

# TEXAS TWO-STEPPING OUT OF BANKRUPTCY

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## INTRODUCTION

Johnson & Johnson has a problem. For decades, it sold talc baby powder, a product that made Johnson & Johnson a household name and earned the business billions. But as those babies grew up, they started getting cancer. And then they began suing. Last June, twenty-two plaintiffs cemented a \$2.12 billion judgment against Johnson & Johnson for cancer caused by its baby powder.<sup>1</sup> Another 38,000 cases (and counting) remain in progress, each with the potential for a similar verdict.<sup>2</sup>

To handle these mass tort liabilities, Johnson & Johnson has followed the lead of many businesses and turned to the bankruptcy courts. But it has done so with a twist. Unlike the businesses that pioneered using bankruptcy for mass torts, Johnson & Johnson is not filing for bankruptcy. Instead, it is dividing itself using an obscure Texas law, moving its assets into one business and its talc liabilities into another, and having the liability-laden business file for bankruptcy.<sup>3</sup> This maneuver, known as the “Texas Two-Step,” threatens the tort recovery of tens of thousands of talc claimants.

The Texas Two-Step is the latest addition to a panoply of aggressive techniques debtors have developed to gain the upper hand against creditors. Other scholars, for example, have identified the use of coercive restructuring support agreements and “deathtraps,”<sup>4</sup> third-party releases,<sup>5</sup> and less-than-impartial

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1. Lawrence Hurley, *U.S. Supreme Court Rebuffs J&J Appeal over \$2 Billion Baby Powder Judgment*, REUTERS (June 1, 2021, 6:17 PM), <https://www.reuters.com/legal/government/us-supreme-court-declines-hear-jj-appeal-over-2-billion-baby-powder-judgment-2021-06-01> [perma.cc/R3SP-CD7R]. For a thorough account of the development of talc powder and the asbestos-based cancer concerns, see Lisa Girion, *Johnson & Johnson Knew for Decades That Asbestos Lurked in Its Baby Powder*, REUTERS (Dec. 14, 2018, 2:00 PM), <https://www.reuters.com/investigates/special-report/johnsonandjohnson-cancer> [perma.cc/WED6-LKXY].

2. Vince Sullivan, *Resistance to J&J's Bankruptcy Gambit May Be Futile*, LAW360 (Oct. 15, 2021, 6:10 PM), <https://www.law360.com/articles/1431485/resistance-to-j-j-s-bankruptcy-gambit-may-be-futile> [perma.cc/7L3X-MB4T].

3. *Id.*

4. David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366, 370–71 (2020) (describing restructuring support agreements and deathtraps). See generally Edward J. Janger & Adam J. Levitin, *The Proceduralist Inversion – A Response to Skeel*, 130 YALE L.J.F. 335 (2020) (arguing against restructuring support agreements and deathtraps).

5. Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances*, 100 TEX. L. REV. (forthcoming 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id](https://papers.ssrn.com/sol3/papers.cfm?abstract_id)

bankruptcy directors<sup>6</sup> to disadvantage creditors. The use of such techniques has been widely criticized as “bankruptcy hardball,”<sup>7</sup> “the breakdown of chapter 11,”<sup>8</sup> or simply “lawlessness.”<sup>9</sup> It is now time to add the two-step to that catalog and to consider how that aggressive tactic might be counteracted.

The balance of this Essay does just that. Part I begins with an explanation of mass torts in bankruptcy and how the Texas Two-Step offers debtors something new. Part II then discusses fraudulent transfer law, the main avenue commentators have considered for tort claimants responding to the Texas Two-Step, and the shortcomings of that avenue. Next, in Part III, this Essay suggests a role for good faith challenges, which tort claimants may bring at the beginning of a bankruptcy and may have resolved far more quickly, enabling claimants to counteract the efficacy of the Texas Two-Step. Finally, the Essay concludes with some reflections on what the two-step means for the longstanding debate on bankruptcy forum shopping and on what the two-step adds to more recent discussions of the ongoing role of common law in bankruptcy’s statutory system.

