Mr. ZUMBRO. Good afternoon, Chairman Whitehouse, Ranking Member Kennedy, and Subcommittee Members. I'm honored to appear before you today to discuss divisional merger bankruptcies, known more colloquially and colorfully as the Texas Two-Step. I'm testifying today solely as an expert in the field and not on behalf of any person or party.

Texas Two-Step has a lighthearted ring to it, but the underlying issues are serious and important, and I commend the Committee for examining the topic. My perspective as a bankruptcy practitioner is this: divisional merger bankruptcies of the type that have been filed are an appropriate use of bankruptcy.

Before discussing the reasons for that conclusion, let me first briefly describe what a divisional merger is. Two States have enacted divisional merger statutes, Delaware and Texas. Unlike a traditional merger, where two entities merge together to form a new entity, a divisional merger involves one entity dividing into two. In a divisional merger bankruptcy, the original company is divided into two parts, one new company that attempts to resolve the asbestos-related claims globally through a Chapter 11 bankruptcy process and one new company that continues to operate the business.

Here is where a critical misunderstanding may arise. While the transaction involves two steps, the separation of entities and a bankruptcy filing, it does not involve the side-stepping of accountability or financial responsibility for the asbestos-related claims. The law should not and would not allow that.

Going all the way back to the Fraudulent Conveyances Act of 1571, also known as the "Statute of 13 Elizabeth", it has been illegal to take actions with the purpose and intent to delay, hinder, or defraud creditors. Those same words appear in our Federal bankruptcy code and in the laws of all 50 U.S. States. Importantly, the Delaware and Texas divisional merger statutes do not attempt to override this longstanding body of law. Rather, both provide that any division of assets and liabilities is subject to existing creditors' rights laws.

The reason these transactions should not constitute a violation of creditors' rights laws is the funding agreement, and agreement from the operating company to fund the trust to be established under section 524(g) of the bankruptcy code to pay the claims. There is a funding agreement in each of the divisional merger bankruptcies filed to date. At the core, the funding agreement evidences an affirmative acceptance of financial responsibility and access to the value of the company that existed pre-separation, not a corporate effort to sidestep accountability.

Why split the company before bankruptcy? Because it allows the company to use the tools contained in the bankruptcy code, such as 524(g) trust, to address mass tort liabilities and compensate claimants while preserving as much value as possible for all constituents. By separating the company into two, productive assets and businesses, which often have operations separate from the operations that resulted in the potential liabilities, will be able to operate without the overhang of bankruptcy which, among other things, affects employee retention and relations and relationship with suppliers and customers.

That value inures to the benefit of the claimholders through the funding agreement so that the claimholders are no worse off, and they may be better off. It also enables the company to use the bankruptcy code to address tort liabilities in a way that is more streamlined and is fair to the claimholders—more fair to the claimholders as a whole than the tort system through the use of provisions like the Section 524(g) of the bankruptcy code.

Claimant trusts have been an accepted method of addressing asbestos claims since at least 1994, when Congress added Section 524(g) to the bankruptcy code. They are fair. They can only be established if 75 percent of the claimants themselves approve it. They are efficient. Bankruptcy provides a single, centralized forum to resolve and pay claims. They are equitable, unlike the lottery-like results of a pot of gold for some claimants and little or nothing to others. That is not allowed in bankruptcy.

Both for these reasons and the strong Federal policy of access to bankruptcy, I do not believe the legislation that has been proposed to outlaw a bankruptcy filing within 10 years of a divisional merger is necessary or appropriate. In my opinion, congressional time and effort would be better spent on other bankruptcy topics such as establishing uniform standards for third-party releases in appropriate cases. Mr. Chairman, I thank you again for the opportunity to share my thoughts on these very important issues.

[The prepared statement of Mr. Zumbro appears as a submission for the record.]

Chair WHITEHOUSE. Thank you. Our final witness on the panel is Mr. Kevin Maclay. He is the head of the bankruptcy and complex litigation practice groups and a member of the board of directors at Caplin & Drysdale. Mr. Maclay's practice focuses on complex civil and commercial litigation and protecting creditors' rights in Chapter 11 bankruptcy cases.

Mr. Maclay has extensive experience in such representations, including serving as co-lead bankruptcy counsel in the DBMP and Aldrich Pump divisive merger bankruptcies. Mr. Maclay.

**STATEMENT OF MR. KEVIN C. MACLAY,
CAPLIN & DRYSDALE, WASHINGTON, DC**

Mr. MACLAY. I would like to thank Chairman Whitehouse, Ranking Member Kennedy, and Members of the Subcommittee for inviting me to testify here today. My name is Kevin Maclay, and I'm here to talk about the Texas Two-Step.

The Texas Two-Step is, at its core, extremely simple. A company splits into two entities. One of those entities gets nearly all of the assets and whatever liabilities the company decides it wants to

keep paying. The second company is a mere shell. It gets almost none of the assets but gets whatever liabilities the company chooses to stop paying.

To date, those disfavored liabilities have been those owed to tort victims like Ms. Naranjo, sitting one chair over to my right and from whom you've just heard. Then, the shell company files for bankruptcy protection. This immediately cuts off Ms. Naranjo's ability to get paid for her injuries, potentially for an extended period of time, while other creditors of the original entity continue getting paid in full and on time.

Indeed, from the perspective of the non-bankrupt company, almost nothing has changed, because that entity carries out business as usual under the same name as the original company, making the same products as the original company, and selling to the same customers as the original company. Yet, because of its artificial creation of a bankrupt shell company through the Texas Two-Step, the non-bankrupt is both immune from suit in the tort system and free from the bankruptcy court oversight and transparency required of all debtors in the bankruptcy system.

No one should be able to put themselves above the law this way, and until 2017, no one had. But then, Georgia-Pacific pioneered the Texas Two-Step. As a result, the tort creditors consigned to its bankrupt shell company, Bestwall, have been stuck in bankruptcy for more than 4 years now without being paid a dime while all other creditors have been paid in full.

Since then, the dominoes have continued to fall as one extremely wealthy corporate family after another, all of them worth many billions of dollars, have used the Texas Two-Step: CertainTeed and Saint-Gobain, Trane Technologies, and now even Johnson & Johnson. Johnson & Johnson is worth more than \$450 billion and its credit rating is higher than the U.S. Government's.

Bankruptcy is intended to assist the honest but unfortunate debtors seeking to reorganize. When the richest and most powerful corporations in the country are using the Federal bankruptcy system to avoid paying the most vulnerable people in the country, something is wrong. The system needs to be fixed. The Texas divisional merger law was never intended to be used this way. It explicitly was intended to preserve all rights of creditors under existing laws. Out-of-state companies have misused that law to pervert the Federal bankruptcy system.

This is just the beginning. While the Texas Two-Step so far has been used to disadvantage tort victims, the very same mechanism can and inevitably will be used to permit corporations to rid themselves of any unwanted creditors: commercial and contract creditors, warranty claim creditors, environmental creditors, or others. The Texas Two-Step is a free pass for a corporation to disregard its obligations under law at will, and I believe that Congress should act now to close this loophole.

You've heard today about the so-called funding agreement. Let's talk about funding agreements. First of all, they're written by the same people who came up with the Texas Two-Step. They're not a protection against the Texas Two-Step; they're part of the scheme.

First of all, they don't prevent the non-bankrupt entities from sending their cash, potentially all of their money, to other entities.

They don't prevent subsequent mergers or acquisitions, and most importantly, the non-bankrupt entities that control the bankrupt shell companies have the final say in whether those bankrupt entities even asked for the funding agreement to be complied with in the first place.

In other words, these are highly contingent and frankly illusory agreements which are not a protection against anything. We've heard about other existing remedies. Well, look, the other existing remedies haven't stopped the Texas Two-Step. More and more of the richest companies in our country are doing it, and their victims are getting stuck in bankruptcy indefinitely, which deprives them of their ability to seek justice in this country, which allows all other creditors to be paid. It's just not fair.

We've already heard about in the Bestwall bankruptcy, 4 years later, they're still stuck in bankruptcy. That's not even-handed justice, and frankly, Members of this Subcommittee, delay is the point. This mechanism is used to stick disfavored creditors into bankruptcy where they're stuck in the hopes that someday, they'll knuckle under and agree to just to accept pennies on the daughters—pennies on the dollars for the values of their claims.

The existing bankruptcy code has not been sufficient to stop this scheme. It's only accelerating. Unless this Subcommittee and Congress does something to stop it, I fear it's only going to get worse. Thank you.

[The prepared statement of Mr. Maclay appears as a submission for the record.]

Chair WHITEHOUSE. Thank you very much. Judge Fitzgerald, to go to your GoodCo, BadCo example, when the division takes place, how does anyone know that all of the injured parties have been found yet? How does one know the scope of the total injury that has been inflicted?

Judge FITZGERALD. I don't think that they do know that, Senator. What they know is the number of suits that have been filed against them and/or complaints that have somehow come to their attention, not necessarily formal complaints. In all of these cases, there are huge numbers of future demands, which is one of the reasons that Congress foresaw the need for Section 524(g). So, I don't think it's possible to know.

Chair WHITEHOUSE. What happens to lawful claims for punitive damages?

Judge FITZGERALD. That depends on the particular case. In the bankruptcy code, punitive damages are generally subordinated to other types of claims. It depends on the State law what has happened in many of the mass tort bankruptcy cases.

Chair WHITEHOUSE. What happens if the total injury exceeds the trust amount? Does BadCo have a continuing claim against assets of GoodCo to fill in any gaps?

Judge FITZGERALD. That depends, Senator, again, on what the relationship between the parties is. In the case of the funding agreements, the assertions have been made that that's the case, but in fact there are cross indemnities generally speaking such that if BadCo pays out money, then GoodCo's supposed to reimburse, but if GoodCo pays out money, BadCo's supposed to reimburse. The net effect is not necessarily clear, first of all. And second—

Chair WHITEHOUSE. Is GoodCo a party in the bankruptcy proceeding?

Judge FITZGERALD. I'm sorry?

Chair WHITEHOUSE. Is GoodCo ordinarily a party in the bankruptcy proceedings?

Judge FITZGERALD. No. It's not a party unless it has co-liability with the debtor. To that extent, it is essentially a party. It's a named party. The problem is that GoodCo usually has independent—or the allegations are that GoodCo has independent liability, which would not be part of the bankruptcy estate.

Chair WHITEHOUSE. How about evidence? Discovery? Corporate documents? Things like that. When somebody's been injured by a corporate entity, usually there's a very robust discovery. That discovery can continue really until the eve of trial on some occasions, and I'm familiar with times when documents have been discovered that completely change the complexion of the liability. When Ms. Naranjo is sent to BadCo, what rights does she have and what rights do her lawyers have to continue discovery and document production and so forth against GoodCo?

Judge FITZGERALD. They still have rights. The problem is that the way the operation has worked in bankruptcy is that those rights are stayed and generally temporarily if not permanently enjoined. Although there may be rights to discovery, they're not accessible. The system simply is not sufficient in that respect to deal with those issues.

Chair WHITEHOUSE. So, discovery effectively stops—

Judge FITZGERALD. Yes.

Chair WHITEHOUSE [continuing]. At the—when the Texas Two-Step begins.

Judge FITZGERALD. It stops as to GoodCo.

Chair WHITEHOUSE. Yes.

Judge FITZGERALD. Yes.

Chair WHITEHOUSE. There's no reason for GoodCo to turn over all of its documents to BadCo, is there?

Judge FITZGERALD. Certainly not.

Chair WHITEHOUSE. In fact, that would be counter to the purpose of the operation, assuming the purpose of the operation is to protect the assets of GoodCo.

Judge FITZGERALD. That would be my opinion, yes, sir.

Chair WHITEHOUSE. Mr. Maclay, do you have any response to any of those comments that I just made? I've got another minute before I turn it over to Senator Kennedy.

Mr. MACLAY. Yes, Mr. Chairman. I think you've made an excellent point and suggest an excellent point, which is that GoodCo isn't in bankruptcy. It's not supposed to get the protections of the bankruptcy, but it gets to enjoy those protections. At the same time, like a puppet on a string, it controls BadCo, because BadCo has overlapping officers and directors with GoodCo and the rest of the corporate family. It's really just an illusion, Your Honor, to think of BadCo as anything other than an empty shell, as even some of the courts applying these bankruptcies have recognized.

Chair WHITEHOUSE. Makes one think of the old doctrine of piercing the corporate veil. Would that apply here?

Mr. MACLAY. You're exactly right, Your Honor, that—not Your Honor, excuse me, Mr. Chairman—

Chair WHITEHOUSE. It's all right.

Mr. MACLAY [continuing]. That—you can tell I'm a lawyer—that there are supposedly remedies that will work, but we're talking here about time. People don't have 10 years to wait for all of this to play out. People are dying now. People need to get paid now. Ultimately, this is all about delay. That's the whole point. Justice delayed is justice denied, Mr. Chairman.

Chair WHITEHOUSE. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. Ms. Naranjo, did I say your name right? I'm sorry for all your troubles.

Ms. NARANJO. Yes, you did. Thank you.

Senator KENNEDY. I'm sorry for all your troubles.

Ms. NARANJO. Thank you.

Senator KENNEDY. Mr. Zumbro, tell my old friend Phil Gelston I said hi.

Mr. ZUMBRO. Yes, sir. I will.

Senator KENNEDY. Very—

Mr. ZUMBRO. He had warm regards to send to you as well.

Senator KENNEDY. Fine lawyer. Fine lawyer. Professor Skeel, with respect to a divisional merger and then a bankruptcy, does the bankruptcy judge—or does the bankruptcy court make a distinction between a divisional merger bankruptcy in good faith and one in bad faith?

Professor SKEEL. Yes. I think a bankruptcy judge would. I think they would look at the BadCo, to use the term that we've adopted from Judge Fitzgerald—they'd look at BadCo and they'd ask the question, "Is that an entity that is in bankruptcy for a proper bankruptcy purpose?" If you set up a BadCo that had real assets in it, and it had the liabilities as well, you might say yes, that's a proper purpose for that—for that entity. The judge looks at what went on in the particular divisional merger and makes a decision.

Senator KENNEDY. Let me explore that a minute. I've not ever practiced in bankruptcy court. When a divisional merger is done, and then there's a bankruptcy, and you have two companies—I'll use the terms RichCo and PoorCo as opposed to Good and Bad. Does the bankruptcy—I assume that counsel for the creditors is raising up fresh hell and saying, "This divisional merger was in bad faith, and it was only done to avoid liabilities." Assume that's one of the allegations. Does the bankruptcy judge then hold a hearing and look to PoorCo and its present and prior management and say, "Tell me why you did this divisional merger"? If they say, "To avoid our liabilities," does the bankruptcy judge then have authority to say, "No. Get out of my courtroom"?

Professor SKEEL. The answer to that would be yes, and I'll unpack it just a little bit if I can. You do the divisional merger. There's nothing strange about a divisional merger in concept. I mean, you can have perfectly appropriate divisional mergers, and nobody thinks about it until we end up in bankruptcy. If you do a divisional merger and then you put BadCo or PoorCo into bankruptcy, and the creditors, the victims, challenge the bankruptcy, say it was filed in bad faith, then the bankruptcy judge assesses

the divisional merger, the Texas Two-Step, and determines whether it belongs in bankruptcy or not.

The standards that courts use vary a little bit from court to court, but the standard that will apply in Johnson & Johnson, for instance, which is the third circuit standard, the Court of Appeals for the Third Circuit—what the court will ask is, “Was there a valid bankruptcy purpose?” That was the first question. Then the second question is, “Was this bankruptcy filed simply to gain a tactical advantage in litigation?” If it’s not a valid bankruptcy purpose or it was solely for a tactical advantage, the court will kick the case out. There is a hearing in Johnson & Johnson in its divisional merger case next week to address that question.

Senator KENNEDY. Let me ask Mr. Zumbro. It seems to me that issue is do we have a prophylactic rule passed by Congress that says you can’t do a divisional merger and then a bankruptcy, or do we rely on the bankruptcy judge to decide when a divisional merger is in good faith and bad faith? Bad faith meaning to avoid your creditors.

Mr. ZUMBRO. Senator, I think that’s right. I think the bankruptcy courts are in much better position to evaluate those issues than Congress. I don’t think a law that flatly prohibits a bankruptcy filing after a divisional merger is appropriate or necessary. I did a divisional merger recently for a media company that needed to sell a content library. If that company that bought the content library—library needs to seek bankruptcy protection in 10 years, why should it be precluded from doing so? I think the courts can make these determinations on a case-by-case basis.

Senator KENNEDY. I understand. Could I ask, Mr. Chairman, for 30 more seconds? Could you weigh in on that, Mr. Maclay?

Mr. MACLAY. Absolutely. First of all, what Mr. Skeel said—what Professor Skeel said is not accurate in the fourth circuit. In the fourth circuit, where these bankruptcies are all originally filed, bad faith is not enough to dismiss the bankruptcy. A judge could find it’s in completely bad faith, it’s a scheme, it’s a fraud, but yet if the defendant, if the debtor, can argue there’s a reasonable likelihood of successful reorganization, a standard which is almost impossible to meet, then the bankruptcy has to stay. So dismissal is not an adequate remedy even for bad faith under the law of the fourth circuit where they of course file.

Second, with respect to this prophylactic rule, think about the implications of what I’ve just said. The court’s hands are bound. They’re bound by this governing controlling precedent, and it doesn’t matter if it’s bad faith. That’s not enough. Judges are, of course, faced with the cases in front of them and they do their best faced with the cases in front of them, but when there is such a widely used scheme where the wealthiest corporations go into bankruptcy to disadvantage some of their disfavored creditors, that is a universal problem that, I would submit, calls for a universal answer.

Senator KENNEDY. Okay. Thank you all. Mr. Chairman, I have been asked by Professor Anthony Casey of the University of Chicago Law School and Professor Parikh of the Lewis & Clark Law School to offer statements on their behalf into the record. I have—

Chair WHITEHOUSE. Without objection, they will be made part of the record.

[The information appears as a submission for the record.]

Senator KENNEDY. Thank you. I'm sorry to go over, Mr. Chair.

Chair WHITEHOUSE. Not a problem. Senator HIRONO.

Senator HIRONO. Thank you. I do not know if these questions have been asked, but it seems to me that, especially in the fourth circuit, there is a giant, I don't know what, I would call it a loophole—Mr. Maclay, you seem to referred to that—for plaintiffs to get any kind of redress. This is pretty elementary, I suppose, for people who practice in that area, but I'm not familiar with bankruptcy practice. If there is this kind of divisive restructuring and the assets are in GoodCo and the BadCo is the one that files for bankruptcy, I don't understand why the plaintiffs—why can't the plaintiffs just turn around sue GoodCo? I think this must be a question for our first witness. Professor.

Judge FITZGERALD. Senator, what happens here—

Senator HIRONO. Or Judge Fitzgerald, I'm sorry.

Judge FITZGERALD. I'm sorry.

Senator HIRONO. Go ahead. It's for you.

Judge FITZGERALD. What happens, Senator, thank you, is that BadCo files bankruptcy and has the benefit of the automatic stay, which stops all litigation against the debtor. In some courts, including those in the fourth circuit that have been looking into these divisional mergers, that automatic stay has been extended to parties that are not the debtor. It's extended to GoodCo, and it's extended in the third circuit right now to Johnson & Johnson.

At the moment, as to Johnson & Johnson, it's on a temporary basis. The court has not ruled yet on a permanent basis. Nonetheless, in the other cases, some of which have been pending for 4 years, tort victims have not been able to pursue their claims against any other company in the corporation chain because the courts have extended the automatic stay and/or issued injunctions prohibiting that action from going forth.

Senator HIRONO. See, that's the part that I don't understand. Why should there be an automatic stay when using this kind of a process? Basically, a company can hide its assets, but literally in your face. I don't understand why, in bankruptcy law, there is this automatic stay and the plaintiffs cannot get to the company that actually did the harm, but they are insulated. Why is there this automatic stay?

Judge FITZGERALD. The—

Senator HIRONO. Anybody else can weigh in and—

Judge FITZGERALD. The stay is sometimes extended to parties who are co-liable with the debtor because, for example, they may share insurance. If the automatic stay is not extended to a party that share insurance with the debtor and all of that insurance is depleted for other claims that are directly against that other estate but not against the debtor, then the debtor's estate is diminished.

There are reasons why the stay may actually be validly employed against other companies. The problem that these companies are facing—that the tort victims are facing, is that the stay is stopping all action. Johnson & Johnson, for example, can go on its merry way without anybody suing it for its direct liability that's totally

unrelated to its co-liability. There are different theories and causes of action that can be brought by parties, and the——

Senator HIRONO. Is this stay a result of judicial action, or is there some law that says in bankruptcy filing, there will be an automatic stay?

Judge FITZGERALD. No. The stay is extended to parties when the debtor files a motion and/or an adversary proceeding and asks the court to extend that stay. Except in Johnson & Johnson's case, the debtor, LTL Management, notified all of the tort cases in which it was involved before it went to court and asked the judge to extend the stay that the stay applied to JJCI and J&J.

Senator HIRONO. That really sounds like an abuse of process to basically stop plaintiffs at the courthouse door. What if we consider legislation that will prevent in these kinds of—from any kind of a stay that completely insulates GoodCo?

Judge FITZGERALD. You know, one of my colleagues used to say that you don't kill a flea with an atom bomb, and so I think the unintended consequences——

Senator HIRONO. Yes.

Judge FITZGERALD [continuing]. May be something that Congress might want to look at because certainly——

Senator HIRONO. Okay. I'm sorry. I understand about unintended consequences. Do you have any suggestions? Do any of you have suggestions to close some of these—to prevent these kinds of, what I would call, abuse? Also, if it's relatively easy to engage in these kinds of divisive mergers, what is to prevent a company from just creating those kinds of entities at the very beginning and just hold BadCo in abeyance until there's time when BadCo should file for bankruptcy? Why don't all companies engage in these kinds of mergers——

Professor SKEEL. Well——

Senator HIRONO [continuing]. To insulate itself?

Professor SKEEL. Well, if I can——

Senator HIRONO. Yes, please.

Professor SKEEL [continuing]. Say a few words. You don't need to, in a way. I mean, you don't need to set this up today because, as Johnson & Johnson did, you can do it at last minute. I mean, you can do it, and it takes a day to do this, so there's no need to do it in advance.

Senator HIRONO. Okay. That's the answer to that question. Mr. Chairman, I'm glad you're having this hearing because I'm learning something about bankruptcy law. I think we need to do something, but we will—I hope that you come up with——

Chair WHITEHOUSE. We will pursue.

Senator HIRONO. I hope you can come up with something.

Chair WHITEHOUSE. We will pursue.

Senator HIRONO. Okay. Thank you very much.

Chair WHITEHOUSE. We are very honored to be joined by the Chairman of the Full Judiciary Committee, Senator Durbin of Illinois, and I recognize him now.

Chair DURBIN. Thanks, Senator Whitehouse. Twenty-six years ago, I walked into this very room to become a brand-new Member of the Senate Judiciary Committee. I was appointed to this Subcommittee, and the Chair was a man named Chuck Grassley. We

were doing something that was interesting. We were rewriting the bankruptcy code. You may remember that, 26 years ago. It turned out I was the resident expert on the bankruptcy code by virtue of taking a course in bankruptcy at Georgetown Law School and having been appointed a trustee in bankruptcy for a gas station in Springfield, Illinois by Judge Basil Coutrakon. I had more experience with bankruptcy than anyone on the Committee by virtue of these two things. We set about writing the code, and Chuck Grassley taught me a lot about bankruptcy. He's a pretty smart fellow.

I've tried to understand it going forward and tried to put aside all the wording of bankruptcy, which can be dry as dust, to get down to the human side. Ms. Naranjo, you helped us understand the human side in a very personal way, and I know it took its toll on you emotionally, but thank you for being here. It makes a difference.

I listened to your explanation, Mr. Zumbro, rationalization of divisional merger. There was one sentence you used that I went back to make sure I caught it. You said, "Why would a company do this?" You said, "By separating the company into two, productive—it's two assets and businesses will be able to operate without the overhang bankruptcy which, among other things, affects employees' retention and relations and relationships with suppliers and customers."

I think it might also be about money. Just going out on a limb here. It isn't just a matter of getting along with people. There's a lot of money on the table. For instance, LTL Management has \$2 billion in its settlement fund; that's the PoorCo or BadCo, depending on how you want to characterize it. Two billion. Huge, right? Not really. In one talc case against Johnson & Johnson involving 22 cancer victims, plaintiffs were awarded a judgment of more than \$2 billion. How would you evaluate the legitimacy of Johnson & Johnson's claims that their actions would actually benefit the 38,000 plaintiffs like Ms. Naranjo who are seeking restitution?

Mr. ZUMBRO. Well, sir, I think that the bankruptcy system is supposed to be fair and equitable to everybody. As I mentioned in my testimony, the pot of gold for that \$2 billion verdict might mean someone else gets zero in a verdict and gets nothing. What the bankruptcy process is meant to do—you can't do that. You can't have one person getting \$2 billion and one person getting nothing in the bankruptcy process because that's not permitted. It's fair and equitable to everybody because everybody has to get treated the same in bankruptcy.

Chair DURBIN. No, you missed something very critical. The GoodCo, if you can call Johnson & Johnson that, is worth \$430 billion. The BadCo, LTL, ends up with \$2 billion for 38,000 claims, and you're saying that is a fair apportionment by Johnson & Johnson? Get real. The idea was to project \$430 billion worth of corporate assets by creating a \$2 billion entity. That, you think, is fair because it's so small, but I think most people want—

Mr. ZUMBRO. Sir, what I'm saying is I don't even know if I could do the math, but whatever \$2 billion is times 38,000, that's bigger than even Johnson & Johnson could pay, right? Johnson & Johnson is a lot more than—and I'm not representing Johnson & Johnson,

but they're a lot more than just the talc. They've done COVID vaccines. They do a lot of other medical things that are very valuable.

Johnson & Johnson is not a monolithic corporate entity. It's owned by pension funds; it's owned by regular Americans in 401(k)'s. This is a more nuanced issue. Yes, it's about saving money because the tort system is broken and you can't resolve 38,000 claims in the tort system. The bankruptcy system—

Chair DURBIN. Mr. Zumbro—

Mr. ZUMBRO [continuing]. Allows it to be done more efficiently.

Chair DURBIN. Mr. Zumbro, if you're looking for—

Mr. ZUMBRO. It's a win-win for both the companies and the victims.

Chair DURBIN. Our legal system is supposed to be looking for justice, not efficiency. If you think efficiency says a \$430 billion corporation can walk away from any wrongdoing—I don't know when or if they ever discovered asbestos in talc, which may have led to the mesothelioma suffered by the gentle lady sitting to your right, but at some point, they're going to be asked that in court and held responsible for their answer. Apparently, they're losing these cases. There could have easily been some knowledge, or there should have been some knowledge, that they were in fact selling a dangerous product which endangered the life of their innocent customers.

Go to Johnson & Johnson's website and take a look at all the pictures of those beautiful babies and all the products they sold for those babies. Our family bought some. Bet you everybody in the room did too, never thinking for a moment they might be dangerous. It turns out it was dangerous, and people are suffering injuries. They're trying to dance around the bankruptcy system to avoid paying these innocent victims. That is not good corporate responsibility. I yield.

Chair WHITEHOUSE. Senator Blumenthal.

Senator BLUMENTHAL. Thanks, Chairman. I apologize that I was absent for part of the testimony because I had to go vote, so forgive me if I'm repeating any of the ground that's covered, but I first want to just second what Chairman Durbin has just said about the purpose of the whole justice system. It is to enable the survivors and victims of harms to have a fair day in court and to have fair access to compensation that they're entitled to receive. I want to focus on one aspect of the bankruptcy system that so deeply troubles me. What we're hearing about the use of the Texas Two-Step rule, as it's known, to borrow your phrase, Mr. Zumbro, colloquially and colorfully, is very, very serious, which is the choice of venues.

I recognize that some districts like the Southern District of New York and the Eastern District of Virginia which, until recently, saw a lot of venue and judge shopping, have taken some steps toward self-correction by requiring random judge assignment in bankruptcy cases. Some individual judges have stepped up as well, like Judge Whitley, who transferred the Johnson & Johnson bankruptcy from North Carolina to New Jersey, where Johnson & Johnson is actually headquartered, but we've seen companies move their headquarters to take advantage of supposedly favorable forums and judges. There's a whole cottage industry that is favorable to one side or another side. A lot of the parties are not only skept-

tical, they are utterly cynical about how this system works, non-lawyers as well as lawyers.

I've been very proud to work with Chairman Durbin and Senator Warren on our Nondebtor Release Prohibition Act to close some of the loopholes that enable these kinds of judge-shopping problems. I'd like to ask all of you, aren't you troubled by it, and what should we do about it?

Mr. MACLAY. Thank you, Senator. Kevin Maclay. I think, really, the venue issue is part of the broader problem that we're here talking about today, which is corporations planning out how to disadvantage their victims, essentially, their creditors, and the fact that they have filed in the fourth circuit and in the Western District of North Carolina. Only they could tell you for sure their subjective reasons for doing so, but of course the effective of it is that bad faith bankruptcy filings can stay around and be used to disadvantage their victims.

It's just one example, Senator, of a facet of the problem that hopefully Congress will be able to fix because it's a very real problem. I don't know—one of the questions was asked earlier, why doesn't everyone do this? Given the way the law is currently being applied, I don't know why everyone doesn't do it. You get to stick all your liabilities into bankruptcy and keep all your operating companies out. Not even the inconvenience associated with the bankruptcy. It's really a major, major problem. It's a loophole that could swallow the entire bankruptcy code. I view it as a problem that needs an urgent and immediate solution.

Senator BLUMENTHAL. No matter how good the rule—and I'm probably one of the few United States Senators, at least in office today, who has actually tried a bankruptcy case, which I did as State Attorney General. I tried a bunch of cases, as did some of my colleagues. I'm no bankruptcy expert, and that's my point, that the bankruptcy system is a set of seemingly abstruse, arcane rules. It has a separate set of practitioners and a separate judicial system.

If you're Purdue Pharma and you go to White Plains, you got a judge that, and I'm not drawing any conclusions here, but according to the plaintiffs in separate actions, the State attorneys general, and some of the victims and survivors, was very favorably inclined toward Purdue Pharma and the Sacklers. Likewise, that pattern repeated. I guess I'm honing down on reforming the rules, but making sure the rules are applied evenhandedly and fairly. Mr. Zumbro.

Mr. ZUMBRO. Senator, first, thank you for the question. I do think I would respectfully disagree on the Nondebtor Prohibition Act. I think a blanket prohibition is not the right way to do it, but I would encourage Congress to consider adopting uniform—more uniform standards for when it is appropriate because that issue, like the issue we discussed today, I think, is more nuanced and less black and white than it may seem because I think there can be appropriate circumstances where the victims can actually recover more than they would've otherwise recovered as a result of that.

I do understand your concerns about venue. I think having the notion that third-party releases are illegal in California, they're illegal in Texas, but they're permitted in Delaware, maybe they're permitted in New York—I think they should be—is probably not

the right way because our Constitution requires Congress to enact uniform laws on the subject of bankruptcy. I would encourage the Congress consider uniform standards for that, but as I've recently written on behalf of the New York City Bar Association—we've written a letter to you and your colleagues explaining the reasons why we don't think an absolute prohibition is the right way to go, but rather more standards that are uniformly applied across the judicial circuits.

Senator BLUMENTHAL. Anyone else? Ms. Naranjo, or—

Ms. NARANJO. Yes. Thank you so much, Senator. What I would like to see is, I would like to have my and other 38,000 victims that are known as of right now—just mesothelioma takes about 30 to 50 years to even show up. There's going to be more victims. I want to have my constitutional right to be heard by the people who harmed me, who harmed my children, who harmed my family. I just want to be heard. That right was taken away from me.

Senator BLUMENTHAL. Thank you for being here today.

Ms. NARANJO. Thank you for listening.

Senator BLUMENTHAL. Professor.

Professor SKEEL. I would just say that I do think there's some venue issues. I think the important thing is to address the problems and not pass anything that fixes things that aren't problems or changes things that aren't problems. In my view, the two big problems we have now—one is judge shopping, which you alluded to, in White Plains, and Houston, Texas, and the Eastern District of Virginia. That seems to be in the process of being solved, at least in the short run, but parties should not be able to pick judges within a district, so that's a problem.

The other problem, in my view, is the affiliate part of the venue provision, which says any—any—if a connected entity, an affiliate entity has filed in a courthouse, you can bring the rest of the entity in, even if it's some tiny little entity that just got formed for the purposes of the bankruptcy filing. That's a problem, in my view. A venue reform that addressed that, I think, could help.

What I don't think would help would be to take away the domicile venue option, which is the Delaware venue option. I do think that firms ought to be able to file in their State of incorporation. In my view, it's very important to solve the problems and not create problems by taking away options that really aren't the problem. The real problem, in my view, is judge shopping and that affiliate hook, which people have used to do outrageous things.

Senator BLUMENTHAL. Part of the problem is, as Mr. Zumbro observed, that these rules can differ from one State, one district to another.

Mr. ZUMBRO. Exactly. Bankruptcy lawyers will tell you quite candidly that they have a conversation about that when they're about to file a bankruptcy case. They feel like it would be malpractice not to consider the fact that the third-party release—nondebtor release law is very different in New York than it is in Delaware than it is in Chicago or Texas.

Senator BLUMENTHAL. A good argument for maybe a nondebtor release national rule, which I proposed in the SACKLER Act.

Mr. ZUMBRO. Possibly, although I am of the view that it's important that it be nuanced. That it—I think it would be a mistake to

completely outlaw third-party releases, but cracking down on them I think makes sense. There is an argument for just getting rid of them, you know? The basic argument is if you don't file for bankruptcy, you don't get the benefits of bankruptcy, you know? What third-party releases are doing is giving the benefits of bankruptcy to folks who don't file.

Senator BLUMENTHAL. Right.

Mr. ZUMBRO. There's a counterargument, which is in some cases, bringing it into the bankruptcy context is better for everybody, but that's not always true.

Senator BLUMENTHAL. Judge Fitzgerald—

Chair WHITEHOUSE. I'm going to take the Chairman's prerogative here. I would like to ask Ms. Naranjo for a last word here because one term that has come up repeatedly in this hearing has been time, and there is no better witness on this panel as to the matter of time than you.

In addition to what time you have remaining, you also have decisions to make with regard to what you can leave to and how you can provide for your children, and presumably without knowing what is going to emerge from this black hole of a bankruptcy that you are stuck in. Those decisions are hard to make, and time is short for you to make those decisions. If you could close us out with a few words about time?

Ms. NARANJO. Yes. Time is something that I think folks take for granted. We sometimes feel, you know, we have time; we can get to that; this will happen. Something that I've heard said today was, you know, to make it fair and even. No bankruptcies can do that. I won't be here. My kids will probably be 18 by then because it takes a long time.

I'm scared for my family. Like I said in my testimony, my daughter's only 28. She's a single mom. She doesn't own a home. She's a hairdresser. She's going to raise my children. I don't have a pension. I don't have a 401(k). I started late in life, but when I started, I took off running.

I would like more time. I don't have time. Thirty-eight thousand other people need more time, but we don't know how much time we have in life. It needs to be heard. It needs to be heard now, not later. I'm scared. I don't what's going to happen, but I am so excited to be here today.

Chair WHITEHOUSE. Would you do me one favor? Would you tell your daughter, Monaliza, that my chief of staff is also named Monalisa?

Ms. NARANJO. I heard that. Such a rare name. Such a rare name. I'm so happy to be here. My family's so happy that I was invited here. I'm so grateful that I got to be heard.

Chair WHITEHOUSE. We're delighted to have you here. The record of the hearing will stay open for 1 week so any further comments can be included. I don't believe we had any questions for the record, but if there were any, please answer within the week.

We will undertake to try to figure out something fair here. It does not make sense for a \$450 billion corporation with 38,000 people with potentially lethal injuries to be able to carve off \$2 billion—I did the math, Mr. Zumbro; it's about \$52,000 per person—and walk away from the responsibility for what it did.

With respect to the questions of fairness and efficiency, there's a larger scope for fairness here in which it looks like big companies are getting away with dodging real responsibilities by using complicated trickery that ordinary people don't have access to with the result that they create delays that cause people like Ms. Naranjo to get actually no recovery in her lifetime. That's neither efficient nor fair. I hope we can find a sensible way to solve this.

Thank you all for your testimony. It has been very helpful.

[Whereupon, at 4:25 p.m., the hearing was adjourned.]

[Additional material submitted for the record follows.]

APPENDIX

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Written Testimony of Hon. Judith Klaswick Fitzgerald (Ret.)

Before the Senate Committee on the Judiciary, Subcommittee on Federal Courts, Oversight,
Agency Action and Federal Rights

“Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy”

February 8, 2022

3:00 P.M.

Witness Background Statement

The Honorable Judith Klaswick Fitzgerald is a retired United States Bankruptcy Judge who sat in the Western District of Pennsylvania from 1987 – 2013 and served as the Chief Judge for five years. She also sat by designation in the District of Delaware (20 years), the Eastern District of Pennsylvania (8 years) and the District of the U.S. Virgin Islands (9 years). While on the bench, she presided over more asbestos mass tort bankruptcy cases than any other bankruptcy judge.

Judge Fitzgerald is now a shareholder at the Pittsburgh-based law firm of Tucker Arensberg, P.C., and a Professor in the Practice of Law at the University of Pittsburgh School of Law where she teaches courses in Bankruptcy and Advanced Bankruptcy. She has also served as a Law Clerk, an Assistant United States Attorney and a tenured Professor of Law at Indiana Tech Law School, teaching courses in Contracts, Commercial Transactions and Bankruptcy. She is a co-author of Rutter's National Bankruptcy Practice Guide.

Judge Fitzgerald holds a J.D. from the University of Pittsburgh School of Law and both a B.S. (Psychology) and a B.A. (English Writing) from the University of Pittsburgh. Among other honors, she has been awarded the American Inns of Court Bankruptcy Alliance Distinguished Service Award and the Lawrence P. King Award for Excellence in the Field of Bankruptcy (Commercial Law League of America).

Judge Fitzgerald is a confidential consultant concerning bankruptcy matters, but not about the Texas Divisive Merger Statute, with law firms and parties, some of which have entered appearances in bankruptcy cases that arose from divisive mergers. She has not received any Federal grants or any compensation in connection with her testimony, and she is not testifying on behalf of any organization. The views expressed in her testimony are solely her own.

Witness Statement

Chairman Whitehouse, Ranking Member Kennedy and Members of The Committee on the Judiciary Subcommittee on Federal Courts, Oversight, Agency Action and Federal Rights:

Thank you for the opportunity to testify in your inquiry into “Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy.” I am honored to appear before you, and to provide this written testimony.

In my testimony, I’ll describe some of the general goals of the Chapter 11 of the Bankruptcy Code,¹ as applicable here, and several features of the bankruptcy process related to today’s topic. I’ll then discuss the Texas Divisive Merger law, colloquially referred to as the “Texas Two-Step.” I’ll argue that the law can be beneficial in some contexts and abusive in others, and I will offer my own views from my experience and understanding of the interplay between the Texas Two-Step and bankruptcy.

Chapter 11²

Chapter 11 provides an “honest but unfortunate debtor”³ suffering financial distress the opportunity to reorganize its business, pay creditors and discharge unsecured claims that are not paid through the bankruptcy. The discharge is limited to the debtor.⁴ In the case of a Chapter 11 corporate debtor, to receive a discharge, the debtor must remain in business and retain all or substantially all of its property.⁵ Because bankruptcy is for the honest but unfortunate debtor, an entity must file its case in good faith. “To be filed in good faith, a petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost—not merely distributed to a different stakeholder— outside of bankruptcy.”⁶

A principal purpose of Chapter 11 in large corporate bankruptcy cases is to provide a collective solution to financial distress which enables a debtor to maximize the value of its estate to pay its creditors and/or to preserve going-concern value.⁷ Creditors want to be paid and understand that, outside the bankruptcy process, the first of them who wins the “race to the courthouse” may get paid. But late-comers are more likely to end up with nothing. Bankruptcy solves this problem by putting all of a debtor’s creditors into one collective forum to help a debtor remedy its financial concerns. Bankruptcy initially protects a struggling business by stopping its

¹ The Bankruptcy Code is codified as Title 11, U.S.C. § 101, *et. seq.*

² This section is not intended to address all of the purposes of bankruptcy. Rather, the intent is to focus on particular aspects relevant to my testimony.

³ The full quotation is: “[s]ince the Code limits the opportunity for a completely unencumbered new beginning to the honest but unfortunate debtor by exempting certain debts from discharge, it is unlikely that Congress would have fashioned a proof standard that favored an interest in giving the perpetrators of fraud a fresh start over an interest in protecting the victims of fraud.” *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654, 655, 112 L. Ed. 2d 755 (1991).

⁴ 11 U.S.C. § 524(e).

⁵ 11 U.S.C. § 1141(d)(3).

⁶ *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 129 (3d Cir. 2004).

⁷ *See, e.g., In re Integrated Telecom Express, Inc.*, *supra*, note 6, 384 F.3d at 119-20 (3d Cir. 2004) (citing *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 453, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999)).

creditors from efforts to collect by imposing the automatic stay.⁸ The stay affords all parties time to (i) access information about the debtor's business, assets and liabilities; (ii) assess what the debtor is worth and able to pay; and (iii) negotiate the most effective and efficient resolution of the debtor's financial problems. Typically, the portions of unsecured claims that are not paid through the bankruptcy are discharged⁹ and the debtor is no longer responsible for their payment.

Bankruptcy provides a debtor with certain tools to assist in formulating a reorganization and paying creditors. As relevant here, the Bankruptcy Code has provisions that permit the debtor to claw back into the estate for distribution to classes of creditors payments that were made on the eve of bankruptcy to particular creditors (known as "preferences")¹⁰ and to recapture payments from particular creditors who engaged in prebankruptcy transactions intended to defraud creditors or for which an insolvent debtor did not receive reasonably equivalent value. These actions are generally described, respectively, as "actual fraudulent conveyances"¹¹ and "constructive fraudulent conveyances."¹² As the United States Supreme Court has stated: "Chapter 11 also embodies the general Code policy of maximizing the value of the bankruptcy estate."¹³

Creditors benefit from bankruptcy because they will share in distributions from the debtor according to the priority provisions Congress has enacted. Rather than one or a few creditors capturing all of a debtor's value, distributions are pro rata within each class. With respect to a valid claim, this distribution will occur without the necessity for a creditor to file suit, prove entitlement, chase the debtor to find assets, and spend time and money trying to collect.

