UPDATE: Johnson & Johnson's Texas two-step sweeps into New Jersey

In November 2021, we reported that an emerging and controversial bankruptcy maneuver—known as the "Texas Two-Step"—was potentially on the path to wider legal acceptance after gaining traction in a major case involving corporate giant Johnson & Johnson (J&J). Since then, the Texas Two-Step has won singular praise from a bankruptcy judge in New Jersey who stated that the Texas Two-Step is "unquestionably a proper use of the Bankruptcy Code."[1] While certainly not the last word, the latest ruling heralds the growing importance of the Texas Two-Step as a tool by which corporations facing potentially massive liability in numerous tort suits might be able to force a single, global settlement through bankruptcy.

Background

Since 2010, J&J has faced an ever-growing number of lawsuits related to claims that its baby powder and other talc-based products caused cancer. The number of cases has grown to over an astonishing 38,000 in recent years. A $4.69 billion verdict against J&J in just one single 2020 case demonstrated the vast universe of potential liability facing the corporate giant. J&J has been attempting to corral those thousands of individual lawsuits into a single bankruptcy case whereby all of its talc-related liability might be resolved in a single, global settlement.

The legal mechanism J&J is using is known as the Texas Two-Step. The first of those steps involved forming a new subsidiary company under Texas' unique "divisional merger" law. Through that process, the new company—LTL Management, LLC (LTL)—took on all of J&J's asbestos liability and admittedly has no other purpose than to hold that liability. The second step was for the newly formed LTL to file immediately for Chapter 11 bankruptcy, having chosen to do so in the Western District of North Carolina.

J&J's use of the Texas Two-Step to force tens of thousands of cases into settlement via bankruptcy has faced stiff opposition from both individual plaintiffs and public policy advocates, who have maintained that the Texas Two-Step is nothing but a ham-fisted maneuver to force an "unfavorable settlement dynamic" on talc victims, thereby essentially creating a bad-faith "bankruptcy discount."[2] Of course, parent company J&J, which is not in bankruptcy, is one of the world's wealthiest corporations with an approximate net worth of $435 billion. However, J&J states that it has agreed to provide funding to LTL Management for the payment of amounts the Bankruptcy Court determines are owed by LTL and it will establish a $2 billion trust in furtherance of that purpose.

As previously reported here, Judge Craig Whitley of the Western District of North Carolina late last year declined to extend a temporary restraining order that would have halted lawsuits against J&J. Judge Whitley agreed that lawsuits involving bankrupt LTL were paused, as being subject to the automatic stay under Chapter 11 rules.

Recent developments—resounding praise and the stay question answered

The LTL case was transferred by Judge Whitley to the District of New Jersey, saying North Carolina was not the correct venue for the case. With the case thus transferred to J&J's home state, LTL was immediately faced with a motion to dismiss filed on behalf of the talc-litigation plaintiffs.

That motion asserted that the LTL bankruptcy has been filed in bad faith and put forward arguments surrounding the unfavorable settlement dynamic that would deny individual plaintiffs their day in court.

In a 56-page opinion, Judge Michael B. Kaplan of the District of New Jersey denied the motion to dismiss and gave J&J's Texas Two-Step resounding praise, stating that bankruptcy court is the "optimal venue" for redressing the harms of both present and future talc claimants.[3]

Judge Kaplan rejected the notion that the tort system offered the only just pathway to redress the talc harms, saying that bankruptcy provided a meaningful "opportunity for justice" that can produce "comprehensive, equitable, and timely recoveries" for injured parties.[4]

Of note for the banking community, Judge Kaplan opined that the bankruptcy process was particularly suited to resolving the issues of potential mass tort liability because it compels the participation of interested parties, including insurers, retailers, distributors, claimants and debtors in a single forum.[5] Judge Kaplan then stated that the case had too much value to be wasted and should instead be spent on achieving "some semblance of justice" for talc victims,[6] adding that there was nothing "inherently unlawful or improper" with the Texas Two-Step.[7]

On top of endorsing the Texas Two-Step as a legitimate tool for resolving the thousands and thousands of pending lawsuits, Judge Kaplan also extended the automatic bankruptcy stay to all of the J&J talc lawsuits—not just the ones involving spin-off LTL.[8] Thus, Judge Kaplan has answered the key question as to the extent of the automatic stay in the J&J litigation, clarifying that it extends to non-debtors for a variety of reasons, including an identity of interests. Thus, even the mature talc cases against other J&J companies that are now nearing jury trial have been stayed, at least for now. Judge Kaplan will revisit the issue.

Ultimately, Judge Kaplan is only one bankruptcy judge out of more than 350 judges in the United States and those other judges, as well as those on appellate courts, may not share his glowing view of the Texas Two-Step. In addition, questions remain as to whether the Texas divisional merger—the first dance step—might be subject to attacks in state court on fraudulent-transfer grounds. Stay tuned.

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The Texas Two-Step is a legal strategy steadily gaining traction as a tool for companies to place large amounts of tort liability into bankruptcy, while shielding the rest of their operations and assets from tort claimants. The reach and long-term viability of this strategy will be determined by the courts as Texas Two-Step cases like the J&J one are litigated. In the meantime, this legal maneuver presents both potential benefits and risks for lenders. In some cases, lenders might prefer that a borrower employ the Texas Two- Step, thereby providing for a more secure borrower. In other cases, lenders might have apprehension about the prospect of a significantly reduced recovery from debtors who are attempting to place the bulk of their assets out of legal reach.

In any event, the banking attorneys at Chuhak & Tecson can recommend best practices and will offer sound advice to help navigate individual circumstances when dealing with a debtor who is using or may be contemplating the use of this evolving bankruptcy development.

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[1] *In re LTL Mgmt., LLC,* No. 21-30589 (MBK), 2022 WL 596617, at *16 (Bankr. D.N.J. Feb. 25, 2022).
[2] *See id.* at *9.
[3] *Id.*
[4] *Id.* at *13.
[5] *Id.*
[6] *Id.* at *21.
[7] *Id.* at *23.
[8] *In re LTL MANAGEMENT, LLC,* No. 21-30589 (MBK), 2022 WL 586161 (Bankr. D.N.J. Feb. 25, 2022).