#### I. MASS TORT BANKRUPTCY, THEN AND NOW

When Congress enacted the Bankruptcy Code in 1978, it did not expect bankruptcy to become a forum for resolving mass torts.<sup>10</sup> Yet, early on, companies with mass tort liabilities turned to the bankruptcy courts. High-profile cases like A.H. Robins (makers of Dalkon Shield) highlighted the practice, and a series of asbestos manufacturer bankruptcies—Johns-Manville, Celotex, Owens Corning—made the mass tort bankruptcy a standard feature of bankruptcy law and bankruptcy courts a common landing ground for mass tort liability.<sup>11</sup> Today, the torts may have changed, but the concept is the same: Purdue Pharma’s bankruptcy addresses the business’s opioid liabilities, the Boy Scouts’ bankruptcy addresses its sexual-abuse liabilities, and PG&E’s bankruptcy addresses a variety of wildfire-related liabilities.

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=3851339 [perma.cc/VH3A-K4FT]; Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 1154, 1169–76 (2022).

6. Jared A. Ellias, Ehud Kumar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. (forthcoming 2022), [https://ecgi.global/sites/default/files/working\\_papers/documents/el-liaskamarkastielfinal.pdf](https://ecgi.global/sites/default/files/working_papers/documents/el-liaskamarkastielfinal.pdf) [perma.cc/J4Q4-Q42].

7. Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745 (2020).

8. Levitin, *supra* note 5.

9. Lynn M. LoPucki, *Chapter 11’s Descent into Lawlessness*, 96 AM. BANKR. L.J. (forthcoming June 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3946577](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3946577) [perma.cc/GN8U-NG3H] (noting the combination of techniques and how forum shopping supercharges them). For an interesting exploration of how these techniques have started to creep outside of bankruptcy and into pre-bankruptcy restructurings, see Diane Lourdes Dick, *Hostile Restructurings*, 96 WASH. L. REV. 1333, 1351–69 (2021) (describing uptiering and dropdown maneuvers).

10. Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, 2046 (2000).

11. See Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1, 58 (1986) (noting managers’ incentives).

From the shareholder perspective, though, bankruptcy is unpleasant. One pesky feature is that the debtor's assets go to creditors, including tort claimants. And though tort recoveries in bankruptcy give cents on the dollar to tort claimants, debtor companies would rather eliminate the tort payments altogether or reduce them significantly.<sup>12</sup>

### A. *The Texas Two-Step*

That's where the Texas Two-Step comes in. It is the latest innovation in the already innovative field of corporate bankruptcy, offering the promise to debtors of shedding altogether mass tort liabilities in bankruptcy.

Here's how it works. Texas law allows business organizations to conduct a divisive merger,<sup>13</sup> which is a division that is treated as a merger. In a divisive merger, a legacy business divides in two and may allocate assets and liabilities as it wishes among the two new businesses.<sup>14</sup> For a Texas Two-Step's first step, the legacy business divides itself into a new business with assets (AssetCo) and a new business with liabilities (LiabilityCo).<sup>15</sup> The second step is to place LiabilityCo into bankruptcy and have the bankruptcy court discharge the liabilities while AssetCo goes on its merry way.<sup>16</sup> For good measure, the legacy business, which will control the two new businesses through their officers and directors, can have the two businesses enter mutual indemnification agreements ensuring that the liabilities of the one will be paid by the other.

At first blush, this appears to give tort creditors the potential for a full recovery, as they can access the assets of AssetCo. But there are reasons to be skeptical. For one, if the debtor, LiabilityCo, indemnifies AssetCo, the bankruptcy court will issue an injunction that bars plaintiffs from suing AssetCo,

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12. Scholars have long recognized the thorny problem of torts in bankruptcy. Tort victims, through no fault of their own, rank low in the list of priorities and often recover cents on the dollar while secured creditors recover in full. For interesting solutions to that problem, see Vincent S.J. Buccola & Joshua C. Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. REGUL. 766, 768, 770 (2021) (arguing that tort claims should follow the debtor's assets after bankruptcy); cf. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1880 (1991) (suggesting that limited liability for shareholders should not extend to tort claims against a corporation). See generally Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 883–84 (1996) (collecting various approaches to tort liability in bankruptcy).