At the risk of over-simplification, when the system is used as intended, bankruptcy provides appropriate remedies for debtor's financial burden by giving creditors the debtor's liquidation value or the distribution creditors negotiate. As the Court of Appeals for the Third Circuit noted: "Chapter 11 vests [debtors] with considerable powers – the automatic stay, the exclusive right to propose a reorganization plan, the discharge of debts, *etc.* – that can impose significant hardship on particular creditors."¹⁴ These are appropriate when "financially troubled [debtors] seek a chance to remain in business . . . [b]ut this is not so when a [debtor's] aims lie outside those of the Bankruptcy Code."¹⁵ In other words, "[c]hapter 11 was not designed for the purpose of protecting assets and interests of non-debtor parties under the guise of a legitimate plan of reorganization."¹⁶

The Texas Divisive Merger Law

As have other states, the State of Texas passed a statute by which corporations can merge or split their business operations. Texas enacted the Texas Business Corporation Act ("TBCA")

⁸ 11 U.S.C. § 362.

⁹ 11 U.S.C. §§ 524, 727, 1141(d).

¹⁰ 11 U.S.C. § 547.

¹¹ 11 U.S.C. § 548(a)(1)(A).

¹² 11 U.S.C. § 548(a)(1)(B).

¹³ *Toibb v. Radloff*, 501 U.S. 157, 163, 111 S. Ct. 2197, 2201, 115 L. Ed. 2d 145 (1991).

¹⁴ *In re SGL Carbon Corp.*, 200 F.3d 154, 164 (3d Cir. 1999). Note that the opinion uses the term "bankruptcy petitioner" or "petitioner" to refer to the debtor.

¹⁵ *Id.* at 165.

¹⁶ *In re Davis Heritage GP Holdings, LLC*, 443 B.R. 448, 462 (Bankr. N.D. Fla. 2011).

in 1989 which changed the definition of a merger.¹⁷ The goal of the legislature was to modernize and streamline the merger provisions, and make Texas's merger provisions attractive among jurisdictions.¹⁸ Through the TBCA, it is now possible to divide a single corporation into two or more entities.¹⁹ The main goal of adding the divisive merger provisions to the TBCA was to allow Texas corporations greater flexibility in effectuating restructuring and merger transactions.²⁰

There are two relevant features of the Texas law which have enabled corporations to split into two entities, one that takes the troublesome liabilities with few assets ("BadCo") and the other that takes the vast majority of assets with few liabilities ("GoodCo").

First:

(a) When a merger takes effect:

(1) the separate existence of each domestic entity that is a party to the merger, other than a surviving or new domestic entity, ceases;

(2) all rights, title, and interests to all real estate and other property owned by each organization that is a party to the merger is allocated to and vested, subject to any existing liens or other encumbrances on the property, in one or more of the surviving or new organizations as provided in the plan of merger without:

(A) reversion or impairment;

(B) any further act or deed; or

(C) any transfer²¹ or assignment having occurred;

(3) all liabilities and obligations of each organization that is a party to the merger are allocated to one or more of the surviving or new organizations in the manner provided by the plan of merger;

(4) each surviving or new domestic organization to which a liability or obligation is allocated under the plan of merger is the primary obligor for the liability or obligation, and, except as otherwise provided by the plan of merger or by law or contract, no other party to the merger, other than a surviving domestic entity or non-code organization liable or otherwise obligated at the time of the merger, and no other new domestic entity or non-code organization created under the plan of merger is liable for the debt or other obligation;

¹⁷ H.B. 472, 1989 Leg., 71st Reg. Sess., at 23 (Tex. 1989).

¹⁸ Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary's L.J. 109, 110-11 (1989).

¹⁹ *Id.* at 110.

²⁰ *Id.* at 115-16.

²¹ A transfer is defined as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, and creation of a lien or other encumbrance. The term does not include a transfer under a disclaimer filed under Chapter 240, Property Code." Tex. Bus. & Com. Code Ann. § 24.002.

...²²

Second:

This code does not affect, nullify, or repeal the antitrust laws or abridge any right or rights of any creditor under existing laws.²³

There are legitimate business reasons why a corporation may want to implement a divisive merger. The difficulty is not with the statute itself or its use as a proper business tool. The difficulty comes into play when BadCo, the company vested with the liabilities, seeks bankruptcy relief while GoodCo, the Company that received the assets, does not. As a bankruptcy judge with over 25 years' experience with mass tort cases and now as consultant in the system across all constituencies (debtors, creditors and trusts), I am aware of the perceived unfairness of this type of action, which is seen as gaming the system when a divisive merger is followed by a bankruptcy of only BadCo.

The Interplay Between Bankruptcy Law and the Texas Divisive Merger Law

To understand the problems that can arise when BadCo files bankruptcy but GoodCo does not, it is important to understand that the bankruptcy court has jurisdiction over the assets (i.e., property of the estate) and liabilities of the debtor as they exist on the day the case is filed. The assets and liabilities that will be disclosed in the bankruptcy schedules and statement of financial affairs are those of the debtor, and *only* those of the debtor. The court has no jurisdiction over property of a non-debtor or over claims that lie solely against the non-debtor.

Absent the divisive merger, the original company ("OldCo") that instituted the divisive merger, would retain all the assets and all the liabilities. Should OldCo file bankruptcy, all of OldCo's assets and liabilities would be listed in its filed pleadings, and the bankruptcy court would have jurisdiction over all. But the divisive merger separates out the assets from the liabilities. It permits OldCo to create GoodCo, which will keep the major assets, and BadCo, which will get the liabilities and nominal assets. Then, when BadCo files bankruptcy, all that is disclosed to the bankruptcy court and parties are the assets and liabilities of BadCo. This step shelters GoodCo's assets from oversight.

The BadCo companies that have filed bankruptcy to date generally have had no business operations; few, if any, employees to protect; and insufficient assets to pay the claims, as BadCo's purpose is solely to hold the liabilities and to file bankruptcy. Typically, a BadCo debtor takes steps to have the automatic stay applied to GoodCo and other affiliates and/or to have an injunction entered in favor of those affiliates to prevent creditors from pursuing their claims against the non-debtor parties. This further shelters GoodCo's assets as there is no corresponding request to stop GoodCo from depleting its assets as it chooses.

Although GoodCo receives benefits by BadCo's bankruptcy, there is nothing in the Bankruptcy Code that requires GoodCo to divulge its assets or net worth, even though GoodCo's

²² Tex. Bus. Orgs. Code Ann. § 10.008 (West).

²³ Tex. Bus. Orgs. Code Ann. § 10.901 (West).

creation was the flip-side of the transaction that left BadCo holding the bag of creditor claims. The effect is that the bankruptcy judge cannot preside over the case the same way she would have, had the split not occurred and had OldCo filed bankruptcy. Without the split, all the assets and liabilities would be in the same company, and all would have to be disclosed in the bankruptcy schedules under penalty of perjury. With the split, only BadCo reveals what it owns and what it owes. In addition, no creditor or party in interest can see any information about GoodCo, because it will not be part of the court record.

As I mentioned, bankruptcy law offers debtors methods of recapturing assets that were transferred fraudulently. However, a BadCo debtor has no incentive to undertake any action to recover the assets. BadCo is still part of the original corporate family and typically has a board and officers that are controlled by a legacy company. That board is unlikely to take action against the company that undertook the divisive merger or its parent or affiliates. Even if a court authorized a creditors' committee, in lieu of a debtor, to bring an action, there is a long delay before any fraudulent transfer litigation gets underway and discovery battles are fought. This type of litigation is time-consuming and costly, which disincentivizes efforts to claw back the assets. That disincentive provides substantial leverage to the debtor to negotiate settlements that pay creditors - who of course want to be paid for their claims - cents on a dollar rather than the full value of their claims.

At the same time, the automatic stay is still in place, and the ensuing delay in any effort to recover the transfers is itself harmful to creditors. In the mass tort context, delay is even more harmful to creditors where thousands of individuals are sick and many die while the bankruptcy goes on, often resulting in a total loss of ability of the injured party to receive compensation. A review of the dockets in several of the Texas Two-Step bankruptcy cases indicates that there is delay in the cases resulting from disputes over efforts to relieve non-debtor parties of asserted liabilities without undergoing their own bankruptcies. The sick and dying claimants receive nothing until a plan is confirmed, so the longer the case runs without a confirmed plan, the longer it takes to provide victims with compensation.

Efforts to recoup the assets left in GoodCo are further complicated when BadCo was formed under the Texas statute, because the statute states that there is no transfer in a divisive merger,²⁴ even though the assets and liabilities are clearly moved from one company into two.²⁵ Bankruptcy law looks askance at prebankruptcy maneuvers by a debtor that prejudice or harm the creditors. However, the currently available options that creditors have are not adequate to reverse the harm when they can look only to BadCo for payment.

²⁴ Tex. Bus. Orgs. Code Ann. § 10.008(a)(2)(C) (West).

²⁵ The Texas statute also says that the split does not jeopardize the rights of creditors. To date, I have not found a case that reconciles these provisions or explains how a creditor can pursue efforts to reclaim assets under a fraudulent transfer theory when the statute defines the transaction as though there were no transfer. *But see In re Aldrich Pump, LLC*, 2021 WL 3729335 (Bankr. W.D. N.C. Aug. 23, 2021) (discussing the issue).

LTL Management LLC

The LTL Management LLC bankruptcy²⁶ has been pointed out by one scholar as an illustration of the financial harm that mass tort creditors face when only BadCo files bankruptcy.²⁷ LTL is the “BadCo” entity that was formed when Johnson & Johnson Consumer, Inc. (“JJCI”), a subsidiary of Johnson & Johnson (“J&J”), used the Texas Divisive Merger law to temporarily move into Texas and split into what eventually became LTL and [New] JJCI (the “GoodCo”).²⁸

[New] JJCI received all of the assets – except those put into LTL – and none of the talc liabilities. LTL had no employees, no business office of its own, no business at all, was undercapitalized with approximately \$2 billion in assets, and received all 38,000+ talc claims, “which could climb into the tens of billions of dollars.”²⁹ The assets were equity in Royalty A&M, which owns the right to receive the proceeds of certain royalty streams (but not to renegotiate or otherwise alter the underlying royalty agreements), some cash, insurance, and a promise from JJCI and J&J, assuming that LTL can confirm a plan, to fund a trust to pay talc victims up to the value of New JJCI, which has been stated at different amounts in different proceedings but is possibly worth \$60 billion.

In other words, [New] JJCI is worth about \$60 billion and has none of the billions of dollars of liability for talc-related debt that the original JJCI held, whereas LTL has all of the billions in talc debt and only \$2 billion in assets.³⁰

LTL filed bankruptcy two days after it was incorporated, but [New] JJCI did not *and has not* filed, leaving the court with jurisdiction over \$2 billion in assets. That \$2 billion in assets would have been \$62 billion if both BadCo LTL and GoodCo [New] JJCI had filed. The effect, in essence, enables J&J (a solvent and well-capitalized company with a reported net worth as of February 4, 2022 of \$454.81 billion)³¹ to avoid subjecting itself to bankruptcy court oversight

²⁶ Bankruptcy Case No. 21-30589 (MBK) pending in the District of New Jersey. In essence, in October 2021, J&J, through JJCI, performed a series of transactions under Texas law that dissolved JJCI and resulted in two entities: (i) LTL, which succeeded to all of Old JJCI’s talc-related liabilities and received limited assets; and (ii) [New] JJCI, which received Old JJCI’s most valuable assets.

²⁷ See, *inter alia*, Michael A. Francus, *Texas Two-Stepping Out of Bankruptcy*, Michigan Law Review Online (Jan. 20, 2022), <https://ssrn.com/abstract=4021502>.

²⁸ Once the divisive merger was accomplished, LTL and [New] JJCI left Texas. LTL became a North Carolina entity and [New] JJCI went back to New Jersey. For a description of the complex transactions that led to the formation of LTL and [New] JJCI, see David Warfield, *Johnson & Johnson: The Texas two-step and talc-related liabilities*, Thompson Coburn LLP (Nov. 23, 2021), <https://www.jdsupra.com/legalnews/johnson-johnson-the-texas-two-step-and-9551060/>.

²⁹ Vince Sullivan, *Resistance to J&J’s Bankruptcy Gambit May Be Futile*, Law360 (Oct. 15, 2021 6:10 PM EDT), <https://www.law360.com/health/articles/1431485>.

³⁰ One commentator explains the asset transfer under the divisive merger as: “When the dust settled, the Debtor LLC was responsible for all talc-related liabilities, and New JJCI owned all non-talc assets and was responsible for non-talc liabilities. To be sure, the divisive merger did not leave the Debtor LLC saddled with all of the talc liabilities without any assets whatsoever. The Debtor LLC estimated in its bankruptcy filing that it holds \$373.1 million in assets due to the allocation made in the divisive merger. Moreover, New JJCI has agreed to fund the Debtor LLC’s Chapter 11 case and contribute \$2 billion into a settlement trust for the benefit of the talc claimants as part of a Chapter 11 reorganization plan.” Warfield, *supra*, note 28.

³¹ Johnson & Johnson Net Worth 2006-2021 | JNJ, Macrotrends (Feb. 5, 2022), <https://www.macrotrends.net/stocks/charts/JNJ/johnson-johnson/net-worth>.

while relieving itself of any liability for claims based on use of J&J's talc products. LTL has no reorganizational purpose because it has no business to reorganize. The bankruptcy was not initiated to maximize LTL's assets for the benefit of the talc claims transferred into it; the assets are insufficient to pay those claims. There is no need to preserve LTL's going-concern value because it is not a going concern. LTL was created solely to protect J&J, and to accomplish that goal by filing bankruptcy and obtaining the extension of the automatic stay, a channeling injunction, and non-debtor third party releases for J&J's benefit – all without J&J acknowledging responsibility or liability for talc claims.³²

Moreover, LTL's bankruptcy is not like other mass tort bankruptcies. LTL's bankruptcy is enabling J&J as an alleged tortfeasor in its own right to escape accountability for its tortious conduct. In the case of a debtor who acknowledges responsibility for manufacturing or distributing hazardous products, the bankruptcy does not become a shield behind which the company hides. There, the debtor has disclosed its conduct, the problems with its product, its assets and its liabilities for the world to see. It pays the price of reputational injury and must address the concerns of its workforce and its lenders and stockholders. It pays fees to the United States Trustee and files monthly operating reports. It bears the cost of all professional assistance to other parties such as the creditors' committees and the future claims representative – and these costs often run into the tens of millions of dollars. These, and others, are real burdens that are part of the price for the benefits bankruptcy offers to debtors.

But in the case of LTL, J&J and [New] JJCI are not subject to any of those burdens. As noted, J&J denies that its talc contained asbestos and claims its products were safe. Nonetheless, it saw the need to vest all that liability in LTL without vesting sufficient assets to pay it, and to escape resolution of its liability and defenses in the tort system. If J&J is correct that its products did not contain asbestos and were safe, then creating a GoodCo and a BadCo to shield GoodCo and J&J from any liability represents deep skepticism in the validity of litigation to determine the facts.

³¹ *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).

³² J&J has continually denied that its talc products contain asbestos and cause ovarian cancer or mesothelioma. *See, inter alia*, Tucker Higgins, POLITICS, *Supreme Court rejects Johnson & Johnson's appeal of \$2 billion penalty in baby powder cancer case*, (Jun. 1 2021 10:40 am EDT Updated, Jun. 1 2021 12:36 pm EDT) <https://www.cnn.com/2021/06/01/supreme-court-rejects-johnson-johnsons-appeal-of-2-billion-baby-powder-penalty.html> (Quoting J&J: "Decades of independent scientific evaluations confirm Johnson's Baby Powder is safe, does not contain asbestos, and does not cause cancer."); Brian Mann, *J&J is using a bankruptcy maneuver to block lawsuits over baby powder cancer claims* (October 21, 2021 2:11 pm ET) <https://www.npr.org/2021/10/21/1047828535/baby-powder-cancer-johnson-johnson-bankruptcy> ("In 2018, separate investigations by Reuters and The New York Times revealed documents showing Johnson & Johnson fretted for decades that small amounts of asbestos lurked in its baby powder, without telling regulators. J&J has repeatedly denied the claim. . . .").

J&J contends that its talc products are safe. *See* Johnson & Johnson Form 10-Q (Oct. 29, 2021) at p. 31, available at <https://johnsonandjohnson.gcs-web.com/static-files/511bb3de-22b0-4acb-b9d4-b016599f1d90>. However, rather than defending its position through litigation, J&J took the steps that led to LTL's bankruptcy. Immediately after it filed and without first filing a pleading seeking to extend the stay to J&J, LTL filed notices "in thousands of pending tort cases around the country" that all claims against [New] JJCI and J&J were also stayed. *See* Objection To Debtor's Emergency Motion To Enforce The Automatic Stay Against Talc Claimants Who Seek To Pursue Their Claims Against The Debtor And Its Non-Debtor Affiliates, *In re LTL Management, Inc.*, Case 21-30589-MBK, Doc. 53 at ¶ 2.

Perceived or actual corporate misbehavior that harms real people, and abuse of the bankruptcy process, are really what the issues center on; *i.e.*, the use of a statute by a well-capitalized company, not for legitimate business purposes, but to avoid the consequences of prior business practices without enduring the ramifications that flow from bankruptcy jurisdiction and oversight. As Judge Friendly noted years ago, “[t]he conduct of bankruptcy cases not only should be right but must seem right.”³³ Of paramount concern to judges and legislators alike is preserving the integrity of the bankruptcy process and assuring that all parties who come before the bankruptcy courts are assured of due process in cases filed by debtors acting in good faith. If the pre-merger company is so inundated with claims from victims of the company’s wrongdoing that it faces economic ruin, it should use the statute that Congress has passed and file its own bankruptcy - put its assets and its liabilities up for public scrutiny and court supervision. If that company wants the benefits that Congress has provided through the bankruptcy system, then it should shoulder the burdens that Congress has imposed on debtors. The bankruptcy system should not be used by a non-debtor as an artifice or stratagem to escape the requirements Congress has instituted to relieve the honest but unfortunate debtor from true financial woes.

Personally Injured Tort Claimants

When a bankruptcy is filed, the automatic stay³⁴ protects a debtor against litigation while the bankruptcy progresses. Stopping efforts to litigate against the debtor is what filing bankruptcy does for the debtor, and sometimes, on court order, for affiliates and others that may have co-liability with the debtor. The effect of extending the stay to non-debtors deprives creditors of the ability to test the validity of their claims of independent liability against the non-debtors. LTL, as the debtor, was entitled to the operation of the automatic stay and successfully convinced the court that the stay should also apply to [New] JJCI and J&J. But in LTL, not only was litigation stopped against [New] JJCI and J&J, but an additional 670 entities benefitted from the ruling without any evidence of record as to why each and every one of 670 entities needed the automatic stay extended to them. To be clear, there was evidence produced in court, but that evidence was general evidence, not evidence that specifically related to each of the 670 entities. Although creditors were prohibited from pursuing claims against 670 third-party non-debtors, none of those parties was prohibited from transferring its money and other assets to other creditors or corporate affiliates. This one-sided protection benefitted no creditors at all.

Because LTL successfully had the court extend the automatic stay and issue a preliminary injunction preventing actions against [New] JJCI, J&J, and 670 other entities, the talc victims have not had many opportunities in the state trial courts or in the MDL pending in New Jersey to prove J&J’s or [New] JJCI’s responsibility for the illnesses that they allege. Trials are important. One successful litigant³⁵ before LTL filed bankruptcy received a judgment of \$4.69 billion³⁶ on behalf

³³ *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).

³⁴ 11 U.S.C. § 362.

³⁵ See *Ingham v. Johnson & Johnson*, 608 S.W.3d 664, 724-25 (Mo. App. E.D. 2020).

³⁶ This judgment contrasts with J&J and [New] JJCI’s promises to put an initial \$2 billion into a trust formed pursuant to a confirmed LTL plan for payment of 38,000 talc claims that now reside in LTL and future claims.

of 22 talc victims and their families.³⁷ In June of 2021, the Supreme Court denied a petition for certiorari³⁸ of the reduced award, which was \$500 million in actual damages against Old JJCI, \$125 million against J&J jointly and severally with Old JJCI, \$900 million in punitive damages against Old JJCI, and \$715,909,091 in punitive damages against J&J (a total exceeding \$2.1 billion, which J&J paid).³⁹ LTL was formed in October 2021 for the specific purpose of filing bankruptcy to form a trust that would pay talc victims through a limited fund.

One impetus to reorganizing in bankruptcy is to bring into the bankruptcy estate all claims against the debtor, so that the debtor can address them all as part of its reorganization. Not many creditors are pleased to be in that situation, but the situation is fairer than a race to the courthouse would be. Having a single adjudicative forum is necessary to make bankruptcy effective and to have whatever assets can be liquidated to pay claims made available to creditors on a fair basis. To the extent that creditors are left with recovering from the debtor's assets, that is the policy choice Congress has made to keep our economy going and return the distributable value of the debtor to creditors, all conducted under the bright sunshine of public scrutiny with robust disclosure regarding assets and liabilities. None of that, however, is disclosed by the GoodCo that gets the assets in a divisive merger and stays out of bankruptcy, or by any other affiliates.

The bankruptcy estate is limited to property of and claims against the debtor. When a debtor or a creditor tries to add in claims that lie solely against non-debtor entities, those claims must be disallowed.⁴⁰ And there is a real, practical downside to efforts to include claims against non-debtors. The third parties who tag along with the debtor but who never have to account for what they actually are able to contribute, and who get released as part of confirmation, get off the hook, while the person who was injured or who contracted cancer has lost the ability to prove the claim against the third parties and recover from them. Even with contributions to fund the plan coming from third parties, tort victims are not paid 100% of what they could prove they are owed if they succeeded at trial. Bankruptcy settlements of mass tort claims resolve all of them, collectively, so that everyone in the class of tort claimants essentially is able to recover the same amount as everyone else who has the same type of claim. When the tort claimants agree to that resolution, a plan that structures the payments can be confirmed.

The economic impact of imposing releases on victims who do not agree to give up their rights against a non-debtor but who will not be fully compensated - despite losing their opportunity to sue the non-debtor entity - is not the subject of much commentary. But it should be, and these hearings are an appropriate forum to discuss the issue. For example, if a talc victim contracts ovarian cancer and dies, her children will be left without a mother and potentially without a means to survive other than on the public dole. And even if the woman does not die immediately, if she has inadequate health insurance or none at all, society at large may bear responsibility to pay for

³⁷ Daniel Fisher, *A Bale Of Hay And A Block Of Cheese: How Mark Lanier Won \$4.7 Billion Talcum Powder Verdict*, *Forbes* (Oct. 3, 2018, 6:10am EDT), <https://www.forbes.com/sites/legalnewsline/2018/10/03/a-bale-of-hay-and-a-block-of-cheese-how-mark-lanier-won-4-7-billion-talcum-powder-verdict/?sh=7c792cc31c10>.

³⁸ *Johnson & Johnson v. Ingham*, 141 S. Ct. 2716, 210 L. Ed. 2d 879 (2021).

³⁹ *Johnson & Johnson Form 10-Q* (Oct. 29, 2021), at p. 31, available at <https://johnsonandjohnson.gcs-web.com/static-files/511bb3de-22b0-4acb-b9d4-b016599f1d90>.

⁴⁰ 11 U.S.C. § 502(b)(1).

her treatment, care and eventual funeral. The emotional cost to children and survivors of the deceased is unmeasurable. That strain can only be magnified if putting food on the table is part of their loss.

The bankruptcy of BadCo, resulting from a divisive merger, is intentionally designed to be an end run around Congressional policies requiring (i) full disclosure and transparency and (ii) making use of the bankruptcy process available to the honest but unfortunate debtor. It has enabled solvent companies to reap the benefits of bankruptcy without bearing any of its burdens. It affords an escape from accountability by the entities who are responsible for the harms caused and able to pay for them. It delays or entirely eliminates the ability of injured people to pursue non-debtors who are alleged to be independently liable for the injuries. It removes assets from the purview of the court, which, absent the merger, would have been part of the bankruptcy estate.

Brain-storming Remedies

The focus of my testimony is to identify some of the problems that can arise when BadCo files bankruptcy. If Congress determines that there are abuses that should be corrected, there are possible solutions. The bankruptcy process depends on transparency. Requiring more transparency, examining the practice of extending the automatic stay to non-debtors, or limiting BadCo's eligibility to be a debtor are possible subjects to begin a conversation. For example, Congress could consider:

1 - requiring GoodCo to file the same schedules and statement of financial affairs that BadCo must file to help assure transparency in the bankruptcy process;

2 - limiting the ability of a BadCo to file bankruptcy for a set period of time after undergoing a divisive merger, in order to help assure that the purpose of the divisive merger is something other than avoiding (i) OldCo's liability to creditors and (ii) any oversight of the bankruptcy system;

3 - requiring specific proof as to each and every entity that the debtor asks to benefit from an extension of the automatic stay or issuance of a temporary or preliminary injunction, supported by findings of fact and conclusions of law regarding, *inter alia*, each such entity's relationship with the debtor, *what the entity will contribute to the bankruptcy*, and why granting this privilege to each such entity is necessary to the debtor's reorganization; or

4 - amending the automatic stay to clarify that, by operation of law, the stay applies only to a debtor and extending it to any other entity requires court approval after notice, served on all parties, and a hearing.

These are just a few of the many possibilities that Congress could explore. The ideas provided here certainly require more nuanced discussion and analysis to assess their viability and any unintended consequences. But any Congressional action would be a first step and send a signal that Congress recognized a problem that harms the people Congress serves, and addressed it.

Conclusion

When a BadCo entity formed as the result of a divisive merger files bankruptcy, creditors can be harmed by the inability to pursue all of the assets that the original company held. The Bankruptcy Code does not require GoodCo (the entity that received the valuable assets without any of the associated liabilities) to make the types of disclosures that are required of a debtor. The lack of disclosure and the inadequacy of available bankruptcy tools to recover the assets placed into GoodCo are worthy subjects for review. The end-run around bankruptcy laws that Congress has enacted – an end-run by well-capitalized non-debtors who tag along with a debtor created solely for the purpose of filing bankruptcy - is ripe for discussion. The Bankruptcy Code should not be used in ways that violate the very principles that Congress, through the Bankruptcy Code, has established.



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Before the
Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights
Committee on the Judiciary
United States Senate

“Abusing Chapter 11: Corporate Efforts to Side-Step Accountability
Through Bankruptcy”

Washington, DC
February 8, 2022
3:00 p.m.

WRITTEN TESTIMONY OF KEVIN C. MACLAY

I would like to thank Chairman Whitehouse, Ranking Member Kennedy, and Members of the Subcommittee for inviting me to testify before this Subcommittee regarding “Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy.” My name is Kevin Maclay. I am a member of the law firm of Caplin & Drysdale, Chartered in Washington, DC, where my practice focuses on protecting creditors’ rights in corporate chapter 11 bankruptcy reorganizations. I have represented the interests of numerous tort creditors’ committees, and significant tort creditors in major Chapter 11 bankruptcy proceedings across the country, and I and my firm currently serve as lead or co-lead counsel to tort creditors’ committees in the bankruptcies of Paddock Enterprises LLC (Owens-Illinois), DBMP LLC (CertainTeed), Aldrich Pump LLC and Murray Boiler LLC (Trane and Ingersoll-Rand), ON Marine Services Company (Ferro), Cyprus Mines Corporation, and Kaiser Gypsum Inc. and Hanson Permanent Cement Inc. As a result of that experience, I am familiar with the bankruptcy process generally, mass tort bankruptcies in particular, and with the recent attempts by certain mass tort defendants to create a one-sided escape from both the tort and bankruptcy systems through use of the so-called “Texas Two-Step.”

Summary

Since 2017, five different companies have filed for bankruptcy after undergoing what is referred to as a “divisional merger” under a somewhat obscure and previously-little-utilized provision of Texas law. They have done so to put their assets out of the reach of creditors and the courts, an unprecedented legal maneuver that undermines the entire civil justice system. All five were large and profitable companies with substantial assets (collectively above 80 billion dollars), part of extremely wealthy corporate families (collectively worth many hundreds of billions of dollars). None of them claimed to be insolvent. Nor were any of them Texas companies either before or after the so-called Texas Two-Step was complete. All five were and are out-of-state companies whose existence as Texas corporations lasted mere hours, in a brazen attempt to exploit what they viewed as a loophole under federal bankruptcy law. The most recent such bankruptcy filing, and the most publicized, is that by Johnson & Johnson’s recently-created shell company, LTL Management LLC (“LTL”).

Under the Texas Two-Step, a rich and successful company effectively divides itself into two new companies. One of the companies (the “GoodCo”) receives the lion’s share of the business assets; the other (the “BadCo”) receives all of the unwanted tort liabilities. Days later, the company with the unwanted liabilities files for chapter 11 bankruptcy, while the richer company with the vast majority of the assets remains outside of bankruptcy. This violates fundamental bankruptcy principles, including that companies should bear the burdens of bankruptcy in order to enjoy its benefits, and the associated principle that debtors should come into bankruptcy with both all of their liabilities and all of their assets.¹

Unless a stop is put to it, the Texas Two-Step effectively places corporations willing to stoop to it above the law. Tort victims can no longer seek redress for their injuries in the court

¹ A “cardinal principle of bankruptcy” is to provide relief to only those debtors that come into bankruptcy with all of their liabilities *and* all of their assets. *Robbins v. Chase Manhattan Bank, N.A.*, No. CIV A. 93-0063-H, 1994 WL 149597, at *6 (W.D. Va. Apr. 4, 1994) (quoting *In re Venture Props., Inc.*, 37 B.R. 175, 177 (Bankr. D.N.H. 1984)).

system, as such corporate defendants argue, so far successfully, that the bankruptcy filing by their BadCo likewise protects their GoodCo from lawsuits. Yet their GoodCo remains outside of bankruptcy and free from the transparency and court oversight usually required as a condition of such bankruptcy protection.

And there are major consequences to the abuse of the Texas Two-Step loophole. As of the dates of their bankruptcy filings, there were hundreds of thousands of claims collectively pending against Georgia Pacific, CertainTeed (part of the Saint-Gobain corporate family), Ingersoll-Rand, Trane, Johnson & Johnson, and their affiliates. Those injured victims have now been trapped in illegitimate bankruptcies manufactured by undeniably wealthy companies. Those victims include dead and dying individuals, or their survivors, some of whom likely have few, if any, other options and are in desperate financial straits. At a minimum, the Texas Two-Step has resulted in substantial delays to their ability to seek justice, and potentially could even eliminate that ability. These are real-world problems, not merely academic concerns, and fundamental fairness is at stake.

While the Texas Two-Step so far has been used to disadvantage tort victims, the very same mechanism can, and will, inevitably be used to permit corporations to rid themselves of any unwanted creditors—contract creditors, warranty claim creditors, environmental creditors or others. The Texas Two-Step is a free pass for a corporation to disregard its obligations under the law at will. Unless this loophole is closed, more corporations will engage in the Texas Two-Step scheme, and twist the bankruptcy system into something unrecognizable.

Corporations, no matter how wealthy they are and no matter how clever the lawyers they hire, should not be able to unilaterally remove themselves from both the U.S. civil justice system and the federal bankruptcy system. No one should be above the law.

In other words, it is up to Congress to deliver needed reform.

Chapter 11 Reorganizations

When Congress enacted the modern Bankruptcy Code in 1978, it struck a careful balance in providing essential benefits to financially distressed debtors seeking to reorganize while at the same time requiring those debtors to fulfill obligations that provide important protections to creditors.² Bankruptcy is designed to benefit the “honest but unfortunate debtor.”³ Since 1978, chapter 11 of the Bankruptcy Code has enabled business debtors to work with their creditors to negotiate a plan of reorganization that restructures their balance sheets or business operations, eases their financial distress, and preserves the going-concern value of the business in an effort to maximize creditor recoveries.

² See 2 COLLIER ON BANKRUPTCY ¶ 1100.01 (Richard Levin & Henry J. Sommer eds., 16th ed.).

³ “Since the Code limits the opportunity for a completely unencumbered new beginning to the honest but unfortunate debtor by exempting certain debts from discharge, it is unlikely that Congress would have fashioned a proof standard that favored an interest in giving the perpetrators of fraud a fresh start over an interest in protecting the victims of fraud.” *Grogan v. Garner*, 498 U.S. 279, 279 (1991).

Chapter 11 provides certain benefits to debtors to facilitate negotiations and ultimately a successful reorganization. The principal benefit to debtors is the automatic stay,⁴ which provides a statutory, nationwide, and indefinite stay of litigation, collection actions, and enforcement proceedings against the debtor. The automatic stay has two primary purposes: first, it provides the debtor with a pause from litigation to work out financial difficulties and to begin the process of reorganization; and, second, it prevents a race to the courthouse by creditors to sue and dismember the debtor, which can destroy value and defeat an orderly reorganization process.⁵

In exchange for the benefits of bankruptcy, the Bankruptcy Code imposes corresponding obligations on debtors that are intended to protect creditors:

- First, debtors are required to make regular reports to their creditors and the bankruptcy court, including information about their assets, liabilities, and financial affairs at the start of the case, and subsequent monthly operating reports to monitor cash flow.⁶ These reporting requirements create an environment of transparency to help creditors understand the debtor's financial state of affairs, which in turn informs plan negotiations and the debtor's reorganization.⁷ They also help to prevent misuse or misappropriation of those assets.

- Second, the chapter 11 debtor cannot layer on additional debt or engage in any transactions outside the ordinary course of business, such as selling any material assets, without prior notice to creditors and the approval of the bankruptcy court.⁸ The purpose of these protections is to prevent debtors or the entities controlling debtors from overleveraging a debtor that is already in financial distress or from stripping the debtor of its assets either for no value or for less than fair value.⁹

- Third, although the Bankruptcy Code initially grants the debtor the exclusive right to propose a chapter 11 plan, that right eventually terminates, thereby giving creditors the ability to propose a competing chapter 11 plan and thus a more level playing field to help shape the outcome of the reorganization.¹⁰

- Fourth, creditors ordinarily can be paid only in accordance with a chapter 11 plan that

⁴ 11 U.S.C. § 362(a).

⁵ See, e.g., *Dean v. Trans World Airlines, Inc.*, 72 F.3d 754, 755-56 (9th Cir. 1995).

⁶ See 11 U.S.C. § 521; Fed. R. Bankr. P. 1007.

⁷ See *In re Sillerman*, 605 B.R. 631, 644 (Bankr. S.D.N.Y. 2019) (stating the Bankruptcy Code's reporting requirements "cannot be ignored" and are necessary to "supply the Court and creditors with relevant and material information . . . thereby enhancing transparency and potentially laying bare any improper transfers or self-dealing"); *In re Berryhill*, 127 B.R. 427, 433 (Bankr. N.D. Ind. 1991) ("Timely and accurate financial disclosure is the life blood of the Chapter 11 process."); cf. *In re V Companies*, 274 B.R. 721, 739 (Bankr. N.D. Ohio 2002) ("While creditors may not be happy with the way in which a bankruptcy case unfolds, at a minimum they are entitled to reasonable assurances that the debtor's affairs are being conducted in a transparent manner with an eye to the debtor's fiduciary obligations to the creditors.").

⁸ See 11 U.S.C. §§ 363(b), (f), 364; 2 COLLIER ON BANKRUPTCY ¶ 363.02 (Richard Levin & Henry J. Sommer eds., 16th ed.).

⁹ See, e.g., *Horse Haven, Inc. v. Stephens*, 907 F.2d 1138 (4th Cir. 1990); *In re Cook & Sons Mining, Inc.*, No. CIV.A. 05-19, 2005 WL 2386238, at *6 (E.D. Ky. Sept. 28, 2005).

¹⁰ See 11 U.S.C. § 1121.

satisfies the Bankruptcy Code's requirements and is approved by the bankruptcy court after notice and a hearing.¹¹

- Fifth, an “absolute priority rule” is embodied in the Bankruptcy Code and generally provides that, unless creditors consent to less favorable treatment, creditors must be paid in full before the debtor’s owners—oftentimes shareholders—can retain their shares or ownership interests in the debtor.¹²

The Texas Two-Step undermines these essential creditor protections and disrupts the careful debtor-creditor balance crafted by Congress.

Overview of Divisional Mergers Implemented for Bankruptcy Purposes

Instead of describing each and every divisional merger and follow-on bankruptcy that has occurred, I will use a hypothetical to illustrate how these divisional mergers typically work and how they make the ensuing chapter 11 bankruptcies so problematic. For those wishing to know more about the divisional mergers that actually occurred, I lay out in the accompanying appendix how the divisional mergers involving five major companies were implemented and set the stage for their follow-on chapter 11 bankruptcies (two of which, Aldrich and Murray, are jointly administered). Those cases all remain pending, are highly contested, and appear no closer to a resolution than the day they began.

Suppose there is a company named “AceCo.” AceCo, which was formed in Delaware, is a successful company, with a strong balance sheet and a line of products generating substantial cash. But AceCo has overhanging tort liabilities to individuals harmed by its products. Although AceCo has more than enough cash to defend itself in the tort system and to settle and pay the tort claims as they arise, AceCo’s management wants to rid AceCo of its tort liabilities once and for all. Bankruptcy may provide a path for resolving the tort liabilities in a single proceeding, but AceCo’s management does not want to put AceCo into bankruptcy because of the perceived reputational harms, court oversight, required transparency and associated costs. To obtain the

¹¹ See *id.* §§ 1128, 1129; see also *Off. Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299, 302 (4th Cir. 1987) (“The Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved. . . . The clear language of . . . [11 U.S.C. §§ 1121-1129], as well as the Bankruptcy Rules applicable thereto, does not authorize the payment in part or in full, or the advance of monies to or for the benefit of unsecured claimants prior to the approval of the plan of reorganization.”); *In re Berry Good, LLC*, 400 B.R. 741, 744 (Bankr. D. Ariz. 2008) (“[I]n the context of a reorganization proceeding, pre-petition debt may not be paid in the absence of a confirmed reorganization plan.”); *In re All Trac Transp., Inc.*, 306 B.R. 859, 875-76 (Bankr. N.D. Tex. 2004) (“Outside of a Chapter 11 plan of reorganization confirmed by the bankruptcy court, the Bankruptcy Code does not provide for the pre-plan payment of pre-petition unsecured debt.”).

¹² See *id.* §§ 726(a), 1129(a)(7), 1129(b); see also *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 979 (2017) (“The Code places equity holders at the bottom of the priority list. They receive nothing until all previously listed creditors have been paid in full.”); 2 COLLIER ON BANKRUPTCY ¶ 1100.01 (Richard Levin & Henry J. Sommer eds., 16th ed.) (“[T]he principle that business reorganizations should be fair and equitable between classes of differing security or priority is embodied in chapter 11 through the absolute priority rule, which has been aptly described as ‘the organizing principle of the modern law of corporate reorganizations.’” (citations omitted)).

benefits of bankruptcy without putting the entire business into chapter 11, AceCo decides to utilize Texas law and implement a divisional merger.

To accomplish this, AceCo first converts from a Delaware company to a Texas company. Then, as a Texas company, AceCo utilizes the Texas divisional merger law to effectively split itself into two new companies, “GoodCo” and “BadCo.” As a formal legal matter, AceCo ceases to exist. GoodCo and BadCo are directly or indirectly owned by the same parent holding companies that once owned AceCo.

As part of the divisional merger, GoodCo receives 99% of AceCo’s assets and all of AceCo’s non-tort liabilities. BadCo receives 1% of AceCo’s assets and *all* of AceCo’s tort liabilities. BadCo has no employees or business operations. Apart from BadCo’s officers and board members, who are also employees of GoodCo or its parent companies, a bare-bones in-house legal team is loaned or seconded to BadCo to manage the pending tort litigation against BadCo (as successor in interest to AceCo) until BadCo files for bankruptcy.

At the same time, to cast a veneer of supposed legitimacy on this scheme, GoodCo and BadCo enter into a “funding agreement” whereby GoodCo promises to provide funds to BadCo, if needed, during BadCo’s remaining few weeks in the tort system and in the bankruptcy. But the so-called “funding agreement” is illusory, providing control to GoodCo and numerous opportunities to use it to GoodCo’s advantage.

After spending only a few hours as Texas entities to complete the divisional merger, GoodCo promptly converts itself from a Texas company back to a Delaware company—just as AceCo was—and BadCo converts itself from a Texas company to a North Carolina company in order to establish a bankruptcy venue in the Western District of North Carolina.

Within a matter of days, BadCo files for chapter 11 bankruptcy with the U.S. Bankruptcy Court for the Western District of North Carolina. As a result of the chapter 11 filing, all tort suits and collection actions by tort claimants against BadCo are automatically stayed.¹³ Thereafter, the bankruptcy court overseeing BadCo’s chapter 11 case grants a preliminary injunction and/or rules that the automatic stay indefinitely enjoins tort claimants from suing GoodCo and all of its nonbankrupt affiliates on account of AceCo’s tort liabilities as well.

While sitting outside chapter 11 but protected by a bankruptcy stay, GoodCo continues to run the same businesses that AceCo once did, manufacture the same products that AceCo once did, and sell to the same customers that AceCo once did. (GoodCo even adopts AceCo’s name, but, for purpose of clarity here, I will continue to refer to GoodCo as “GoodCo.”) GoodCo pays its (non-tort) creditors, the former vendors and suppliers of AceCo, in the ordinary course of business. And, as AceCo once did, GoodCo regularly distributes its substantial earnings to its direct and indirect parent companies. For non-tort creditors, shareholders, employees and other stakeholders in GoodCo, which is now doing business as “AceCo,” nothing has changed with the divisional merger and follow-on bankruptcy; everything is still “business as usual.”

¹³ See 11 U.S.C. § 362(a).

By contrast, everything has changed for the tort creditors as a result of the divisional merger and follow-on bankruptcy filing. Beforehand, tort creditors had direct recourse against AceCo; they could fix judgment liens against AceCo's assets if they prevailed in litigation against AceCo. As a result of the Texas Two-Step, however, the recourse of tort creditors is limited to BadCo, which is only a very stripped-down version of AceCo. GoodCo touts the funding agreement as providing recourse that is equivalent to what tort creditors had against AceCo, but that is not the case. Such a contract is not equivalent to the cash and assets that have been stripped away. Moreover, the tort creditors are not parties to the funding agreement, and the agreement itself expressly excludes them as third-party beneficiaries. Accordingly, tort creditors likely cannot even sue GoodCo to enforce its obligations under the funding agreement; those creditors must instead rely on BadCo to do so. But BadCo is controlled by GoodCo and its affiliates.

