Reuters Legal News

Debtors without a cause: whether non-distressed entities can access bankruptcy

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JULY 9, 2024

The benefits afforded debtors in bankruptcy are so compelling that businesses have initiated bankruptcy proceedings without experiencing insolvency or imminent financial distress. But do such businesses have the right to do so?

With no express guidance under the Bankruptcy Code, and no bright line ruling from the courts, the door is open for creditors to challenge bankruptcy cases filed in these circumstances.

While some bankruptcy courts have frowned upon and dismissed such petitions as filed prematurely or in bad faith, others have permitted them to proceed. Recent bankruptcy cases filed to resolve mass tort claims through the use of "channeling injunctions," which direct all claims to a funded trust created under a plan of reorganization, provide broad guidance.

Divergent rulings

In 2023, the 3rd U.S. Circuit Court of Appeals dismissed *In re LTL Management, LLC*, the first bankruptcy case of Johnson & Johnson's ("J&J") affiliate, LTL Management, LLC ("LTL"), one of two entities formed in a divisional merger known as a "Texas two-step."

The bankruptcy was filed to address J&J's mounting tort liability arising from its alleged cancer-causing talc powders. The divisional merger funneled virtually all talc liability into LTL, and another new entity, Johnson & Johnson Consumer Inc. ("New Consumer"), assumed J&J's consumer business. J&J and New Consumer funded LTL via a funding agreement providing amounts up to New Consumer's value (then, about $60 billion) to address current and future talc litigation.

Prior to LTL's bankruptcy filing, tens of thousands of actions had been filed in respect of J&J's baby powder products, resulting in unfavorable verdicts and litigation costs in the billions. The purpose of the bankruptcy filing was to channel the talc liabilities into a trust created pursuant to Bankruptcy Code Section 524(g), with the goal of getting ahead of the liability with minimal intrusion on J&J and New Consumer.

On direct appeal, the 3rd Circuit reversed the bankruptcy court, holding that LTL's case had not been filed in good faith, however sincere J&J's belief that its strategy would be in the best interest of all parties, including talc claimants. The decision resulted in the dismissal of the case.

The "good faith" requirement is implicit in Bankruptcy Code Section 1112(b), which provides for dismissal (or conversion to Chapter 7) of Chapter 11 cases "for cause."

The 3rd Circuit ruled that "financial distress" is required for a finding of good faith. While explicitly declining to define the term, it determined such circumstances were not present in LTL's case. In ruling that LTL lacked financial distress, the Court relied in significant part on the fact that, in connection with the divisional merger, J&J and New Consumer agreed to backstop LTL's talc liability pursuant to the funding agreement.

In contrast to the 3rd Circuit's approach, in the 4th U.S. Circuit Court of Appeals, bankruptcy courts have not mandated financial distress to demonstrate good faith.

Later in 2023, the Bankruptcy Court for the District of New Jersey dismissed LTL's second bankruptcy case, *In re LTL Management, LLC* ("*LTL II*"), on similar grounds, based on the 3rd Circuit's earlier ruling. Notably, the *LTL II* Court stated that the 3rd Circuit's opinion may be "at odds with a pro-active approach" to financial trouble.

In contrast to the 3rd Circuit's approach, in the 4th U.S. Circuit Court of Appeals, bankruptcy courts have not mandated financial distress to demonstrate good faith. The bankruptcy case of *In re Bestwall LLC*, filed in the Western District of North Carolina, presents a somewhat apples-to-apples comparison to *LTL Management*.

There, as in *LTL Management*, the debtor was formed pursuant to a Texas divisional merger and, in connection with the merger, assigned massive asbestos-related liabilities. As was also the case in *LTL Management*, the debtor's tort liabilities were backstopped by a newly created entity pursuant to a funding agreement.

In a 2024 decision denying motions to dismiss the bankruptcy, the *Bestwall* Court explained that, unlike in the 3rd Circuit, a finding of bad faith in the 4th Circuit requires both *subjective* bad faith and that reorganization would be objectively *futile* (unlikely where a

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company is adequately funded). As the Court had already ruled in a prior decision that reorganization was not futile, it declined to reach the issue of subjective bad faith.

Nevertheless, the *Bestwall* Court did address the merits of a new argument by the official committee of asbestos claimants — namely, that the lack of financial distress rendered the bankruptcy court without subject matter jurisdiction under the United States Constitution's Bankruptcy Clause.

The Court rejected the argument, relying in part on Supreme Court precedent recognizing the Bankruptcy Clause's broad scope, the far-reaching authority it confers on Congress to legislate, and the absence of case law supporting a jurisdictional requirement of financial distress.

The Court also noted the practical difficulties in defining and administering such a requirement, as financial distress is a "nebulous" concept that can change over the course of a case and subject matter jurisdiction can be challenged at any time. Finally, as expressed by the bankruptcy court in *LTL II*, the Court was concerned with the goal of encouraging early access to bankruptcy relief.

Financial distress: drawing the line

Most courts agree that insolvency is not a prerequisite for a Chapter 11 bankruptcy filing. Section 109 of the Bankruptcy Code, "Who can be a debtor," contains no insolvency requirement for businesses or individuals to qualify for voluntary bankruptcy. And when insolvency is required, the Bankruptcy Code specifically says as much, as in the case of municipal bankruptcy filings (disputed involuntary bankruptcies have a similar requirement).

It is the concept of financial distress that is splitting the courts.

The *LTL Management* Court opined that "financial distress" is required to demonstrate good faith, and that courts are well equipped to handle case-by-case determinations of whether financial distress exists — a concept it expressly avoided defining. The *Bestwall* Court, in contrast, rejected a "financial distress" requirement (in the context of jurisdiction) and was troubled by the practical realities of applying such a requirement.

Considerations for debtors

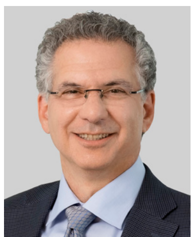
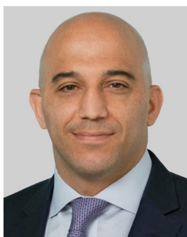
Regardless of which Court has the better of the argument (and that ultimately may be for the Supreme Court to decide), it seems clear that, currently, access to bankruptcy for certain entities may differ depending on which district has venue.

While "forum shopping" could present a solution, the tactic has not always been successful where a court finds that venue has been manufactured solely to reap the benefits of advantageous case law. Notably, *LTL Management* was initially filed in the Western District of North Carolina, but later transferred to the District of New Jersey following a motion by stakeholders.

For now, it appears entities considering Chapter 11 bankruptcy as part of a preemptive strategy should carefully weigh their options. There are, of course, the standard bankruptcy considerations — the potential reputational (and consequently, financial) impacts, required disclosures of sensitive financial information, and the often-hefty price tag of a bankruptcy filing. It seems now parties should also consider whether such a filing could be subject to dismissal for lack of "financial distress," and whether there is a valid claim to venue in a more favorable district.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

About the authors

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This article was first published on Reuters Legal News and Westlaw Today on July 9, 2024.

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