13. TEX. BUS. ORGS. CODE ANN. § 1.002(55)(A) (West 2021). Texas is not alone in doing so, but few states do. Donald F. Parsons, Jr. et al., *The Business Lawyer—Seventy-Five Years Covering the Rise of Alternative Entities*, 75 BUS. LAW. 2467, 2485 n.144 (2020) (noting that Delaware, Pennsylvania, and Arizona have similar divisive mergers).

14. TEX. BUS. ORGS. CODE ANN. §§ 10.003(1), (3) (West 2006).

15. Samir D. Parikh, *Mass Exploitation*, 170 U. PA. L. REV. ONLINE 53, 58–59 (2022); Adam Levitin, *The Texas Two-Step: The New Fad in Fraudulent Transfers*, CREDIT SLIPS (July 19, 2021, 10:50 AM), <https://www.creditslips.org/creditslips/2021/07/the-texas-two-step.html#more> [perma.cc/28Y6-5KUM].

16. Parikh, *supra* note 15; Levitin, *supra* note 15.

as liabilities incurred by AssetCo are potential liabilities of LiabilityCo.<sup>17</sup> So tort claimants cannot sue the out-of-bankruptcy, asset-rich AssetCo for recompense. Further, the indemnification agreement of LiabilityCo by AssetCo will be enforceable *only* by those same officers and directors at LiabilityCo who are controlled by the legacy business.<sup>18</sup> The result is that the on-paper indemnification means little for the creditors, who may be limited to the assets of a liability-laden debtor without recourse to those of its out-of-bankruptcy, asset-rich counterpart.

Finally, in exchange for a contribution to LiabilityCo's creditors, AssetCo can likely obtain a third-party release in LiabilityCo's bankruptcy. That release would bar tort claimants from ever recovering for their harms from AssetCo. While such releases are controversial (the Code authorizes them expressly, but only for asbestos cases<sup>19</sup>), courts have approved third-party releases in mass torts involving breast implants, diet pills, and gasoline cans.<sup>20</sup> The result is that a two-stepper, and especially one with asbestos liability, can extinguish claims against an asset-rich business through the bankruptcy of the liability-laden one, cutting off tort claimants from any further recovery.

#### B. Two-Steps So Far

To date, only a handful of businesses have attempted the Texas Two-Step. All have similar stories and mirror the pattern above. The earliest was Bestwall in 2017. Bestwall spun off from Georgia-Pacific after years of asbestos litigation (some 64,000 cases) and promptly filed for bankruptcy that same year in the Western District of North Carolina.<sup>21</sup>

Two years later, DBMP was spun off from CertainTeed, another asbestos-laden business, and was allocated "no employees, no operations, and few assets" in the divisive merger but "was allocated 100% of Old CertainTeed's considerable asbestos liabilities."<sup>22</sup> Three months after the divisive merger, DBMP filed a Chapter 11 petition, also in the Western District of North Carolina.<sup>23</sup>

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17. *In re DBMP L.L.C.*, No. 20-30080, 2021 WL 3552350, at \*27 (Bankr. W.D.N.C. Aug. 11, 2021).

18. *Id.* at \*11–12.

19. 11 U.S.C. § 524(g). The logic of 524(g) is that asbestos liabilities have a long latency, so injuries can appear decades after exposure (well after the company stops using asbestos), making the magnitude of claims uncertain. Creating a trust can put a set amount on that liability and eliminate the uncertainty plaguing asbestos debtors that enables them to continue productive activities. Other torts, like gasoline can injuries, typically lack the latency that underlies 524(g).