Impact of the Divisional Merger on Chapter 11 Proceedings

With bankruptcy stays in place shielding BadCo's entire enterprise group—*i.e.*, BadCo, GoodCo, and their affiliates—GoodCo and the affiliates enjoy a principal benefit of bankruptcy without actually being in bankruptcy, *i.e.*, an indefinite, nationwide stay of tort claims. But GoodCo and its affiliates are also free of the obligations normally required of a chapter 11 debtor—obligations that constitute essential creditor protections, to wit:

- GoodCo is not required to file schedules of its assets and liabilities, a statement of financial affairs, and monthly operating reports, thereby foreclosing any transparency regarding GoodCo's financial condition or what it is doing with the money that is supposedly available to pay its tort victims.
- GoodCo can layer on debt that is senior in priority to its obligations under the funding agreement and can engage in transactions outside the ordinary course of business, including transferring its entire value, without any notice to tort creditors and without first obtaining the bankruptcy court's approval.
- GoodCo can continue to pay its non-tort creditors in the ordinary course of its business and outside of a court-approved chapter 11 plan. By contrast, tort claimants trapped in BadCo's bankruptcy are not treated the same, as they are not getting paid, and it is not clear when, if ever, they will be.
- GoodCo need not respect the "absolute priority rule"; while tort creditors in BadCo's bankruptcy remain uncompensated, GoodCo can distribute its substantial earnings to its direct and indirect parent companies and shareholders, which effectively renders GoodCo "cash-poor" while it is allegedly on the hook to pay BadCo under the funding agreement. And in bankruptcy, all creditors are supposed to be paid before shareholders.

In addition, the funding agreement has been engineered to prevent the tort creditors and their representatives in BadCo's bankruptcy from proposing a competing chapter 11 plan when exclusivity ends, because GoodCo is not obligated to fund a victim compensation trust under the plan unless GoodCo approves of that plan and receives permanent injunctive protection when BadCo exits chapter 11.

As a result, almost all of AceCo's former assets are outside the bankruptcy court's jurisdiction, and GoodCo is not subject to the obligations and creditor protections that are required of a chapter 11 debtor. The normal economic pressures and incentives that motivate corporate debtors to come to the negotiating table in good faith and attempt to quickly achieve a fair bargain with their creditors in the form of a consensual chapter 11 plan do not exist as a result of the Texas Two-Step,¹⁴ nor would a corporation need to resort to the Texas Two-Step if that were its intention.

Moreover, GoodCo thereby evades the quarterly bankruptcy fees that are owed to the U.S. government under 28 U.S.C. § 1930(a)(6) and (7), because such fees are tied to the amount of the assets entering bankruptcy.

Without the normal economic incentives and pressures that encourage a debtor to make a seasonable exit from chapter 11, BadCo can idle in chapter 11 as long as it wants, with little downside due to the stay of tort litigation against its enterprise group, and can thus delay the resolution of its chapter 11 case until the tort creditors knuckle under and agree to a substantial discount on the value or recovery of their claims. This is not a normal chapter 11 process; it is a perversion of that process.

Additionally, the Texas divisional merger law was not intended as a device to disadvantage creditors. Through the use of the Texas Two-Step, the Texas legislature made a conscious decision to include a provision in the Texas Business Organizations Code—section 10.901—that preserves all “rights of . . . creditor[s] under existing laws,” notwithstanding any other provision in that Texas code, including the divisional merger provisions.¹⁵ Moreover, the legislative history of the Texas statute confirms that, even with the divisional merger law in place, “creditors would continue to have the protections provided by the Uniform Fraudulent Transfer Act and other existing statutes that protect the rights of creditors.”¹⁶

Congress Should Address the Divisional Merger Problem with Legislation

Without direct congressional action, there is no assurance that these divisional-merger schemes will stop.¹⁷ Since the first one was filed in 2017, the number of such cases has snowballed. A total of five divisional-merger schemes have now been implemented, and have led to chapter 11 cases that all remain pending. This state of affairs has saved those wealthy corporations many

¹⁴ For example, GoodCo need not assure lenders and bondholders that it will move through the chapter 11 process speedily and need not take steps to assure suppliers and vendors that it will abide by the previous payment terms for post-filing trade debt.

¹⁵ TEX. BUS. ORGS. CODE § 10.901.

¹⁶ CHRISTOPHER J. BABCOCK & KEVIN A. CHUMNEY, *H.B. 472. Bill Analysis of H.B. 472 of the 71st Legislature (1989)* § 26, in O'CONNOR'S BUSINESS ORGANIZATIONS CODE PLUS.

¹⁷ Fraudulent transfer actions and similar claims take a long time to pursue, are fact-intensive, require extensive discovery, and there could be no assurance that such claims will ultimately be successful. See *Double Eagle Club, Inc. v. Genovese*, No. CV 117-073, 2019 WL 2151367, at *2 (S.D. Ga. Apr. 4, 2019) (the “fact intensive” fraudulent transfer analysis “require[s] broad and deep discovery” on multiple factors); *In re Soup Kitchen Int'l Inc.*, 506 B.R. 29, 43 (Bankr. E.D.N.Y. 2014) (approving settlement and avoiding the “strong likelihood of complex, protracted, and expensive litigation” posed by rejecting settlement and requiring parties to litigate fraudulent transfer action); *Sec. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 480 B.R. 501, 521 (Bankr. S.D.N.Y. 2012) (noting the inevitability of “protracted, expensive litigation” if creditors were required to bring avoidance action to recover fraudulent transfers).

millions of dollars, while leaving their mass-tort victims out in the cold. As a result, more divisional-merger schemes are likely underway, which will lead to more abusive chapter 11 filings. The Texas Two-Step is a clear and obvious abuse of the bankruptcy process.

While a comprehensive analysis of all of the potential legislative fixes are beyond the scope of my testimony here today, there are a number of alternatives that Congress can consider. For example, Congress could limit the duration of a bankruptcy court's stay or injunction of litigation against the debtor's nonbankrupt affiliates to no more than 60 days, to incentivize the "BadCo" and "GoodCo" entities to begin good-faith negotiations with their disfavored creditors in earnest, and to limit the harm to the innocent tort victims. Congress could also amend the Bankruptcy Code to provide for the dismissal of any chapter 11 case that was preceded by a divisional merger, which would likely deter the Texas Two-Step from occurring in the first place. The critical point is that Congress should act now to provide much-needed reform and protection for creditors in this area and to clarify and reaffirm the essential debtor-creditor balance that it crafted 43 years ago.

APPENDIX: DIVISIONAL-MERGER CASE STUDIES**I. GEORGIA-PACIFIC**

Georgia-Pacific LLC (“GP”) is a high-value company. When Koch Industries acquired GP in 2005, the acquisition was valued at \$21 billion.¹⁸ GP and its affiliates were a multibillion-dollar enterprise behind several major paper product brands.¹⁹ GP also had substantial asbestos liabilities associated with some of its products.²⁰

In 2017, GP converted from a Delaware company to a Texas company.²¹ As a Texas company, GP made use of the Texas divisional merger law and separated into two new entities: one with limited assets and the other with most of the remaining assets of “old” GP.²² The company with limited assets became Bestwall LLC (“Bestwall”), holding approximately \$175 million in assets as well as *all* of GP’s asbestos liabilities,²³ which is estimated to be in the billions of dollars.²⁴ The entity that received almost all of “old” GP’s assets retained GP’s name (*i.e.*, Georgia-Pacific LLC). Within a matter of hours after the divisional merger was implemented, GP converted back to a Delaware company, and Bestwall converted to a North Carolina company.²⁵

As part of the divisional merger, “new” GP and Bestwall entered into a funding agreement whereby GP promised to provide funds to Bestwall, if necessary, including funds necessary for a chapter 11 reorganization.²⁶ Among other problematic features of this transaction, no collateral is securing GP’s obligation to pay Bestwall under the funding agreement.²⁷ And the funding agreement does not preclude GP from transferring substantially all of its assets or otherwise disposing of its valuable business.²⁸

Less than four months later, Bestwall filed its chapter 11 petition with the U.S. Bankruptcy Court for the Western District of North Carolina.²⁹ As a result of the filing, asbestos lawsuits and other creditor actions against Bestwall were automatically stayed. The same day, Bestwall moved to enjoin asbestos lawsuits against affiliates that did not file for bankruptcy, including GP. Over the objection of the asbestos claimants’ representatives, the bankruptcy court granted the injunctive

¹⁸ Koch’s Philosophy of Philanthropy, <https://news.kochind.com/CMSPages/GetFile.aspx?guid=4c2feb6b-6a22-4df2-97c8-984f611c9e4b> (last visited Feb. 2, 2022).

¹⁹ *Id.*; see Declaration of Tyler L. Woolson in Support of First Day Pleadings ¶ 13, *In re Bestwall LLC*, No. 17-31795 (Bankr. W.D.N.C. Nov. 2, 2017), ECF No. 2 (“Woolson Decl.”).

²⁰ See Woolson Decl. ¶¶ 26-29.

²¹ See *id.* ¶ 17 (explaining steps of GP’s divisional merger).

²² See *id.* ¶¶ 17-18.

²³ See *id.* ¶ 18.

²⁴ See Brief of Appellant Official Committee of Asbestos Claimants of Bestwall LLC, at 3, 9, *In re Bestwall LLC*, No. 3:20-cv-00103 (W.D.N.C. Apr. 15, 2020), ECF No. 6.

²⁵ See *id.* ¶ 17.

²⁶ See Woolson Decl. ¶ 20.

²⁷ See generally *id.* annex 2 (Second Amended and Restated Funding Agreement).

²⁸ See *id.* ¶ 4(b)(i).

²⁹ GP’s divisional merger was executed on July 21, 2017, and Bestwall filed chapter 11 on November 2, 2017. See Woolson Decl. ¶¶ 5, 17.

relief and three years later the district court affirmed.³⁰ On August 15, 2018, a motion to dismiss the bankruptcy was filed, but was later denied by the bankruptcy court. To this day, the nearly five-year long injunction shielding GP and other nonbankrupt affiliates remains in place.

³⁰ See *In re Bestwall LLC*, 606 B.R. 243 (Bankr. W.D.N.C. 2019), *aff'd*, No. 3:20-CV-105-RJC, 2022 WL 68763 (W.D.N.C. Jan. 6, 2022).

II. CERTAINTEED

CertainTeed Corporation (“CertainTeed”) was part of a large, multinational, and multibillion-dollar building products conglomerate, and it faced significant legacy tort liabilities to individuals harmed by its asbestos-containing products.³¹ CertainTeed had spent billions of dollars to defend and resolve the hundreds of thousands of asbestos lawsuits filed against it over the past 20 years.³²

To address its legacy asbestos liabilities and prepare the way for a chapter 11 filing, CertainTeed engaged in a divisional merger under Texas law in October 2019.³³ CertainTeed first converted from a Delaware corporation to a Delaware limited liability company known as CertainTeed LLC (“CT”). The next day, CT converted from a Delaware limited liability company to a Texas limited liability company. A half-hour later, CT engaged in the divisional merger, effectively splitting itself into two Texas limited liability companies: “new” CT and DBMP LLC (“DBMP”). In connection with the divisional merger, “new” CT received 97% of “old” CT’s assets, while the remaining 3% of old CT’s assets were allocated to DBMP.³⁴ DBMP also received all of “old” CT’s asbestos liabilities.³⁵ “New” CT converted to a Delaware limited liability company, and DBMP converted to a North Carolina limited liability company. All told, CT and DBMP were Texas entities for less than four hours.³⁶

As part of the divisional merger, “new” CT and DBMP entered into a “funding agreement” whereby CT promised to provide funds to DBMP, if necessary, including funds necessary for DBMP’s eventual chapter 11 case.³⁷ Among other problematic features of this transaction, no collateral secured CT’s obligation to pay DBMP under the funding agreement.³⁸ And the funding agreement did not preclude CT from transferring substantially all of its assets or otherwise disposing of its valuable business.³⁹

Ninety-one days after completion of CT’s divisional merger, DBMP filed its chapter 11 petition with the U.S. Bankruptcy Court for the Western District of North Carolina.⁴⁰ As a result of the filing, asbestos lawsuits and other creditor actions against DBMP were automatically stayed. The same day, DBMP moved to enjoin asbestos lawsuits against affiliates and distributors that did

³¹ See *In re DBMP LLC*, No. 20-30080, 2021 WL 3552350, at *5-6 (Bankr. W.D.N.C. Aug. 11, 2021).

³² *Id.* at *6.

³³ See *id.* at *8, *17.

³⁴ *Id.* at *9.

³⁵ *Id.*

³⁶ The bankruptcy court’s findings of fact regarding the steps of CertainTeed’s divisional merger can be found at *DBMP LLC*, 2021 WL 3552350, at *8-10.

³⁷ See *id.* at *9, *11.

³⁸ See *id.* at *11-12.

³⁹ *Id.* at *12.

⁴⁰ *Id.* at *15.

not file for bankruptcy, including CT.⁴¹ Over the objection of the asbestos claimants' representatives, the bankruptcy court "extended" the automatic stay and granted injunctive relief.⁴²

The court did, however, note the following:

- "Old CertainTeed never entertained a bankruptcy filing for itself and all of its subsidiaries and affiliates (the "CertainTeed Enterprise"). This was a profitable going concern whose assets significantly outweighed its combined operating and asbestos liabilities."⁴³
- "Old CertainTeed took advantage of a corporate restructuring procedure under Texas law to put all of its asbestos liabilities into one company, DBMP, and virtually all of its assets and all of its non-asbestos liabilities, into another, New CertainTeed. The Debtor's own documents describe the procedure as the '[s]plitting of CertainTeed legal entity . . . (Carving out two locations to isolate Asbestos liability).'"⁴⁴
- "In sum, while the Funding Agreement may provide funding for a plan, it will do so only if New CertainTeed favors that Plan. And that favor is dependent on New CertainTeed receiving permanent injunctive relief from the DBMP Asbestos Claims—whether it is entitled to it or not."⁴⁵

To this day, the injunction shielding CT and its other nonbankrupt affiliates remains in place.

⁴¹ *Id.* at *1.

⁴² *See id.* at *1, *43.

⁴³ *DBMP LLC*, 2021 WL 3552350, at *8.

⁴⁴ *Id.* (alteration in original).

⁴⁵ *Id.* at *12.

III. INGERSOLL-RAND AND TRANE U.S.

Along with their affiliates and subsidiaries, Ingersoll-Rand Company (“IR”) and Trane U.S., Inc. (“Trane”) were global manufacturers of climate control products for buildings, homes, and transportation and were indirectly owned by the same parent holding company, Ingersoll-Rand plc, now known as Trane Technologies plc.⁴⁶ While IR and Trane were successful companies, holding billions of dollars of assets, they also faced significant asbestos liabilities arising from exposures to their asbestos-containing products.⁴⁷ To address those liabilities and prepare the way to put their asbestos liabilities into a chapter 11 bankruptcy without subjecting the vast majority of their assets to the jurisdiction of the bankruptcy court, IR and Trane each engaged in divisional mergers under Texas law.⁴⁸

A. IR’s Divisional Merger

IR first merged with and into a shell Texas limited liability company that had been formed the previous day. That same day, IR effected its divisional merger under Texas law, effectively dividing into two new Texas limited liability companies: Trane Technologies Company LLC (“TTC”) and Aldrich Pump LLC (“Aldrich”). TTC received 99% of old IR’s assets, while the remaining 1% of IR’s assets were allocated to Aldrich.⁴⁹ Aldrich was also assigned all of IR’s asbestos liabilities. Later that day, TTC converted to a Delaware limited liability company, and Aldrich converted to a North Carolina limited liability company. All told, TTC and Aldrich were Texas companies for less than 24 hours.⁵⁰

B. Trane’s Divisional Merger

While IR was undergoing its divisional merger, Trane was doing the same. Trane first converted from a Delaware corporation to a Texas corporation. That same day, Trane effected its Texas divisional merger, effectively splitting into two Texas entities: “new” Trane and Murray Boiler LLC (“Murray”). “New” Trane received 98% of “old” Trane’s assets, while the remaining 2% of those assets were allocated to Murray.⁵¹ Murray also received all of Trane’s asbestos liabilities. Later that day, “new” Trane converted to a Delaware corporation, and Murray converted to a North Carolina limited liability company. All told, Trane and Murray were Texas entities for less than 24 hours.⁵²

⁴⁶ *In re Aldrich Pump LLC*, No. 20-30608 (JCW), 2021 WL 3729335, at *1, *4 (Bankr. W.D.N.C. Aug. 23, 2021).

⁴⁷ *See id.* at *6, *22.

⁴⁸ *Id.* at *9.

⁴⁹ *Id.* at *10.

⁵⁰ The bankruptcy court’s findings of fact regarding the steps of IR’s divisional merger can be found *In re Aldrich Pump LLC*, 2021 WL 3729335, at *10.

⁵¹ *Id.* at *11.

⁵² The bankruptcy court’s findings of fact regarding the steps of Trane’s divisional merger can be found *In re Aldrich Pump LLC*, 2021 WL 3729335, at *10-11.

C. Funding Agreements

As in the previous divisional mergers involving Bestwall and DBMP, Aldrich and Murray entered into separate funding agreements with TTC and Trane, respectively. Under the Aldrich-TTC funding agreement, TTC promised to provide funds to Aldrich, if necessary, including funds necessary for Aldrich's eventual chapter 11 case.⁵³ Similarly, under the Murray-Trane funding agreement, Trane promised to provide funds to Murray, if necessary, including funds necessary for Murray's eventual chapter 11 case.⁵⁴ As with the funding agreements used in the *Bestwall* and *DBMP* bankruptcies, the funding agreements for Aldrich and Murray contained several problematic features. For example, TTC's and Trane's respective funding obligations were not secured by any collateral, nor were they guaranteed by any other entity.⁵⁵ And the funding agreements did not prevent TTC and Trane from engaging in additional divisional mergers, and they explicitly allowed TTC and Trane to engage in consolidations and mergers, and to transfer all or substantially all of their assets to third-parties.⁵⁶ What is more, the funding agreements contained provisions that impair, if not effectively disable, the ability and right of other parties-in-interest to propose a competing chapter 11 plan once Aldrich's and Murray's exclusive right to propose a plan terminates.⁵⁷

D. Chapter 11 Filings of Aldrich and Murray

Seven weeks after completing their respective divisional mergers, Aldrich and Murray filed their chapter 11 petitions with the U.S. Bankruptcy Court for the Western District of North Carolina and moved to enjoin asbestos lawsuits against affiliates (including TTC and Trane), insurers, and third parties, all of which had not filed for bankruptcy.⁵⁸ Over the objection of the current asbestos claimants' representatives, the bankruptcy court "extended" the automatic stay and granted injunctive relief.⁵⁹

The court did, however, note the following:

- "*Old IRNJ and Old Trane never entertained a bankruptcy filing for themselves and all of their subsidiaries and affiliates* (the "Trane Enterprise"). This was a profitable going concern whose assets significantly outweighed its combined operating and asbestos liabilities."⁶⁰
- "Meanwhile, Project Omega team members expected and planned for a long-term bankruptcy prior to the 2020 Corporate Restructuring, which they estimated would last for five or more years."⁶¹

⁵³ *Id.* at *12.

⁵⁴ *Id.*

⁵⁵ *Id.* at *14.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.* at *1.

⁵⁹ *In re Aldrich Pump LLC*, 2021 WL 3729335, at *2, *38.

⁶⁰ *Id.* at *8-9 (emphasis added).

⁶¹ *Id.* at *9.

- “The 2020 Corporate Restructuring and the Divisional merger were undertaken so that the Trane Enterprise might obtain the injunctive benefits of an asbestos bankruptcy plan and trust without filing themselves.”⁶²
- “Rather, *these bankruptcies were designed to isolate the asbestos claimants* from the overall corporate enterprise *and strand them in bankruptcy* until such time as they agree to a Section 524(g) plan.”⁶³

To this day, the injunction shielding TTC, Trane, and their other nonbankrupt affiliates remains in place.

⁶² *Id.* at *21.

⁶³ *Id.* (emphasis added).

IV. JOHNSON & JOHNSON

Johnson & Johnson Consumer Companies, Inc. (“J&J Consumer”) was part of the Johnson & Johnson enterprise group. In 2021, *Fortune* magazine noted Johnson & Johnson⁶⁴ had a market value of over \$434 billion.⁶⁵

J&J Consumer, a New Jersey company, manufactured and sold a wide variety of consumer health products.⁶⁶ J&J Consumer also faced mounting tort liabilities arising from its baby powder and cosmetic talc products.⁶⁷ As of October 2021, J&J Consumer had been named as a defendant in tens of thousands of lawsuits, including multidistrict litigation pending in the U.S. District Court for the District of New Jersey.⁶⁸

In October 2021, J&J Consumer engaged in a divisional merger under Texas law.⁶⁹ To utilize the Texas divisional merger law, J&J Consumer converted to a Texas limited liability company. J&J Consumer then effectively divided itself into two new companies: Chenango One LLC (“Chenango One”) and Chenango Two LLC (“Chenango Two”). Chenango One received assets and holdings valued at approximately \$373 million, while also receiving the entirety of J&J Consumer’s tort liabilities, estimated to be in the billions of dollars.⁷⁰ That same day, Chenango One converted to a North Carolina company and changed its name to LTL Management LLC (“LTL”).

Chenango Two, on the other hand, received all of J&J Consumer’s remaining assets (worth approximately \$15 billion) and other liabilities.⁷¹ Later that day, Chenango Two merged with and into a New Jersey entity formed the previous day, and the surviving merged entity changed its name to Johnson and Johnson Consumer Inc. (“new J&J Consumer”). New J&J Consumer is the direct parent of LTL and manufactures and sells the same broad range of products used in the baby care, beauty, and consumer health care fields as the former J&J Consumer.

As with the other entities that previously engaged in Texas divisional mergers, new J&J Consumer and LTL entered into an unsecured funding agreement that purports to provide LTL with certain funds (if necessary), including funds necessary for LTL’s chapter 11 case.⁷²

⁶⁴ Johnson & Johnson is the New Jersey company incorporated in 1887 that was the ultimate parent of J&J Consumer.

⁶⁵ <https://fortune.com/company/johnson-johnson/worlds-most-admired-companies/> (last visited Feb. 2, 2022). Indeed, Johnson & Johnson is one of only two U.S. companies with a AAA credit rating, which is higher than the credit rating of the U.S. government. See <https://www.thestreet.com/markets/johnson-johnson-break-up-may-put-triple-a-credit-rating-at-risk> (last visited Feb. 2, 2022).

⁶⁶ See Declaration of John K. Kim in Support of First Day Pleadings ¶ 19, *In re LTL Mgmt. LLC*, No. 21-30589 (Bankr. D.N.J. Oct. 14, 2021), ECF No. 5 (“Kim Decl.”).

⁶⁷ *Id.* ¶ 31.

⁶⁸ *Id.* ¶ 42.

⁶⁹ See *id.* ¶¶ 22-23 (explaining steps of J&J Consumer’s divisional merger).

⁷⁰ See *id.* ¶¶ 26, 28.

⁷¹ *Id.* ¶ 25; see Exhibit E to the Debtor’s Objection to Motions to Dismiss Chapter 11 Case, *In re LTL Mgmt. LLC*, No. 21-30589 (Bankr. D.N.J. Dec. 22, 2021), ECF No. 956-6.

⁷² See Kim Decl. ¶ 27; see also generally *id.* at Annex 2 (Amended and Restated Funding Agreement).

Two days after its formation, LTL filed its chapter 11 petition with the U.S. Bankruptcy Court for the Western District of North Carolina.⁷³ Shortly thereafter, LTL sought to stay tort litigation against its affiliates that did not file for bankruptcy, including new J&J Consumer.⁷⁴ The North Carolina bankruptcy court granted the stay for a brief period in light of the fact that it had ordered LTL's chapter 11 case to be transferred to the U.S. Bankruptcy Court for the District of New Jersey.⁷⁵ The merits of LTL's efforts to extend the litigation stay to its non-debtor affiliates remain pending in a New Jersey bankruptcy court, though the court recently extended the temporary stay to February 28, 2022, while a motion to dismiss that bankruptcy remains pending.⁷⁶

In its order transferring venue to the District of New Jersey, the North Carolina bankruptcy court noted that LTL "may have assets, but they were all created to effectuate a bankruptcy filing and have *no other business purpose*."⁷⁷

⁷³ J&J Consumer's divisional merger was implemented on October 12, 2021, and LTL filed chapter 11 on October 14, 2021. See Kim Decl. ¶¶ 5, 23.

⁷⁴ LTL filed its complaint on October 21, 2021. See Debtor's Complaint for Declaratory and Injunctive Relief (I) Declaring that the Automatic Stay Applies to Certain Actions Against Non-Debtors or, (II) Preliminarily Enjoining Such Actions and (III) Granting a Temporary Restraining Order Pending a Final Hearing, *LTL Mgmt. LLC v. Those Parties Listed on Appendix A to Complaint*, Adv. Pro. No. 21-03032-MBK (Bankr. D.N.J. Oct. 21, 2021), ECF No. 1.

⁷⁵ See Order Granting the Debtor's Request for Preliminary Injunction, *LTL Mgmt. LLC v. Those Parties Listed on Appendix A to Complaint*, Adv. Pro. No. 21-03032-MBK (Bankr. D.N.J. Nov. 15, 2021), ECF No. 102.

⁷⁶ See Bridge Order Extending Termination Date of Order Granting the Debtor's Request for Preliminary Injunctive Relief, *LTL Mgmt. LLC v. Those Parties Listed on Appendix A to Complaint*, Adv. Pro. No. 21-03032-MBK (Bankr. D.N.J. Jan. 15, 2022), ECF No. 157.

⁷⁷ *In re LTL Mgmt. LLC*, No. 21-30589, 2021 WL 5343945, at *6 (Bankr. W.D.N.C. Nov. 16, 2021) (emphasis added).

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**Written Testimony of
Kimberly A. Naranjo**

Before the Committee on the Judiciary

Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights

United States Senate

**“Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through
Bankruptcy”**

February 8th, 2022

Chairman Whitehouse, Ranking Member Kennedy, Members of the Subcommittee, my name is Kimberly Naranjo, and I'm here to ask for your help in preserving my constitutional right and the rights of so many others to pursue accountability in our courts.

I have been diagnosed with mesothelioma, which is a terminal cancer that is only caused by one thing – exposure to asbestos. I was given 12-16 months of life which puts my expiration date at March of 2023, 1 month before my 50th birthday. I am a single mother, with 2 of my 7 children still under the age of 18, Angelica, my 14-year-old daughter who has been diagnosed with autism and Jayce, my son who is 9. I would like to share my story with you.

I was born into dysfunction. My biological mother was deep in her disease of addiction, and I experienced horrific abuse. I was in and out of foster care, passed around from family members, and on my own since age 15.

As a result of the trauma and abuse I experienced during my early years, family, being a good mother, and having stability was all I dreamed about. At the age of 19, I became pregnant with my oldest daughter Maria and gave birth to four additional daughters, Adrianna, Monaliza, Faviola, and Karina over the next 6 years. I wanted to be a good mom, something that I didn't have until my Aunt Cathy who never gave up on me, took me in, and later adopted me as an adult. She has supported me my whole life and is here supporting me today. All the good morals and values I possess were instilled by her.

Although I did my best at being a good mother, the unhealthy behavior patterns that I had been exposed to in my early years started to manifest in my life. I needed to do something to stop the cycle. My adopted mom permanently took over caring for my children, and I attended a residential treatment program where I lived for 13 months. I am proud to say that next month I will celebrate 15 years of sobriety.

After completing treatment, I gained enough skills to become a productive member of society. I decided that I wanted to get an education and dedicate the rest of my life to helping others overcome hardships. I graduated with highest honors with my Associate's Degree in Alcohol and Drug Counseling. I started working as an addiction counselor. I have dedicated the last 7 years of my life helping and advocating for others. I didn't want to stop there; I continued my education at BYU- Idaho working towards a Bachelor's Degree in Marriage and Family Studies. My goal was to get my Master's Degree in Social Work.

I have worked really hard to break the cycle for my children who I am blessed to have a wonderful relationship with today. Since my disease of addiction has been in remission, I have been an active and supporting participant in all their lives.

Throughout my life I have never lived in one residence longer than two years, and I wanted that to change. Last year, I purchased my first home, my forever home. I was also hired at my dream job, working for the Salt Lake County Sheriff's Office as an addiction counselor.

Three days into working at the Sherriff's Department, I felt a pain in my side. The next week I was diagnosed with mesothelioma. It all happened so fast. One week I was enjoying my forever home, eating with my mom and children, and playing with my grandsons. The next week I was I was given an aggressive treatment plan in hopes to extend my life by a few months.

Unfortunately, I was no longer able to work. With no income, I was unable to pay my mortgage and forced to sell my forever home. I then had to sit down with my children and grandchildren to let them know that I am going to be leaving my body. That was a really hard day. My oldest daughter Maria is 28 years old and a single mother. She is going to raise my two youngest children after my death.

After spending hours going over every place I've ever lived or worked, it was determined that the only way I was exposed to asbestos was from Johnson and Johnson's Baby Powder. Instead of

protecting my children as advertised by Johnson and Johnson, I had no idea I was exposing them and myself to the deadly asbestos inside that white plastic bottle I associated with motherly love.

When I learned that I could file a lawsuit and have it decided by a jury, I saw a path forward for my family. There was a way that my children could be taken care of, monetarily, as if I lived. I was less scared knowing that even though I can't control the fact that I am dying, I could use my constitutional right and be heard in a court of law. I knew that justice would take care of my family. I was filled with hope. That hope was also taken from me.

I learned that Johnson and Johnson filed for bankruptcy and that I would not receive a court date. I didn't understand. Johnson and Johnson is a really big and thriving company. How could they be bankrupt? I learned that Johnson and Johnson took advantage of a loophole, where they made a new company and put all their responsibilities related to Johnson and Johnson's Baby Powder into that company, then filed bankruptcy, and now everything has stopped, except for the progression of my cancer.

I have accepted the fact that I do not have much time left. I even held a living memorial where I gave all my friends an opportunity to say goodbye. I made parting gifts. When I graduated from residential treatment for my addiction, I was given a large, framed poem titled "Do Not Quit". This has been my motto. I took a picture of me standing next to the poem and pointing to the title. I made wallet sized copies, put it in a mesh bag along with a little guardian angel key chain and handed them out to everyone who came to celebrate my life with me.

I don't have much time left, but I will not quit. Even though I am in pain every day I get up and do my best to make a difference in the world. I have even made myself a sticker chore chart, giving myself a star for taking a shower, walking my son to the bus stop, and cooking. I will not quit, no matter how tough this gets. It took every ounce of strength for me to be here before you today, but I am here today

because I am a voice for the thousands of people that Johnson & Johnson harmed, and we have a right to be heard. I am so grateful that you have listened to me, I wish that Johnson and Johnson would listen too, but they took away that right from me and thousands of other people who have their own stories, families, and lives that also deserve a right to be heard by a jury.

Thank you again for your time and attention, I am truly grateful.

Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Federal Courts, Oversight, Agency Action and Federal Rights

Senate Committee on the Judiciary

United States Senate

February 8, 2022

Thank you for the opportunity to testify about “Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy.” It is a great honor to appear before you, and to provide this written testimony.¹

I should start by noting that this testimony reflects my own views, not the views of the University of Pennsylvania Carey Law School, where I work, or of the Financial Oversight & Management Board for Puerto Rico, which I currently chair.

The issue we’re focusing on today—the potential abuse of so-called Texas Two-Step transactions and other divisive mergers—is one of the principal reasons for a growing backlash against perceived abuses in the Chapter 11 reorganization process. I have written about some of the other controversial practices in detail elsewhere and will refer to those practices in a footnote below.²

The term “divisive” or “divisional” merger is an oxymoron. A merger ordinarily combines two firms, with one or the other emerging as the “surviving” firm. In a divisive merger, by contrast, a firm tears itself asunder, separating its assets and/or liabilities into two entities. In the controversial recent Johnson & Johnson divisive merger, for instance, Johnson & Johnson put its talc liabilities into a new entity called LTL. Shortly after this transaction, LTL filed for bankruptcy, seeking to resolve the talc liability in bankruptcy. This strategy—effecting a divisional merger under the Texas statute and then putting the new entity in bankruptcy, has become known as the “Texas Two-Step.”

Texas Two-Step transactions are part of a larger pattern of transferring assets or liabilities from one corporate entity to another in a way that potentially disadvantages creditors of the original entity. In Johnson & Johnson’s case, talc claimants were shunted off to a separate entity

¹ I am grateful to Caroline Nowlin and David Wreesman, both University of Pennsylvania Carey Law School class of 2022, for providing excellent research for this testimony on very short notice.

² Other controversial practices include third party releases, forum shopping by corporate debtors, payment of bonuses to managers before or after filing for bankruptcy, and “equitable mootness.” For discussion, see David Skeel, *The populist backlash in Chapter 11*, ECONOMIC STUDIES AT BROOKINGS, Jan. 10, 2022.

with essentially no assets of its own. The new entity, LTL, is the passive recipient of funds from Johnson & Johnson and the entity that retained the assets (now called Johnson & Johnson Consumer Inc., or New JJCI) as expenses are incurred or victims obtain judgments.

Texas's divisive merger statute was not created with bankruptcy in mind. Texas lawmakers introduced it in 1989, hoping to add flexibility to corporate transactions.³ Its potential use to shift liabilities to a separate entity and then address those liabilities in bankruptcy seems to have been discovered roughly five years ago by companies with mass tort liability.⁴ The opportunity for abuse—and for undercutting the rights of victims and other creditors—is obvious.

Bankruptcy law offers at least two major mechanisms for policing potential abuses. The first is to ask the court to dismiss the case as having been filed in bad faith or because the case is not suitable for Chapter 11. The J&J case has been challenged on these grounds—victims argue that LTL has essentially no assets of its own other than the funding agreement, that it was created simply for the purpose of capping Johnson & Johnson's talc liability, and thus it not the kind of enterprise Chapter 11 is designed to restructure.

The second response is fraudulent conveyance law, which comes into play if the case is not dismissed at the outset. When a transaction is intended to defraud creditors (known as “actual fraud”) or assets are transferred or liabilities incurred for less than “reasonably equivalent value” (constructive fraud), the transaction can be challenged as a fraudulent conveyance and its harm undone by reversing (“avoiding”) the transaction.

Legislation recently introduced in the United States House would take a much more sweeping approach.⁵ The legislation would amend bankruptcy law to require dismissal of any divisive merger that “had the intent of foreseeable effect of . . . separating material assets from material liabilities . . . and . . . assigning all or a substantial portion of those liabilities to the debtor.”⁶ This language would essentially bar the doors to bankruptcy for divisive mergers.

If divisive mergers pose a serious risk of abuse—and I believe they do—the question is whether the best solution is to rely on bankruptcy's existing remedies, or to amend the Bankruptcy Code to intervene more directly.

The current remedies are not perfect. Courts are generally reluctant to dismiss cases as filed in bad faith in the absence of egregious behavior. Fraudulent conveyance actions face legal and practical obstacles in some contexts. Texas's divisive merger statute adds to these obstacles by explicitly stating that the divisive merger does not constitute a “transfer,” which is the

³ See H.B. 472, Bill Analysis of H.B. 472 of the 71st Legislature (1989)(stating that the reforms “introduce options for structuring business combinations that are not available in other jurisdictions and are intended to make the State of Texas a more attractive jurisdiction in which to incorporate”); see also Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109, 114-15 (1989).

⁴ The first appears to have been Bestwall, which filed for bankruptcy in the Western District of North Carolina in 2017.

⁵ H.R. 4777, 117th Cong., 1st Sess. (July 28, 2021). The primary purpose of the proposed legislation is to ban so-called third party releases, but it includes a provision (§ 4) barring divisional mergers.

⁶ *Id.* § 4.

principal basis for a fraudulent conveyance action. Some commentators also worry that venue shopping-- debtors' ability to choose where to file their bankruptcy case—discourages oversight. This concern has been fueled in part by the filing of a series of Texas Two-Step bankruptcy cases in the same, somewhat unlikely location: the Western District of North Carolina.

Despite these concerns, I think the existing remedies are likely to be adequate to the task. Courts can dismiss divisive merger bankruptcies that are clearly abusive, and the obstacles to fraudulent conveyance actions to not appear to preclude intervention. Moreover, the notoriety the cases already have seems to have prompted transfer of the Johnson & Johnson case to New Jersey from its favored venue in North Carolina.

My optimism could be mistaken. Courts may fail to adequately police divisional mergers. If they do, legislative intervention would be warranted. But I do not believe it is currently warranted and I worry that any legislation may have unfortunate unintended consequences.

The remainder of this testimony will discuss these points in slightly more detail. After providing the context and describing the Texas merger statute, I will assess the principal current tools for curbing abuses, as well as the proposed legislation.

The Context

The strategy of shuffling assets and liabilities prior to bankruptcy in ways that can harm the company's current creditors—whether they be tort victims as in the Johnson & Johnson case or financial creditors—is not new, but it seems to have become more prevalent and at times more brazen in recent years. In several of these recent cases, a private equity fund acquired a company—largely using borrowed money-- then moved assets around to the detriment of its creditors before filing for bankruptcy.⁷

Perhaps the most notorious example—if only because it is the subject of a recent book-- was Caesars.⁸ After acquiring the casino enterprise, two private equity funds transferred some of its most valuable casino properties to a new entity that its current creditors did not have an interest in. Although the current creditors might nevertheless have been protected by the parent corporation's guaranty of their obligations, the private equity sponsors took actions that terminated the guaranties. The transactions were challenged as fraudulent conveyances in the Caesars bankruptcy. These challenges were central to the Chapter 11 reorganization that ensued.

⁷ Private equity funds, which previously were called leveraged buyout (LBO) or takeover firms, often buy publicly held companies using borrowed funds, run them for a few years, then take them public again.

⁸ MAX FRUMES & SUJEET INDAP, *THE CAESARS PALACE COUP: HOW A BILLIONAIRE BRAWL OVER THE FAMOUS CASINO EXPOSED THE POWER AND GREED OF WALL STREET* (2021).

In other recent cases, companies have taken advantage of loopholes in loan documents to transfer assets to other entities or to borrow additional funds. Widely discussed examples include Serta and Nine-West.⁹

Texas's divisive merger statute is more than simply a loophole in loan documents. It is a statutory provision that seems to invite abusive behavior.

Texas's Divisive Merger Statute

Dating back to 1989, Texas's divisive merger statute consists of three related provisions in the Texas Business Organizations Code. The central provision is Tex. Bus. Orgs. Code § 1.002(55)(A), which defines the term "merger" to include "the division of a domestic entity into two or more new domestic entities." This provision supplies the basis for a merger whose oxymoronic purpose is "divisive"—intended to divide.

The second provision is Tex. Bus. Orgs. Code § 10.003, which requires that for mergers that result in more than one organization, the "plan of merger" must allocate the property (§ 10.003(1)) and liabilities (§ 10.003(3)) of the original organization(s) to the surviving organizations.

Finally, Tex. Bus. Orgs. Code § 10.008(a)(4) states that newly created entities are not responsible for the liabilities assigned to other newly created entities.

Together, these provisions enable a business to hive off liabilities—with or without assets—to a separate entity. The divisive merger statute gives the company complete flexibility to decide which assets or liabilities to put in which entity. The company theoretically could put all of the liabilities in a new entity without any source of funds for paying them, though most divisive mergers include a funding agreement with the entity that retains the assets.

The Texas House Committee that produced the divisive merger protection signaled that its goal in redefining the concept of a merger in this fashion was to make Texas an attractive jurisdiction for incorporation. The Committee sought to enhance flexibility, with a particular concern for potentially risky farming operations. I am not aware of any evidence that the drafters contemplated that companies would effect divisive mergers as an immediate prelude to bankruptcy. The Texas Two-Step seems to have emerged in the past five years, as companies with mass tort liabilities have created a separate entity for this liability and subsequently put the new entity in bankruptcy.

In a Texas Two-Step transaction, a company shifts its liabilities into a new entity, and the original entity enters into a funding agreement that provides payments to and/or indemnification of the new entity. If the funding agreement were backed by all of the assets of the original entity,

⁹ For discussion of these maneuvers, see, for example, Diane Lourdes Dick, *Hostile Restructurings* (unpublished manuscript, 2021); Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J. FORUM 363 (2021).

the transaction might not leave the victims or other creditors any worse than they were before. If it isn't, the risk that the transaction is abusive from the victims' perspective is far higher.

Johnson & Johnson is a troubling use of the divisive merger statute.¹⁰ Johnson & Johnson effected a divisional merger on October 12, 2021, transferring its talc liabilities to LTL. LTL's only real asset is its funding agreement with Johnson & Johnson and the original entity (now called New JJCI). Under this agreement, LTL can obtain payments from the original entity or Johnson & Johnson. One commentator describes agreements that take this form as "drip financing."¹¹ Just two days after the transaction, Johnson & Johnson put J&L into bankruptcy. The point of the divisive merger seems to have been to separate the talc liabilities from the original entity and from Johnson & Johnson itself, so that they can be resolved in bankruptcy—or, as the victims have put it, quoting internal Johnson & Johnson documents, to "capture the liability in one subsidiary . . . and then basically bankrupt that subsidiary."¹² The new entity was domiciled in North Carolina so that the bankruptcy could be filed in the Western District of North Carolina, as several other cases had been.¹³

Existing Remedies: Bad Faith

Under existing law, victims and other creditors have at least two significant remedies against abusive transactions: alleging bad faith and bringing a fraudulent conveyance challenge.

If a company has engaged in an abusive divisive merger, victims can ask that the bankruptcy case be dismissed. Although bad faith actions rarely succeed under ordinary circumstances when a troubled company files for bankruptcy, courts have dismissed cases where the debtor signaled that bankruptcy was not really necessary. In the best known case in the Third Circuit, the federal court of appeals that provides the governing law for the Johnson & Johnson case, the debtor said it had no need for bankruptcy and had only filed for Chapter 11 to deal with a lawsuit it faced.¹⁴ The court held that this constituted bad faith. In another case, the court dismissed that case because the entity had no real business that needed to be restructured in bankruptcy.¹⁵

With Johnson & Johnson, victims and the victims' committees have asked for the case to be dismissed on bad faith grounds. They argue, among other things, that the purpose of bankruptcy is to maximize the value of a company's assets for the benefit of its creditors and other constituencies. Because J&L has no real assets, they argue, and because the only purpose

¹⁰ Reuters recently ran a lengthy special report on the transaction. Mike Spector & Dan Levine, *Special Report: Inside J&J's secret plan to cap litigation payouts to cancer victims*, REUTERS, Feb. 4, 2022.

