A Two-Step Forward and One Step Back

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"A good run of bad luck."[1] Clint Black's classic Texas Two-Step tune is a sad analogy for Johnson & Johnson headquartered a long way from the singer's Nashville home. Nestled on the banks of the old Raritan river in New Brunswick, New Jersey, Johnson & Johnson put it all on the line with its "Texas Two-step" strategy. The law was on their side, but their good run of bad luck persisted and are now facing the potential dismissal of their Chapter 11 filing and a whole lot of liability.

The "Texas Two-Step" is a legal strategy used by some corporations to separate their mass tort liability from their assets. The Two-Step goes a little something like this:

Step one, a company with mass tort liabilities becomes a Texas corporation. The newly formed Texas corporation splits into two (or more) separate entities as permitted by the Texas Business Organizations Code, which allows for "divisive mergers."[2] During this split, one corporation retains all (or most) of its liabilities, while the other retains all (or most) of its assets. Step two, the entity that holds the liabilities files for Chapter 11 bankruptcy and releases all claims against the entity holding its assets. This maneuver protects the new corporation holding assets from mass tort liability. The "Texas Two-Step" has been moderately successful for a handful of corporations.

Corporations that have danced the "Texas Two-Step" include Bestwall, Aldrich Pump LLC, DBMP (CertainTeed), Murray Boiler, and most recently Johnson & Johnson. Bestwall was the first to try the strategy. Bestwall, a subsidiary of Koch Industries, was created under Texas's divisive merger statute when Koch Industries was experiencing mass tort liabilities from its asbestos litigation. Plaintiff's claiming asbestos exposure from Koch Industries are now creditors to Bestwall and have been enjoined from suing Koch Industries. Plaintiff's have to resolve remaining and future claims in bankruptcy court, which limits their recovery. Aldrich Pump, LLC, DBMP and Murray Boiler have had a similar experience when two-stepping.

The success is due in part to the Western District of North Carolina. All of these corporations filed for Chapter 11 bankruptcy in this district because it had accepted the legality of the maneuver and the Fourth Circuit's stringent bad-faith dismissal standard makes it harder to have a Chapter 11 case dismissed. In the Fourth Circuit, a bad-faith dismissal requires the court to find (1) objective futility of any possible reorganization and (2) subjective bad-faith in invoking bankruptcy protection, one of the most stringent standards in the country.[3] In *Bestwall* the Official Committee of Asbestos Claimants ("the Committee") opposed Bestwall's motion to prohibit the filing or continued prosecution of any Koch Industries asbestos claims, arguing the divisive merger was fraudulent.[4] The Committee's allegation of fraud did not persuade Judge Laura Beyer. Judge

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[1] Clint Black, A Good Run of Bad Luck (RCA Nashville 1994).
[2] Tex. Bus. Orgs. Code Ann. § 1.002(55)(A) (2019).
[3] *Carolin Corp. v. Miller*, 886 F.2d 693, 694 (4th Cir. 1989).
[4] *In re Bestwall LLC*, 606 B.R. 243 (Bankr. W.D.N.C. 2019).

Beyer granted Bestwall's motion and side-stepped the issue of whether Bestwall's Two-Step was a fraudulent filing by stating,

> Texas has adopted the Uniform Fraudulent Transfer Act . . . and fraudulent transfer law is also a part of the bankruptcy code. 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.[5]

In response to the Court's holding, the Committee filed suit against Bestwall appealing their bankruptcy filing. While this slows Bestwall's bankruptcy proceedings—Koch Industries is no longer strapped with pending asbestos litigation and if the bankruptcy filing is found to be fraudulent, the years it takes to resolve the appeal can reduce future settlement figures. A win for Bestwall no matter the resolution.