20. Simon, *supra* note 5, at 1174–75. These releases play into the forum shopping discussed below. Even though the releases are on dubious legal footing, the liberal venue rules for bankruptcy enable debtors to shop for a court with an expansive view of bankruptcy courts' powers to authorize third-party releases.

21. *In re Bestwall L.L.C.*, 606 B.R. 243, 247–49 (Bankr. W.D.N.C. 2019).

22. *DBMP L.L.C.*, 2021 WL 3552350, at \*1.

23. *Id.*

Then, in 2020, Aldrich Pump and Murray Boiler were spun off from Trane Technologies, housing “100% of their predecessor’s considerable asbestos liabilities” but “no employees, no operations, and relatively few assets.”<sup>24</sup> Seven weeks after the divisive merger, both businesses filed Chapter 11 petitions in the Western District of North Carolina.<sup>25</sup>

The largest Two-Step yet, though, is Johnson & Johnson. In October 2021, Johnson & Johnson’s talc-laden subsidiary, JJCI, created LTL Management and New JJCI through a Texas divisive merger. LTL Management was assigned all of Johnson & Johnson’s talc liabilities.<sup>26</sup> It received assets too—a lump sum of about \$2 billion, designed to be a settlement trust for all talc claims.<sup>27</sup> (Recall that the verdict on behalf of just twenty-two plaintiffs alone yielded more than that.<sup>28</sup>) By contrast, New JJCI, the other business created by the divisive merger, received all other assets of the original business. The parent, Johnson & Johnson, remains valued at some \$400 billion.<sup>29</sup> LTL Management re-formed itself as a North Carolina corporation and filed for bankruptcy two days later in the Western District of North Carolina.<sup>30</sup>

## II. THE TEXAS TWO-STEP AND FRAUDULENT TRANSFER LAW

If the Texas Two-Step sounds like a fraudulent transfer, that’s because it fits the textbook definition of one. But that’s not the point. The cleverness of the Texas Two-Step is that a fraudulent transfer challenge takes significant time and expense. So even if the creditors would prevail on that challenge, they have a reason to settle early and at a discount.

Start with the fraudulent transfer challenge itself. Under the Uniform Fraudulent Transfer Act (which Texas has adopted), the two-step fits the definition of a fraudulent transfer—defined as a transfer made “with actual intent

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24. *In re Aldrich Pump L.L.C.*, No. 20-30608, 2021 WL 3729335, at \*1 (Bankr. W.D.N.C. Aug. 23, 2021).

25. *Id.* The filings’ venue suggests forum shopping, and of a particular kind. These companies were, after the divisive merger, Texas entities, so the move to Charlotte suggests that something about the court appeals to them. See Laura Napoli Coordes, *The Geography of Bankruptcy*, 68 VAND. L. REV. 381, 382–83, 388–90 (2015). This is particularly odd, as much forum shopping occurs in Texas, Delaware, and New York. *Id.* at 388–90; Levitin, *supra* note 5. Here, though, the forum shopping is by *circuit*, not by judge. Three bankruptcy judges sit in the district: Chief Judge Beyer hears all cases in Statesville, Judge Whitley hears all cases in Shelby, and Judge Hodges hears all cases in Asheville. See *Chambers Information*, U.S. BANKR. CT. FOR THE W. DIST. OF N.C., <https://www.ncwb.uscourts.gov/chambers-information> [perma.cc/Y8VW-QG7K]. In Charlotte, where each debtor filed, cases are assigned between Chief Judge Beyer and Judge Whitley. *Id.* What is not assigned is Fourth Circuit precedent, which is particularly favorable to debtors on good faith challenges.

26. Sullivan, *supra* note 2.

27. Felix Salmon, *Johnson & Johnson Pulls the Trigger on Texas Talc Gambit*, AXIOS (Oct. 19, 2021), <https://www.axios.com/johnson-johnson-texas-baby-powder-gambit-a2a39456-4a8b-46fe-ba1e-9d56c12d6022.html> [perma.cc/QR26-8WHC].