¹¹ Samir D. Parikh, *Mass Exploitation*, 170 U. PA. L. REV. ONLINE 53, 71 (2022).

¹² Arnold & Itkin Reply in Support of Motion to Dismiss Bankruptcy Case, In re LTL Management LLC, Case No. 21-30589 (MBK)(Bankr. D.N.J. Feb. 2, 2022), at 22.

¹³ See In re Bestwall LLC, 606 B.R. 243 (Bankr. W.D.N.C. 2019), aff'd, No. 3:20-CV-105-RJC, 2022 WL 68763 (W.D.N.C. Jan. 6, 2022); In re DBMP LLC, No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021); In re Aldrich Pump LLC, No. 20-30608 (JCW), 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021).

¹⁴ Official Comm. of Unsecured Creditors v. Nucor Corp. (In re SGL Carbon Corp.), 200 F.3d 154 (3d Cir. 1999).

¹⁵ NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.), 384 F.3d 108 (3d Cir. 2004).

for creating LTL was to cap and contain Johnson & Johnson's talc liabilities, the case does not belong in bankruptcy.

One limitation of dismissal is that it would not undo the effects of the divisive merger. The assets would still be separate from the original entity.¹⁶ Dismissal would prevent bankruptcy from being used to reduce the liabilities, however, and the victims could invoke any rights they had against the original entity or other related entities, including fraudulent conveyance actions under state law.

Existing Remedies: Fraudulent Conveyance

Assuming a divisive merger bankruptcy is not dismissed, the victims can challenge the transaction as a fraudulent conveyance. Fraudulent conveyance law can be used to reverse prebankruptcy transactions that are intended to defraud creditors ("actual fraudulent conveyances")¹⁷ or for which an insolvent debtor did not receive "reasonably equivalent value" ("constructive fraudulent conveyances").¹⁸ The Bankruptcy Code includes a federal fraudulent conveyance provision (§ 548) and nearly every state has very similar state law fraudulent conveyance provisions.¹⁹

With an abusive divisive merger, victims can argue the transaction was deliberately intended to harm creditors' interests, or that the entity to which the liabilities were assigned did not receive reasonably equivalent consideration for assuming the liabilities.

The divisive merger statute creates an important complication for both actual and constructive fraudulent conveyance challenges. Because the statute explicitly states that no "transfer" takes place, it is possible that fraudulent conveyance law simply does not apply. Fraudulent conveyance law applies when there has been a transfer (or the incurring of a debt, as discussed below). Courts have already begun wrestling with the question whether this feature of the divisive merger statute precludes fraudulent conveyance challenges. Several have suggested that it does not.²⁰ The statute explicitly states that it does not alter any existing creditors' rights. Since fraudulent conveyance law is an important creditor protection, this may open the door to a fraudulent conveyance challenge. In addition, courts may apply a federal bankruptcy definition

¹⁶ The victims could challenge the divisive merger under state fraudulent conveyance law, which would raise the same issues as discussed below.

¹⁷ The Bankruptcy Code's prohibition of actual fraud is 11 U.S.C. § 548(a)(1)(A). The debtor or trustee can also use any state law fraudulent provision that would apply outside of bankruptcy, because section 544(b) gives it access to nonbankruptcy avoidance provisions.

¹⁸ 11 U.S.C. § 548(a)(1)(B).

¹⁹ The debtor or trustee can invoke state fraudulent conveyance law in bankruptcy, as an alternative to the federal provision. See 11 U.S.C. § 544(b). The principal benefit of the state law provisions is that they often have a longer statute of limitations.

²⁰ In the *Bestwall* case, Judge Laura Beyer stated that "if a debtor used the Texas statute to commit a fraudulent transfer – creating the harm that the Committee complains of – such law would be available to address such acts." *Bestwall*, 606 B.R. at 252. In the *DBMP* case, Judge Craig Whitley noted that, while the Bankruptcy Code does not preempt Texas law on divisional mergers, the Texas Two Step "appears" prejudicial to the rights of the claimants and "is subject to legal challenge." *DBMP v. Those Parties Listed on Appendix A to Complaint and John and Jane Does 1–1000*, Adv. No. 20-03004 (Bankr. W.D.N.C. Jan. 23, 2020).

of transfer, rather than the language in the Texas statute, at least with respect to fraudulent conveyance challenges under the federal Bankruptcy Code. Finally, fraudulent conveyance law applies not only to “transfers” but also to the incurring of a debt. It is possible that courts would construe the assignment of liabilities to a new entity, as with LTL, as the incurring of debts.

Constructive fraudulent conveyance challenges face an additional obstacle. The debtor must be insolvent or nearly so at the time of the transaction. Because the funding agreement in the Johnson & Johnson transaction provides for payment of expenses and of talc judgments by the original entity and by Johnson & Johnson, the debtor (LTL) arguably is fully solvent.

Because LTL may be solvent, representatives of the talc victims have alleged actual fraud rather than constructive fraud. They argue that the divisive merger was designed to undermine their ability to pursue their claims. In cases where the funding agreement is more limited, the debtor may be insolvent, enabling victims to argue both for actual and for constructive fraud.

A final practical issue for victims and other creditors is the question of who is entitled to pursue the fraudulent conveyance action. Under the bankruptcy laws, the debtor or trustee is the one with explicit authority to challenge problematic transactions.²¹ With a challenge to a divisive merger, the debtor itself obviously has little incentive to pursue a fraudulent conveyance action, especially if it is controlled by the original entity or the entity’s parent corporation. A creditors’ committee can ask to be permitted to bring the action under these circumstances.²²

Overall, fraudulent conveyance law appears to offer a robust basis for challenging abusive transactions, but it does face potential obstacles.

Will Venue Shopping Impede Use of the Remedies?

It is well-known that companies that file for bankruptcy can file their case nearly anywhere they wish to, and that a disproportionate percentage of the largest cases go to New York, Delaware, Richmond and Houston. I and others have written extensively about this phenomenon elsewhere.

Some worry that the desire to attract large cases will cause courts to look the other way when abusive cases are filed in their district. Professor Lynn LoPucki, the most prominent critic of forum shopping, argues that bankruptcy courts are unable “to push back against anything the case placers [the debtor, its lawyers or others who decide where to file the case] demand. Pushback has no effect because the cases can so easily go elsewhere.”²³

²¹ For example, § 548 authorizes the “trustee” (which is defined in § 1107 to include the debtor in possession) to challenge a fraudulent conveyance.

²² In the DBMP case, for instance, Judge Whitley noted that creditors seeking to challenge the divisive merger as fraudulent need to obtain derivative standing to bring such claims.

²³ Lynn M. LoPucki, *Chapter 11’s Descent into Lawlessness*, AM. BANKR. L.J. (forthcoming, 2022), manuscript at 58.

This conclusion strikes me as overly pessimistic, including with divisive mergers. Over the past few years, the Western District of North Carolina became an attractive filing location for divisive mergers, apparently because the standard for determining whether a bankruptcy case was filed in bad faith is more difficult for victims or other creditors to meet in the Fourth Circuit—the federal court of appeals that governs North Carolina—than in other circuits.²⁴ The pattern of filing Texas Two-Step bankruptcies in the Western District of North Carolina dates back to Bestwall, which filed for bankruptcy there in 2017.

With the controversy surrounding Johnson & Johnson, this seems to have quickly changed. The bankruptcy court transferred the case to New Jersey, since any connection to North Carolina was quite limited. This ruling seems likely to have diminished the attractiveness of filing Texas Two-Step bankruptcies in the Western District of North Carolina.²⁵

Proposed Legislation

H.R. 4777, which was recently proposed by Congressman Nadler, Congresswoman Maloney, and Congressman Cicilline to prohibit third-party releases includes a provision aimed at divisive mergers. This provision would amend bankruptcy law to require dismissal of any divisive merger that “had the intent of foreseeable effect of . . . separating material assets from material liabilities . . . and . . . assigning all or a substantial portion of those liabilities to the debtor.” This language would essentially bar access to bankruptcy for a divisive merger such as the Johnson & Johnson transaction.

In my view, such a sweeping crackdown is not currently needed. Divisive mergers do not strike me as invariably pernicious—it is noteworthy in this regard that the Texas statute was not enacted with bankruptcy in mind. And the existing bankruptcy remedies seem likely to be sufficient to police problematic transactions. In my view, a wait-and-watch approach is preferable to a sweeping ban.

That said, if bankruptcy courts fail to adequately police abusive transactions, legislative reform might be warranted. A more tailored approach would be preferable to the approach of H.R. 4777—an approach that would focus more narrowly on clearly abusive transactions rather than barring every divisive merger from bankruptcy.

²⁴ Under the Fourth Circuit standard, a party seeking to have the case dismissed needs to show that the reorganization would be objectively futile and the case was filed subjective bad faith. *Carolin Corp. v. Miller*, 886 F.2d 693, 700-01 (4th Cir. 1989)

²⁵ Delaware and other popular Chapter 11 venues do not appear to have handled divisive merger bankruptcies. The only divisive merger case I am aware of in Delaware is *In re Imerys Talc America, Inc.*, 2021 WL 4317388 (Bankr. D. Del. 2021), which found that the debtors, who claimed indemnification from Johnson & Johnson, did not have standing to seek to enjoin a divisive merger by Johnson & Johnson.

Conclusion

Divisive or divisional mergers are one of a growing number of practices that are contributing to a growing perception that Chapter 11, our corporate reorganization framework, has become seriously dysfunctional. Many worry that it is controlled by insiders, and that outsiders fare poorly under current practices. This perception has prompted a populist backlash, as reflected in hearings like this one.²⁶

I believe the concerns are indeed serious. In several recent cases, courts have pushed back against perceived abuses. Third party releases have been a particular focus, with federal district courts rejecting proposed releases in the Purdue Pharma and Ascena cases. As noted earlier, the Johnson & Johnson case was transferred to New Jersey, and the court appears to be giving serious consideration to a motion to dismiss the case.

If this pushback continues, it will obviate the need for legislative intervention, which often has unintended consequences. But if Texas Two-Step transactions escape meaningful oversight, the opposite conclusion may be warranted.

²⁶ See, e.g., Skeel, *supra* note 1.

TESTIMONY
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BEFORE THE
U.S. SENATE
COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON FEDERAL COURTS, OVERSIGHT, AGENCY
ACTION AND FEDERAL RIGHTS
February 8, 2022

Introduction

Good afternoon Chairman Whitehouse, Ranking Member Kennedy, and Subcommittee members. I am honored to appear before you today to discuss divisional merger bankruptcies, known more colloquially — and colorfully — as the “Texas Two-Step”. I am testifying today solely as an expert in the field and not on behalf of any person or party.¹

Testimony

Texas Two-Step has a lighthearted ring to it, but the underlying issues are serious and important, and I commend the Committee for examining the topic. My

¹ Certain of the companies that are involved in the divisional merger bankruptcies that are the subject of this hearing are or have been clients of my law firm, but neither I nor anybody else at Cravath is representing any person or party in any of the relevant pending bankruptcy proceedings.

perspective as a bankruptcy practitioner is this: *divisional merger bankruptcies of the type that have been filed are an **appropriate use of bankruptcy.***

Before discussing the reasons for that conclusion, let me first briefly describe what a divisional merger is. Two States have enacted divisional merger statutes: Delaware and Texas. Unlike a traditional merger, where two entities merge together to form a new entity, a divisional merger involves one entity dividing into two. In a divisional merger bankruptcy, the original company is divided into two parts: one new company that attempts to resolve the asbestos-related claims globally through a Chapter 11 bankruptcy process, and one new company that continues to operate the business.

Here is where a critical misunderstanding may arise: while the transaction involves two steps—the separation of entities and a bankruptcy filing—it *does not* involve the side-stepping of accountability or financial responsibility for the asbestos-related claims. The law should not and would not allow that.

Going all the way back to the Fraudulent Conveyances Act of 1571, also known as the Statute of 13 Elizabeth, it has been illegal to take actions with the purpose and intent to “delay, hinder or defraud creditors”. Those same or similar words appear in our Federal Bankruptcy Code and in the laws of all 50 U.S. States. Importantly, the Delaware and Texas divisional merger statutes do not attempt to

override this longstanding body of law; rather, both provide that any division of assets and liabilities is subject to existing creditors' rights laws.

The reason these transactions should not constitute a violation of creditors' rights laws is the *funding agreement* — an agreement from the operating company to fund the trust to be established under section 524(g) of the Bankruptcy Code to pay the claims. There is a funding agreement in each of the divisional merger bankruptcy cases filed to date. At the core, the funding agreement evidences an affirmative acceptance of financial responsibility and access to the value of the company that existed pre-separation, not a corporate effort to side-step accountability.

So why split the company before the bankruptcy? Because it allows companies to use the tools contained in the Bankruptcy Code (such as 524(g) trusts) to address mass tort liabilities and compensate claimants, while preserving as much value as possible for all constituents. By separating the company into two, productive assets and businesses (which often have operations separate from the operations that resulted in the potential liabilities) will be able to operate without the overhang of bankruptcy, which among other things affects employee retention and relations and relationships with suppliers and customers. That value inures to the benefit of the claim holders through the funding agreement, so the claim holders are no worse off (and may be better off). It also enables the

company to use the Bankruptcy Code to address tort liabilities in a way that is more streamlined and fair to the claim holders as a whole than the tort system, through the use of provisions like section 524(g) of the Bankruptcy Code.

Claimant trusts have been an accepted method of addressing asbestos claims since at least 1994, when Congress added section 524(g) to the Bankruptcy Code. They are *fair*: they can only be established if approved by at least **75% of the claimants** themselves; they are *efficient*: bankruptcy provides a single, centralized forum to resolve and pay all claims; and they are *equitable*: lottery-like results of a pot of gold for some and little or nothing for others is not allowed in bankruptcy.

Both for these reasons and the strong Federal policy of access to bankruptcy, I do not believe the legislation that has been proposed to outlaw a bankruptcy filing within 10 years of a divisional merger is necessary or appropriate. In my opinion, Congressional time and effort would be better spent on other bankruptcy topics, such as establishing uniform standards for third party releases in appropriate cases.

* * * * *

Mr. Chairman, I thank you again for the opportunity to share my thoughts on these very important issues.

**United States Senate Subcommittee on Federal Courts, Oversight,
Agency Action, and Federal Rights
Committee on the Judiciary**

**Supplement to Hearing on “Abusing Chapter 11: Corporate Efforts
to Side-Step Accountability Through Bankruptcy”**

Hon. Judith K. Fitzgerald (Ret.)’s Responses to Written Questions of Senator Thom Tillis

1. *Tell me about how the system works for people who might discover their injury a few years down the road. Does the current Chapter 11 process allow for injured people to access compensation right away as well as in the future if it takes them a while to discover their injury? Or are they out of luck if they don't get in to file a claim right away?*

People who have been exposed to a product or circumstance that will eventually result in a recognizable injury but who do not realize they have been injured at the time a bankruptcy is filed are generally referred to as “future demand holders,” “future claimants,” or “futures.” In Bankruptcy Code section 524(g), Congress has enabled futures to be represented by a future claimants’ representative, referred to as an “FCR,” who participates in the bankruptcy case on their behalf. 11 U.S.C. § 524(g). Although there is no other provision in Chapter 11 that provides for the appointment of an FCR, the practice used in section 524(g) has been utilized in other mass tort cases and sexual abuse cases that do not have the very large numbers of claims typical to toxic substance mass tort cases. In these cases, as part of the plan confirmation process, a trust is formed and the FCR continues to represent the interest of the futures. The trust lasts until the claims are paid, which can be decades in the case of toxic torts, to give the futures the opportunity to submit their claims to the trust once the claim is known and actionable (i.e., the claimant now has a disease). Then the same review process that occurs for present claims is used for the futures and, when a future claim is determined to comply with the trust distribution procedures, payment is issued.

It is not possible to answer this question succinctly in cases where a debtor pays claims through a confirmed plan but without the trust mechanism described above. The answer is much more complex and depends on the facts of each case. Factors such as whether the claim arose prepetition or post-petition, the type of notice provided to file claims in the bankruptcy case, the notice provided regarding debtor’s discharge, how the plan is structured regarding such claims, and many other matters all must be considered in making a determination of whether the claim can be brought against a reorganized debtor. Generally, if the claim has not been discharged, then the claimant can pursue the reorganized debtor.

2. *Do you have a sense of how the turnaround time for compensation under one of these funds compares with the turnaround time in a personal injury lawsuit through the courts? I mean, it seems like a compensation fund might be quicker? And isn't a lawsuit kind of a gamble compared to a fund that is already set aside?*

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As a litigator and retired bankruptcy judge, my personal opinion is that a lawsuit is always a kind of gamble because one never can be certain how a jury will rule and what factors will sway that jury for or against a claimant. Nonetheless, it is difficult to compare what happens in tort litigation with what happens when a claim is submitted to a trust. The claimant must satisfy the requirement to prove entitlement to compensation and the elements that must be shown differ with each trust. Each trust is established to address a particular type of liability that the particular debtor faces, and how a claimant must prove that liability necessarily depends on the facts and circumstances of each case. Hypothetically, for example, a trust to address asbestos personal injury claims will require different proof than a trust to address property damages. How quickly a trust claim is processed depends on many factors including, *inter alia*, how quickly the claimant produces all the evidence required by the trust and whether the claimant has requested the trust to defer processing the claim. Once all the required information is submitted, the trust processes the claim and issues payment.

A future claimant who discovers he or she was injured by a company faces significant uncertainty and risk about when, whether and how much he or she will obtain as a judgment and be able to collect in the tort system, assuming that the company remains in existence. In the tort system the claimant must prove liability and then damages. That claimant faces substantially less risk in recovering from a trust, as the liability is admitted and the amount of the distribution is fixed and known by virtue of the requirements of section 524(g) and the timing is fixed by the terms of the trust distribution procedures.

a. *The plaintiffs' bar claims delay, but isn't that entity the sole source of delay in all of the divisional merger cases, to the point, in most cases, of even refusing to start a negotiation?*

I do not have information sufficient to say that the sole source of delay in all divisional merger cases is the plaintiffs' bar. In my experience, all constituent parties negotiate to try to reach a consensual plan, even though the negotiation is not always successful in that regard. However, the divisional merger strategy changes the dynamics of chapter 11.

The Texas Two-Step enables a solvent entity to avoid the balances Congress established in chapter 11 by permitting use of a state law to split the liabilities and assets into different entities and then filing bankruptcy only for "BadCo" with its overwhelming liabilities, no business or employees, and few, if any, assets; removing the valuable assets from the purview of the bankruptcy court by keeping "GoodCo" out of bankruptcy; enabling "GoodCo" to use its assets free of any oversight of the bankruptcy court and without any assurance that the assets are preserved for the benefit of the creditors; and, so far, successfully stopping all actions and claims from proceeding against "GoodCo" and related entities even though they have not invoked the provisions of the Bankruptcy Code. This structure is entirely different from the situation that Congress envisioned in enacting chapter 11, in which a debtor puts all of

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its assets and liabilities before the court, subject to scrutiny by the United States Trustee and the public, and negotiates a resolution with its creditors. The incentive to exit bankruptcy as quickly as is feasible has no import in this process. “GoodCo” can go about its business, free of lawsuits and claims that it otherwise would have faced before the divisional merger. The longer “GoodCo” can remain in that position, the less incentive there is to devote what have become assets belonging only to “GoodCo’s to assist “BadCo” (which has no business to reorganize in any event) from emerging from bankruptcy.

- b. *In one current divisional merger case, the debtors and the future claimants representative representing 80+% of asbestos claims have negotiated a deal for over half a billion dollars for claimants. Yet even in that case, the plaintiffs’ bar refuses even to engage and continues to delay payment to claimants. Don’t examples like these refute the various statements that the debtor is causing delay or trying to avoid providing compensation?*

I do not know what case is referenced. In my experience the FCR generally does not represent 80% of asbestos claims as the number of *current* mass tort claims far exceeds estimates of how many future claims are likely to be submitted over time. And of course, they are “future” claims because no one knows for certain how many there are and how many will be submitted.

3. *Can you explain how the compensation funds come together? What’s the process and what kind of oversight do the funds have? And who has a seat at the table in the negotiation when these funds are put together? Is it just the current creditors or do people who might make a future claim have any representation to protect their rights in these discussion[s]?*

In the mass tort context, the trust funds are put together from a combination of contributions, generally including the debtor, insurance companies that settle their policies with the debtor, and third parties who want to receive an injunction against lawsuits that could be or have been brought against them and a release of liability for claims that could be or have been brought against the third party. When all creditors and parties in interest agree, consensual third-party releases are often issued in favor of those third parties.

Typically in a mass tort context, a plan that will provide for a trust is negotiated for by the debtor with the tort claim creditors, the FCR (who is included to protect the interests of future claimants), third-parties who want to contribute to the fund and insurers who want to settle their policies. Insurers who do not want to settle their policies generally are not included in the bargaining, once the decision has been made that they will not settle.

Trusts are created under and governed by applicable state law. In some cases, the trustees report to a board which oversees the trustees. In the mass tort context, one or more trustees who have fiduciary duties to the trust beneficiaries are designated to administer the trust; the trustees hire, direct and supervise the claims administrators and make distributions on valid claims. Trustees are generally required to consult with the other fiduciaries, *i.e.*, the

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FCR and members of the Trust Advisory Committee (“TAC”), for certain matters identified in a trust agreement, such as making changes to the trust or to the payment percentages paid out by the trust.

Trust agreements typically include requirements to undergo audits and testing procedures and to file annual reports with the court. Audits are conducted of the medical and exposure evidence submitted by selected claimants and often contain penalties when the audit reveals improper or fraudulent conduct. Audits also examine the trust’s operations regarding the number of claims submitted, reviewed, and paid in a set time period. Audits of the trust’s finances are used to insure that the trust is in a position to pay future claimants to the same extent that payments have already been made to others.

a. Given that the lion share of the money spent in tort cases goes to lawyers and not asbestos claimants, and that a large percentage of those claims are ultimately dismissed after proving to be frivolous or fraudulent, wouldn’t that money better be redirected to a trust system for all legitimate current and future claimants?

I am unaware of a prevalent practice of lawyers taking the lion’s share of money in asbestos cases. I am aware that state bar associations regulate contingent fees and many have statutes to address frivolous lawsuits. In federal court, lawyers must comply with Federal Rule of Civil Procedure 11 (or its analogue Federal Rule of Bankruptcy Procedure 9011), which authorizes the imposition of sanctions for frivolous actions. Likewise the Rules of Professional Conduct proscribe an attorney from charging an illegal or clearly excessive fee. *See, e.g.,* ABA Model Rules of Professional Conduct Rule 1.5. Fees.

The purpose of post-confirmation trusts is to provide compensation to legitimate current and future claimants and the trusts have mechanisms in place to analyze claims. Claims that are determined not to meet the criteria for payment are not paid.

4. A court recently found rampant fraud perpetrated by plaintiff lawyers in the tort system on corporate defendants that necessitated a RICO lawsuit against those lawyers. Is that a concern given the calls to favor that system in these divisional merger cases?

Assuming this question refers to actions related to the Garlock Sealing Technologies, LLC bankruptcy, my understanding is that the RICO lawsuits and counterclaims were dismissed years ago, and there was no finding of fraud. *See John Crane Inc. v. Simon Greenstone Panatier Bartlett, APC*, No. 16-CV-05918, 2017 WL 1093150, at *1 (N.D. Ill. Mar. 23, 2017), *aff’d sub nom. John Crane, Inc. v. Shein L. Cr., Ltd.*, 891 F.3d 692 (7th Cir. 2018); *Simon Greenstone Panatier Bartlett PC v. John Crane, Inc.*, No. 216CV01179CBMAGR, 2016 WL 4769749, at *6 (C.D. Cal. Aug. 26, 2016), *appeal dismissed sub nom Garlock Sealing Technologies v. Simon Greenstone Panatier Bartlett, APC*, No. 15-2178 (4th Cir. Sept. 7, 2017).

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5. *I have introduced, alongside Senators Grassley and Cornyn, legislation designed to promote transparency and accountability in asbestos bankruptcies and trusts funds created to compensate asbestos victims. The PROTECT Asbestos Victims Act would require the appointment of independent, non-conflicted fiduciaries and allow the Department of Justice to audit bankruptcy trust funds. Do you believe that Congress, if it considers any modification to bankruptcy courts' consideration of divisive mergers and non-debtor releases, should also consider reforms that would promote equitable distribution of funds and deter waste, fraud, and abuse that may limit victims' access to compensation?*

I firmly believe in protecting the integrity and goals of the bankruptcy system, which helps so very many people and companies resolve their financial problems and provides a path forward that otherwise would not be available. Using the Department of Justice to audit post-confirmation trusts, however, may pose constitutional issues and questions regarding the appropriate role of the United States Trustee when there is no bankruptcy pending and the trusts are governed by applicable state law.

**United States Senate Subcommittee on Federal Courts, Oversight,
Agency Action, and Federal Rights
Committee on the Judiciary**

**Hearing on “Abusing Chapter 11: Corporate Efforts to Side-Step
Accountability Through Bankruptcy”**

Mr. Maclay’s Responses to Written Questions of Senator Thom Tillis

1. *Tell me about how the system works for people who might discover their injury a few years down the road. Does the current Chapter 11 process allow for injured people to access compensation right away as well as in the future if it takes them a while to discover their injury? Or are they out of luck if they don’t get in to file a claim right away?*

Someone who discovers in the future that he or she has been injured by asbestos can seek compensation from the companies responsible for that injury. Such a person is often called a “future claimant.” If a future claimant later discovers that he or she was injured by a company, the claimant can sue that company in court. The company either settles that lawsuit or decides to fully litigate it, which can either result in a dismissal, or a trial where it is decided by a jury. In the tort system, trials are relatively rare. Most cases are settled or dismissed.

If the future claimant discovers he or she was injured by a company that has filed for bankruptcy, whether he or she gets compensation, how much that compensation is, and when that compensation will be paid are all uncertain. To help explain why, I will provide some overview of the Chapter 11 process as it relates to asbestos cases.

The Unique Characteristics of Asbestos Bankruptcies

Chapter 11 of the Bankruptcy Code enables business debtors to work with their creditors to negotiate a plan of reorganization that restructures the debtors’ balance sheets or business operations, eases their financial distress, and preserves the going-concern value of the business in an effort to maximize creditor recoveries.

In an ordinary bankruptcy, existing unsecured claims of banks and trade creditors are liquidated. If there are tort claims, they are usually few in number and can be resolved individually or sent back to state court for trial. Typically, there are no future claims.¹ The plan of reorganization deals with all claims in existence as of the petition date, pays those claims amounts as stipulated in the plan, and discharges the claims.² The assumption is that the company, once its debt has been reduced and its capital structure improved, will be able to go on as a viable business and handle subsequent obligations as they arise.³

¹ Elihu Inselbuch, *Some Key Issues in Asbestos Bankruptcies*, 44 S. TEX. L. REV. 1037, 1039 (2003).

² *Id.*

³ *Id.*

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However, asbestos is not a normal tort.⁴ There can be a long latency period before the disease manifests.⁵ Thus, in asbestos bankruptcies, one issue is dealing with the thousands of unliquidated present and future asbestos claims to fairly allocate the insufficient limited assets among various creditor groups.⁶ Often, the business enterprises that file for bankruptcy are viable businesses seeking bankruptcy protection for the sole reason of resolving asbestos liabilities resulting from the exposure of their employees and customers to asbestos over many decades.⁷

Future asbestos claims represent a contingent liability that gradually becomes concrete, confronting the reorganized debtor with the same litigation that precipitated its first trip to bankruptcy court.⁸ If asbestos bankruptcies only resolved asbestos claims that had already manifested, each reorganization would be followed by another mass of asbestos claims, triggering further reorganizations extending indefinitely into the future.⁹ For these reasons, it is impossible to reorganize a company with serious asbestos problems unless the plan of reorganization somehow deals with future claims.¹⁰

To resolve this conundrum, the concept of a trust dedicated to payment of asbestos claims was developed in *Johns-Manville*.¹¹ The trust, rather than the debtor, would have the responsibility to pay all asbestos claimants, present and future.¹² Future claimants would be enjoined from seeking recovery from the reorganized company, and instead would be required to seek recovery only from the trust.¹³ Thus, a so-called “channeling injunction”—an injunction that channeled future claimants to the trust and so protected the reorganized debtor—was an essential element of the *Johns-Manville* solution.¹⁴

Thereafter, Congress codified the *Johns-Manville* trust mechanism in the Bankruptcy Reform Act of 1994. See *In re Federal-Mogul Glob. Inc.*, 684 F.3d 355, 359 (3d Cir. 2012). And for the nearly three decades since, chapter 11 bankruptcies “have employed a statutory mechanism created by 11 U.S.C. § 524(g) to resolve massive asbestos liability and to evaluate claims and allocate payments to current and future asbestos claimants. When this provision’s requirements are satisfied, the bankruptcy court may issue an injunction channeling all current and future claims based on the debtor’s asbestos liability to a personal injury trust.” *Id.* at 357. In other words, “the § 524(g) injunction aims to ‘control the future litigation of all asbestos-related claims against the parties it protects’ by preventing ‘any entity from taking legal action to collect a claim or demand

⁴ *Id.* at 1038.

⁵ *Id.*

⁶ See *id.*

⁷ Inselbuch, *supra* note 1, at 1038.

⁸ *Id.* at 1039.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*; *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 639 (2d Cir. 1988).

¹² Inselbuch, *supra* note 1, at 1039.

¹³ *Id.*

¹⁴ *Id.*

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that is to be paid in whole or in part by a trust created through a qualifying plan of reorganization.” *In re Thorpe Insulation Co.*, 677 F.3d 869, 877 (9th Cir. 2012) (quoting COLLIER ON BANKRUPTCY ¶ 524.07).

There are several statutory prerequisites imposed by § 524(g) which are “specifically tailored to protect the due process rights of future claimants.” *In re Combustion Eng’g, Inc.*, 391 F.3d 190, 234 n.45 (3d Cir. 2004), *as amended* (Feb. 23, 2005).

Under . . . [§ 524(g)], the bankruptcy court may grant a channeling injunction only if (1) the debtor is subject to substantial and uncertain future asbestos liability, (2) the trust owns a majority of the voting shares of the debtor or corporate parent, (3) seventy-five percent of current claimants vote to approve the plan, and (4) the trust operates through mechanisms that assure the plan will pay “present claims and future demands . . . in substantially the same manner.” 11 U.S.C. § 524(g)(2)(B). The injunction may bind future claimants only if a future claims representative is appointed during the reorganization and the bankruptcy court determines the injunction is “fair and equitable” with respect to future claimants. *Id.* § 524(g)(4)(B).

Federal-Mogul Glob. Inc., 684 F.3d at 359 n.9 (alteration in original).¹⁵ As such, at least under a § 524(g) plan, a future claimant can be assured that at some point he or she will receive compensation in substantially the same manner as a current claimant would. How much that compensation will be in absolute terms, and when that compensation might be paid, is not determined by § 524(g).

Bankruptcy Cases Can Take Years During Which Claimants Generally Cannot Receive Compensation

As I mentioned in my prior written testimony, when a debtor files for chapter 11 bankruptcy, the Bankruptcy Code provides certain benefits to debtors to facilitate negotiations and ultimately a successful reorganization. The principal benefit to debtors is the automatic stay,¹⁶ which provides a statutory, nationwide, and indefinite stay of litigation, collection actions, and enforcement proceedings against the debtor. The automatic stay typically remains in effect during the entirety of the bankruptcy, which can last for many years. The automatic stay has two primary purposes: first, it provides the debtor with a pause from litigation to work out financial difficulties and to begin the process of reorganization; and, second, it prevents a race to the courthouse by creditors to sue the debtor, which can impact an orderly reorganization process.¹⁷

¹⁵ Some additional requirements of a § 524(g) channeling injunction include: “the trust must be funded in whole or in part by the securities of at least one debtor and by the obligation of the debtor to make future payments” and “the trust must own, or be entitled to own, a majority of the voting shares of the debtor, its parent corporation, and any subsidiary.” *Thorpe Insulation Co.*, 677 F.3d at 877.

¹⁶ 11 U.S.C. § 362(a).

¹⁷ *See, e.g., Dean v. Trans World Airlines, Inc.*, 72 F.3d 754, 755-56 (9th Cir. 1995).

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Meanwhile, it can take years for a bankruptcy case to reach the point of a § 524(g) plan of reorganization being proposed, voted upon by asbestos creditors, and confirmed by the bankruptcy court. Because of the complexities of mass-tort bankruptcies, the bankruptcy process can be a lengthy one even in cases where the chapter 11 debtor and the asbestos claimants' representatives reach a consensual deal on the terms of a plan relatively quickly. For example, in the *Sepco* bankruptcy, a case where a consensual deal was reached relatively quickly, the duration between the chapter 11 filing and the plan's effective date was four years.¹⁸ In another similar case, the *Fairbanks* bankruptcy, the duration between chapter 11 filing and the plan's effective date was three years.¹⁹ And the *Duro Dyne* bankruptcy, which involved a chapter 11 plan that was negotiated and agreed to by the debtors and the claimants' representatives *before* the chapter 11 filing, took two years.²⁰

Asbestos mass-tort bankruptcies that are more contentious can take even longer to resolve. For example, the *Pittsburgh Corning* case lasted over 16 years, including approximately 13 years after the debtor and the asbestos claimants reached a consensual deal.²¹ The *W.R. Grace* bankruptcy lasted almost 13 years.²² *Garlock* lasted for over 7 years.²³ All the while in these cases, asbestos claimants were forced to wait and did not receive even a penny of compensation due to the automatic stay. And these claimants included not only those who had lawsuits pending on the date of the chapter 11 filing, but also those who manifested asbestos-related diseases and whose tort claims accrued after the chapter 11 filing.

¹⁸ Petition, *In re Sepco Corp.*, No. 16-50058 (Bankr. N.D. Ohio Jan. 14, 2016), ECF No. 1; Notice of (A) Entry of Confirmation Order, (B) Effective Date of the Plan, (C) Substantial Consummation of the Plan, and (D) Bar Date for Administrative Expense Claims, Including Professional Fee Claims, *In re Sepco Corp.*, No. 16-50058 (Bankr. N.D. Ohio June 8, 2020), ECF No. 749.

¹⁹ Petition, *In re Fairbanks Co.*, No. 18-41768 (Bankr. N.D. Ga. July 31, 2018), ECF No. 1; Notice of (I) Entry of Order Confirming the First Amended Plan of Reorganization of the Fairbanks Company Under Chapter 11 of the Bankruptcy Code, (II) Occurrence of Effective Date, (III) Issuance of Asbestos Channeling Injunction, and (IV) Issuance of Insurance Policy Injunction, *In re Fairbanks Co.*, No. 18-41768 (Bankr. N.D. Ga. Aug. 27, 2021), ECF No. 844.

²⁰ Petition, *In re Duro Dyne Nat'l Corp.*, No. 18-27963 (Bankr. D.N.J. Sept. 7, 2018), ECF No. 1; Order Closing Chapter 11 Cases Effective as of December 31, 2020 and Directing Entry of Final Decree, *In re Duro Dyne Nat'l Corp.*, No. 18-27963 (Bankr. D.N.J. Dec. 29, 2020), ECF No. 1367.

²¹ Petition, *In re Pittsburgh Corning Corp.*, No. 00-22876 (Bankr. W.D. Pa. Apr. 16, 2000), ECF No. 1; Disclosure Statement to Accompany the Plan of Reorganization Dated April 30, 2003 Jointly Proposed by Pittsburgh Corning Corporation, the Official Committee of Asbestos Creditors and the Future Claimants' Representative, *In re Pittsburgh Corning Corp.*, No. 00-22876 (Bankr. W.D. Pa. Apr. 30, 2003), ECF No. 2065; Notice of Effective Date of Modified Third Amended Plan of Reorganization of Pittsburgh Corning Corporation Dated January 29, 2009, as Amended, *In re Pittsburgh Corning Corp.*, No. 00-22876 (Bankr. W.D. Pa. Apr. 26, 2016), ECF No. 10616.

²² Petition, *In re W.R. Grace & Co.*, No. 01-01139 (Bankr. D. Del. Apr. 2, 2001), ECF No. 1; Notice of Satisfaction or Waiver of Conditions to Occurrence of Effective Date of Plan, *In re W.R. Grace & Co.*, No. 01-01139 (Bankr. D. Del. Feb. 3, 2014), ECF No. 31700.

²³ Petition, *In re Garlock Sealing Techs. LLC*, No. 10-31607 (Bankr. W.D.N.C. June 5, 2010), ECF No. 1; Notice of Occurrence of Effective Date, *In re Garlock Sealing Techs. LLC*, No. 10-31607 (Bankr. W.D.N.C. July 31, 2017), ECF No. 6099.

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Even after a § 524(g) plan of reorganization is confirmed by the bankruptcy court, that plan may be appealed by objecting parties, first to the district court (or in some jurisdictions the Bankruptcy Appellate Panel), and often to the circuit level. *See, e.g., Federal-Mogul Glob. Inc.*, 684 F.3d 355; *In re Kaiser Gypsum Co.*, No. 16-31602, 2021 WL 3239513, at *1 (W.D.N.C. July 28, 2021) (currently pending on appeal before the Fourth Circuit). Those appeals can be lengthy.

Tragically, time is not on the side of asbestos claimants. Most cases of mesothelioma are “fatal within 12 to 18 months following diagnosis.” *Sebright v. Gen. Elec. Co.*, 525 F. Supp. 3d 217, 227 (D. Mass. 2021).²⁴ As such, it is highly likely that those suffering from these terminal diseases at the start of these cases will not live to see the cases’ conclusion. In fact, in two recent Texas Two-Step bankruptcies, *In re Bestwall LLC* and *In re DBMP LLC*, several asbestos victims sitting on the respective committees died from mesothelioma while the bankruptcies remain pending with no signs of a confirmable plan on the horizon in either case.²⁵ In *Bestwall*, five different committee members who had previously filed tort claims died while their claims were automatically stayed.²⁶

Setting up the Trust Takes Time

Even after the confirmation of the plan of reorganization, the plan may not become effective, meaning the provisions of the plan cannot actually go into effect, for a substantial period of time. Often, “the effective date of the plan will be tied to the absence of any successful appeals from the order of confirmation, or the satisfaction of conditions contained in the plan.”²⁷ Consequently, there is often a significant delay between confirmation and the effective date of the plan.

²⁴ *See also* British Thoracic Society Standards of Care Committee, *BTS statement on malignant mesothelioma in the UK, 2007*, 62 *Thorax* (Suppl II) ii1-ii19 (2007), <http://dx.doi.org/10.1136/thx.2007.087619> (noting that life expectancy in malignant mesothelioma is poor, with the median survival varying between 8 and 14 months).

²⁵ Motion of the Official Committee of Asbestos Claimants of Bestwall LLC to Substitute Committee Member, *In re Bestwall LLC*, No. 3:17-bk-31795 (Bankr. W.D.N.C. Oct. 5, 2018), ECF No. 270 (Committee member Cresante Perreras passed away due to mesothelioma); Second Motion of the Official Committee of Asbestos Claimants of Bestwall LLC to Substitute Committee Member, *In re Bestwall LLC*, No. 3:17-bk-31795 (Bankr. W.D.N.C. Feb. 21, 2018), ECF No. 648 (Committee member Stephen F. Lanphear passed away due to mesothelioma); Third Motion of the Official Committee of Asbestos Claimants of Bestwall LLC to Substitute Committee Member, *In re Bestwall LLC*, No. 3:17-bk-31795 (Bankr. W.D.N.C. June 4, 2021), ECF No. 1812 (Committee member Jeffrey A. Watts passed away due to mesothelioma); Fourth Motion of the Official Committee of Asbestos Claimants of Bestwall LLC to Substitute Committee Member, *In re Bestwall LLC*, No. 3:17-bk-31795 (Bankr. W.D.N.C. June 4, 2021), ECF No. 1813 (Committee member Richard S. Trumbull passed away due to mesothelioma); Fifth Motion of the Official Committee of Asbestos Claimants of Bestwall LLC to Substitute Committee Member, *In re Bestwall LLC*, No. 3:17-bk-31795 (Bankr. W.D.N.C. Nov. 22, 2021), ECF No. 2246 (Committee member Linda Hofferber passed away due to mesothelioma); Motion of the Official Committee of Asbestos Claimants to Substitute Committee Member, *In re DBMP LLC*, No. 20-30080 (Bankr. W.D.N.C. Nov. 22, 2021), ECF No. 1229 (Committee member Michael D. Nuzzolese passed away due to mesothelioma).

²⁶ *See* sources cited *supra* note 25.

²⁷ 7 COLLIER ON BANKRUPTCY ¶ 1129.06[1][e] (Alan N. Resnick Henry J. Sommer, eds. rev. 15th ed. 2004).

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The trust agreement, a document approved as part of the plan, governs the terms of the asbestos trust, pursuant to which the asbestos trust assumes liability and responsibility for all asbestos claims, and, among other things: (a) directs the processing, liquidation and payment of asbestos claims in accordance with the plan, the trust distribution procedures (“TDP”), and the debtors’ confirmation order; (b) preserves, holds, manages, and maximizes the assets of the asbestos trust for use in paying and satisfying asbestos claims; and (c) qualifies at all times as a qualified settlement fund under the QSF Regulations. Moreover, the trust agreement establishes that the asbestos trust is to use the asbestos trust’s assets and income to pay holders of asbestos claims in accordance with the terms of the trust agreement and the TDP.²⁸

Asbestos personal injury trusts established by § 524(g) plans of reorganization “have Trust Distribution Protocols (TDPs) to govern how claims are processed and compensated. These procedures are approved as part of the bankruptcy reorganization plan but may later be modified.” *Federal-Mogul Glob. Inc.*, 684 F.3d at 360-61.