Koch Industries' experience with the Texas Two-Step is an enticing proposition for any corporation facing mass tort liabilities. However, that song may have been overplayed in the Western District of North Carolina. Johnson & Johnson was the most recent corporation that tried the Two-Step. Faced with over 38,000 lawsuits based on alleged injuries from the company's baby powder. The claimants allege Johnson & Johnson's talc contained asbestos, which caused ovarian cancer and mesothelioma.

In the face of this litigation Johnson & Johnson took the first step and turned Johnson & Johnson Consumer Inc., ("Old JJCI"), into two new corporate entities in Texas. The first entity is LTL Management LLC ("LTL"), holding $2 Billion in assets and all of Old JJCI's liabilities from the baby powder claims. The second entity is Johnson & Johnson Consumer Inc. ("New JJCI") which holds the rest of Old JJCI's assets.[6] After the division, LTL converted into a North Carolina limited liability company and filed for bankruptcy two days after its formation. Johnson & Johnson together with LTL has requested the baby powder lawsuits be frozen while the bankruptcy filing is reviewed. Relying on *Bestwall*, Johnson & Johnson anticipated smooth moves in North Carolina, but the case got transferred to New Jersey, near Johnson & Johnson's headquarters.

Johnson & Johnson's attempt at two-stepping was widely publicized and widely criticized. Lawmakers condemned the use of bankruptcy courts by non-bankrupt corporations. Senator Warren even used twitter to make a statement tweeting, "[a]nother giant corporation is abusing our bankruptcy system to shield its assets and evade liability for the harm it has caused people across the country." Plaintiff's lawyers across the nation have denounced the dance following the Committee, calling the move fraudulent and illegal. This widely publicized criticism is likely what lead to Johnson & Johnson's transfer.

In his order, Judge Craig Whitley of the Western District of North Carolina's Bankruptcy Court seemed somewhat suspicious of Johnson & Johnson's bankruptcy filing. In an unusual fashion, the Court ordered a Rule to Show Cause as to why venue should not be transferred to the

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[5] *Id.* at 252.

[6] *See In re LTL Mgmt. LLC*, No. 21-30589, 2021 WL 5343945, at *7 (Bankr. W.D.N.C. Nov. 16, 2021).

District of New Jersey.[7] The Court gave two reasons for the transfer. First, the lack of connection to the District of North Carolina and second was its own lack of judicial resources.[8] In response, Johnson & Johnson asked the Court to keep the bankruptcy filing in North Carolina and stay the pending asbestos lawsuits until the bankruptcy matter was resolved. After oral argument, the Court transferred the bankruptcy proceeding to the District of New Jersey and stayed the asbestos lawsuits for only sixty days.[9]

This holding was big step back for Johnson & Johnson. Not simply because its baby powder lawsuits will continue to be prosecuted quickly or because the case was transferred to a potentially not so Two-Step friendly jurisdiction, but because Judge Whitley's order questioned the legitimacy and true purpose of the divisive merger. The Court opined that LTL's bankruptcy filing was not in the interest of justice because, "the Debtor is not just forum shopping; the Debtor is manufacturing forum and creating a venue to file bankruptcy."[10] The Court also recognized that the novel "'Texas Two[-]Step' tactic is being employed by national corporations and impacts tens of thousands of present and future claimants across the country."[11] These statements by the Court potentially support the idea that the "Texas Two-Step" is on its way out.

After the Bankruptcy Court's ruling Johnson & Johnson announced plans to split its consumer health division from its pharmaceutical division. Whether this move is part of Johnson & Johnson's third step is yet to be known. Further, as another blow to Johnson & Johnson, the United States Supreme Court denied its petition for certiorari regarding Mississippi's Attorney General's case seeking to collect millions for improper labels on its talc bottles, which included notice of the Bankruptcy Court's stay.

These rulings shake up the viability the Texas Two-Step strategy. Time will tell if corporations can keep on dancing. Like the two-step, asbestos litigation can only be worked with a capable partner—choosing outside counsel with a sound strategy ensures you and your organization put your best foot forward.

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[7] *See In re LTL Mgmt. LLC*, at *7.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*