28. Hurley, *supra* note 1.

29. Salmon, *supra* note 27.

30. *Id.*

to hinder, delay, or defraud any creditor of the debtor”—as it aims to limit the recovery of tort creditors.<sup>31</sup> At the same time, under the Texas Business Organizations Code, a divisive merger occurs without “any transfer or assignment having occurred.”<sup>32</sup> So there is a colorable argument that the divisive merger can escape Texas’s fraudulent transfer law.<sup>33</sup> That said, Texas law does not allow mergers to “abridge any right or rights of any creditor under existing laws,” leading one bankruptcy judge to suggest that divisive merger tactics cannot circumvent Texas fraudulent transfer law.<sup>34</sup> To date, though, no case has resolved the tension between the business organization code and the fraudulent transfer statute.<sup>35</sup>

The fraudulent transfer issue is easier to address under the Bankruptcy Code. There, a transfer to “hinder, delay, or defraud” a creditor may be avoided by the trustee.<sup>36</sup> And the provision’s two-year look-back period would capture a two-step undergone just days before the petition’s filing, regardless of the treatment of mergers under Texas law.<sup>37</sup> So even if Texas law does not afford a remedy, tort claimants in a bankruptcy proceeding can likely rely on the Code to undo a fraudulent transfer achieved via a divisive merger.

The few scholars to examine the two-step have analyzed it through a fraudulent transfer lens. Adam Levitin calls the Texas Two-Step “a new fad in fraudulent transfers.”<sup>38</sup> Samir Parikh likewise writes that “divisive mergers that involve funding agreements that push insolvency risk onto victims should be viewed as fraudulent transfers.”<sup>39</sup>

But the difficulty lies not in convincing a court that the Texas Two-Step is a fraudulent transfer. The difficulty is in the *delay* caused by litigating that claim and in tort claimants bearing the risk while the claim is being litigated.<sup>40</sup> Fraudulent transfer claims must be litigated in an adversary proceeding, with the full trappings of a trial.<sup>41</sup> That means service, pleadings, counterclaims, discovery, summary judgment, and trial, all of which take time.<sup>42</sup> On top of

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31. TEX. BUS. & COM. CODE ANN. § 24.005(a)(1) (West 2021).

32. TEX. BUS. ORGS. CODE ANN. § 10.008(a)(2)(C) (West 2021).

33. Levitin, *supra* note 15.

34. *In re DBMP L.L.C.*, No. 20-30080, 2021 WL 3552350, at \*24 (Bankr. W.D.N.C. Aug. 11, 2021) (quoting TEX. BUS. ORGS. CODE ANN. § 10.901 (West 2021)).

35. A search for cases citing the relevant statutes reveals no opinions that grappled with the issue.

36. 11 U.S.C. § 548(a)(1)(A).

37. *Id.* § 548(a)(1).

38. Levitin, *supra* note 15.

39. Parikh, *supra* note 15, at 69.

40. *Id.*; Adam Levitin (@AdamLevitin), TWITTER (Oct. 22, 2021, 5:36 PM), <https://twitter.com/AdamLevitin/status/1451663890274734085> [perma.cc/46CE-7HB7].

41. FED. R. BANKR. P. 7001(1).

42. *See generally* FED. R. BANKR. P. 7002–87 (incorporating most of the procedures of an ordinary civil case).

that, the unsettled question of Texas fraudulent transfer law injects uncertainty into that claim, yielding other possible delays and litigation costs.

Worse yet, in the Fourth Circuit—the venue of choice for two-steppers—the debtor-in-possession (that is, management installed by the legacy business) receives the “first crack” at recovering fraudulent transfers.<sup>43</sup> The logic is that a fraudulent transfer suit belongs to the estate, not the creditors, and thus the estate, through the debtor-in-possession, must decide to pursue it.<sup>44</sup> But this also means that the Bestwalls of the world can file for bankruptcy, operate as a debtor-in-possession, and control the pursuit of fraudulent transfer claims against its corporate relatives (AssetCo), at least for a while. So tort claimants are beholden to a debtor that has no interest in helping them.