TDP procedures are similar across most trusts Claimants generally select between expedited or individual review. Under expedited review, a claimant presents evidence to satisfy pre-established medical and exposure criteria. Once met, the claim is liquidated according to a compensation grid based on eight disease levels that provide the highest payment to those suffering from mesothelioma and other malignant diseases. If a claimant seeks individual review—mandated when medical and exposure criteria are not satisfied, but also used to assess whether special circumstances might warrant greater compensation—the processing facility determines whether the claim would be compensable in the tort system, with valuation based on historical tort awards for similarly situated plaintiffs. In the event of a dispute, claims are submitted to nonbinding arbitration, or, if that fails, to the courts, although such resolutions are reportedly rare. Finally, after valuation, claims are paid based on a payment percentage on a first-in-first-out basis, subject to an annual cap on total compensation and, in some trusts, a claim ratio that reserves a certain percentage of annual compensation to claimants with the most serious diseases. Under the TDPs, few trusts pay the full value of submitted claims: current payment percentages range widely, but the median is 25%, with most trusts paying between ten and forty-six percent of a claim’s liquidated value.

Id. at 360 n.12 (internal citations omitted).

Once the plan is effective, the trust is funded and the process for opening the trust can begin. Claim forms and systems must be developed, claims review processes must be established, and a variety of other important governance and administrative tasks must be accomplished. As a

²⁸ See, e.g., Third Amended Joint Plan of Reorganization of Kaiser Gypsum Co., Inc. and Hanson Permanente Cement, Inc., *In re Kaiser Gypsum Co.*, No. 16-31602 (Bankr. W.D.N.C. Oct. 21, 2019), ECF No. 1868; Second Amended Plan of Reorganization as Modified, for Sepco Corporation Under Chapter 11 of the Bankruptcy Code, *In re Sepco Corp.*, No. 16-50058 (Bankr. N.D. Ohio Dec. 15, 2019), ECF No. 664.

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result, there is also some delay between the effective date of the plan and the date that the trust becomes operable.

Filing a Claim with a Trust Takes Time

Once the trust is up and running, claimants must file their claims with the trust to receive payment on claims that qualify for payment under the subject TDP. A statute of limitations is typically established pursuant to the TDPs, and claimants usually have to file their proofs of claim by a certain date that is determined based on whether their diagnosis date was before or after the Petition Date. *See, e.g.*, Sepco Asbestos Personal Injury TDP § 5.1(a)(2).

Filing a claim with the trust begins the process that finally determines whether and how much a claim is paid. The answer may depend on whether an asbestos claimant seeks expedited review or individual review. In an expedited review process, a claimant, upon making certain exposure and medical showings, can obtain a standard settlement amount, an amount typically based on the disease from which the claimant is suffering.²⁹ Under the individual review process, a claimant may elect to have his or her asbestos claim reviewed either for purposes of determining whether the claim would be valid in the applicable tort system even though it does not meet the presumptive medical and exposure criteria or to assess whether the claim might warrant greater compensation than would be provided under the expedited review process.³⁰ The former is faster, but may result in a lower payout. In contrast, an individual review could take longer, including arbitration or a return to the tort system, but might result in a larger payment if the claim meets the presumptive medical and exposure criteria for the relevant disease level.³¹

In sum, a future claimant who discovers he or she was injured by a company that has filed for bankruptcy faces significant uncertainty about when and how much he or she will obtain from an asbestos trust. If the company that injured the claimant filed for bankruptcy just before she discovered her injury, her compensation could be delayed by bankruptcy for many years, during which time it is not clear how much compensation she might receive.

²⁹ *See, e.g.*, Sepco Asbestos Personal Injury TDP § 5.3(a), <http://sepco.mfrclaims.com/Resources/Sepco%20-%20Trust%20Distribution%20Procedures.pdf> (explaining the expedited review process) (“Sepco TDP”); Owens Corning/Fibreboard Asbestos Personal Injury TDP § 5.3(a), <http://www.ocfbasbestostrust.com/wp-content/uploads/2015/12/OC-FB.-Amended-TDP.12.2.2015-C0463534x9DB18.pdf> (same) (“Owens Corning TDP”); Babcock & Wilcox Asbestos PI Settlement TDP § 5.3(a), <http://www.bwasbestostrust.com/wp-content/uploads/2015/12/BW.-Amended-TDP.12.2.2015-C0463536x9DB18.pdf> (same) (“B&W TDP”).

³⁰ *See, e.g.*, Owens Corning TDP § 5.3(b) (explaining the individual review process); B&W TDP § 5.3(b) (same).

³¹ *See supra* note 30.

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2. *Do you have a sense of how the turnaround time for compensation under one of these funds compares with the turnaround time in a personal injury lawsuit through the courts? I mean, it seems like a compensation fund might be quicker? And isn't a lawsuit kind of a gamble compared to a fund that is already set aside?*

Even setting aside the years of delay imposed by a bankruptcy case, it is difficult to say whether a claim to a trust or a personal injury lawsuit in court would result in a quicker payment. The turnaround time for both types of claim resolution depends on numerous factors.

The time it takes a claimant to receive payment from a trust depends on factors including but not limited to: (i) whether the claimant pursues expedited review or individual review; (ii) the status of the claimants' own discovery of the facts needed to make a claim, which in turn can depend on developments in litigation activity elsewhere such as discovery of witnesses, and availability of product information; (iii) the review time by the relevant claims processor and relevant claim backlogs by processors; (iv) the expediency with which claim deficiencies are identified by a trust and are then cured; (v) when a trust delivers an offer and then the timing of the acceptance or rejection of any offer from the trust; (vi) whether a claimant invokes alternative dispute resolution, or an exit to the tort system to liquidate their claim; (vii) how quickly a release is sent by the trust and then executed and returned; and (viii) whether limits on the amount a given trust can pay in a given year are reached. Depending on these and other factors, it may take months or even years to be paid by a trust even after it is up and processing claims.

Similarly, timing of payment for a claim in the tort system is dependent on numerous factors. Is the claim on an *in extremis* docket or subject to some other expedited court process? Have the defendants and third parties provided the necessary discovery to identify witnesses, product information, and the like? Is the defendant choosing to settle the claim or instead trying it to verdict? If a verdict is obtained, will an appeal be taken by either side? These and various other things can impact the length of a case. If on an *in extremis* or other special docket, a trial could be set within a year. There is, of course, no inherent delay in compensation if the defendant companies settle the cases.

With respect to whether a lawsuit may be a "gamble" compared to a trust claim, it is important to remember that an injured person who has a claim against a company does not get to choose whether that company is in bankruptcy or remains outside of bankruptcy and is able to be sued. That is a strategic decision the company makes, not the claimant.

Of course, if a company remains in the tort system and a claimant has to file a lawsuit, that lawsuit is itself a gamble in the sense that both sides are uncertain how a judge or jury will evaluate a case. But that is an inextricable part of the American justice system, which determines which claims are meritorious against a particular defendant and the value of those claims. Settlement

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eliminates the uncertainty for both the plaintiff and the defendant, and many cases in the tort system settle.³²

- a. *The plaintiffs' bar claims delay, but isn't that entity the sole source of delay in all of the divisional merger cases, to the point, in most cases, of even refusing to start a negotiation?*

The source of delay in Texas Two-Step cases is the Texas Two-Step strategy itself. It is a bankruptcy tactic designed to avoid the normal economic pressures and incentives that motivate corporate debtors to come to the negotiating table in good faith and attempt to quickly achieve a fair bargain with their creditors in the form of a consensual chapter 11 plan. With bankruptcy stays in place shielding BadCo's entire enterprise group—i.e., BadCo, GoodCo, and their affiliates—GoodCo and the affiliates enjoy a principal benefit of bankruptcy without actually being in bankruptcy, i.e., an indefinite, nationwide stay of tort claims.³³ Creditor representatives have been forced to address this inequity. The alternative—to simply concede that a corporation can one-sidedly place its unwanted creditors in limbo until they will accept any price to escape—is unrealistic and contrary to fundamental bankruptcy principles.

The Texas Two-Step allows GoodCo and its affiliates to be free of the obligations normally required of a chapter 11 debtor—obligations that constitute essential creditor protections. First, GoodCo is not required to file schedules of its assets and liabilities, a statement of financial affairs, and monthly operating reports, thereby foreclosing any transparency regarding GoodCo's financial condition. Second, GoodCo can layer on debt that is senior in priority to its obligations under the funding agreement and can engage in transactions outside the ordinary course of business, including transferring its entire value, without any notice to tort creditors and without first obtaining the bankruptcy court's approval. Third, GoodCo can continue to pay its non-tort creditors in the ordinary course of its business and outside of a court-approved chapter 11 plan. By contrast, tort claimants trapped in BadCo's bankruptcy are not treated the same, as they are not getting paid, and it is not clear when, if ever, they will be. Fourth, GoodCo need not respect the "absolute priority rule"; while tort creditors in BadCo's bankruptcy remain uncompensated, GoodCo can distribute its substantial earnings to its direct and indirect parent companies and shareholders, which effectively renders GoodCo "cash-poor" while it is allegedly on the hook to pay BadCo under the funding agreement. And in bankruptcy, all creditors are supposed to be paid before shareholders.

³² *In re Plant Insulation Co.*, 734 F.3d 900, 912-13 (9th Cir. 2013) (noting that most tort claims against the debtor settle prior to trial and thus, do not proceed to trial); Bruce Mattock, Andrew Sackett, and Jason Shipp, *Clearing Up the False Premises Underlying the Push for Asbestos Trust "Transparency"*, 23 WIDENER L.J. 725, 751-52 (2014) ("[P]ractically no asbestos cases go to trial." (citation omitted)); CONGRESSIONAL BUDGET OFFICE, *THE ECONOMICS OF U.S. TORT LIABILITY: A PRIMER* 6 (2003), <https://www.cbo.gov/publication/14835> ("The vast majority of all [state] tort cases are disposed through some form of settlement, with only 3 percent of all tort matters resulting in a jury trial." (alteration in original)).

³³ As in my written testimony, I will occasionally refer to the predecessor entity as "AceCo" and the post-divisional merger entities as "GoodCo" and "BadCo."

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This stands in stark contrast to appropriate bankruptcy cases, where all the debtor's assets and liabilities are in bankruptcy. There, a debtor's non-asbestos creditors, like bondholders, vendors, and customers, are exerting pressure on the debtor to seasonably exit from bankruptcy to remove uncertainty and reorganize the business. However, under the Texas Two-Step regime, those stakeholders are entirely unaffected by the bankruptcy, and there is not a business to reorganize, as the debtor is simply a shell manufactured solely to be eligible for chapter 11 relief.³⁴ Moreover, AceCo's equity holders risk nothing as they are not subject to the "absolute priority rule"; in other words, they can still retain the value of their equity interests and receive dividends ahead of creditors, something that would not be the case in a non-Texas Two-Step bankruptcy.

Thus, without the economic incentives and pressures that encourage a debtor to make a seasonable exit from chapter 11, Texas Two-Step debtors can idle in chapter 11 as long as they want, with little downside due to the stay of tort litigation against their enterprise groups, and can thus delay the resolution of their chapter 11 cases until the tort creditors knuckle under and agree to a substantial discount on the value or recovery of their claims. In fact, the Court found that in planning for the Texas Two-Step in *Aldrich*, "team members expected and planned for a long-term bankruptcy prior to the 2020 Corporate Restructuring, which they estimated would last for five or more years."³⁵

Placing the blame on representatives of asbestos victims in Texas Two-Step bankruptcies is misplaced. Each of the Texas Two-Step debtors has chosen a contentious litigation approach instead of one focused on consensual negotiations. Each of the Texas Two-Step debtors has successfully pursued a preliminary injunction enjoining tort claimants from suing the debtors' affiliates (and sometimes other parties such as insurers and distributors). Those Texas Two-Step debtors whose cases are farther along have pursued estimation of claims, bar dates, and personal injury questionnaires, among other litigation strategies. Each of these forms of litigation not only takes months or years, but are designed to give asbestos defendants more leverage to make as small a payout to their tort claimants as possible. Official committees' refusal to knuckle under and agree to a substantial discount by accepting a low-ball offer is by no means embracing delay.

b. In one current divisional merger case, the debtors and the future claimants representative representing 80+ % of asbestos claims have negotiated a deal for over half a billion dollars for claimants. Yet even in that case, the plaintiffs' bar refuses even to engage and continues to delay payment to claimants. Don't examples like these refute the various statements that the debtor is causing delay or trying to avoid providing compensation?

I infer from the question that you are referring to *Aldrich*, a case in which I serve as co-lead counsel for the *Aldrich* Committee. As counsel for the *Aldrich* Committee, my answer is

³⁴ *In re Aldrich Pump LLC*, No. 20-30608 (JCW), Adv. No. 20-03041 (JCW), 2021 WL 3729335, at *16 (Bankr. W.D.N.C. Aug. 23, 2021) ("Creating two companies with no employees evidences the fact that Aldrich and Murray were simply inert vessels designed to carry their predecessors' asbestos liabilities into bankruptcy.")

³⁵ *Id.* at *9, *20 (citations omitted).

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constrained by confidentiality, privilege, and ethical principles. With those in mind, I can make the following observations.

As stated previously, the Texas Two-Step strategy itself is the source of delay in payments to asbestos victims. The course of action pursued by the *Aldrich* debtors is the same litigation strategy pursued by the other Texas Two-Step debtors. Indeed, their litigation strategy was even more aggressive, as it extended to nominating, and getting approved by the bankruptcy court, a specific candidate for the FCR position over the Committee's objections.³⁶

Second, as I have stated publicly in open court in my role as counsel for the *Aldrich* Committee, the *Aldrich* Committee is and always has been open to talking with the debtors and others.³⁷

3. *Can you explain how the compensation funds come together? What's the process and what kind of oversight do the funds have? And who has a seat at the table in the negotiation when these funds are put together? Is it just the current creditors or do people who might make a future claim have any representation to protect their rights in these discussions?*

Compensation trusts established through bankruptcy are formed by the negotiation among participants in the bankruptcy process as reflected in the confirmed plan of reorganization. In the context of asbestos trusts formed pursuant to § 524(g), those participants include debtors, the official committees, and the Future Claimants' Representatives appointed by the bankruptcy court. The terms of the bankruptcy plans and the associated plan documents, including trust agreements and TDPs, are highly scrutinized by bankruptcy courts, require the approval of district courts, and oftentimes are subject to circuit court review.

Management and operation of the trust is overseen by a qualified panel of one or more independent, non-conflicted trustees. The trustees have included retired state court judges, retired district court judges, former practitioners and practicing lawyers, and business people. In managing the trusts, trustees have engaged highly qualified professionals on behalf of the trust, including executive directors supported by management consulting firms with statistical and econometric expertise; financial advisors who oversee the selection and performance of the managers of the trust's investment portfolio; claims processing facilities that receive, organize and review the electronically submitted claims; and independent certified public accounting firms. In

³⁶ The law recognizes that asbestos debtors are "profoundly adverse" to both current and future asbestos claimants: "[T]he 'claimants wish to receive as much as possible' and the . . . debtors 'wish to hold their payment obligations to a minimum.'" *In re Leslie Controls, Inc.*, 437 B.R. 493, 501 (Bankr. D. Del. 2010).

³⁷ See, e.g., Transcript of Hearing at 131:3-9; 21-24, *In re Aldrich Pump LLC*, No. 20-30608 (Bankr. W.D.N.C. Mar. 3, 2022) ("The Committee has never refused to talk to the debtor, has never refused to talk to the FCR, and, in fact, just recently in discussions over the PIQ and bar date, as I mentioned, I think we had five committee members on that call talking with other parties. I have never enunciated nor has the Committee ever stated that it was unwilling to negotiate. . . . [T]hat, of course, is what we have said before and what I'm repeating today. The Committee is willing to negotiate. It's always been willing to negotiate. We haven't—no offer has been made to the Committee.").

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addition, each trust has an advisory committee (“TAC”), which represents the interests of present claimants, and an FCR, who represents the interests of future claimants.

The trustees are the fiduciaries to the trust in accordance with the provisions of the trust agreement and the plan of reorganization.³⁸ The trustees administer the trust and the trust assets in accordance with the trust agreement.³⁹ The TAC members serve in a fiduciary capacity representing all holders of present trust claims,⁴⁰ and the FCR also serves in a fiduciary capacity, representing the interests of the holders of future trust claims.⁴¹ The trustees are required to consult with the TAC and FCR on certain matters identified in the trust agreement and trust distribution procedures, and must obtain their consent on certain other matters.⁴² Among other things, the trustees may retain and/or consult with counsel, accountants, appraisers, auditors, forecasters, experts, financial and investment advisors, and other parties deemed by the trustees to be qualified as experts on the matters submitted to them.⁴³

Asbestos trusts have a series of oversight mechanisms built into the trust through trust distribution procedures and trust agreements. First, the trustee or trustees are obligated to provide an annual report to the applicable bankruptcy court that includes audited financial statements as well as a report summarizing the number and type of claims processed in the preceding year. That annual report is also made publicly available for inspection.⁴⁴ Under the operative plans of reorganization, the bankruptcy court retains a supervisory role over the trust with respect to certain enumerated trust matters that may arise post-effective date.

With respect to auditing procedures, asbestos trusts have the power to: (1) audit the reliability of medical and exposure evidence provided by claimants and (2) penalize claimants or claimants’ attorneys for providing fraudulent information.⁴⁵ For example, many trusts participate in a “cross-trust” audit program that includes a comparison of asbestos claims filed with the trust against claims filed with all other asbestos trusts that participate in the cross-trust audit program.⁴⁶ The audit results have significant consequences. For example, the Sepco TDP states as follows:

³⁸ *E.g.*, Owens Corning/Fibreboard Asbestos Personal Injury Trust Agreement § 2.1.

³⁹ *Id.*

⁴⁰ *Id.* § 5.2.

⁴¹ *Id.* § 6.1.

⁴² *See id.* § 2.2.

⁴³ *Id.* § 4.8(a).

⁴⁴ *Id.* § 2.2(c).

⁴⁵ *E.g.*, Sepco TDP § 5.7; Kaiser Gypsum Asbestos Personal Injury TDP § 5.10, http://www.kaisergypsumtrust.org/assets/documents/resources/3_B_Trust_Distribution_Procedures.pdf (“Kaiser TDP”); Fairbanks Asbestos Personal Injury TDP § 5.8, *In re Fairbanks Co.*, No. 18-41768 (Bankr. N.D. Ga. Apr. 29, 2021), ECF No. 721-2 (“Fairbanks TDP”); Owens Corning TDP § 5.8; Amended and Restated WRG Asbestos PI Trust TDP § 5.8, <http://www.wrgraceasbestostrust.com/wp-content/uploads/2019/12/WRG-Amended-and-Restated-Trust-Distribution-Procedures-Revised-September-26-2019-C1076870x9DB18.pdf> (“W.R. Grace TDP”); B&W TDP § 5.8.

⁴⁶ *See, e.g.*, Sepco TDP § 5.7; Kaiser TDP § 5.10.

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Further, in the event that an audit reveals that fraudulent information has been provided to the Asbestos Trust, the Asbestos Trust may penalize any claimant or claimant's attorney by rejecting the Asbestos Claim or by other means including, but not limited to, requiring the source of the fraudulent information to pay the costs associated with the audit and any future audit or audits, reordering the priority of payment of all affected claimants' Asbestos Claims, raising the level of scrutiny of additional information submitted from the same source or sources, refusing to accept additional evidence from the same source or sources, seeking the prosecution of the claimant or claimant's attorney for presenting a fraudulent claim in violation of 18 U.S.C. § 152, and seeking sanctions from the Bankruptcy Court.⁴⁷

- a. Given that the lion share of the money spent in tort cases goes to lawyers and not asbestos claimants, and that a large percentage of those claims are ultimately dismissed after proving to be frivolous or fraudulent, wouldn't that money better be redirected to a trust system for all legitimate current and future claimants?*

I first want to address some misimpressions contained in the question. In the tort system, defendants determine how much they want to spend on their counsel defending the lawsuits brought against them. Historically, defendants in asbestos litigation have taken a variety of approaches. Some spend heavily on defense attorneys, which can result in lower payments to claimants as a whole. Others adopt an early settlement approach, which results in lower defense costs and a relatively higher proportion of money going to claimants. The *Aldrich* debtors were paying approximately \$70 million per year in indemnity payments and \$25 million per year in defense costs in the tort system.⁴⁸ DBMP's informational brief failed to split out defense costs versus indemnity costs, simply stating it spent \$80 million to over \$160 million in defense and indemnity costs per year from 2002 to 2019.⁴⁹ On the plaintiffs' part, personal injury plaintiffs are usually represented by lawyers under a contingent fee arrangement. They are paid only if they win the case for their client, and then receive only an amount limited by their contracts and state law. In short, how much money goes to lawyers rather than claimants is largely up to the defendants.

Further, there is no evidence that a large percentage of asbestos claims are frivolous or fraudulent claims. They may ultimately be claims that are not compensable, but that is different. In asbestos cases, discovering what sources of asbestos exposure contributed to an individual's asbestos disease can be difficult work. Many people were exposed to asbestos in industrial and commercial settings decades earlier. Witnesses and documents establishing the claim have to be found and developed. While some cases may ultimately be dismissed due to insufficient evidence, this is largely because a plaintiff is unable to obtain sufficient evidence, including evidence from

⁴⁷ Sepco TDP § 5.7; *see also* Kaiser TDP § 5.10; Fairbanks TDP § 5.8; Owens Coming TDP § 5.8; W.R. Grace TDP § 5.8; B&W TDP § 5.8.

⁴⁸ Informational Brief of Aldrich Pump LLC and Murray Boiler LLC, at 37, *In re Aldrich Pump LLC*, No. 20-30608 (Bankr. W.D.N.C. June 18, 2020), ECF No. 5.

⁴⁹ Informational Brief of DBMP LLC, at 22, *In re DBMP LLC*, No. 20-30080 (Bankr. W.D.N.C. Jan. 23, 2020), ECF No. 22.

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asbestos defendants themselves, to establish that an asbestos defendant's products existed at given locations and times.

As to whether asbestos defendants would agree to contribute funds that they would have spent on defense counsel to a trust, recent developments suggest that is unlikely. The Texas Two-Step strategy appears to be designed not to facilitate more money being put into trusts, but as a way to force claimants to accept less—a “bankruptcy discount.”⁵⁰

4. *A court recently found rampant fraud perpetrated by plaintiff lawyers in the tort system on corporate defendants that necessitated a RICO lawsuit against those lawyers. Is that a concern given the calls to favor that system in these divisional merger cases?*

I know of no case that fits that description. I believe you may be referring to the *Garlock* case, which is neither recent (the estimation decision was issued on January 10, 2014) nor found rampant fraud (indeed, the decision never even mentions the word “fraud”). See generally *In re Garlock Sealing Techs., LLC*, 504 B.R. 71 (Bankr. W.D.N.C. 2014). When discussing the alleged withholding of exposure evidence, the court noted that it “makes no determination of the propriety of that practice.” See *id.* at 86-87. Nor could the court have made any such findings, because no plaintiffs’ law firms or asbestos victims were parties to the estimation proceeding. See generally *id.* I believe that is among the reasons why the successor judge in *Garlock* later noted about the estimation decision: “It’s interesting to me, as I watched him when he did this, Judge Hodges’ ruling was written narrowly, but has been read broadly and it is, admittedly, based on a fairly [] limited number of instances of suppression of evidence by plaintiffs’ firms, only 15.”⁵¹ Moreover, the *Garlock* opinion itself recognizes that those 15 cases were cherry-picked, as “they are not purported to be a random or representative sample” of *Garlock*’s experience in the tort system. See *id.* at 85. This was a tiny fraction of the many thousands of claims pending against *Garlock*.

The *Garlock* estimation process lasted years and cost the debtors’ estates more than \$120 million in professional fees—a number that fails to include or account for the additional expenses imposed on *Garlock*’s asbestos victims during that time period. While the *Garlock* estimation decision concluded that *Garlock*’s aggregate liability for present and future mesothelioma claims

⁵⁰ See, e.g., *In re Aldrich Pump LLC*, 2021 WL 3729335, at *20 (“Manlio Valdes, a member of both boards, admitted that, after the May 29, 2020 joint meeting of the boards, he thought it was ‘a probability’ that the Trane entities would end up paying less to asbestos claimants in bankruptcy.”); *id.* at *21 (“Nor were these actions undertaken for the benefit of the asbestos claimants. Rather, these bankruptcies were designed to isolate the asbestos claimants from the overall corporate enterprise and strand them in bankruptcy until such time as they agree to a Section 524(g) plan.”); see also *In re DBMP LLC*, No. 20-30080, Adv. No. 20-03004, 2021 WL 3552350, at *6 (Bankr. W.D.N.C. Aug. 11, 2021) (“Seeking a less expensive way of dealing with these tort liabilities, in 2019, Old CertainTeed engaged in a series of transactions (described herein and collectively referred to as the ‘Corporate Restructuring’) which led to the Debtor’s creation and its chapter 11 filing.”); *id.* at *26 (“[I]t appears that the Divisive Merger had a material, negative effect on the asbestos creditors’ ability to recover on their claims.”).

⁵¹ Transcript of Hearing at 51:13-17, *In re Kaiser Gypsum Co.*, No. 16-31602 (Bankr. W.D.N.C. Sept. 4, 2019).

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totalled \$125 million,⁵² the final settlement number jointly negotiated by the Committee, the debtor, and the FCR bore no resemblance to that number, but was \$500 million.⁵³

Because the parties settled, the methodology employed by the *Garlock* court was never reviewed on appeal. Given that the court's methodology conflicted with the methodology used in all other asbestos cases where estimation was contested, there is a high likelihood that the *Garlock* opinion would have been overruled on appeal, as is also supported by the fact that the settlement number was four times higher. And notably, the RICO lawsuits were voluntarily dismissed at the time of the settlement.⁵⁴

It is also important to know that, unlike tort-system defendants, the asbestos trusts concede what they know and publish lists of work sites where past litigation showed that their predecessor's products were in use. Many claims are submitted to trusts relying on proof that the claimant worked at a site on the applicable trust's published work site list in an occupation that typically involved asbestos exposure.

5. *I have introduced, alongside Senators Grassley and Cornyn, legislation designed to promote transparency and accountability in asbestos bankruptcies and trusts funds created to compensate asbestos victims. The PROTECT Asbestos Victims Act would require the appointment of independent, non-conflicted fiduciaries and allow the Department of Justice to audit bankruptcy trust funds. Do you believe that Congress, if it considers any modification to bankruptcy courts' consideration of divisive mergers and non-debtor releases, should also consider reforms that would promote equitable distribution of funds and deter waste, fraud, and abuse that may limit victims' access to compensation?*

In my opinion, curbing debtor abuse of the bankruptcy process via the Texas Two-Step should not be contingent on or otherwise tied to Congress considering proposed legislation such as the PROTECT Act. The former concerns ensuring that a debtor's pre- and post-petition conduct does not fundamentally disrupt the bankruptcy system and creditors' rights; whereas the latter concerns a proposed extension of federal oversight to post-confirmation trusts governed by state law. The two issues are not related in such a way that one must, or even should, follow the other.

⁵² *Garlock Sealing Techs., LLC*, 504 B.R. at 97.

⁵³ See Disclosure Statement for Modified Joint Plan of Reorganization of Garlock Sealing Technologies LLC, et al. and OldCo, LLC, Proposed Successor by Merger to Coltec Industries Inc., at ii, *In re Garlock Sealing Techs., LLC*, No. 10-31607 (Bankr. W.D.N.C. July 29, 2016), ECF No. 5444.

⁵⁴ The RICO suits were dismissed pursuant to a settlement articulated in § 8.4.4 of the Garlock Joint Plan, which provides that, with respect to the actions pending against the law firms, "such actions and any claims, counterclaims, or countersuits the respective parties asserted or could have asserted therein shall be dismissed with prejudice in exchange for mutual general releases and mutual waivers of costs and attorneys' fees." Modified Joint Plan of Reorganization of Garlock Sealing Technologies LLC, et al. and OldCo, LLC, Successor by Merger to Coltec Industries Inc., *In re Garlock Sealing Techs., LLC*, No. 10-31607 (Bankr. W.D.N.C. May 14, 2017), ECF No. 5951-1.

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Moreover, I have reviewed the PROTECT Act as proposed and do not believe it would be beneficial. The bill's apparent premise, that federal governmental intervention into the administration and operation of asbestos settlement trusts operating under state law is necessary to protect the interests of trust beneficiaries (*i.e.*, asbestos victims) from "fraudulent claims," is, to the best of my knowledge, unsubstantiated.⁵⁵ I am not aware of any trusts or asbestos victims that have called for such "protection." I am not aware of any indication that the trustees appointed to manage the trusts have not done so consistent with their fiduciary obligations. And I am not aware of any indication that the trusts' existing procedures for identifying and responding to any potential fraud perpetrated on the trusts are inadequate. To the contrary, it is my understanding that the majority of the trusts that my firm works with have implemented sophisticated audit programs designed to ensure that the carefully drawn trust procedures are being properly implemented and enforced. In my opinion, the bill, and any similar measure, is a solution in search of a problem, and would only harm the very asbestos victims it is intended to help.

Apart from being unnecessary to "protect" trusts' or their beneficiaries' interests, the PROTECT Act would potentially undermine those interests. The PROTECT Act contains a provision requiring the trust to provide *any* defendant in an asbestos-related legal action with any information relating to a payment or demand for payment from the trust upon written request.⁵⁶ Neither trusts nor their beneficiaries benefit from third parties gaining unfettered access to asbestos victims' confidential settlements and sensitive medical information. Indeed, the only beneficiaries would be the apparent primary supporters of the PROTECT Act and similar legislation: the asbestos defense bar. Further, the asbestos defense bar already has access to the information they could receive under the PROTECT Act, but currently they must obtain it through traditional legal process that is designed to protect the rights of those from whom such information is sought. A Government Accountability Office report regarding the asbestos settlement trusts confirmed that litigants in the tort system can readily obtain information from the trusts regarding claimants, such as their exposure to a particular company's asbestos-containing product, pursuant to court-issued subpoenas.⁵⁷ Moreover, defendants can obtain such information directly from tort claimants themselves in discovery.⁵⁸

It is also my opinion that the PROTECT Act would likely authorize bankruptcy courts to take on matters beyond their appropriate jurisdiction. Indeed, the PROTECT Act appears to contemplate bankruptcy courts having unending plenary post-confirmation jurisdiction over trusts and, potentially, reorganized debtors. For example, it proposes the mandatory reopening of a

⁵⁵ See PROTECT Asbestos Victims Act of 2021, S. 574, 117th Cong. at 1 (2021).

⁵⁶ *Id.* at 4-5.

⁵⁷ See UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, ASBESTOS INJURY COMPENSATION: THE ROLE AND ADMINISTRATION OF ASBESTOS TRUSTS (2011), <https://www.gao.gov/assets/gao-11-819.pdf> ("Other information in the possession of a trust, such as an individual's exposure to asbestos, is generally not available to outside parties but may be obtained, for example, in the course of litigation pursuant to a court-ordered subpoena.").

⁵⁸ See *id.* at 26 ("Judges may require that a claimant or trust disclose trust claim forms during the discovery phase, which may include statements of work history, asbestos exposure, and medical diagnosis, for claims previously submitted to trusts.").

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closed bankruptcy case at any time to enable the United States Trustee⁵⁹ to conduct an investigation into any aspect of the administration and operation of a trust, even a trust created prior to the bill's enactment.⁶⁰ Furthermore, once the case is reopened, the bill provides that the court may issue "any order" it deems necessary or appropriate relating to the trust.⁶¹

In general, bankruptcy courts have limited jurisdiction, which is further diminished once a bankruptcy plan has been confirmed.⁶² Post-confirmation, bankruptcy courts only have jurisdiction over matters with "a close nexus to the bankruptcy plan or proceeding."⁶³ The fact that a trust was formed as part of a bankruptcy proceeding does not mean that any issue regarding the trust fits into that exacting standard.⁶⁴

In sum, I do not believe that Congress should consider enacting the PROTECT Act.

⁵⁹ It is unclear that providing a United States Trustee with sweeping authority to oversee and investigate trusts formed under state law is warranted or would be consistent with their authority or expertise.

⁶⁰ S. 574, *supra* note 55, at 8.

⁶¹ *Id.* at 6-7.

⁶² See, e.g., *In re Resorts Int'l, Inc.*, 372 F.3d 154, 165 (3d Cir. 2004) ("[T]he scope of bankruptcy court jurisdiction diminishes with plan confirmation."); *Guccione v. Bell*, No. 06 CIV. 492(SHS), 2006 WL 2032641, at *4 (S.D.N.Y. July 20, 2006) ("Courts generally agree that . . . [bankruptcy] jurisdiction . . . shrinks once bankruptcy plan confirmation has occurred.")

⁶³ *In re Resorts Int'l, Inc.*, 372 F.3d at 167.

⁶⁴ *Id.* (holding claim involving trust was not within bankruptcy court's jurisdiction); see also *Falise v. Am. Tobacco Co.*, 241 B.R. 48, 58 (E.D.N.Y. 1999) (finding trust is not a continuation of the bankruptcy estate and claimants to trust are not creditors of estate, but those with rights to make claims against the trust).

Questions from Senator Tillis for David Skeel

Many thanks for your questions and for inviting me to share my thoughts on them. I should preface my responses by saying that I have not carefully studied the operation of the trusts often used for compensating the victims in mass tort cases. But I answer each of your questions below based on my understanding of the process.

1. *Tell me about how the system works for people who might discover their injury a few years down the road. Does the current Chapter 11 process allow for injured people to access compensation right away as well as in the future if it takes them a while to discover their injury? Or are they out of luck if they don't get in to file a claim right away?*

Chapter 11 generally does not contemplate paying injured people or other creditors until a reorganization plan has been confirmed (or the case has been resolved in some other fashion). My understanding is that, once a reorganization plan has been confirmed and a trust has been set up, injured people can sometimes obtain compensation relatively promptly, but this may vary based on the terms of the trust and the nature of the injury.

2. *Do you have a sense of how the turnaround time for compensation under one of these funds compares with the turnaround time in a personal injury lawsuit through the courts? I mean, it seems like a compensation fund might be quicker? And isn't a lawsuit kind of a gamble compared to a fund that is already set aside?*

I do think the turnaround time may often be considerably quicker for payment from the trust set up as part of a Chapter 11 reorganization plan as compared to the ordinary litigation process, and that the ordinary litigation process is more of a gamble. There may be exceptions to this, depending factors such on the nature of the injury, when the injury occurs, and how the litigation is handled outside of bankruptcy. But in general, an important benefit of the trust approach is that, once the trust is set up, it can provide a payout relatively promptly and treat similar claims similarly.

- a. *The plaintiffs' bar claims delay, but isn't that entity the sole source of delay in all of the divisional merger cases, to the point, in most cases, of even refusing to start a negotiation?*

I'm not familiar with the particular allegation of delay. As mentioned above, a benefit of handling mass tort cases in bankruptcy is that, when a trust is set up, the process can be more expeditious and provide payouts than are more consistent from one claim to the next than traditional litigation.

- b. In one current divisional merger case, the debtors and the future claimants representative representing 80+ % of asbestos claims have negotiated a deal for over half a billion dollars for claimants. Yet even in that case, the plaintiffs' bar refuses even to engage and continues to delay payment to claimants. Don't examples like these refute the various statements that the debtor is causing delay or trying to avoid providing compensation?*

I'm not familiar with the details of the negotiations in this particular case, so I can't speak to the extent of any delay or to its cause.

3. *Can you explain how the compensation funds come together? What's the process and what kind of oversight do the funds have? And who has a seat at the table in the negotiation when these funds are put together? Is it just the current creditors or do people who might make a future claim have any representation to protect their rights in these discussion?*

In asbestos cases that are governed by section 542(g) of the Bankruptcy Code, a legal representative is appointed to represent the interest of future claimants. In other mass tort cases, legal representatives are not always appointed. Given that the future claimants' interests are not the same as current claimants' interests, I believe it is very important that the future claimants have their own representative or representatives. Otherwise, the trust is created through negotiations among the debtor, the current victims, and other creditors, without the perspective of future claimants.

- a. Given that the lion share of the money spent in tort cases goes to lawyers and not asbestos claimants, and that a large percentage of those claims are ultimately dismissed after proving to be frivolous or fraudulent, wouldn't that money better be redirected to a trust system for all legitimate current and future claimants?*

Although I haven't carefully studied the details of how the asbestos cases have been handled, there have long been complaints that too little of the payouts get to the victims who are most harmed. I would favor the implementation of a trust system that sought to regularize the treatment of asbestos victims, and in the past I have been involved in discussions about legislation that was intended to have this effect.

4. *A court recently found rampant fraud perpetrated by plaintiff lawyers in the tort system on corporate defendants that necessitated a RICO lawsuit against those lawyers. Is that a concern given the calls to favor that system in these divisional merger cases?*

I'm not familiar with this particular ruling. As discussed in my written and oral testimony, I believe it is important to use traditional bankruptcy doctrines such as fraudulent conveyance law and the requirement that a bankruptcy be filed in good faith to police divisional mergers, and to make sure that they are not used abusively. But for a divisional merger that is not abusive, I believe resolution in bankruptcy provides important benefits as compared to the traditional litigation process outside of bankruptcy.

5. *I have introduced, alongside Senators Grassley and Cornyn, legislation designed to promote transparency and accountability in asbestos bankruptcies and trusts funds created to compensate asbestos victims. The PROTECT Asbestos Victims Act would require the appointment of independent, non-conflicted fiduciaries and allow the Department of Justice to audit bankruptcy trust funds. Do you believe that Congress, if it considers any modification to bankruptcy courts' consideration of divisive mergers and non-debtor releases, should also consider reforms that would promote equitable distribution of funds and deter waste, fraud, and abuse that may limit victims' access to compensation?*

I have not studied your proposed legislation carefully, so I won't speak to the details. But I do favor measures that would ensure that representatives of future victims and other court-appointed representatives be truly independent, and that would promote transparency and accountability in the operation of the funds.

Questions from Senator Tillis for Paul Zumbro

Q.1. Tell me about how the system works for people who might discover their injury a few years down the road. Does the current Chapter 11 process allow for injured people to access compensation right away as well as in the future if it takes them a while to discover their injury? Or are they out of luck if they don't get in to file a claim right away?

A.1. Section 524(g) was added to the Bankruptcy Code to allow both present and future claimants to recover. The first Johns-Manville trust failed because funds were not preserved for future claims, so claimants rushed to submit their claims and depleted the trust within a few years after it was created. Section 524(g) now requires the court to ensure that the trust "provide[s] reasonable assurance that the trust will value, and be in a financial position to pay, present claims and future demands that involve similar claims in substantially the same manner."

All section 524(g) trusts have processes that allows claimants with current injuries as well as those who discover injuries in the future to submit claims to the trust and receive compensation. These processes include periodic adjustments of the amounts to be disbursed over time and require that future claimants' representatives ("FCRs"), who have fiduciary duties to protect the interests of future claimants, consent to significant changes in trust administration and fund distribution. Thus, individuals who are not yet aware of their injuries are not out of luck, and their claims should be treated in substantially the same manner as earlier claims.

Q.2. Do you have a sense of how the turnaround time for compensation under one of these funds compares with the turnaround time in a personal injury lawsuit through the courts? I mean, it seems like a compensation fund might be quicker? And isn't a lawsuit kind of a gamble compared to a fund that is already set aside?

A.2. Yes, compensation through the section 524(g) trust is designed to be quicker. The trust distribution system is supposed to be predominantly an expedited system that avoids the drawn out trial and appeals processes of normal litigation. Generally, a trust has an expedited review procedure and an individual review procedure. The expedited review procedure allows for faster, fixed payments based on predetermined criteria regarding the extent of one's injury and level of exposure to the debtor's asbestos-containing products. Trusts also give claimants the opportunity to pursue an individual review procedure, which requires additional documentation of evidence of injuries and asbestos exposure (similar to the discovery process) and can take as long as resolution through litigation would take. Thus, the claimant decides whether to accept general treatment based on preestablished criteria for quicker compensation or seek individualized treatment through a longer process. When comparing the time to compensation between litigation of a claim and the processing of a claim by a trust, generally speaking the compensation fund should be quicker, but it depends on the individual claimant's choices and circumstances.

Further, resolving asbestos claims through litigation is a gamble in that two similarly situated claimants could receive two very different outcomes in litigation, which courts and commentators have described as a "lottery". One claimant may receive a large verdict, while the other claimant, perhaps due to poor representation or an unpersuaded jury, may receive nothing.

Section 524(g) trusts avoid these disparate outcomes, as all similarly situated claimants, present and future, must be compensated in substantially the same manner.

Q.2.a. The plaintiffs' bar claims delay, but isn't that entity the sole source of delay in all of the divisional merger cases, to the point, in most cases, of even refusing to start a negotiation?

A.2.a. In all of the divisional merger cases to date, there has been a lot of time spent on legal skirmishes over whether divisional merger bankruptcies are appropriate uses of the bankruptcy system and whether filings have been made in good faith. It could be argued that this has been to the detriment of claimants seeking as much compensation as soon as possible. Perhaps now that Judge Kaplan in the LTL Management case has found the divisional merger bankruptcy was not filed in bad faith, all parties in divisional merger cases will spend more time negotiating the terms of trusts and preparing for estimation hearings rather than arguing motions and objections to the bankruptcy filing. The sooner the section 524(g) trusts are approved, the sooner injured claimants on the whole will receive fair and equitable compensation.

Q.2.b. In one current divisional merger case, the debtors and the future claimants representative representing 80+% of asbestos claims have negotiated a deal for over half a billion dollars for claimants. Yet even in that case, the plaintiffs' bar refuses even to engage and continues to delay payment to claimants. Don't examples like these refute the various statements that the debtor is causing delay or trying to avoid providing compensation?

A.2.b. I believe you are referring to the Aldrich Pump case, in which debtors Aldrich Pump and Murray Boiler have estimated that future claims will make up over 80% of the total asbestos claims and the FCR has supported the debtors' proposed plan of reorganization. Certainly, motions by asbestos claimants committees asking the court to undo the divisional merger through substantive consolidation, as in the Aldrich Pump case, or alleging the divisional merger bankruptcy filing was made in bad faith, as mentioned above, are delaying the formation of the 524(g) trusts and compensation to claimants. Contrary to what asbestos claimants committees argue, debtors likely have little incentive to delay; while there are cost savings from the stay of asbestos claim litigation, there are significant legal fees and costs involved in the bankruptcy process. Thus, it should be in the best interest of both asbestos claimants committees and debtors to reach agreements and establish trusts as soon as possible to compensate claimants quickly and to preserve debtors' resources for the payment of claims rather than legal expenses.

Regarding the statements that debtors are trying to avoid providing compensation, as I mentioned in my testimony, the best evidence that debtors are not avoiding their obligations to compensate claimants is the funding agreement in each of the divisional merger cases.

Q.3. Can you explain how the compensation funds come together? What's the process and what kind of oversight do the funds have? And who has a seat at the table in the negotiation when these funds are put together? Is it just the current creditors or do people who might make a future claim have any representation to protect their rights in these discussions?

A.3. Much like a plan of reorganization, an asbestos claimant trust is the product of negotiations between a debtor and its creditors, with the additional involvement of the FCR. Claimants have

significant involvement in the negotiations of a section 524(g) trust, as the plan of reorganization must receive the approval of at least 75% of the claimants affected by the trust, and the FCR negotiates on behalf of future claimants to ensure equitable treatment between current and future claimants.

The trust is managed by one or more trustees, often including a retired bankruptcy judge. The trustee manages the investments of the trust in order to maximize the value of the trust and oversees disbursements from the trust. The trustee owes fiduciary duties to the claimants and manages the trust for their sole benefit.

The trust (and the trustee) must be approved by the bankruptcy court, which evaluates whether the trust meets the requirements of section 524(g) of the Bankruptcy Code, as well as the qualifications and disinterestedness of the trustee. The requirements of section 524(g) ensure, among other things, adequate funding of the trust and equality of treatment among present and future claimants. The trust is required to provide regular reports with the bankruptcy court (which are publicly filed) to ensure continued compliance with the requirements of section 524(g).

The trustee must generally obtain the consent of the trust advisory committee (which represents current claimants) and the FCR before taking any major actions, such as amending the trust distribution procedures or adjusting the percentages to be paid on claims asserted against the trust. Current claimants, the FCR and the U.S. Trustee provide continuing oversight of the trust, as they may raise objections with the bankruptcy court to the extent they believe that the administration of the trust is not in compliance with section 524(g) or orders of the court.

Q.3.a. Given that the lion share of the money spent in tort cases goes to lawyers and not asbestos claimants, and that a large percentage of those claims are ultimately dismissed after proving to be frivolous or fraudulent, wouldn't that money better be redirected to a trust system for all legitimate current and future claimants?

A.3.a. As mentioned in my testimony, the private litigation system is not able to effectively manage mass tort cases. One of the principal benefits of the trust system is that it allows limited resources to be distributed directly to claimants rather than consumed by litigation costs and attorneys' fees. As a result, the trust system generally allows for greater and faster recovery to the claimants compared to the tort system, which involves significant cost, delay and uncertainty.

Q.4. A court recently found rampant fraud perpetrated by plaintiff lawyers in the tort system on corporate defendants that necessitated a RICO lawsuit against those lawyers. Is that a concern given the calls to favor that system in these divisional merger cases?

A.4. There is always a risk of malfeasance in any court proceeding, including the potential for fraud in the tort system, which leads to inequitable results in mass tort cases. Without the protection of bankruptcy, a debtor's limited pool of assets creates a "race to the courthouse", where claimants (and their attorneys) try to receive as much compensation as possible before the

money runs out. As shown by the behavior in some cases, this can create incentives to exaggerate or even fabricate claims against the debtor.

However, the Bankruptcy Code requires that all similarly situated creditors be treated equally, and section 524(g) extends that principle so that current and future claimants are treated equally. Eliminating the “race to the courthouse” and the incentives and inequities it creates is one of the critical ways that bankruptcy is the most efficient, equitable and just way to resolve mass tort liabilities while maximizing recoveries for both present and future claimants.

Q.5. I have introduced, alongside Senators Grassley and Cornyn, legislation designed to promote transparency and accountability in asbestos bankruptcies and trusts funds created to compensate asbestos victims. The PROTECT Asbestos Victims Act would require the appointment of independent, non-conflicted fiduciaries and allow the Department of Justice to audit bankruptcy trust funds. Do you believe that Congress, if it considers any modification to bankruptcy courts' consideration of divisive mergers and non-debtor releases, should also consider reforms that would promote equitable distribution of funds and deter waste, fraud, and abuse that may limit victims' access to compensation?

A.5. The PROTECT Asbestos Victims Act provides that the FCR would be appointed by the U.S. Trustee, subject to approval by the court, rather than simply being appointed by the court, and that the FCR (and any professionals employed by it) must be disinterested. There has been criticism that the FCR appointed by the court is often one that is nominated by the debtor and agreed to by the current claimants. While, as a practical matter, the court must rely on the parties for nominations, there may be legitimate concern with relying on debtors and current claimants, whose interests are adverse to the future claimants, to nominate the FCR. Accordingly, having the U.S. Trustee select the FCR, subject to court approval (as provided in the PROTECT Asbestos Victims Act), may be beneficial in ensuring independence of the FCR, the protection of future claimants and the public's trust in the section 524(g) process. In addition, while most courts have found that the FCR must be disinterested, the Bankruptcy Code does not directly provide the standard for appointing an FCR (or the standard for the professionals it employs), and the provisions of the PROTECT Asbestos Victims Act would help to clarify the proper standard. Finally, the provisions of the PROTECT Victims Act that would clarify that the FCR (and the professionals it employs) may be compensated by the estate would bring certainty to potential FCRs and their professionals and potentially attract a greater pool of qualified candidates.

Beyond the provisions of the PROTECT Asbestos Victims Act that would give the U.S. Trustee greater oversight of section 524(g) trusts, I do not see a need for further legislative action to deter waste, fraud and abuse, whether in the context of divisional merger bankruptcies or non-debtor releases. Given that the primary goal of asbestos trusts and mass tort settlements (of which non-debtor releases are often a part) is to provide the greatest amount of compensation to claimants as quickly and efficiently as possible, and given the enormous difficulties that already exist in achieving a global resolution in such cases, I would be hesitant to endorse any additional requirements that may impose further delays to claimants' compensation.



**HOW LOOSE BANKRUPTCY VENUE LAWS¹ FACILITATE “TEXAS TWO-STEP” CASE
FILINGS, FURTHER ERODE THE PUBLIC’S CONFIDENCE IN THE BANKRUPTCY
COURTS AND SYSTEM, AND WHY BANKRUPTCY VENUE REFORM BILLS
(S. 2827 & H.R. 4193) ARE PART OF THE SOLUTION**

To: Senate Judiciary Subcommittee on Federal Courts, Oversight, Agency Action and Federal Rights

From: The Commercial Law League of America

Date: February 14, 2022

Re: Supplement to Record of Hearing (the “Hearing”) Held February 8, 2022 on “Abusing Chapter 11: Corporate Efforts Side-Stepping Accountability Through Bankruptcy”

The Texas Two-Step - How It Works

Step One: Mass tortfeasors use Texas law to transfer liabilities and certain minimal assets into a new Texas incorporated shell company (“BadCo”) using the Texas divisive merger maneuver described at the Hearing. BadCo then quickly converts or reincorporates itself under another state’s law, primarily North Carolina, for the sole purpose of placing BadCo into bankruptcy.

Step Two: Mass tortfeasors then exploit 28 U.S.C. §1408 to venue shop the BadCo’s bankruptcy case into a North Carolina bankruptcy court of their choice, having no connection whatsoever to the tortfeasors, but where they expect to take advantage of more favorable law that makes it harder for creditor tort victims to successfully obtain dismissal of the chapter 11 cases, and where they are confident the judge will shield their healthy non-debtor parent companies (“GoodCo”) by extending the Bankruptcy Code’s “automatic stay” to stop all pending tort litigation against GoodCo. The apparent hope is to shop BadCo’s case into a court that will rule in their favor and retain the case despite dismissal requests, extend the automatic stay to non-debtor third parties, and confirm a chapter 11 plan with nonconsensual third party releases of non-debtors and approve the scheme to cap financial responsibility and insulate the GoodCo from further liability.²

¹ 28 U.S.C. §§ 1408 (venue choices for debtors), 1412 (remedy of transfer of case).

² Rampant forum shopping is not used only in Texas Two-Step Cases. A recent study by Georgetown University Law Professor Adam Levitin found that 57% of public company chapter 11 cases filed in 2020 were heard by only three bankruptcy judges (out of more than 300 judges nationwide). Similarly, a 2015 study by the GAO observed that, between 2010 and 2014, 71% of large companies (assets and liabilities of \$50 million or more) filed for bankruptcy in two Districts.

The Texas Two-Step Problem Is Exacerbated by a Bankruptcy Filing and Venue Shopping:

The financial and human toll of these forum-shopped Texas Two-Step cases is compelling. *LTL Management* (Johnson & Johnson spinoff), *Bestwall*, *DBMP*, *Aldrich Pump* and *Murray Boiler*, to name a few, manipulated lenient venue statutes to file in their courts of choice to stack the deck against their victim creditors and make it very difficult to obtain dismissal of these bankruptcy cases as not having been filed in “good faith.” The ability of debtors and their professionals to manufacture restructured companies, manipulate laws, and choose their own venue to achieve a desired outcome directly threatens the integrity of the bankruptcy system and erodes public confidence.

Bankruptcy venue shopping is a key component to making the Texas Two-Step strategy work.

Three of the four “Texas Two-Step” cases filed in the United States District Court for the Western District of North Carolina demonstrate the ease by which companies can pick their venue, and even their judge, and favorable controlling Fourth Circuit law. But for the ability to use state of incorporation as a basis for filing a bankruptcy case in a particular state, the following three (3) case examples would not have likely been able to commence their cases in the Western District of North Carolina, where, as testified to by witnesses at the Hearing, the standard is much more difficult than in other circuits for creditors³, like tort victims, to obtain dismissal of chapter 11 bankruptcy cases:

- *In re Bestwall LLC* (Case No. 17-31795): Bankruptcy Petition lists the principal place of business as Atlanta, Georgia, and the Resolution of the Board of Managers states that the company is a North Carolina limited liability company (See Voluntary Petition attached hereto). But for incorporating in North Carolina, the case would have likely had to commence in the Northern District of Georgia and be subject to Eleventh Circuit law which has a lower standard for dismissal than Fourth Circuit law.⁴
- *In re DBMP LLP*, Case No. 20-30080: Bankruptcy Petition lists the principal place of business as Malvan, Pennsylvania, and the Secretary’s Certificate states that the company is a North Carolina limited liability company (See Voluntary Petition attached hereto). But for incorporating in North Carolina, the case would have likely had to commence in the Eastern District of Pennsylvania and be subject to Third Circuit law which has a lower standard for cause for dismissal than in the Fourth Circuit.⁵
- *In re LTL Management LLC*, Case No. 21-30589: Bankruptcy Petition lists the principal place of business as New Brunswick, New Jersey, and the Secretary’s Certificate states that the company is a North Carolina limited liability company (See Voluntary Petition attached hereto). But for incorporating in North Carolina, the case would have likely had to commence in the District of New Jersey and be subject to Third Circuit law which has a lower standard for dismissal than Fourth Circuit law.⁶

³ See *Carolina Corp v. Miller*, 886 F. 2d 693, 700-01 (4th Cir. 1989) (bankruptcy court cannot dismiss a petition for bad faith unless it also finds that no legitimate possibility of reorganization exists). This is the most difficult standard in the country for creditors to successfully overcome in order to obtain dismissal of a bankruptcy case.

⁴ CLLA Appx. Pages 1 & 5. The Bankruptcy Petition also lists an address in North Carolina as the location of principal assets, although it is unclear from the petition what assets were located in North Carolina at the time of filing.

⁵ CLLA Appx. Pages 18 & 22. The Bankruptcy Petition also lists “North Carolina” as the location of principal assets, although it is unclear from the petition what assets were located in North Carolina at the time of filing.

⁶ CLLA Appx. Page 36 & 42. The Bankruptcy Petition also lists “North Carolina” as the location of principal assets, although it is unclear what, if any, assets were located in North Carolina at the time of filing.

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In fact, Judge Whitley, the original North Carolina bankruptcy judge in the LTL Management case, made it clear that state of incorporation was the primary basis upon which venue was proper in North Carolina. In his Order to Appear and Show Cause Why Venue Should Not Be Transferred to Another District (the "Show Cause Order", attached hereto), he stated:

Venue is arguably proper in this judicial district since the Debtor was a North Carolina entity on the filing date, if only for two days. However, nearly all the assets and employees of the Debtor, New JJCI, and the Debtor's ultimate parent, J&J, are located in New Jersey. The Debtor has a mailing address of 501 George St., New Brunswick, NJ 08933. Moreover, New JJCI and J&J are both headquartered in New Jersey. The only employees of the Debtor are employees of Johnson & Johnson Services, Inc., a New Jersey corporation, that have been seconded to the Debtor. These employees continue to work in New Jersey. The only assets the Debtor owns in North Carolina are a bank account with \$6 million in cash and other intangible assets, including membership interests in a North Carolina limited liability company and the rights to a funding agreement. The Debtor, which only existed for two days before filing this case, set up these assets primarily for the purpose of filing bankruptcy in this district. The Debtor conducts no other business in North Carolina.⁷

Bankruptcy venue shopping allows debtors to select their bankruptcy judge.

Because of how easy it is for mass tortfeasors to incorporate their "BadCo" entities in any state in the United States, it allows them to pick which circuit, state, judicial district, judicial division, and even judge to administer their cases. Judge Whitley essentially stated as much in his Show Cause Order, as detailed below.

Even though the Fourth Circuit covers five (5) states, nine (9) judicial districts, thirty-two (32) divisions and has twenty-nine (29) bankruptcy judges, *all of the Texas Two-Step cases were filed in one state (North Carolina), one judicial district (the Western District of North Carolina) and one division (the Charlotte Division), which has only two (2) bankruptcy judges, one of whom is conflicted out of most of these cases.* Judge Whitley recognized this issue and how he repeatedly becomes the judge administering these cases:

There are currently five other mass tort bankruptcies pending in this district, all involving the controversial "Texas Two Step" divisional merger stratagem. This is a two-judge district, with one judge conflicted out of this and several other of these cases. Thus, this court has limited judicial resources to devote to this case.⁸

Bankruptcy venue shopping erodes the public's confidence in the courts.

Beyond the Texas Two-Step cases, venue shopping by corporate debtors to obtain desired results has become so prevalent that United States District Court judges sitting as appellate courts of bankruptcy court decisions are taking notice and openly questioning the integrity of the bankruptcy system. In a recent decision, attached hereto (the "Memorandum Opinion"), overturning approval of third-party releases, United States District Court Judge Novak of the Eastern District of Virginia observed that 91% of large

⁷ CLLA Appx. Page 59 (Show Cause Order at p. 2).

⁸ CLLA Appx. Page 59-60 (Show Cause Order at pp. 2-3).

chapter 11 cases file in only four Districts.⁹ In reversing the bankruptcy court's confirmation of a plan with broad third-party releases, Judge Novak made a point to remand the matter to a different bankruptcy court and not the one chosen by the debtors through forum shopping:

The Court . . . believes reassignment is warranted here due to the practice of issuing third-party releases in the Richmond Division in contravention of the Fourth Circuit's admonitions in *Behrmann*. To be clear, the undersigned does not question the integrity or impartiality of Judge Huennekens. Indeed, the contrary is true, as the undersigned holds Judge Huennekens in high regard. *However, the practice of regularly approving third-party releases and the related concerns about forum shopping call into question public confidence in the manner that these cases are being handled by the Bankruptcy Court in the Richmond Division.*¹⁰

The implication was clear. Current venue law undermines public confidence in the bankruptcy courts by allowing debtor companies to pick judges who regularly approve third party releases for the benefit of the companies' owners.¹¹

In an opinion piece published in the *Wall Street Journal*, retired Bankruptcy Judge Steven Rhodes called the current venue law "*the single most significant source of injustice in chapter 11 bankruptcy cases.*" Judge Marvin Isgur of the U.S. Bankruptcy Court for the Southern District of Texas, one of the judges who is overseeing many large bankruptcy cases filed in Houston, recognized that: "*The public needs to have confidence that what we're doing is being done for all the right reasons . . . even though I'm convinced that we are all doing that, I think we do need venue reform.*"¹²

The Solution: Pass H.R. 4193 and S. 2827, Bankruptcy Venue Reform Act of 2021

The venue reform bills pending in the Senate and House, sponsored by Senators Cornyn (R-TX) and Warren (D-MA) in the Senate, and by Reps. Lofgren (D-CA) and Buck (R-CO) in the House, have wide bipartisan support and are clearly part of the solution to the problems posed by the Texas Two Step cases. These bills will require Chapter 11 cases to stay local by requiring corporate debtors to file where they have their principal assets or principal place of business. If passed, companies will have to file Chapter 11 bankruptcy where they actually conduct their business. They will no longer be able to unilaterally choose the jurisdiction they deem friendly. Instead, competent bankruptcy judges assigned randomly to oversee the reorganization of companies that are based in their own communities would consider these attempts to avoid responsibility for mass torts. Victims will have the opportunity to litigate on a level playing field.

Support for Bankruptcy Venue Reform

Venue reform has been supported by the Commercial Law League of America, National Association of Attorneys General, United Mine Workers of America, National Association of Credit Managers, Iowa

⁹ CLLA Appx. Page 64 (Memorandum Opinion at p. 4, *Patterson, et. al. v. Mahwah Bergen Retail Group, Inc.* (Civil No. 3:21 cv 167 (DJN), Docket No. 79), 2022 WL 135398 (E.D. Va. Jan.13, 2022)).

¹⁰ CLLA Appx. Page 146 (Memorandum Opinion at p. 86, n. 16 (emphasis added)).

¹¹ See *Patterson v. Mahwah Bergen Retail Group (In re Retail Group, Inc.)*, 2022 WL 135398 (E.D. Va. Jan.13, 2022).

¹²<https://news.bloomberglaw.com/bankruptcy-law/purdue-bankruptcy-spurs-forum-shopper-pushback-in-n-y-congress>

Bankers Association, Texas Hotel & Lodging Association, 163 sitting and retired bankruptcy judges, law professors from around the country, and dozens of state and local bar associations.

For more information, contact Peter Califano, CLLA Past-President, pcalifano@cwclaw.com.

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**UNITED STATES BANKRUPTCY COURT
 DISTRICT OF NEW JERSEY**

In re:

LTL MANAGEMENT, LLC,

Debtor.

Case No. 21-30589 (MBK)

Chapter 11

Hon. Michael B. Kaplan

Hearing Date:

**NOTICE OF MOTION BY ERWIN CHEMERINSKY, DEAN OF THE UNIVERSITY
 OF CALIFORNIA, BERKELEY SCHOOL OF LAW, FOR LEAVE TO FILE AMICUS
 CURIAE BRIEF**

PLEASE TAKE NOTICE that Erwin Chemerinsky, Dean of the University of California, Berkeley School of Law (“Dean Chemerinsky”), by and through his undersigned counsel, shall move (the “Motion”) before this Court on February __, 2022 at __:00 __.M. or as soon thereafter as counsel may be heard for leave to file an amicus curiae brief in support of the Motion of the Official Committee of Talc Claimants to Dismiss Debtor’s Chapter 11 Case [ECF No. 632].

PLEASE TAKE FURTHER NOTICE that, in support of the Motion, Dean Chemerinsky relies upon the within Notice of Motion and the Memorandum of Law filed herewith. A proposed form of Order is also submitted herewith.

PLEASE TAKE FURTHER NOTICE that any opposition to the Motion must be filed and served in accordance with the Order adjudicating Dean Chemerinsky's Application to file the within Motion on shortened time.

PLEASE TAKE FURTHER NOTICE that pursuant to Local Bankruptcy Rule 9013-3(d), the Motion will be decided on the papers unless opposition is filed.

LEX NOVA LAW LLC

Dated: January 31, 2022

By: /s/ E. Richard Dressel
E. Richard Dressel
Attorneys for Dean Chermerinsky,
Proposed Amicus Curiae

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| UNITED STATES BANKRUPTCY COURT DISTRICT OF NEW JERSEY | |
| Caption in Compliance with D.N.J. LBR 9004-1(b) | |
| E. Richard Dressel, Esquire (ED 1793) Lex Nova Law LLC 10 E. Stow Road, Suite 250 Marlton, NJ 08053 856.382.8211 rdressel@lexnovallaw.com Attorneys for Erwin Chemerinsky, Proposed Amicus Curiae | |
| In re: | Case No. 21-30589 (MBK) |
| LTL MANAGEMENT, LLC, | Chapter 11 |
| Debtors. | Hon. Michael B. Kaplan |

**ORDER GRANTING MOTION BY DEAN CHEMERINSKY FOR LEAVE TO FILE
AMICUS CURIAE BRIEF**

The relief set forth on the following page, numbered two (2), is hereby **ORDERED**.

Page (2)

LTL MANAGEMENT, LLC; Bankr. No. 21-30589(MBK)

ORDER GRANTING MOTION BY DEAN CHEMERINSKY FOR LEAVE TO FILE AMICUS

CURIAE BRIEF

This Court having considered the motion (the “Motion”) of Erwin Chemerinsky, Dean of the University of California, Berkeley School of Law (“Dean Chemerinsky”) for leave to file a proposed amicus curiae brief (the “Amicus Brief”) in support of the Motion of the Official Committee of Talc Claimants to Dismiss Debtor’s Chapter 11 Case [ECF No. 632]; and this Court having considered any papers filed in opposition; and this Court having found that due and proper notice of the Motion was provided; and this Court having considered arguments at the hearing on the Motion, if any; and this Court having found good cause for the relief sought in the Motion; it is hereby

ORDERED that the Motion shall be, and hereby is, GRANTED; and it is further

ORDERED that Dean Chemerinsky be and hereby is granted leave to file the Amicus Brief.

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**UNITED STATES BANKRUPTCY COURT
 DISTRICT OF NEW JERSEY**

In re:

LTL MANAGEMENT, LLC,

Debtor.

Case No. 21-30589 (MBK)

Chapter 11

Hon. Michael B. Kaplan

Hearing Date:

**MEMORANDUM OF LAW IN SUPPORT OF MOTION BY DEAN CHEMERINSKY
 FOR LEAVE TO FILE AMICUS CURIAE BRIEF**

Erwin Chemerinsky, Dean of the University of California, Berkeley School of Law (“Dean Chemerinsky”), by and through his undersigned counsel, hereby submits this Motion for leave to file an amicus curiae brief in support of the Motion of the Official Committee of Talc Claimants to Dismiss Debtor’s Chapter 11 Case [ECF No. 632] (the “Motion to Dismiss”). In support of the relief sought, Dean Chemerinsky respectfully states as follows:

INTEREST OF PROPOSED AMICUS CURIAE

1. Dean Chemerinsky is a legal scholar with substantial expertise in constitutional law and constitutional issues relating to the bankruptcy courts. As set forth in the Motion to Dismiss, mass tort claims are pending against Johnson & Johnson in a variety of non-bankruptcy forums, including a multi-district litigation before Chief Judge Freda Wolfson of the United States District

Court for the District of New Jersey. *See* Motion to Dismiss at ¶15; *see also In re Johnson & Johnson*, 509 F. Supp. 3d 116 (D.N.J. 2019).

2. As a legal scholar, Dean Chemerinsky has a professional interest in providing the Court with information regarding the constitutional guarantees afforded to mass tort plaintiffs with cases against Johnson & Johnson that are potentially infringed upon as the consequence of the Debtor's bankruptcy filing, and the impact of the Court's adjudication of the Motion to Dismiss.

LEGAL ARGUMENT

3. This Court has inherent authority to appoint amicus curiae to assist in its proceedings. *See Liberty Res., Inc. v. Phila. Hous. Auth.*, 395 F.Supp. 2d 206, 209 (E.D.Pa. 2005).

4. The decision to permit submissions from amicus curiae is within the broad discretion of this Court. *See United States v. Alkaabi*, 223 F.Supp. 2d 583, 592 (D.N.J. 2002).

5. Although there is no rule in the Federal Rules of Bankruptcy Procedure or the Local Bankruptcy Rules of this Court governing the appearance of amicus curiae, the Third Circuit's application of Federal Rule of Appellate Procedure 29 provides guidance to this Court. *Ibid*.

6. Federal Rule of Appellate Procedure 29 provides that a motion for leave to appear as amicus curiae "must be accompanied by the proposed brief and (A) state the movant's interest and (B) the reason why an amicus brief is desirable and why the matters asserted are relevant to the disposition of the case." F.R.A.P. 29(a)(3).

7. Thus, a movant must show "(a) an adequate interest, (b) desirability, and (c) relevance..." *Neonatology Assocs., P.A. v. Commissioner*, 293 F.3d 128, 131 (3d Cir. 2002). A movant is not required to demonstrate impartiality, or that the party to be supported is unrepresented or inadequately represented. *Id.* at 132.

8. Further, “it is preferable to err on the side of granting leave” so that a court will not “be deprived of a resource that might have been of assistance.” *Id.* at 133; *see also ibid.* (“[O]ur court would be well advised to grant motions for leave to file amicus briefs unless it is obvious that the proposed briefs do not meet Rule 29’s criteria as broadly interpreted.”); *Newark Branch, NAACP v. Town of Harrison*, 940 F.2d 792, 808 (3d Cir. 1991) (amicus briefs help “insur[e] a complete and plenary presentation of difficult issues so that the court may reach a proper decision”).

9. Here, Dean Chemerinsky’s proposed amicus curiae brief satisfies all three conditions set forth in Federal Rule of Appellate Procedure 29, as interpreted by the Third Circuit.

10. First, Dean Chemerinsky has an adequate interest in the Court’s adjudication of the Motion to Dismiss. The Third Circuit permits parties with a wide range of interests, including “pecuniary, as well as policy, interests” to file amicus curiae submissions. *Neonatology, supra*, 293 F.3d at 132. Here, Dean Chemerinsky has professional and policy interests in the outcome of the Motion to Dismiss because his scholarship focuses on constitutional law and constitutional issues relating to the bankruptcy courts. The outcome of the Motion to Dismiss will have significant constitutional consequences for the mass-tort litigation currently pending against Johnson & Johnson, and will potentially have constitutional ramifications in bankruptcy cases designed to shield large corporations from liability in mass tort actions.

11. With respect to the second and third factors, the Third Circuit has held that a proposed amicus curiae brief is “relevant” and “desirable” where the brief “alerts the [court] to possible implications” of its decision. *Neonatology, supra*, 293 F.3d at 133. Further, the Third Circuit quoted with approval a legal treatise setting forth other qualities that render an amicus brief desirable and relevant:

Some amicus briefs collect background or factual references that merit judicial notice. Some friends of the court are entities with particular expertise not possessed by any party to the case. Others argue points deemed too far-reaching for emphasis by a party intent on winning a particular case. Still others explain the impact a potential holding might have on an industry or other group.

Ibid. (quoting Luther T. Munford, *When Does the Curiae Need An Amicus?*, 1 J. App. Prac. & Process 279 (1999)).

12. Dean Chemerinsky's proposed amicus curiae brief provides substantial information to the Court regarding the possible implications of its adjudication of the Motion to Dismiss, and supplies Dean Chemerinsky's expertise regarding the protection of constitutional guarantees such as due process in mass tort actions in the bankruptcy courts.

13. Accordingly, Dean Chemerinsky's proposed amicus curiae brief is desirable and relevant.

14. For the foregoing reasons, Dean Chemerinsky respectfully submits that his proposed amicus curiae brief satisfies the standard in Federal Rule of Appellate Procedure 29, and requests the Court to exercise its discretion to accept his brief.

CONCLUSION

WHEREFORE, Dean Chemerinsky respectfully requests that this Court grant (i) his Motion; and (ii) such other and further relief as may be just and proper.

LEX NOVA LAW LLC

Dated: January 31, 2022

By: /s/ E. Richard Dressel
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Attorneys for Dean Erwin Chemerinsky,
Proposed Amicus Curiae

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**UNITED STATES BANKRUPTCY COURT
 DISTRICT OF NEW JERSEY**

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| In re: LTL MANAGEMENT, LLC, <div style="text-align: center;">Debtor.</div> | Case No. 21-30589 (MBK) Chapter 11 Hon. Michael B. Kaplan Hearing Date: |
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**CERTIFICATION OF DEAN ERWIN CHEMERINSKY IN SUPPORT OF MOTION
 FOR LEAVE TO FILE AMICUS CURIAE BRIEF**

Erwin Chemerinsky, of full age, hereby certifies as follows:

1. I am Dean of the University of California, Berkeley School of Law (“Dean Chemerinsky”).
2. I submit this Certification in support of my motion (the “Motion”) for leave to file an amicus curiae brief in support of the Motion of the Official Committee of Talc Claimants to Dismiss Debtor’s Chapter 11 Case [ECF No. 632] (the “Motion to Dismiss”).
3. I have personal knowledge of the information set forth herein and set forth in the Memorandum of Law submitted herewith.
4. Annexed hereto as **Exhibit “A”** is a copy of my proposed amicus curiae brief.

I certify that the foregoing statements made by me are true. I am aware that if any of the
foregoing statements are willfully false I am subject to punishment.

By: /s/ Erwin Chemerinsky
ERWIN CHERMERINSKY

Dated: January 31, 2022

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|--|---|
| UNITED STATES BANKRUPTCY COURT DISTRICT OF NEW JERSEY | |
| Caption in Compliance with D.N.J. LBR 9004-1(b) E. Richard Dressel, Esquire (ED 1793) Lex Nova Law LLC 10 E. Stow Road, Suite 250 Marlton, NJ 08053 856.382.8211 rdressel@lexnovallaw.com Attorneys for Erwin Chemerinsky, Proposed Amicus Curiae | |
| In re: LTL MANAGEMENT LLC, Debtor. | Chapter 11 Case No.: 21-30589 (MBK) Honorable Michael B. Kaplan Ref. Docket No. 632 |

**MEMORANDUM OF LAW OF AMICUS CURIAE BY ERWIN CHEMERINSKY IN
SUPPORT OF MOTION OF THE OFFICIAL COMMITTEE OF TALC CLAIMANTS
TO DISMISS DEBTOR'S CHAPTER 11 CASE**

INTEREST OF AMICUS CURIAE

1. Erwin Chemerinsky is the Dean of the University of California, Berkeley School of Law and the Jesse H. Choper Distinguished Professor of Law. Prior to assuming this position, from 2008-2017, he was the founding Dean and Distinguished Professor of Law, and Raymond Pryke Professor of First Amendment Law, at University of California, Irvine School of Law, with a joint appointment in Political Science. Before that, he was the Alston and Bird Professor of Law and Political Science at Duke University from 2004-2008, and from 1983-2004 was a professor at the University of Southern California Law School, including as the Sydney M. Irmas Professor of Public Interest Law, Legal Ethics, and Political Science. He also has taught at DePaul College of Law and UCLA Law School. He is the author of fifteen books, including leading casebooks and treatises about constitutional law, criminal procedure, and federal jurisdiction. He also is the

author of more than 200 law review articles. He is a contributing writer for the Opinion section of the Los Angeles Times, and writes regular columns for the Sacramento Bee, the ABA Journal and the Daily Journal, and frequent op-eds in newspapers across the country. He frequently argues appellate cases, including in the United States Supreme Court. In 2016, he was named a fellow of the American Academy of Arts and Sciences. In 2017, National Jurist magazine again named Dean Chemerinsky as the most influential person in legal education in the United States. In 2022, he is the President of the Association of American Law Schools.

2. As a scholar and teacher of constitutional law, Dean Chemerinsky has a strong interest in the constitutional issues presented in this case. He has frequently written and lectured about constitutional issues relating to the bankruptcy courts.

3. Dean Chemerinsky files this brief in support of the *Motion of the Official Committee of Talc Claimants to Dismiss Debtor's Chapter 11 Case* [Dkt. No. 632], and respectfully represents as follows:

INTRODUCTION AND SUMMARY OF ARGUMENT

4. The Bankruptcy Code provides powerful relief that potentially infringes on a host of constitutional guarantees: the right to have Article III courts resolve traditional causes of action, such as personal injury suits; the right to jury trial in such cases; and the right to due process – the right to a day in court and the right to have each individual case heard on the merits. When bankruptcy filings adhere to the Code's "basic policy" of "affording relief only to an 'honest but unfortunate debtor,'" *Cohen v. de la Cruz*, 523 U.S. 213, 217 (1998), ordinarily these constitutional guarantees are satisfied. But where a bankruptcy petition seeks to abuse the Code's remedies in unprecedented ways, serious constitutional issues arise. That is the situation here, where the Debtor's bankruptcy petition stretches the Bankruptcy Code beyond the breaking point.

5. The Debtor's bankruptcy petition in this case is a sham that was created solely to avoid legal liability and thus to deny individuals their day in court and possible recovery. The only entity filing for bankruptcy is a two-day-old shell company, LTL Management LLC (which stands for "Legacy Talc Liabilities" Management). LTL was allocated carefully chosen assets and liabilities in order to stage a phony bankruptcy allowing the operating company (Johnson & Johnson Consumer Inc., or "JJCI") and its enormously wealthy parent (Johnson & Johnson, or "J&J"), with a market capitalization of over \$400 billion, to enjoy all the benefits of bankruptcy, with none of the burdens. It seems obvious that the principal benefit sought by J&J is to shift thousands of claims away from Article III courts and then force the plaintiffs to resolve them *en masse* in an Article I forum without jury trials or even adjudications on the merits.

6. The petition seeks a litigation advantage, pure and simple. It disserves rather than promotes the reorganization purposes of Chapter 11. The Debtor has no business to restructure, no operations to rehabilitate, and no customers or genuine employees to serve. The Debtor is a manufactured entity created solely to resolve J&J's talc liabilities through the bankruptcy process. The Third Circuit has explained that the Bankruptcy Code does not "allow for the filing of a bankruptcy petition that lacks a valid reorganizational purpose." *In re SGL Carbon Corp.*, 200 F.3d 154, 163 (3d Cir. 1999).

7. The Debtor's abuse of the Bankruptcy Code raises grave constitutional questions under Article III of the Constitution, the Due Process Clause of the Fifth Amendment, and the right to jury trial protected by the Seventh Amendment. The Court should avoid the serious constitutional issues presented, by construing the Bankruptcy Code as foreclosing the Debtor's case. Such a course of action would comport with separation of powers principles by ensuring

that courts do not apply the Bankruptcy Code in a manner that Congress never imagined, let alone authorized.

ARGUMENT

I. The Debtor’s Petition Raises Grave Constitutional Questions.

A. This Case Raises Serious Questions Under Article III.

8. Permitting the Debtor to invoke bankruptcy jurisdiction to resolve tort claims on the basis of this “Texas two-step” Bankruptcy petition would raise serious questions under Article III of the Constitution. Simply stated, there *is* no legitimate “restructuring” in this case. This is a “Potemkin” bankruptcy in which the parent company (J&J) seeks to take advantage of bankruptcy protection without assuming its burdens.

9. “Article III provides for the establishment of a court system as one of the separate but coordinate branches of the National Government” *United States ex rel. Toth v. Quarles*, 350 U.S. 11, 15 (1955). “Since ratification, Article III has served a crucial role in our ‘system of checks and balances’ and ‘preserve[s] the integrity of judicial decisionmaking[.]’” *In re Millennium Lab Holdings II, LLC*, 945 F.3d 126, 139 n.13 (3d Cir. 2019) (quoting *Stern v. Marshall*, 564 U.S. 462, 483-84 (2011)). It protects each branch from undue interference by the other two branches and helps secure individual liberty. *Stern*, 564 U.S. at 483.

10. The “record of history shows that the Framers crafted this charter of the judicial department with an expressed understanding that it gives the Federal Judiciary the power, not merely to rule on cases, but to *decide* them, subject to review only by superior courts in the Article III hierarchy.” *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211, 218-19 (1995) (emphasis in original). The Supreme Court has “long recognized that, in general, Congress may not ‘withdraw from judicial cognizance any matter which, from its nature, is the subject of a suit at the common law,

or in equity, or admiralty.” *Stern*, 564 U.S. at 484 (citation omitted). “When a suit is made of ‘the stuff of the traditional actions at common law tried by the courts at Westminster in 1789,’ and is brought within the bounds of federal jurisdiction, the responsibility for deciding that suit rests with Article III judges in Article III courts.” *Id.* (quoting *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 90 (1982) (Rehnquist, J., concurring in judgment)); *see also Northern Pipeline*, 458 U.S. 50 (1982) (plurality opinion) (holding bankruptcy court could not constitutionally decide state law claim for breach of contract against entity that was not otherwise part of the bankruptcy proceedings).

11. Article III prevents a bankruptcy court from adjudicating common-law tort claims against non-debtors that are brought before the bankruptcy court only through artifice, as in this case. In *Stern*, the Supreme Court held that the bankruptcy court lacked the constitutional power to enter a final judgment on a state law tortious interference counterclaim the debtor asserted in an adversary proceeding where the claim would not be “resolved in the process of ruling on [the counterclaim defendant’s] proof of claim” and did not derive from or depend upon bankruptcy law. 564 U.S. at 499, 503; *see also id.* at 497. *Stern* explained that the tortious interference claim had to be decided by an Article III court because “this case involves the most prototypical exercise of judicial power: the entry of a final, binding judgment *by a court* with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime.” *Id.* at 494 (emphasis in original). “[T]he ‘‘experts’ in the federal system at resolving common law counterclaims such as [debtor’s] are the Article III courts, and it is with those courts that [debtor’s] claim must stay.” *Id.* Otherwise, “[i]f such an exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by deeming it part of some amorphous ‘public right,’ then Article III would be transformed from the guardian of

individual liberty and separation of powers we have long recognized into mere wishful thinking.” *Id.* at 494-95.¹ Thus, “Congress may not bypass Article III simply because a proceeding may have *some* bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process.” *Id.* (emphasis in original).

12. The Supreme Court’s subsequent cases adopted the same reasoning. *See Wellness Int’l Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 1939 (2015) (holder of a *Stern* claim is entitled to an adjudication of that claim by an Article III court, unless he *consents* to a final disposition of the claim by the Bankruptcy Court); *Exec. Benefits Ins. Agency v. Arkison*, 134 S. Ct. 2165, 2172 (2014). *Stern* held that Article III barred bankruptcy court adjudication of the claim even though the bankruptcy court had statutory power to adjudicate that counterclaim as a “core” proceeding. As the Third Circuit has explained, *Stern* makes clear that “bankruptcy courts may violate Article

¹ *See also Waldman v. Stone*, 698 F.3d 910, 918-20 (6th Cir. 2012); *In re Bellingham Ins. Agency, Inc.*, 702 F.3d 553, 564 (9th Cir. 2012) (“*Granfinanciera* involved a federal-law claim, and *Stern* involved a state-law claim. But *Stern* held that both claims required an Article III court.”); *In re Global Techs. Inc.*, 694 F.3d 705, 722 (6th Cir. 2012) (*Stern* held that “[w]hen a claim is ‘a state law action independent of the federal bankruptcy law and not necessarily resolvable by a ruling on the creditor’s proof of claim in bankruptcy,’ the bankruptcy court cannot enter final judgment.”) (quoting *Stern*, 564 U.S. at 487) (additional citation omitted); *In re Frazin*, 732 F.3d 313, 319 (5th Cir. 2013) (“Despite the narrowing language at the end of the Court’s opinion, *Stern* clearly grounded its reasoning in principles that are broad in scope.”); *In re Ortiz*, 665 F.3d 906, 911, 914 (7th Cir. 2011); *In re Fisher Island Invs., Inc.*, 778 F.3d 1172, 1192 (11th Cir. 2015).

As now-Justice Gorsuch explained for the Tenth Circuit:

But along the way *Stern* did clearly take at least one thing off the table. It held that when a “claim is a state law action . . . and not necessarily resolvable by a ruling on the creditor’s proof of claim in bankruptcy,” it implicates private rights and thus is not amenable to final resolution in bankruptcy court.

In re Renewable Energy Dev. Corp., 792 F.3d 1274, 1279 (10th Cir. 2015) (Gorsuch, J.), *as amended on denial of reh’g* (July 28, 2015) (citations omitted).

III even while acting within their statutory authority in “core” matters.” *In re Millennium Lab Holdings II, LLC.*, 945 F.3d 126, 135 (3d Cir. 2019) (citation omitted). But the constitutional concerns are magnified in a case such as this one, given Congress’ express exclusion of “the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11” from “core” claims. *See* 28 U.S.C. § 157(b)(2)(B).

13. The mesothelioma and ovarian cancer talc claims at issue here are ““made of the stuff of the traditional actions at common law tried by the courts at Westminster in 1789.”” *Millennium*, 945 F.3d at 134 (quoting *Stern*, 564 U.S. at 484). These claims do not “stem from the bankruptcy itself.” *Id.* at 136. And the claims against third-party entities would not “necessarily”—indeed *cannot*—be resolved in the bankruptcy proof of claim process. And, since the bankruptcy is a transparent attempt to evade the limits of Article III by creating a shell “debtor” to take on the liabilities of the parent company (and true defendant), the claims cannot be considered integral to the restructuring of a debtor-creditor relationship, which the Third Circuit has said is critical to assessing a *Stern* claim. *Millennium*, 945 F.3d at 140.

14. The Debtor and its parent seek to subvert Article III jurisdiction through a carefully orchestrated charade where the Debtor (i) was allocated certain deliberately chosen assets and liabilities (for example, talc products-liability debts associated with the assets of JJCI, but not the assets themselves, nor any trade creditor or intellectual property liabilities) and then (ii) filed for bankruptcy two days after its creation. On the basis of this charade, the Johnson & Johnson parent has sought to claim all the benefits of bankruptcy, with none of the burdens. If the “exercise of judicial power may nonetheless be taken from the Article III Judiciary simply by” manipulation of corporate structure such as occurred here, “then Article III would be transformed from the guardian

of individual liberty and separation of powers we have long recognized into mere wishful thinking.” *Stern*, 564 U.S. at 494-95.

15. This Court should reject the Debtor’s gamesmanship.

B. This Case Gives Rise to Grave Seventh Amendment Questions.

16. The Seventh Amendment provides: “In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved” U.S. Const., Amend. 7. The Seventh Amendment applies to suits in which “legal rights [are] to be ascertained and determined,” *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 41 (1989) (internal quotation marks omitted), and these include “[a]ctions sounding in tort” for damages to person or property. *Billing v. Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242, 1245 (3d Cir. 1994). Accordingly, “asbestos claims . . . constitute lawsuits seeking the adjudication of ‘legal rights’ under the Seventh Amendment,” and the court may not sanction any application of the Bankruptcy Code that infringes upon those rights. *In re G-I Holdings, Inc.*, 323 B.R. 583, 602 (Bankr. D. N.J. 2005).

17. Congress “lacks the power to strip parties contesting matters of private right of their constitutional right to a trial by jury” by assigning them to a bankruptcy court. *Granfinanciera*, 492 U.S. at 51-52. “[L]egal claims are not magically converted into equitable issues by their presentation to a court of equity,” *Ross v. Bernhard*, 396 U.S. 531, 538 (1970), “nor can Congress conjure away the Seventh Amendment by mandating that traditional legal claims be brought there or taken to an administrative tribunal.” *Granfinanciera*, 492 U.S. at 53-55 (holding that fraudulent conveyance action was a “private right” that was “not closely intertwined with a federal regulatory program” and had to be decided “by an Article III court”); *see also Beard v. Braunstein*, 914 F.2d 434, 439-40 (3d Cir. 1990); *cf. Northern Pipeline*, 458 U.S. at 90-91 (Rehnquist, J., concurring in

judgment) (explaining that the damages claims for breach of contract and misrepresentation under state law were “the stuff of the traditional actions at common law tried by the courts at Westminster in 1789” as to which “[n]o method of adjudication is hinted, *other than the traditional common-law mode of judge and jury*”) (emphasis added). The Third Circuit applied these teachings to invalidate a bankruptcy court decision in a breach of contract action brought by the Trustee. *Beard*, 914 F.2d at 447. It held that the assertion of a compulsory counterclaim did not constitute consent to jurisdiction. *Id.* at 442.²

18. Just as the bankruptcy court’s decision on the merits in *Beard* violated the Seventh Amendment, a bankruptcy court’s decision to resolve legal claims without consent and without any determination of the merits *at all* violates the Seventh Amendment, and this is so even if the decision is reviewed *de novo* by a district court. Indeed, *G-I Holdings* already held that asbestos claimants possess jury trial rights for purpose of liquidating their claims. 323 B.R. at 602, 605.

19. In *In re SGL Carbon Corp.*, 200 F.3d at 169 n.23, the Third Circuit reserved the question whether a bankruptcy plan that resolves, without consent, jury-triable claims violates the Seventh Amendment right to a jury trial. At least for third-party claims brought into the purview

² The Bankruptcy Code itself recognizes that even in core proceedings, there may be a right to a jury trial. With respect to personal injury tort and wrongful death claims, it directs that such claims “shall be tried in the district court” where such claim “is pending or in the district court” presiding over the bankruptcy proceedings. 28 U.S.C. § 157(b)(5). And it says that “[i]f the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties.” 28 U.S.C. § 157(e). Absent that express consent, the jury trial must occur in court. But the Debtor’s petition is designed to eliminate the jury rights of parties whose claims that are not even against the Debtor and who have not consented to resolution in bankruptcy court.

of a bankruptcy court through gamesmanship such as occurred here, resolution of those claims through a bankruptcy court would raise serious questions under the Seventh Amendment.

C. This Case Raises Serious Questions of Due Process

20. The Debtor's petition also raises grave due process concerns. "[A] cause of action is a species of property protected by the Fourteenth Amendment's Due Process Clause." *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 428 (1982). Thus, "the Due Process Clauses protect civil litigants who seek recourse in the courts, either as defendants hoping to protect their property or as plaintiffs attempting to redress grievances." *Id.* at 429 (citation omitted). The Third Circuit has explicitly "recognized as a protected property interest the ability to pursue an asbestos claim." *In re Energy Future Holdings Corp.*, 949 F.3d 806, 822 (3d Cir. 2020) (citing *In re Grossman's Inc.*, 607 F.3d 114, 127 (3d Cir. 2010)); *see also Tulsa Pro. Collection Servs., Inc. v. Pope*, 485 U.S. 478, 485 (1988) ("Appellant's interest is an unsecured claim, a cause of action against the estate for an unpaid bill. Little doubt remains that such an intangible interest is property protected by the Fourteenth Amendment.").

21. Bankruptcy calls into question the ability of claimants to pursue their claims in the civil justice system, which is a constitutionally protected due process interest. Here, the Debtor proposes to curtail that interest by imposing an asbestos trust on unwilling claimants through an artificially staged and orchestrated bankruptcy. The Supreme Court has twice rejected similar attempts to impose asbestos trusts via the class action mechanism of Fed. R. Civ. P. 23, and that experience is highly instructive here. *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 845-48 (1999); *Amchem Prods. v. Windsor*, 521 U.S. 591, 597-98 (1997).

22. The *Ortiz* case involved a staged proceeding in which a "limited fund" was created between the parties through an insurance settlement. In *Ortiz*, the Supreme Court held that a

federal court may not rely on a “limited fund” rationale where the limitation was contrived by a settlement between the parties. 527 U.S. at 864. The Court explained that “[a]ssuming, arguendo, that a mandatory, limited fund rationale could under some circumstances be applied to a settlement class of tort claimants, it would be essential that the fund be shown to be limited *independently of the agreement of the parties to the action.*” *Id.* at 864 (emphasis added). This case involves a parallel situation: here, of course, the features of this bankruptcy are entirely orchestrated by the Debtor and J&J.

23. *Ortiz* further explained that permitting an artificially limited fund to justify a mandatory class action would be “irreconcilable with the justification of necessity in denying any opportunity for withdrawal of class members whose jury trial rights will be compromised, whose damages will be capped, and whose payments will be delayed.” *Ortiz*, 527 U.S. at 860. Enforcing “the traditional norm” that each individual is entitled to his day in court absent non-artificial inadequacy of funds, *id.* at 842, ensures that the defendant with the inadequate fund “ha[s] no opportunity to benefit himself or claimants of lower priority by holding back on the amount distributed to the class,” and giving himself “a better deal than *seriatim* litigation would have produced.” *Id.* at 839.

24. Such concerns are squarely applicable here.

II. Separation of Powers Principles Require Application of the Canon of Constitutional Avoidance.

25. The Third Circuit has warned that “Chapter 11 vests petitioners with considerable powers—the automatic stay, the exclusive right to propose a reorganization plan, the discharge of debts, etc.—that can impose significant hardship on particular creditors. When financially troubled petitioners seek a chance to remain in business, the exercise of those powers is justified.

But this is not so when a petitioner's aims lie outside those of the Bankruptcy Code." *In re SGL Carbon*, 200 F.3d at 164-65.

26. That warning is fully applicable here. At a minimum, there are serious constitutional questions whether (1) under the principles recognized by the Supreme Court in *Stern v. Marshall*, 564 U.S. 462, 484 (2011), *Granfinanciera*, 492 U.S. at 58-59, *Northern Pipeline*, 458 U.S. at 52, an Article I judge may properly preside over litigation transferred to the bankruptcy court by virtue of a Chapter 11 filing that serves no valid reorganizational purpose; (2) resolution of causes of action that are before the Article I judge only as a result of that filing would violate the right to a jury trial, and (3) resolution without adjudication on the merits would be consistent with due process.

27. These constitutional concerns arise because the Debtor's bankruptcy petition lies at the very outer limits of the Code, if not beyond. "Congress' power under the Bankruptcy Clause 'contemplate[s] an adjustment of a failing debtor's obligations.'" *Ry. Lab. Execs.' Ass'n v. Gibbons*, 455 U.S. 457, 466 (1982) (quoting *Cont'l Ill. Nat'l Bank & Tr. Co. of Chi. v. Chi., R.I. & P. Ry. Co.*, 294 U.S. 648, 673 (1935)). "The purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state." *In re SGL Carbon*, 200 F.3d at 166 (internal quotation marks and citation omitted). And "there must be 'some relation' between filing and the 'reorganization-related purposes that [Chapter 11] was designed to serve.'" *Id.* at 165. The Court of Appeals has explained that "filing a Chapter 11 petition merely to obtain tactical litigation advantages is not within 'the legitimate scope of the bankruptcy laws.'" *Id.* (citation omitted). "The Bankruptcy provisions are intended to benefit those in genuine financial distress. They are not intended to be used as a mechanism to orchestrate pending litigation." *Id.* (internal quotation marks and citation

omitted). “Chapter 11 was designed to give those teetering on the verge of a fatal financial plummet an opportunity to reorganize on solid ground and try again, not to give profitable enterprises an opportunity to evade contractual or other liabilities.” *Id.* at 166 (internal quotation marks and citation omitted). In such circumstances, “the ‘statutory provisions designed to accomplish the reorganizational objectives become destructive of the legitimate rights and interests of creditors.” *Id.* (citation omitted).

28. The Debtor in this case has no business or operations to rehabilitate, and its petition simply seeks to force resolution of claims against the non-debtor J&J, a solvent and indeed extremely wealthy entity. The Debtor has not cited any other case under the Bankruptcy Code where a parent entity like J&J has been permitted to reap the benefit of the bankruptcy process, through a staged allocation of assets and liabilities filing, while avoiding any of the burdens of bankruptcy. This Court should not construe the Bankruptcy Code as authorizing the kind of abusive filing the Debtor is attempting here.

29. Settled principles of statutory interpretation, as well as the separation of powers, require this Court to construe the Code as precluding the faux bankruptcy filing here. The canon of constitutional avoidance requires courts to construe statutes, “if fairly possible, so as to avoid not only the conclusion that it is unconstitutional but also grave doubts upon that score.” *Almendarez-Torres v. United States*, 523 U.S. 224, 237-38 (1998) (citations omitted); *see also Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring) (“The Court will not pass upon a constitutional question, although properly presented by the record, if there is also present some other ground upon which the case may be disposed of Thus, if a case can be decided on either of two grounds, one involving a constitutional question, the other a question of statutory construction or general law, the Court will decide only the latter.”). “[W]here

an otherwise acceptable construction of a statute would raise serious constitutional problems,” courts will construe the statute to avoid such problems “unless such construction is plainly contrary to the intent [of the legislature].” *DeBartolo Corp. v. Florida Gulf Coast Bldg. & Const. Trades Council*, 485 U.S. 568, 575 (1988). “The elementary rule is that every reasonable construction must be resorted to, in order to save a statute from unconstitutionality.” *Id.* (quoting *Hooper v. California*, 155 U.S. 648, 657 (1895)). “This approach not only reflects the prudential concern that constitutional issues not be needlessly confronted, but also recognizes that [legislatures,] like [the courts] [are] bound by and swear[] an oath to uphold the Constitution.” *Id.*

30. The Supreme Court has already opined that the courts should defer to Congress with respect to the creation of innovative administrative compensation schemes for mass torts and asbestos in particular. *Amchem Products*, 521 U.S. at 628-29 (“The argument is sensibly made that a nationwide administrative claims processing regime would provide the most secure, fair, and efficient means of compensating victims of asbestos exposure. Congress, however, has not adopted such a solution.”)

31. At a minimum, the Debtor’s petition raises serious constitutional questions, and the Court should interpret the Bankruptcy Code to preclude it.

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CONCLUSION

32. For the reasons stated above, the motion to dismiss the petition should be granted.

Date: January 31, 2022

Respectfully submitted,

Lex Nova Law LLC

By: /s/ E. Richard Dressel

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February 7, 2022

Senate Committee on the Judiciary
Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Whitehouse, Ranking Member Kennedy and members of this Subcommittee:

On behalf of my wife, GERALYN ANN ERICKSON and our family, I would like to thank you for holding a hearing to examine how corporations abuse bankruptcy laws to escape accountability.

I am a resident of Newport, Rhode Island. GERALYN left us too soon, at age 58. She suffered from ovarian cancer and died because she used Johnson and Johnson's baby powder from at least 1979 through 2013. Thank you for reading my wife's story, I hope that it sheds some light on the ill effects of bankruptcy abuse.

GERALYN ANN ERICKSON was born in Fall River, Massachusetts on December 5, 1956. At 19 years old I met GERALYN at a downtown Newport hotspot and from that day forward we were rarely apart. After 9 years of dating we were married on August 30, 1986. Four years later, our son JOHN was born and four years after that our son MICHAEL was born. GERALYN had an associate's degree from Green Mountain College in Vermont and was a dental assistant until 2003. Together we owned and ran the Beachstone Bed and Breakfast in Newport, Rhode Island and a family landscaping business, Grasshopper Lawn and Landscape Service LLC.

The day GERALYN was diagnosed with ovarian cancer ended our lives as we knew it. We knew she would have to be operated on, but first she had pre-surgical chemotherapy that was completed that October. On November 13, 2014 she had an exploratory laparotomy which resulted in a total abdominal hysterectomy, bilateral salpingo-oophorectomy, omentectomy and descending/superior rectosigmoid resection that confirmed stage IIIC primary peritoneal high-grade serous carcinoma that was spread to colon and appendix. She had post-surgical chemotherapy, but passed away less than a year later. We were shocked and came to learn that the baby powder she heavily used contained asbestos, a known carcinogen.

The unbearable pain and overwhelming suffering she endured was nothing short of barbaric. Even at 58 years old I had no idea that in this day and age with modern medicine that cancer patients suffered that much. There was never any relief of pain - not for a moment - for 13 months. After her operation in November of 2014 she could not eat solid food ever again. The indignity of losing one's long blonde hair and aging decades in 13 months was and still is too horrific to think about. We had a houseful of people for a year helping us with her care. I don't know how you could do this otherwise.

Six and a half years later, I still wake with PTSD and have nightmares of the countless emergency wagon trips to the various hospitals. I still cannot shake the horrific sights I saw, as I helplessly watched GERALYN endure. I walk the beach every morning before work, yet all this time later rarely come back with a dry face. Her memorial bench with her likeness sits at the entrance to the famed Cliff Walk and the entrance to the beach we spent our dating life on, our married life on, and raised our family on.

A few days after GERALYN's passing our youngest son Michael turned 21. We had GERALYN's wake that day. GERALYN had purchased a gift for him - knowing she may not be alive to see him open it. I don't know what is in it because he has never opened it. It's too hard, too painful, even now.

The boys and I continue to run our family business. Cancer set us back financially quite a bit. Not a second goes by that we don't miss her. Our lives will never be the same or as good. There will always be something missing. We volunteer at GERALYN's doctors' charity, The Izzy Foundation, supporting children with cancer and their families in memory of GERALYN. Had she lived it would have been one of the many charities she would volunteer for.

I'd like to thank the committee for looking at this issue. In closing, a choice to not punish - really punish - the intentional acts of torture this most cowardly conglomerate is trying to hide from in bankruptcy would be egregious. My wife fought a tough battle with ovarian cancer and I know there are thousands of families like mine, with many children who have had to say goodbye too soon to their mothers. Johnson and Johnson should not be allowed to escape responsibility for poisoning so many. If you are not moved by my story - think how you would feel if YOUR mother, wife, or sister came down with ovarian cancer due to poisoning for profit.

Sincerely,

A handwritten signature in black ink, appearing to read "John C. Erickson, Jr." with a stylized, cursive script.

John C. Erickson, Jr.

John A. Tassone
38 Earles Court
Narragansett, RI 02882

February 7, 2022

Senate Committee on the Judiciary

Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Whitehouse, Ranking Member Kennedy and members of this Subcommittee:

Thank you for holding this hearing to examine corporate abuse of bankruptcy

I was exposed to asbestos containing materials in a consumer product by routinely using Johnson & Johnson's baby powder. My mother began using Johnson & Johnson baby powder on me as an infant and I continued to use this product almost daily after baths and showers, until it was recently disclosed that the Johnson & Johnson baby powder contained asbestos.

In March of 2021, I was diagnosed with mesothelioma. This disease, which is only caused by exposure to asbestos has completely changed my life.

In April of 2021, I underwent major lung surgery to remove the lining of my left lung, the place where mesothelioma can quickly spread. I was in surgery for 11 hours and in the hospital recovering for 15 days. I am still recovering from the effects of this surgery which resulted in a massive loss of my strength and muscles. My weight went from 205 lbs. to 160 lbs.

Since returning home from the hospital, I have been receiving many treatments of chemotherapy and immunotherapy. As of January 2022, my most recent PET scan showed that the mesothelioma is still active and growing.

Now, as a result of Johnson & Johnson's greed and cover-up, long after they knew of the dangers, I am dealing with a possible death sentence.


I am fighting the mesothelioma with the support of my wife and family; four children and seven grandchildren. Doctors at Brigham & Women's Hospital, Dana Farber, and my local hospital, South County Hospital, are working hard to give me more time in the hope they can find a cure.

My story is similar-I am sure-to many others exposed to asbestos and other carcinogens.

I am writing to you in the hope that your committee will ensure Johnson & Johnson and other wrongdoers cannot escape accountability and unilaterally decide how much peoples lives are worth.

Thank you for your time and interest in this important subject.

Respectfully,


John A. Tassone

The Hon. Sheldon Whitehouse
 Chair, Senate Judiciary Committee
 Subcommittee on Federal Courts, Oversight,
 Agency Action and Federal Rights
 224 Dirksen Senate Office Building
 Washington, DC 20510

The Hon. John Kennedy
 Ranking Member, Senate Judiciary
 Committee Subcommittee on Federal Courts,
 Oversight, Agency Action and Federal Rights
 224 Dirksen Senate Office Building
 Washington, DC 20510

Dear Sens. Whitehouse and Kennedy:

We are a group of scholars who study the bankruptcy system.¹ We understand you are about to hold a hearing on the topic of “Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy.” We write to share our views through this letter (“Letter”), based on our research and expertise, of the so-called “Texas 2-Step,” which was recently used by Johnson & Johnson (“J&J”) to spin off its Talc-related liabilities from the rights of its assets and to file a new shell corporation, LTL Management LLC (“LTL Management”), for Chapter 11 bankruptcy. That bankruptcy case is now pending in the U.S. Bankruptcy Court for the District of New Jersey before the Honorable Judge Michael Kaplan. We recently expressed our views at length in an *amicus brief* (the “Amicus Brief”), filed with the bankruptcy court on February 4, 2022 and attached to this letter as Exhibit A. In this Letter, we summarize three of the most relevant points for your consideration.

First, we believe the litigation strategy that J&J has deployed in the LTL Management Chapter 11 filing is inconsistent with the congressional design of bankruptcy law. Congress created an incredibly versatile federal bankruptcy system that has proven itself useful to the American economy and helpful for corporations with a wide range of problems. This utility is not without cost, and the basic trade that bankruptcy law offers is simple: a corporation can receive judicial protection and a range of “bankruptcy powers” to try to deal with its problems, but, in exchange, that corporation must submit to “the burdens” of bankruptcy.² Those burdens include transparency through judicial oversight and mandatory disclosures, creditor participation through the use of creditor committees and open court hearings, and an obligation to reorganize the firm’s assets in a transaction that maximizes the value of the firm for the benefit of creditors. By using the Texas 2-Step to eliminate potential tort liability, J&J has severed the link between bankruptcy benefits it wants to receive and burdens it should have incurred in a way that is inconsistent with bankruptcy law and debtor-creditor law more broadly.

¹ The signatories to this Letter are seven professors who study the bankruptcy system, including, with institutional affiliation included for identification purposes only: Kenneth Ayotte (University of California Berkeley Law), Susan Block-Lieb (Fordham University School of Law), Diane Lourdes Dick (Seattle University School of Law), Jared A. Elias (University of California Hastings College of the Law), Bruce Markell (Northwestern University Pritzker School of Law), Robert Rasmussen (University of Southern California Gould School of Law) and Yesha Yadav (Vanderbilt University Law School). None of the signatories have any financial interest in the matter and write purely to advance the public interest in the administration of the bankruptcy system.

² *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 503 (Bankr. D.N.J. 1997); *In re SGL Carbon*, 200 F.3d 154, 161 (3d Cir. 1999) (“A debtor who attempts to garner shelter under the Bankruptcy Code . . . must act in conformity with the Code’s underlying principles.”)

Second, we believe that existing bankruptcy law allows Judge Kaplan to dismiss the LTL Management Case. Bankruptcy law requires any bankruptcy filing to be made in good faith, which means it must have a “valid reorganizational purpose.” Precedent strongly suggests that the LTL Management filing lacked a valid reorganizational purpose. It appears that the transaction was not designed to address issues of a company in financial distress but rather engineered to gain a tactical litigation advantage over injured consumers. This maneuver is not a proper use of the bankruptcy system. To be sure, many debtors with tort liability have successfully reorganized in Chapter 11 and the bankruptcy system is designed to help those companies overcome their problems in a framework that maximizes the potential recoveries of the victims. However, in using Chapter 11, those companies placed both their liabilities as well as their assets under court administration – the exact opposite of J&J’s approach. J&J is welcome, and indeed encouraged, to file for bankruptcy itself if Chapter 11 is needed to resolve financial distress created by its Talc-related liability.

Finally, the tactic that J&J has deployed creates a dangerous precedent. To summarize, one of America’s wealthiest and most successful companies has placed some of its product liability claims into the equivalent of a “special purpose vehicle,” and then abandoned those claims to the bankruptcy system in an effort to side-step and thwart state and federal tort systems. That type of evasion is not what bankruptcy law (or any law, for that matter) was designed to do. To the extent J&J succeeds it will undoubtedly inspire imitators. This perversion of the normal tort system will inevitably lead to an erosion of public trust in the legal system. Federal law displaces the state tort systems when there is a federal reason to do so. Federal law is not designed to create an escape option from the state law system.

Our amicus brief attempts to convince the bankruptcy court that the processes LTL Management and J&J used are an anathema to bedrock bankruptcy principles. We stand by that view. We thank you for your interest and stand ready to aid your efforts to address the problem.

Sincerely,

[SIGNATORIES ON FOLLOWING PAGE]

| | |
|---|--|
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EXHIBIT A

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW JERSEY**

Caption in Compliance with D.N.J. LBR 9004-1(b)

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In Re:

LTL MANAGEMENT, LLC,

Debtor.

Chapter 11

Case No. 21-30589 (MBK)

Honorable Michael B. Kaplan

Hearing: February 14, 2022 at 10:00 a.m.

**MEMORANDUM OF LAW OF AMICI CURIAE BY CERTAIN
LAW PROFESSORS IN SUPPORT OF MOTION OF THE OFFICIAL
COMMITTEE OF TALC CLAIMANTS TO DISMISS DEBTOR'S CHAPTER 11 CASE**

The *amici curiae* are law professors from 7 different law schools who have lectured, practiced, and written extensively in the field of bankruptcy law (the "Amici Professors"). The Amici Professors are scholars with expertise in the purposes of the Bankruptcy Code and the historical, statutory, and common law bases for dismissals of Chapter 11 petitions filed in bad faith. The Amici Professors file this brief in support of the *Motion of the Official Committee of*

Talc Claimants to Dismiss Debtor's Chapter 11 Case [ECF No. 632] (the "Motion to Dismiss"),¹ and respectfully represent as follows:

PRELIMINARY STATEMENT

1. This bankruptcy is not about reorganizing, rehabilitating, or granting a fresh start to an honest, unfortunate debtor. Nor is it about maximizing estate value for the benefit of creditors. Rather, this bankruptcy is about *minimizing* estate value to the detriment of J&J's tort victims, the sole "creditors" in this case. J&J, an obviously solvent company with a market capitalization of about \$400 billion, created LTL, a shell corporation with no operating business and *no reorganizational purpose*, specifically to distance and protect J&J's assets from its talc victims, end all existing and future litigation against J&J, and deprive innocent talc victims of their day in court. Neither LTL nor its creditors benefit from this bankruptcy filing—only J&J benefits.

2. This is not the first time a company has sought bankruptcy relief to address its mass tort litigation exposure. But the strategy employed here—manufacturing an undercapitalized company solely to file for bankruptcy for that entity—is a novel and dangerous tactic that represents a "significant departure from the use of Chapter 11 to validly reorganize financially troubled businesses."² The Amici Professors believe this strategy is a direct attack on the fundamental integrity of the Chapter 11 system, which is intended to protect honest but unfortunate debtors who are willing to subject themselves and their assets to the supervision of the Court. Solvent tortfeasors, like J&J, should not be permitted to use Chapter 11 as a tool to shield assets from the claims of their victims.

¹ Capitalized terms used but not defined herein shall have the meaning ascribed to them in the Motion to Dismiss.

² See *In re SGL Carbon*, 200 F.3d 154, 169 (3d Cir. 1999) (remanding proceeding to District Court for dismissal "for cause" due to lack of valid reorganizational purpose and good faith where debtor's filing was a litigation tactic).

3. Although amicus briefs are rare in trial court proceedings, the Amici Professors believe they can bring their experience as scholars to assist the Court in evaluating the Motion to Dismiss because they believe LTL's bankruptcy case is wholly incompatible with the equitable purpose and spirit of the Bankruptcy Code. The Amici Professors have no economic interest at stake, but they share a concern about the effect of this case, and others like it, on the bankruptcy system. If the Court sanctions LTL's strategy, the important concept of dismissal because of a "bad faith" filing will be eviscerated. Any company facing a debt it does not wish to repay, regardless of its solvency or bad faith actions, could wipe the slate clean simply by creating a new entity to file for bankruptcy in its stead. In another case dealing with a perceived abuse of the Bankruptcy Code system, Judge Chapman noted: "Whether one characterizes [it] as exploiting a loophole or as simply not fair, one thing is clear: it is not the thing which the statute intended."³

4. Although J&J is not the first entity to use the Texas Two-Step strategy, this case is part of an alarming recent trend, and J&J's status as a prominent public company warrants the Amici Professors' attention. Permitting LTL's bankruptcy case to proceed would be a serious abuse of Chapter 11 and would add to an evolving roadmap for other companies facing liability to manufacture a sham entity to unfairly rid themselves of liability. The Amici Professors believe that the egregious circumstances of this case warrant immediate dismissal.

BACKGROUND

5. In October 2021, J&J performed a series of transactions under Texas law known as the "Texas Two-Step."⁴ These transactions resulted in two entities: (i) LTL, which succeeded to

³ *In re Patriot Coal Corp.*, 482 B.R. 718, 745 (Bankr. S.D.N.Y. 2012).

⁴ See *Declaration of John K. Kim in Support of First Day Pleadings* (ECF No. 5) (the "First Day Declaration"), ¶ 16.

all of Old JJCI's talc-related liabilities and received limited assets; and (ii) New JJCI, which received Old JJCI's most valuable assets.⁵

6. Just two days after its creation, LTL filed a bankruptcy petition in the Western District of North Carolina and the case was assigned to Judge Craig Whitley.⁶ The Bankruptcy Administrator and other entities filed motions to transfer venue to the District of New Jersey, which Judge Whitley granted.⁷

7. Judge Whitley found, *inter alia*, that “[t]he Debtor may have assets, but they were all created to effectuate a bankruptcy filing and have no other business purpose” and that the Debtor “[was] not just forum shopping; the Debtor [was] manufacturing forum and creating a venue to file bankruptcy.”⁸ LTL was forum shopping, according to Judge Whitley, based on its “preference to file bankruptcy in this district, likely due to the Fourth Circuit’s two-prong dismissal standard.”⁹

⁵ First Day Declaration, ¶¶ 21-25.

⁶ Some parties have suggested that entities formed via the Texas Two-Step could constitute avoidable fraudulent transfers. The Amici Professors believe that the Court does not need to resolve whether LTL’s use of the Texas Two-Step constitutes a fraudulent transfer under Bankruptcy Code sections 548 and 544 or under Texas state law to determine that this was a bad faith filing and should be dismissed on those grounds.

⁷ *In re LTL Management, LLC*, 2021 WL 5343945 at * 1 (Bankr. W.D.N.C. Nov. 16, 2021).

⁸ *Id.* at *6.

⁹ *Id.* at *6.

ARGUMENT**I. To enjoy the extraordinary relief afforded by the Bankruptcy Code, the law requires that a debtor file in good faith with a valid reorganizational purpose.**

A. The requirement that a bankruptcy petition must be filed in good faith is rooted in equity and reinforces the fundamental purpose of bankruptcy.

8. The Bankruptcy Code provides for extraordinary relief—*i.e.*, “the forced compromise of creditors’ claims against the debtor by limiting creditors to a pro rata distribution and prohibiting creditors, by the discharge provisions, from taking any further action on their claims.”¹⁰

9. A bankruptcy court has the power to dismiss any case for lack of good faith “in order to prevent abuse of the Chapter 11 process or in response to misconduct that is incompatible with the functioning of the bankruptcy system.”¹¹

10. The good faith filing standard stems from principles of equity.¹² As the Fifth Circuit has noted, the requirement “protects the jurisdictional integrity of the bankruptcy courts by rendering their equitable weapons . . . available only to those debtors and creditors with clean

¹⁰ Judith R. Starr, *Bankruptcy Court Jurisdiction to Release Insiders from Creditor Claims in Corporate Reorganizations*, 9 Bankr. Dev. J. 485, 498 (1993).

¹¹ 7 Collier on Bankruptcy ¶ 1112.07[1] (citing *Carolin Corp. v. Miller*, 886 F.2d 693, 702 (4th Cir. 1989) (the aim of the good faith standard “is to determine whether the petitioner’s real motivation is ‘to abuse the reorganization process’ and ‘to cause hardship or to delay creditors by resort to the Chapter 11 device merely for the purpose of invoking the automatic stay, without an intent or ability to reorganize his financial activities.’”) (citation omitted)).

¹² *In re SGL Carbon*, 200 F.3d 154, 161 (3d Cir. 1999) (“The ‘good faith’ requirement for Chapter 11 petitioners has strong roots in equity.”).

hands.”¹³ Moreover, “Congress has never intended that bankruptcy be a refuge for the irresponsible, unscrupulous or cunning individual.”¹⁴

11. The Collier’s treatise summarizes the purpose of the good faith filing requirement:

One of the basic underpinnings of the good faith doctrine, and a factor that helps explain its purpose, is *the fundamental policy that bankruptcy relief is generally limited to the honest but unfortunate debtor*

[B]ankruptcy relief is equitable in nature, and as a general rule, equitable remedies are not available to any party who fails to act in an equitable fashion. . . . Indeed, there is a strong equitable undercurrent within the good faith standard that establishes that it is designed to fulfill the promise that *application of the bankruptcy laws in pursuit of the benefits of reorganization will not operate to create injustice*.¹⁵

B. A Chapter 11 bankruptcy case should be dismissed as a bad faith filing where the debtor lacks a valid reorganizational purpose.

12. The leading case in the Third Circuit on the issue of dismissal of a bad faith filing under 11 U.S.C. § 1112, *In re SGL Carbon*, emphasizes that the good faith standard requires that the debtor “enter Chapter 11 with a valid reorganizational purpose.”¹⁶

13. The Supreme Court has identified two basic purposes of Chapter 11: (1) “preserving going concerns” and (2) “maximizing property available to satisfy creditors.”¹⁷ Other objectives of the Bankruptcy Code include “avoidance of the consequences of economic

¹³ *Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (In re Little Creek Dev. Co.)*, 779 F.2d 1068, 1072 (5th Cir. 1986).

¹⁴ *In re Rognstad*, 121 B.R. 45, 50 (Bankr. D. Haw. 1990).

¹⁵ 7 Collier on Bankruptcy ¶ 1112.07[3] (citation omitted) (emphasis added).

¹⁶ *In re SGL Carbon*, 200 F.3d at 164.

¹⁷ *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’Ship*, 526 U.S. 434, 452, 119 S. Ct. 1411, 143 L.Ed.2d 607 (1999); see also *Integrated Telecom*, 384 F.3d at 119 (citation omitted).

dismemberment and liquidation, and the preservation of ongoing values in a manner which does equity and is fair to rights and interests of the parties affected.”¹⁸

14. The Third Circuit has explained “[w]hen financially troubled petitioners seek a chance to remain in business,” the exercise of the considerable powers afforded a debtor under the Bankruptcy Code is justified. “But this is not so when a petitioner’s aims lie outside those of the Bankruptcy Code.”¹⁹

15. The Amici Professors believe that two Third Circuit cases construing the good faith standard should guide the Court’s analysis here: *In re SGL Carbon Corp.*²⁰ and *In re Integrated Telecom Express, Inc.*²¹ In *SGL Carbon*, the debtor was a financially healthy company with potentially significant civil antitrust liability.²² But at the time it filed its petition, no judgment had been entered; the debtor merely faced settlement demands.²³ In determining that the filing lacked good faith, the Court made the following findings: (i) there was no evidence that the possible antitrust judgment might force the debtor out of business;²⁴ (ii) the debtor lacked a valid reorganizational purpose;²⁵ and (iii) the debtor’s officers expressly and repeatedly acknowledged that the Chapter 11 petition was filed solely to gain tactical litigation advantages.²⁶

¹⁸ *SGL Carbon*, 200 F.3d at 161 (citing *In re Victory Construction Co., Inc.*, 9 B.R. 549, 558 (Bankr. C.D. Cal. 1981) *order stayed*, *Hadley v. Victory Construction Co., Inc. (In re Victory Construction Co., Inc.)*, 9 B.R. 570 (Bankr. C.D. Cal. 1981), *order vacated*, 37 B.R. 222 (1984)).

¹⁹ *SGL Carbon*, 200 F.3d at 165-66.

²⁰ 200 F.3d 154 (3d Cir. 1999).

²¹ 384 F.3d 108 (3d Cir. 2004).

²² *SGL Carbon*, 200 F.3d at 156.

²³ *Id.* at 157.

²⁴ *Id.* at 167.

²⁵ *Id.* at 166.

²⁶ *Id.* at 167.

16. The *SGL Carbon* Court concluded its analysis with the following observation:

In reaching our conclusion, we are cognizant that it is growing increasingly difficult to settle large scale litigation. . . . We recognize that companies that face massive potential liability and litigation costs continue to seek ways to rapidly conclude litigation to enable a continuation of their business and to maintain access to the capital markets. As evidenced by SGL Carbon's actions in this case, the Bankruptcy Code presents an inviting safe harbor for such companies. ***But this lure creates the possibility of abuse which must be guarded against to protect the integrity of the bankruptcy system and the rights of all involved in such proceedings.*** Allowing SGL Carbon's bankruptcy under these circumstances seems to us a significant departure from the use of Chapter 11 to validly reorganize financially troubled businesses.²⁷

17. The *Integrated Telecom* opinion sheds further light on the Third Circuit's good faith standard. In *Integrated Telecom*, the debtor was "out of business," and had no going concern value to preserve in Chapter 11 through reorganization or liquidation under the Bankruptcy Code.²⁸ In determining whether the debtor's filing was undertaken in good faith, the Third Circuit considered whether the debtor's petition "might reasonably have maximized the value of the bankruptcy estate."²⁹ In defining the parameters of what reasonably maximizes the value of the bankruptcy estate, the Court noted that "[t]o say that liquidating under Chapter 11 maximizes the value of an entity is to say that there is some value that otherwise would be lost outside of bankruptcy."³⁰ The Third Circuit also found that "[t]o be filed in good faith, a petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve

²⁷ *Id.* at 169 (internal citations omitted) (emphasis added).

²⁸ See *Integrated Telecom*, 384 F.3d at 120.

²⁹ *Id.* (citation omitted).

³⁰ *Id.* at 120-21 (citing Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336, 350 (1993)).

some value that would otherwise be lost—not merely distributed to a different stakeholder—outside of bankruptcy.”³¹

18. The Third Circuit could “identify no value for Integrated’s assets that was threatened outside of bankruptcy by the collapse of Integrated’s business model, but that could be preserved or maximized in an orderly liquidation under Chapter 11,” and ultimately found that the debtor’s petition was not filed in good faith.³²

II. LTL’s petition should be dismissed because, as an entity simply created to funnel mass tort litigation claims through bankruptcy, LTL has no reorganizational purpose.

A. Mass tort bankruptcies are not new, but the circumstances of LTL’s bankruptcy filing are unique.

19. “When the Bankruptcy Code was enacted in 1978, Congress did not contemplate the unique problems caused by mass tort liability involving future, as well as present, claimants, or that companies facing such massive liability would seek relief under bankruptcy laws.”³³

20. Nonetheless, as the Debtor has argued,³⁴ there is a long line of debtors who have used Chapter 11 to manage mass tort liabilities. In *Johns-Manville*—the first case to employ a mass tort channeling injunction, which led to the enactment of Bankruptcy Code section 524(g)—the world’s largest miner of asbestos and a major manufacturer of insulating materials and other asbestos products filed for Chapter 11 because it knew it could not meet the massive personal injury liability it faced as a result of scientific studies linking respiratory disease with asbestos.³⁵

³¹ *Id.* at 129.

³² *Id.* at 129.

³³ Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. Pa. L. Rev. 2045, 2046 (2000).

³⁴ See Debtor’s Objection to Motions to Dismiss Chapter 11 Case (ECF No. 956), at pp. 15-16.

³⁵ See *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 640 (2d Cir. 1988).

Similarly, in *Dow Corning*, the predominant producer of silicone gel breast implants—accounting for nearly 50% of the entire market—filed for bankruptcy to address billions of dollars of litigation exposure arising out of its allegedly defective silicone breast implants.³⁶

21. More recently, USA Gymnastics³⁷ filed its bankruptcy petition to “implement orderly, equitable, and efficient procedures to allocate [its] available insurance proceeds to survivors who hold allowed claims against USAG” and to regain the trust and confidence of the United States Olympic Committee and the athletes in USA Gymnastics.³⁸ And in 2020, the Boy Scouts of America filed its bankruptcy petition to achieve dual objectives: (i) “timely and equitably compensating victims of abuse in Scouting” and (ii) “ensuring that the BSA emerges from bankruptcy with the ability to continue its vital charitable mission.”³⁹

22. In nearly all other Chapter 11 cases involving mass tort liability, however, the debtor seeking Chapter 11 protection was the actual company or organization facing the threat of litigation that, collectively, threatened to prevent the company from meeting its business and organizational objectives. In that light, it is easy to understand the reorganizational purpose to be served by those debtors’ bankruptcy filings.

23. LTL’s Chapter 11 filing, as well as other recent cases employing the same Texas Two-Step strategy, departs from that precedent. LTL has never been an operating company and has no business to rehabilitate. Instead, it was manufactured just days before its bankruptcy filing as a means to funnel J&J’s and Old JJCI’s talc litigation liabilities into bankruptcy without

³⁶ *In re Dow Corning Corp.*, 86 F.3d 482, 485 (6th Cir. 1996).

³⁷ *In re USA Gymnastics*, Case No. 18-09108 (Bankr. S.D. Ind. 2018).

³⁸ Declaration of James Scott Shollenbarger in Support of Chapter 11 Petition and Requests for First Day Relief, *USA Gymnastics* (ECF No. 8).

³⁹ Debtors’ Informational Brief (ECF No. 4), *In re: Boy Scouts of America and Delaware BSA, LLC* (Case No. 20-10343) (D. Del. 2020) at 6.

requiring those obviously solvent operating businesses to accept the burdens associated with a Chapter 11 case.

24. In the words of former Chief Judge William H. Gindin, “the enjoyment of the benefits afforded by the code is contingent on the acceptance of its burdens.”⁴⁰ The Court’s opinion also included this observation:

The Bankruptcy Code essentially provides for the forced compromise of creditors’ claims against the debtor by limiting creditors to a pro rata distribution and prohibiting creditors, by the discharge provisions, from taking any further action on their claims. ***In return for this protection, the debtor must disclose all its assets and submit them to the control of the bankruptcy court.*** It is the acceptance of this burden by the debtor, together with the economic reality that a debtor in a bankruptcy cannot pay all claims against it in full, which form the basis for the extraordinary power of the court to force a creditor to accept less than full value for its claim . . . “[S]uch an extension of the [discharge] is necessarily naked of the protections woven into [the Code].”⁴¹

B. LTL’s bankruptcy filing should be dismissed because LTL does not enter Chapter 11 with a valid reorganizational purpose.

25. Although the facts in *SGL Carbon* and *Integrated Telecom* may be factually distinguishable, the Third Circuit’s reasoning in these cases is on point. LTL was specifically manufactured to be undercapitalized and to have no business other than to file for bankruptcy and

⁴⁰ *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 503 (Bankr. D.N.J. 1997) (citation omitted); *In re SGL Carbon*, 200 F.3d 154, 161 (3d Cir. 1999) (“A debtor who attempts to garner shelter under the Bankruptcy Code . . . must act in conformity with the Code’s underlying principles.”).

⁴¹ *Arrowmill*, 211 B.R. at 506 (quoting Judith R. Starr, *Bankruptcy Court Jurisdiction to Release Insiders from Creditor Claims in Corporate Reorganizations*, 9 Bankr.Dev.J. 485, 498 (1993)) (emphasis added).

protect J&J from the tort system and unfavorable jury verdicts. Settling third party claims, on its own, is not a valid reorganizational purpose.⁴²

26. This case was not commenced to preserve or maximize the value of LTL's assets under Chapter 11 for the benefit of its creditors, the talc claimants. Quite the contrary, J&J created LTL to shelter its assets by filing for bankruptcy and capping the value paid to the talc claimants—in effect, *minimizing* the value that may be recoverable by those claimants.⁴³

27. Although J&J was the entity that acted in bad faith when it created LTL, any bad faith by J&J should be attributed to LTL because LTL has fully complied with and acquiesced in J&J's scheme.⁴⁴

28. The facts and circumstances supporting LTL's petition cannot amount to a good faith filing for three separate reasons: (i) LTL's bankruptcy filing serves no recognized Bankruptcy Code objective; (ii) LTL has no business to protect and therefore no reorganizational purpose; and (iii) LTL's petition was filed solely to gain a tactical advantage for J&J respecting its talc litigation.

⁴² See, e.g., *In re Davis Heritage GP Holdings, LLC*, 443 B.R. 448, 462 (Bankr. N.D. Fla. 2011) (“Chapter 11 was not designed for the purpose of protecting assets and interests of non-debtor parties under the guise of a legitimate plan of reorganization.”).

⁴³ The effect of the Funding Agreement is that J&J and New JJCI are only required to fund LTL up to the value of Old JJCI as of the date of the Texas Two-Step. See Funding Agreement, at § 2(a) (“Nothing in this Agreement shall obligate the Payors to (i) make Payments under this Agreement that in the aggregate exceed the lesser of (A) the JJCI Value and (B) the aggregate amount of all Permitted Funding Uses”); Funding Agreement, § 1 (defining “JJCI Value”).

⁴⁴ See *In re Quigley Co., Inc.*, 437 B.R. 102, 126-27 n. 32 (Bankr. S.D.N.Y. 2010) (in finding that Pfizer, the debtor's parent company, had wrongfully manipulated the voting process to assure confirmation of the Quigley plan, the Court noted that “Quigley acquiesced in if not actively embraced Pfizer's actions in connection with the prosecution of its chapter 11 case, and Pfizer's bad faith may be attributed to Quigley as well”). Indeed, J&J and LTL have acted together from the beginning, even through the same in-house legal counsel. LTL's Chief Legal Officer, John Kim, is actually employed by a non-debtor affiliate of LTL and a subsidiary of LTL's ultimate non-debtor parent company, J&J. See First Day Declaration, ¶¶ 1-2. Before Mr. Kim was Chief Legal Officer of LTL, he was J&J's Assistant General Counsel. See First Day Declaration, ¶ 2.

1. LTL's bankruptcy filing serves no recognized Bankruptcy Code objective.

29. LTL's bankruptcy filing does not serve any recognized objective of the Bankruptcy Code. LTL's First Day Declaration states that it "has at least the same, if not greater, ability to fund talc-related claims and other liabilities as Old JJCI had before its restructuring,"⁴⁵ implying that it is maximizing property available to satisfy the talc claimants. But this premise is nonsensical and should not be accepted as evidence of good faith. Indeed, the opposite must be true—LTL was created, and entered into the Funding Agreement with J&J, solely to *minimize* property available to satisfy talc victims. LTL cannot file a bankruptcy petition with the goal of capping tort victims' claims while simultaneously claiming that its reorganizational purpose is to maximize property available to satisfy these claimants.

30. LTL's aims and the strategy it used to file its bankruptcy are antithetical to the basic purpose of bankruptcy,⁴⁶ and allowing LTL's bankruptcy case to continue under these circumstances would signal a "significant departure from the use of Chapter 11 to validly reorganize financially troubled businesses."⁴⁷

2. LTL has no business to protect and, therefore, no reorganizational purpose.

31. In reviewing multiple motions to dismiss the *Johns-Manville* case, Bankruptcy Judge Burton R. Lifland in the Southern District of New York found that "in the case of a filing by a viable and legitimate company with real creditors not formed as a sham solely for the purpose

⁴⁵ See First Day Declaration, ¶¶ 21, 26.

⁴⁶ See *Integrated Telecom*, 384 F.3d at 119 ("At its most fundamental level, the good faith requirement ensures that the Bankruptcy Code's careful balancing of interests is not undermined by petitioners whose aims are antithetical to the basic purposes of bankruptcy."); *SGL Carbon*, 200 F.3d at 165 ("[F]iling a Chapter 11 petition merely to obtain tactical litigation advantage is not within the legitimate scope of bankruptcy laws. . . .").

⁴⁷ See *SGL Carbon*, 200 F.3d at 169.

of filing, the burden of establishing the company's 'good faith' should be tested where Congress placed it: for emergence out of Chapter 11 pursuant to Section 1129.⁴⁸

32. Even as the *Johns-Manville* court "express[ed] doubt that § 1112(b) impose[d] a good-faith requirement in all Chapter 11 cases,"⁴⁹ Judge Lifland recognized that a filing by a company "formed as a sham solely for the purpose of filing" would, at the very least, raise questions as to whether that filing was in good faith.⁵⁰

33. Here, LTL is a sham debtor with no reorganizational purpose because (i) it has no business; and (ii) there is no value to LTL's assets that was threatened outside of bankruptcy but that could be preserved or maximized under Chapter 11. LTL has confirmed that its overriding objective is to settle the talc claims against J&J.⁵¹ Even setting aside that settling third party claims against a non-debtor, on its own, is not a recognized reorganizational purpose,⁵² this objective can be accomplished outside of Chapter 11. In other words, LTL does not need Chapter 11 to settle the talc claims—it can settle them through counsel, on a case-by-case basis, the way that most litigations settle.⁵³ And, as more fully discussed below, if LTL's only purpose in filing its petition

⁴⁸ See *In re Johns-Manville*, 36 B.R. 727, 737 (Bankr. S.D.N.Y. 1984).

⁴⁹ See *SGL Carbon*, 200 F.3d at 168 (citing *Johns-Manville*, 36 B.R. at 737).

⁵⁰ *Johns-Manville*, 36 B.R. at 737.

⁵¹ See First Day Declaration, ¶ 59 ("The Debtor's goal in this case is to negotiate, obtain approval of, and ultimately consummate a plan of reorganization that would, among other things, (a) establish and fund a trust to resolve and pay current and future talc-related claims and (b) provide for the issuance of an injunction that will permanently protect the Debtor, its affiliates and certain other parties from further talc-related claims arising from products manufactured and/or sold by Old JJCI, or for which Old JJCI may otherwise have had legal responsibility, pursuant to sections 105(a) and/or 524(g) of the Bankruptcy Code.").

⁵² See, e.g., *Davis Heritage* 443 B.R. at 462 ("Chapter 11 was not designed for the purpose of protecting assets and interests of non-debtor parties under the guise of a legitimate plan of reorganization.").

⁵³ See *Integrated Telecom*, 384 F.3d at 126-27 (finding that even though the sale of certain assets during the bankruptcy realized an additional \$1 million beyond the sale that the debtor had

was to gain an advantage with respect to settling this litigation, such a purpose would be indicative of bad faith.

34. LTL was created solely to protect J&J by (i) taking on all of the talc claims, along with minimal assets, and (ii) filing a bankruptcy petition to obtain a channeling injunction and non-debtor third party releases for J&J's benefit.⁵⁴

35. Neither LTL nor its creditors benefit from this bankruptcy filing. The only entity benefitting from this filing is J&J, a financially healthy non-debtor that manufactured LTL solely to reap the benefits of Chapter 11. J&J should not be rewarded for this abusive behavior. Manufacturing a financially unhealthy debtor for the sole purpose of using the power of Chapter 11 to protect a solvent non-debtor cannot be a valid reorganizational purpose.

3. LTL's petition was filed solely to gain a tactical advantage with respect to talc litigation.

36. LTL has all but admitted that it filed its petition solely to aid in J&J's settlement of talc litigation, which the Third Circuit has made clear is not within the legitimate scope of bankruptcy law.

negotiated prior to filing its petition, that fact "hardly justifie[d] invocation of Chapter 11" because the debtor "did not need Chapter 11 to discover that a more open and competitive auction might increase the price obtained for its assets").

⁵⁴ The strategy of this case—namely, filing bankruptcy for LTL solely to protect non-debtor J&J—rests on jurisdictional principles and arguments about substantive bankruptcy law that the Third Circuit rejected over fifteen years ago. *See In re Combustion Engineering*, 391 F.3d 190, 234 (3d Cir. 2004) (vacating a section 105(a) injunction "[b]ecause the injunctive action on independent non-derivate claims against non-debtor third parties . . . would violate § 524(g)(4)(A), would improperly extend bankruptcy relief to non-debtors, and would jeopardize the interests of future [non-debtor] claimants").

37. “[B]ecause filing a Chapter 11 petition merely to obtain tactical litigation advantage is not within the legitimate scope of bankruptcy laws, . . . courts have typically dismissed Chapter 11 petitions under these circumstances as well.”⁵⁵

38. The First Day Declaration admits that LTL’s only goal is to consummate a plan of reorganization that would “establish and fund a trust to resolve and pay current and future talc-related claims” and to provide for the issuance of an injunction for the Debtor, its affiliates, and certain other parties from talc claims.⁵⁶

39. Further, “[w]here the timing of the filing of a Chapter 11 petition is such that there can be no doubt that the primary, if not sole, purpose of the filing was a litigation tactic, the petition may be dismissed as not being in good faith.”⁵⁷ For example, in *In re 15375 Memorial Corp. v. Bepco, L.P.*, the Court found that given a mix of facts and “the Debtors’ sudden decision to file for bankruptcy despite their having been dormant and without employees or offices for several years,” the Court “[could not] escape the conclusion that the filings were a litigation tactic.”⁵⁸

40. Here, too, the Court cannot ignore the timing and circumstances surrounding LTL’s filing, which point to the inescapable conclusion that the filing was a litigation tactic.

- March 2020: “J&J assure[s] the *Imerys* court that ‘J&J, of course, has the financial wherewithal to defend these claims and satisfy any successful talc claim in full.’”⁵⁹

⁵⁵ *SGL Carbon*, 200 F.3d at 165 (internal citation omitted); see also *Integrated Telecom*, 384 F.3d at 120 (quoting *SGL Carbon*, 200 F.3d at 165); see also *Furness v. Liliendfeld*, 35 B.R. 1006, 1013 (D. Md. 1983) (“The Bankruptcy provisions are intended to benefit those in genuine financial distress. They are not intended to be used as a mechanism to orchestrate pending litigation.”) (cited by *SGL Carbon*, 200 F.3d at 165).

⁵⁶ See First Day Declaration, ¶ 59.

⁵⁷ *In re 15375 Memorial Corp. v. Bepco, L.P.*, 589 F.3d 605, 625-26 (3d Cir. 2009) (citing *SGL Carbon*, 200 F.3d at 165).

⁵⁸ *Id.* at 625-26.

⁵⁹ Motion to Dismiss, ¶ 38 (citing *In re Imerys Talc America, Inc. et al.*, Case No. 19-10289 (Bankr D. Del. Mar. 20, 2020) (LSS), *Johnson & Johnson’s Motion Pursuant to 11 U.S.C. § 362(d)(1), Fed. R. Bankr. P. 4001, and Local Bankruptcy Rules 4001-1 for Entry of Order Modifying the*

- June 2021: The Supreme Court denies a petition for certiorari of a decision awarding \$500 million in actual damages against Old JJCI, \$125 million against J&J jointly and severally with Old JJCI, \$900 million in punitive damages against Old JJCI, and \$715,909,091 in punitive damages against J&J.⁶⁰
- July 2021: Reuters reports that J&J is “exploring a plan to offload liabilities from widespread Baby Powder litigation into a newly created business that would then seek bankruptcy protection”⁶¹
- October 2021: LTL is formed⁶² and days later, LTL’s bankruptcy petition is filed.⁶³

41. The timing of this filing, together with the circumstances of LTL’s formation, make clear that LTL’s bankruptcy petition was filed as a litigation tactic.

42. While there is precedent for filing a bankruptcy petition to resolve existing and future litigation claims when a debtor is financially troubled, there is no precedent for *creating* a financially troubled entity to file a bankruptcy petition solely to resolve litigation for the benefit of a non-debtor.

III. This Court should not create precedent for other courts to entertain such a blatant abuse of the Bankruptcy Code.

43. This case is a flagrant attempt by J&J to abuse benefits granted to legitimate debtors by the Bankruptcy Code while evading its rules and requirements. Bankruptcy courts are courts of equity, and debtors who seek shelter under the Bankruptcy Code must act in conformity with the Code’s underlying principles.⁶⁴ Accordingly, and especially because other entities have already

Automatic Stay to Permit J&J to Send Notice Assuming Defense of Certain Talc Claims and Implement Talc Litigation Protocol [Dkt. No. 1567], ¶¶ 4, 41, 45.).

⁶⁰ See *Ingham v. Johnson & Johnson*, 608 S.W.3d 664, 724-25 (Mo. App. E.D. 2020).

⁶¹ Reuters, *EXCLUSIVE: J&J exploring putting talc liabilities into bankruptcy*, available at <https://www.reuters.com/business/healthcare-pharmaceuticals/exclusive-jj-exploring-putting-talc-liabilities-into-bankruptcy-sources-2021-07-18/>.

⁶² First Day Declaration, ¶ 23.

⁶³ First Day Declaration, ¶ 5.

⁶⁴ See *SGL Carbon*, 200 F.3d at 161.

used this inappropriate strategy to take advantage of the Bankruptcy Code, the Court should not rubberstamp J&J's bad faith attempt to outmaneuver the good faith standard.⁶⁵

44. In *In re Patriot Coal Corp.*, a debtor created two new entities and incorporated them in New York weeks prior to the petition date, which resulted in 96 affiliates across the country filing for bankruptcy in the Southern District of New York.⁶⁶

45. The Court noted that the debtors did not act in bad faith in filing in the Southern District of New York, but did not allow their venue choice to stand because "to do so would elevate form over substance in [a] way that would be an affront to the purpose of the bankruptcy venue statute and the integrity of the bankruptcy system."⁶⁷ The Court further found:

Whether one characterizes the creation of venue as exploiting a loophole or as simply not fair, one thing is clear: ***it is not the thing which the statute intended***. While the Court agrees, at least as a general matter, with the Debtors' observation that it is the province of Congress and not the courts to close loopholes in legislation, ***nothing in our jurisprudence requires the Court to condone every strategy devised by clever lawyers to outsmart statutory purpose and language***, even where, as here, they do so with the best of intentions. To do so here would violate Judge Friendly's oft-quoted maxim that ***'[t]he conduct of bankruptcy cases not only should be right but must seem right'***.⁶⁸

46. Here, too, the strategy undertaken by LTL is nothing more than an attempt to outsmart the purpose of the Bankruptcy Code and clear language in both the Code and case law.

⁶⁵ Improperly filed cases, such as the one before the Court, are not only improper as to that organization's creditors. These cases threaten to undermine the legitimacy of the bankruptcy system entirely. *See, e.g.*, David Skeel, The populist backlash in Chapter 11, Jan. 12, 2022, available at <https://www.brookings.edu/research/the-populist-backlash-in-chapter-11/>.

⁶⁶ 482 B.R. 718, 726-28 (Bankr. S.D.N.Y. 2012).

⁶⁷ *Patriot Coal*, 482 B.R. at 743-44.

⁶⁸ *Id.* at 745 (emphasis added) (citing *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966)).

It is not the thing which the Bankruptcy Code intended. This Court is not required to—and should not—condone this strategy.

CONCLUSION

For the reasons set forth above, the Court should grant the Motion to Dismiss and hold that LTL's bankruptcy petition was filed in bad faith.

Dated: February 4, 2022

Respectfully submitted,

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BANKRUPTCY

Profitable Companies Enlist Bankruptcy Courts to Sidestep Cancer Trials

Corporations facing unwieldy asbestos litigation are accessing the benefits of bankruptcy without filing chapter 11 themselves

By [Jonathan Randles](#) | Photography by Kendrick Brinson for *The Wall Street Journal*

Feb. 8, 2022 6:30 am ET

A handful of large, profitable corporations are using a new strategy to access U.S. bankruptcy courts, unlocking powerful legal tools for settling thousands of asbestos lawsuits for a fraction of what juries might force these companies to pay.

The new legal tactic is shifting the balance of power toward corporate defendants Johnson & Johnson, Georgia-Pacific LLC as well as U.S. units of Ireland's Trane Technologies PLC and France's Compagnie de Saint-Gobain SA, which have corporate affiliates accused of previously selling products that contain asbestos, a cancer-causing mineral.

J&J, Georgia-Pacific, Trane and Saint-Gobain haven't filed for bankruptcy. But they have used a Texas law to shift at least 250,000 personal-injury cases to bankruptcy court through newly created subsidiaries with limited business operations, a strategy developed by law firm Jones Day, court records show.

The Texas law let the companies fill their new subsidiaries with legal liability for pending and future injury litigation before those units filed for chapter 11. The bankruptcies have paused pending lawsuits either against the parent companies or

their U.S. affiliates, locking injury claimants out of the tort system and preventing them, at least for now, from putting their claims to juries.



Mr. Gregory at his home.

These four companies are receiving legal and financial benefits from chapter 11 without risking the likely loss of equity value that would come from placing whole business divisions in bankruptcy. The legal strategy will be put on trial in a New Jersey bankruptcy court later this month as personal-injury lawyers seek to dismiss the bankruptcy case filed in October by a J&J subsidiary, LTL Management LLC, to drive a settlement of roughly 38,000 cancer lawsuits over its talc-based products.

Some personal-injury lawyers and academics have said that J&J is abusing the bankruptcy system by shifting legal liabilities to a shell company with limited business operations. They have said LTL was created solely to benefit its owner and stockholders

and to sap tort claimants' negotiating leverage

"This is an attack on the American tort system," said Bruce Markell, a Northwestern Pritzker School of Law professor and retired bankruptcy judge who is among several academics urging a bankruptcy judge to dismiss LTL's chapter 11 case.

J&J has denied that the restructuring was done in bad faith or will shortchange victims. The subsidiary in chapter 11 has a funding agreement with its parent company to cover any amounts it is deemed to owe.

A J&J spokeswoman said that LTL's bankruptcy filing "follows established process, and courts have uniformly acknowledged that equitably resolving these types of claims through chapter 11 is a legitimate use of the restructuring process."

J&J said in 2020 it would stop selling its talcum-powder-based products in the U.S. and Canada, citing a decline in demand fueled by changing consumer habits and "misinformation around the safety of the product and a constant barrage of litigation advertising." In court papers, J&J has said it could face new talc lawsuits for decades to come.

Law firm Jones Day didn't respond to requests for comment about the legal strategy.

Willie Gregory, who said his wife, Sonna Gregory, died in May from ovarian cancer at the age of 59, said he was shocked when he learned of the bankruptcy filing by LTL. Mr. Gregory, 55, said his wife used Johnson's Baby Powder for nearly 30 years up until about 1990 and was diagnosed with cancer in 2016. A lawsuit they filed against J&J in 2020, now on pause, blames the use of its talc-based products for the cancer developed by his wife, who was a longtime commissioner for Georgia's Clayton County.

"It's almost like they're trying to brush it off and sweep it under the rug," said Mr. Gregory, a helicopter pilot with the Clayton County Police Department.

J&J has denied liability in Mr. Gregory's lawsuit, one of his lawyers said. The J&J spokeswoman said that Johnson's Baby Powder is safe and doesn't contain asbestos or cause cancer.

Chapter 11 allows companies facing asbestos claims to forge a settlement covering both pending claims and new injuries that arise years after exposure, a challenging task outside of bankruptcy. Bankruptcy courts can also value large numbers of tort claims collectively, giving defendants a court-imposed cap on aggregate payouts.

J&J began exploring a bankruptcy strategy and moved its talc liabilities to a new

subsidiary after the U.S. Supreme Court declined in June to review a \$2.1 billion judgment in Missouri in favor of 20 women who blamed the company's baby powder for their ovarian cancer.



Johnson & Johnson in 2020 said it would stop selling talcum-based baby powder in the U.S. and Canada.

PHOTO: JUSTIN SULLIVAN/GETTY IMAGES

Michelle Ryan, J&J's former treasurer, said in a July email to a Moody's Investors Inc. analyst that a chapter 11 strategy was a potential option for "capping our talc liability, especially with the recent disappointing Supreme Court inaction," according to a copy of the email shown in bankruptcy court.

Ms. Ryan retired from J&J in January, according to her LinkedIn page. While being questioned about the email during a January deposition, Ms. Ryan said uncertainty over the talc cases hurt J&J's credit rating and that she used the term "capping" to describe the company's desire to have "a defined liability."

Moody's declined to comment Monday.

LTL said when it filed for bankruptcy that J&J offered \$2 billion to settle all talc-related injury claims against J&J. LTL said J&J also gave it an equity interest in a royalty business worth \$350 million. Robert Wuesthoff, a J&J vice president who runs the LTL unit, said in a December deposition that filing for bankruptcy was "a pretty common sense call" and that the settlement offer is significant because J&J stands behind the safety of its products and believes the talc lawsuits lack merit.

Mr. Wuesthoff said he thought the \$2 billion offer "was a great start, and hopefully, not even two billion is needed," according to court documents.

If LTL's bankruptcy case is dismissed, injury lawyers could resume litigating against J&J around the country. Otherwise, they could be negotiating a settlement with J&J or fighting in bankruptcy and appellate courts, potentially for years.

"If the bankruptcy courts allow this to happen, they better create a whole new division and hire a bunch of new bankruptcy judges because every company will be doing it," said Roy Barnes, the former Georgia governor who represents Mr. Gregory and dozens of ovarian cancer victims suing J&J.

LTL said its corporate predecessor incurred roughly \$3.5 billion in indemnity payments before the chapter 11 filing. In court papers, LTL has described jury trials as a "lottery like" system, where a handful of personal-injury claimants win astronomical sums while others lose at trial and get nothing. J&J has said a resolution of the litigation through chapter 11 is a fairer and quicker way to dispense compensation.



A lawsuit filed against J&J in 2020 by Mr. Gregory and his wife is now on pause. J&J has denied liability, one of his lawyers said.

Some cancer patients are hoping their legal claims will provide payouts for their families after they die. California resident Vincent Hill died Sunday at age 56 after battling malignant mesothelioma, his lawyer said. Last month, Mr. Hill testified in bankruptcy court that he had put Johnson's Baby Powder on patients' bed linens after they finished bathing while working at Sutter General Hospital in Sacramento, Calif.

Mr. Hill had been scheduled to go to trial last December over his personal-injury lawsuit against J&J, but a California judge postponed his case after J&J moved his lawsuit and the others to chapter 11.

"It's very important that I get a chance to tell my story," Mr. Hill said last month. He said he had been in hospice care and sought to provide financial security for his wife

and 2-year-old daughter.

J&J denied liability in Mr. Hill's lawsuit. A lawyer for J&J during the bankruptcy hearing cited Mr. Hill's medical records, saying he smoked, could have been exposed to asbestos while working construction and that none of his physicians said his cancer was caused by J&J's baby powder.

Although family members or estate representatives can continue lawsuits after someone dies, in some states, death itself wipes out some of a person's legal claims, such as for pain and suffering, according to plaintiffs' attorneys.

Judge Michael Kaplan of the U.S. Bankruptcy Court in New Jersey said that while it was "unfortunate and horrific" that Mr. Hill was aware he likely wouldn't live to see a resolution to his lawsuit, it couldn't move forward because it would likely undermine the possibility of a broad settlement in the chapter 11 case filed by LTL.

Although asbestos lawsuits against J&J are paused, chapter 11 has procedures to protect the interests of asbestos victims. A committee is representing claimants' in court and, if LTL's case proceeds, plaintiffs would have an opportunity to vote on any settlement. These procedures will likely motivate J&J to negotiate with claimants and build support for any settlement proposal, said Samir Parikh, a law professor at the Lewis & Clark Law School in Portland, Ore.

"There are a number of parties at the table pushing back making sure their clients' interests are represented," Mr. Parikh said.

A pair of U.S. affiliates of Ireland's Trane Technologies holding legacy asbestos liabilities were put into chapter 11 in 2020 after they also underwent a Texas corporate restructuring. Separately, Saint-Gobain's CertainTeed LLC, a construction parts maker, carved off its asbestos liabilities in 2019, sending a new subsidiary holding those liabilities to chapter 11.

CertainTeed was "seeking a less expensive way of dealing with these tort liabilities" and turned to a strategy that its corporate representative said was "driven not by businesspeople, but by lawyers," a bankruptcy judge ruled in August. The judge said that CertainTeed's corporate reshuffling had "apparent negative effects...on the legal rights of asbestos claimants" but didn't conclude it broke the law. He made similar findings about Trane's use of chapter 11 later that month.



The Georgia-Pacific building in Atlanta.

A Saint-Gobain spokesman said that its attempts to resolve asbestos litigation through a trust that would pay valid injury claims is consistent with bankruptcy law and will result in current and future plaintiffs receiving faster payments “without the delay, stress and uncertainty of litigation in the tort system.”

Georgia-Pacific, owned by Koch Industries Inc., also used Texas law to shift about 64,000 pending asbestos cases as well as future liability arising from past sales of gypsum plaster products into a subsidiary before placing it in chapter 11 in 2017. The unit, Bestwall LLC, has sought to put a price tag on its asbestos liabilities through estimation, the process available in bankruptcy court to collectively value mass torts. In estimation, legal and medical experts debate how much a company should pay to be done with a litigation for good.

Georgia-Pacific declined to comment. Trane didn’t respond to requests for comment. These companies have said they put corporate affiliates into chapter 11 to fairly and equitably compensate asbestos victims and resolve costly litigation arising from asbestos-containing products they stopped producing decades ago.

Georgia-Pacific spent about \$3 billion defending and resolving asbestos claims in the decades leading up to Bestwall’s chapter 11 filing, court papers show. After the bankruptcy filing, a 10-member committee was formed to represent claimants who allege they were sickened by asbestos.

Five people on the original committee have died since the chapter 11 case began and have been replaced by their representatives. Bestwall and the committee have had negotiations but haven’t agreed yet to a deal for how, and how much victims would be paid.

Profitable Companies Enlist Bankruptcy Courts to Sidestep Cancer Trials <https://www.wsj.com/articles/profitable-companies-enlist-bankruptcy-cou...>

Write to Jonathan Randles at jonathan.randles@wsj.com

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Healthcare & Pharmaceuticals

Special Report: Inside J&J's secret plan to cap litigation payouts to cancer victims

By Mike Spector and Dan Levine

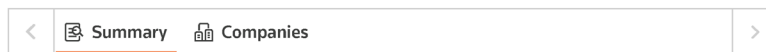
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A bottle of Johnson and Johnson Baby Powder is seen in a photo illustration taken in New York, February 24, 2016. REUTERS/Mike Segar/Illustration/File Photo



J&J's covert 'Project Plato' team crafted strategy to redirect cancer plaintiffs out of trial courts and into bankruptcy process

J&J documents show how it planned 'Texas two-step' maneuver to limit payouts for talc claims

J&J executive asked whether maneuver would affect company's credit rating, documents show

U.S. judge to weigh whether bankruptcy was filed in bad faith

NEW YORK, Feb 4 (Reuters) - Johnson & Johnson created a plan last year to limit the financial bleeding from billions of dollars in jury awards to plaintiffs who alleged the company's Baby Powder and other talc products caused deadly cancers. The healthcare and consumer-goods giant assigned more than 30 staffers to "Project Plato." In a memo on the project in July, a company lawyer warned the team: Tell no one, not even your spouse.

"It is critical that any activities related to Project Plato, including the mere fact the project exists, be kept in strict confidence," Chris Andrew, a J&J lawyer, wrote in an internal memo reviewed by Reuters.

The covert team would go on to evaluate a strategy to shift all the liability from about 38,000 pending talc cases onto a newly created subsidiary, which would immediately declare bankruptcy. The goal, as a lawyer for the subsidiary said in a court filing: To halt all

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the litigation and transfer the cases to bankruptcy court, where plaintiffs would compete for compensation from a limited pool of money.

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In court and in public statements last July, J&J (JNJ.N) said it intended to keep fighting the allegations that its products were unsafe in trial courts. The company was actively defending itself in talc trials, including one that would result in a \$27 million jury award that could be nullified by the bankruptcy maneuver. The plaintiff in that case now may have to instead seek compensation through a bankruptcy process.

Privately, J&J took concrete steps starting as early as April to consider and plan the bankruptcy maneuver, according to internal company documents, depositions and other court records reviewed by Reuters. The strategy seeks to ensure the pending cases never reach a jury and instead be handled in a bankruptcy court.

The documents provide the most detailed account to date of how the New Jersey-based conglomerate strategized to limit compensation to tens of thousands of talc plaintiffs.

Reuters exclusively reported the broad outlines of the bankruptcy strategy being explored by J&J in July. The company went ahead with the plan in October, offloading responsibility for the cases to the new subsidiary, which then filed for bankruptcy. Before the filing, the company faced costs from \$3.5 billion in verdicts and settlements, including one in which 22 women were awarded a judgment of more than \$2 billion, according to bankruptcy-court records.

Now, J&J proposes to give the subsidiary in bankruptcy \$2 billion to put into a trust to compensate all 38,000 current plaintiffs, as well as all future claimants. J&J has said in court filings and in public statements that the subsidiary, LTL Management LLC, could also tap a stream of royalty revenues valued at more than \$350 million at the time of the bankruptcy filing.

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J&J did not answer detailed written questions from Reuters about its planning of the bankruptcy maneuver. In a statement, J&J defended the LTL bankruptcy as a way to resolve the talc claims.

"This filing follows established process, and courts have uniformly acknowledged that equitably resolving these types of claims through Chapter 11 is a legitimate use of the restructuring process," the statement said. "LTL's objective is to reach a fair and equitable resolution for claimants through a plan of reorganization and create a reasonable framework to address the unprecedented number of existing and future talc-related claims."

It continued: "We stand behind the safety of Johnson's Baby Powder, which is safe, does not contain asbestos and does not cause cancer. We continue to believe resolving this matter as quickly and efficiently as possible is in the best interests of claimants and all stakeholders. We will continue to follow the process and put forth our position in the court."

On Thursday, a lawyer for the J&J subsidiary appeared at a bankruptcy hearing and accused attorneys for people who have sued Johnson & Johnson over its talc products of sharing confidential documents with Reuters in a "calculated" effort to try the case "in the press."

Later Thursday, lawyers for J&J and its subsidiary sought a temporary restraining order from the bankruptcy judge to **block Reuters** from publishing information that, the company claims, comes from confidential documents.

A Reuters spokesperson called J&J's claims without merit.

"We reject the factually-unfounded and legally-meritless claims made by J&J's lawyers and will continue to report without fear or favor on matters of public interest," the spokesperson said in a statement on Thursday.

BANKRUPTCY BENEFITS WITHOUT BURDENS

2/8/22, 7:24 PM

Special Report: Inside J&J's secret plan to cap litigation payouts to cancer victims | Reuters

J&J started secretly considering and planning the maneuver to redirect plaintiffs to bankruptcy court as early as April, when company attorneys were briefed on the strategy by lawyers at Jones Day, a firm with experience in the tactic, according to deposition testimony from an LTL lawyer.

On July 19, the day after Reuters broke the news of the strategy, a J&J official contacted Moody's, the Wall Street ratings firm, to ask if the subsidiary bankruptcy would harm the company's pristine credit, according to emails reviewed by Reuters. She was told it likely wouldn't because the agency would only consider the maneuver's impact on the finances of J&J, and not those of the subsidiary in bankruptcy.

The exchange underscores why the strategy was so attractive: J&J could create a related-party bankruptcy to limit liability, while avoiding "the burdens" of declaring bankruptcy itself, seven legal experts argued in an amicus brief filed with the court.

Moody's declined to comment.

In court papers, a lawyer for the J&J subsidiary said the bankruptcy filing was a "prudent and necessary" step that "offered the only alternative for equitably and permanently resolving" all the talc litigation.

Last July, Reuters reported that one of J&J's attorneys told plaintiffs' lawyers that the company could pursue the bankruptcy plan, according to people familiar with the matter. At the time, J&J publicly downplayed concerns about the strategy and did not confirm that it was exploring the option. "Johnson & Johnson Consumer Inc has not decided on any particular course of action in this litigation other than to continue to defend the safety of talc and litigate these cases in the tort system, as the pending trials demonstrate," the company told Reuters at the time.

A few days later, in a California courtroom, a lawyer defending J&J against talc plaintiffs told a judge that news of the bankruptcy strategy amounted to unsubstantiated "rumors." J&J executed the bankruptcy plan starting on Oct. 11, taking the first steps to create the new subsidiary. The new company swiftly filed for Chapter 11, on Oct. 14.

'ALTERNATIVE JUSTICE SYSTEM'

The strategy, while rare, could be adopted more widely by big companies facing liability crises if Johnson & Johnson gets bankruptcy-court approval, according to lawyers for talc plaintiffs and some legal experts. If J&J succeeds, they argue, it could provide a blueprint for Corporate America on how to circumvent jury trials involving allegations of defective products or misconduct.

Such a precedent could allow companies to routinely pursue related-party bankruptcies to escape accountability from juries, said Melissa Jacoby, a University of North Carolina law professor.

"That's one step closer to making bankruptcy an alternative justice system for big corporations," Jacoby said. "If a company as deeply pocketed as J&J can do this, where does it stop?"

In testimony last November, a lawyer for the Johnson & Johnson subsidiary has said the company pursued the strategy in reaction to an onslaught of litigation with the potential for outsized jury awards. A bankruptcy court, the lawyer argued, could provide a more consistent and equitable process for compensating claimants. Johnson & Johnson has said it would provide a fair amount of money to the subsidiary to pay claims.

Johnson & Johnson, valued at more than \$450 billion, had about \$31 billion in cash and marketable securities on hand at the end of the third quarter, securities filings show.

The New Jersey judge overseeing the subsidiary's bankruptcy is scheduled on Feb. 14 to begin hearing arguments on plaintiff-creditors' contention that the bankruptcy should be dismissed because it was filed in bad faith.

The October bankruptcy temporarily halted the litigation against Johnson & Johnson. LTL has said it will seek to "permanently" resolve the talc litigation through a reorganization plan that would prohibit current and future plaintiffs from seeking redress in a trial court.

Instead, their claims would be directed to a trust, which would divvy up a limited amount of money through an administrative process approved by the bankruptcy court.

TENS OF THOUSANDS OF PLAINTIFFS

J&J's bankruptcy strategy is the latest example of the company's efforts to manage liability amid mounting allegations that asbestos lurks in its iconic Baby Powder and other talc products. A December 2018 [Reuters investigation](#) revealed that the company knew for decades about tests showing its talc sometimes contained carcinogenic asbestos but kept that information from regulators and the public.

Tens of thousands of plaintiffs, many with mesothelioma or ovarian cancer, have filed lawsuits alleging that exposure to talc in J&J's Baby Powder and other company products made them sick. Records J&J produced in response to those lawsuits led plaintiff lawyers to refine their argument: The culprit wasn't necessarily talc itself, but also asbestos in the talc.

That assertion, backed by decades of science showing that asbestos causes mesothelioma and is associated with ovarian and other cancers, has had mixed success in court. The company has insisted in lawsuits and public-relations campaigns that the product was safe and asbestos-free.

One plaintiff is Thomas McHattie, 78 years old, who traveled the world as an obstetrician-gynecologist before receiving a mesothelioma diagnosis in March 2020. McHattie said he recommended Baby Powder to "countless pregnant women" while also using it himself. McHattie said he endured five courses of chemotherapy to treat tumors in his abdomen, and has suffered from pronounced fatigue and shortness of breath.

He sued J&J in New York in July, a few months after receiving his diagnosis. His case had not yet gone to trial when LTL Management filed for bankruptcy.

In a 2020 court filing, J&J said it denied "each and every allegation, statement, matter and thing" asserted by McHattie in his lawsuit.

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McHattie told Reuters in an interview that he was "disappointed they've chosen to do what is expedient and not what is right."

"There is no excuse for them filing a bankruptcy," McHattie said. "Why? This is a solvent company."

RELEASED FROM LIABILITY

J&J's subsidiary bankruptcy is one variation of a longstanding and increasingly controversial tactic of limiting liability through so-called nondebtor releases granted to companies, owners or executives. The releases can allow companies or executives to piggyback on the bankruptcies of other entities to obtain broad protection from lawsuits and restrict litigation payouts. The party receiving the release typically agrees to contribute a lump sum to the company in bankruptcy to pay off plaintiffs in exchange for an exemption from all future liability.

That was the case with members of the Sackler family, the billionaire owners of Purdue Pharma LP, which filed for bankruptcy as a hail of lawsuits alleged it had contributed to a deadly addiction epidemic with its opioid painkiller, OxyContin. In a landmark decision in December, a U.S. district judge in New York invalidated Purdue's bankruptcy reorganization plan on the grounds that it improperly insulated the Sackler family from liability through nondebtor releases.

Purdue has appealed the ruling. The company pleaded guilty in November 2020 to three felonies covering misconduct regarding its handling of opioids. Sackler family members, who also faced litigation, have denied allegations they contributed to the opioid crisis.

J&J's bankruptcy takes the approach a step further. Instead of seeking releases from liability in an existing bankruptcy proceeding, the company created a bankruptcy by forming a company that plaintiff-creditors allege has no business purpose other than to limit J&J's legal exposure.

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Lawyers for talc plaintiffs contend that the J&J maneuver amounts to an abuse of the bankruptcy system, which is intended to help a struggling business reorganize – and not to help a well-capitalized conglomerate limit legal liability for alleged wrongdoing.

“This case is all about litigation advantage” for J&J, said Robert Stark, a Brown Rudnick LLP lawyer representing a creditors’ committee of talc plaintiffs during a December hearing of the subsidiary’s bankruptcy. J&J successfully halted the claims by tens of thousands of plaintiffs “while people are dying of cancer” and trying to prepare their families financially for their deaths, Stark said at the hearing. “It does not get more inhumane than that,” he said.

The Purdue and J&J bankruptcy strategies have sparked efforts in the U.S. Congress to stop such tactics. U.S. Senator Dick Durbin of Illinois is co-sponsoring legislation with other Democrats that would all but outlaw the strategy J&J is using and restrict the ability of companies to obtain liability releases without declaring bankruptcy themselves.

“Our bankruptcy code and civil procedure has to be explored to make sure that this exploitation does not take place,” Durbin said in an interview.

Business groups and some bankruptcy lawyers say that nondebtor releases can be an effective tool to resolve litigation to the benefit of both plaintiffs and the companies they sue. While limited amounts for compensation are often criticized, they offer plaintiffs better odds of getting paid than if they take their chances in trial courts, said Donald Workman, a Baker & Hostetler restructuring lawyer who isn’t involved in the J&J subsidiary’s case.

“You have an elegant solution to resolve burdensome if not crushing obligations,” Workman said, that “provides funding for constituencies that might otherwise receive nothing.”

TEXAS TWO-STEP

J&J turned to the bankruptcy plan following a series of setbacks.

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The U.S. Food and Drug Administration found trace amounts of asbestos in a bottle of Baby Powder purchased online, forcing the company to issue a recall in October 2019. In May 2020, the company stopped selling talc-based Baby Powder in the U.S. and Canada, citing "misinformation" and "unfounded allegations" regarding the product's safety.

In April, J&J attorneys consulted with Jones Day lawyers, who explained how the company could use a Texas law to split the company's consumer-product business into two parts. One would absorb all the talc liability; the other would carry on the business free from the threat of billion-dollar judgments. Texas pioneered the so-called divisional merger, which allows companies to break apart and more easily divvy up assets and liabilities among the resulting companies.

Jones Day helped Georgia-Pacific, a company owned by conglomerate Koch Industries, execute the maneuver in 2017 to offload mounting asbestos litigation. Georgia-Pacific faced allegations regarding asbestos exposure from building products that spanned decades.

Georgia-Pacific used the Texas law to create a new subsidiary called Bestwall to shoulder asbestos liability. As the subsidiary declared bankruptcy, the "new" Georgia-Pacific continued to produce Brawny paper towels and other lucrative brands. The maneuver came to be known in legal circles as a "Texas two-step."

Georgia-Pacific paid nearly \$3 billion in dividends to Koch over the next several years, according to a court filing, that it might have been unable to dole out had it filed for bankruptcy itself. Georgia-Pacific has proposed giving Bestwall \$1 billion to settle all asbestos claims, an amount plaintiff-creditors are still challenging in bankruptcy court.

Koch Industries and Georgia-Pacific declined to comment; Jones Day did not respond to a request for comment.

When J&J needed help last year, it hired Dallas-based Jones Day partner Greg Gordon and other members of the firm's Georgia-Pacific legal team.

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As the bankruptcy planning moved forward, a major court defeat heightened the urgency. In June of last year, J&J lost a bid to reverse a watershed verdict in favor of 22 women who blamed their ovarian cancer on Baby Powder and other talc products. The women had initially won a verdict of \$4.69 billion from a Missouri jury. A state appeals court reduced the award to more than \$2 billion.

PROJECT PLATO

By July 12, the company had secretly set up the Project Plato team. The more than 30 employees staffing it came from J&J's finance, risk management, tax and business development operations, according to the internal J&J memo and deposition testimony.

A week later, J&J treasurer Michelle Ryan reached out to Moody's to get guidance on the impact to J&J's credit rating.

"We are looking at a number of ways of capping our talc liability," Ryan said in a July 19 email to Michael Levesque, a senior vice president at the credit-ratings firm focused on pharmaceutical companies. One scenario under consideration, Ryan said, would be to "capture the liability in one subsidiary" and then "basically bankrupt that subsidiary."

Ryan asked whether the bankruptcy would hurt the company's credit rating. J&J at the time was one of just two U.S. companies with a triple-A rating, the other being Microsoft.

Levesque replied that the "technical aspect" of the subsidiary bankruptcy wasn't likely to cause concern about J&J's creditworthiness. Rather, he said, Moody's was "highly likely" to focus on how the subsidiary's Chapter 11 filing affected J&J's finances, which the maneuver intended to help.

Ryan did not respond to a request for comment.

To execute the plan, J&J created a limited liability company on Oct. 11 in Texas through a series of transactions. That company then merged with J&J's existing consumer products

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business. The merged company then divided itself under the state's divisional merger law, creating the subsidiary that would take on all the talc liability.

The consumer business could then go on as if the lawsuits had never been filed.

GREEN LIGHT

Early on the morning of Oct. 11, Andrew, the in-house J&J lawyer who initially sent the internal memo to the Project Plato team, sent an email to eight J&J colleagues, including several senior executives. He asked them to approve the Texas two-step bankruptcy plan "as soon as possible" and no later than that day, according to Andrews' email to his colleagues, which was reviewed by Reuters.

He attached a detailed memo outlining the impending bankruptcy's purported benefits. It would allow, the memo said, the bankruptcy court to determine the final amount of money for resolving all of the litigation, in a process enabling claims to be settled in an "equitable and efficient manner, without the waste and abuses experienced in the state court tort system."

The memo warned of risks. The plan would be consummated under a tight time frame and would be scrutinized by the media. "Appropriate messaging (internally and externally) will be required to avoid or mitigate misunderstandings about the nature of the restructuring and negative publicity," the memo said.

Andrew quickly received the green light, within hours of the request, internal emails reviewed by Reuters show.

LTL, the new subsidiary, held its first board meeting on Oct. 14.

The board members and lawyers discussed that LTL faced what they viewed as "exorbitant" costs if the current talc litigation barrage continued, which included 12,000 lawsuits alone through the first nine-and-a-half months of 2021, according to meeting

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minutes and deposition testimony Reuters reviewed. The group noted that J&J faced a total of about \$5 billion in costs from judgments, settlements and legal fees.

The board voted to pursue a Chapter 11 filing. J&J disclosed the move in a news release that evening as one that would "equitably" resolve the litigation.

A plaintiffs' lawyer grilled Robert Wuesthoff – a J&J manager appointed president of LTL Management – on that point in a Dec. 22 deposition.

"One of the considerations was to treat claimants equitably; it was for their benefit? Is that what you're saying?" asked Jeffrey Jonas, a Brown Rudnick lawyer representing a creditors committee comprising talc plaintiffs.

"Yes, it would be more equitable to the claimant. Yes, we believe that," Wuesthoff responded.

"But the real reason we filed for bankruptcy," the LTL executive said, was that the large and growing amount of talc cases – some with "lottery-size" awards – put J&J's consumer products business in "financial distress."

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