The result is that the tort claimants are caught in a “breath-holding contest” with the debtors, where resources and time favor the debtor and will be used to extract settlement value, reducing the claimants’ ultimate recovery.<sup>45</sup> Texas Two-Steps to date reflect that result—Bestwall filed for bankruptcy in 2017, and the suit remains ongoing.<sup>46</sup> Meanwhile, tort claimants have been enjoined from suing the AssetCo that emerged from Bestwall’s divisive merger.<sup>47</sup> Thus, even if the law is against two-steppers, the two-steppers can anticipate that the maneuver will save them significant expenses on tort payouts.

### III. THE TEXAS TWO-STEP AND GOOD FAITH

There is, however, another route that offers more to tort claimants. The Texas Two-Step, in addition to being a textbook fraudulent transfer, is also a textbook bad faith bankruptcy. Two separate lines of good faith doctrine suggest that the two-step is a bad faith bankruptcy: new debtor syndrome and no-bankruptcy-purpose filing. Critically, good faith challenges can be raised on a motion to dismiss and thus can be heard early in the case, resolved faster than an adversary proceeding, end the bankruptcy (and with it any discharge of the tort liability), and negate the delay tactics of two-steppers.

#### A. *New Debtor Syndrome*

Though Congress eliminated the textual good-faith filing requirement in the 1978 Code, every court to consider the question has found that it has the power to dismiss a case for bad faith.<sup>48</sup> Critical here, courts in the Fifth Circuit

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43. Nat’l Am. Ins. Co. v. Ruppert Landscaping Co., 187 F.3d 439, 441–42 (4th Cir. 1999).

44. Cf. *Ellias et al.*, *supra* note 6 (manuscript at 4).

45. *Levitin*, *supra* note 40.

46. *In re Bestwall L.L.C.*, 606 B.R. 243, 246 (Bankr. W.D.N.C. 2019).

47. *E.g.*, *In re Aldrich Pump L.L.C.*, No. 20-30608, 2021 WL 3729335, at \*3–4 (Bankr. W.D.N.C. Aug. 23, 2021).

48. Cf. *Dewsnup v. Timm*, 502 U.S. 410, 433 (1992) (Scalia, J., dissenting) (“We have, of course, often consulted pre-Code behavior in the course of interpreting gaps in the express coverage of the Code, or genuinely ambiguous provisions.”). For an argument that Congress’ omission intended to remove the good-faith filing requirement, see Janet A. Flaccus, *Have Eight*

(Texas), Fourth Circuit (the venue of most Texas Two-Steps<sup>49</sup>), and Second Circuit (often a forum of choice for sophisticated corporate debtors<sup>50</sup>) have applied the good faith rule.

Because the requirement emerged, and developed, as a matter of judge-made law, the precise contours of good faith have remained unclear, which has perhaps contributed to its underuse by creditors.<sup>51</sup> Despite this lack of clarity, though, the courts' development of doctrine has revealed a few categories of debtors who are considered bad faith filers.<sup>52</sup>

Foremost among them are those with "new debtor syndrome."<sup>53</sup> The pattern is simple: the entity has a distressed asset (or assets) but no ongoing business operations and is created on the eve of filing.<sup>54</sup> As Bankruptcy Judge Robert Ordin writes, there is a "[b]asic [p]lot" for such cases, in which a newly formed (or newly revitalized) corporation receives assets on the eve of bankruptcy.<sup>55</sup> The corporation has no employees or business operations, pays no bills, and has no other property; it simply exists to file for bankruptcy.<sup>56</sup> In such cases, courts routinely deny a stay and dismiss the bankruptcy.<sup>57</sup>

This basic plot describes the Texas Two-Step. The two-stepper creates a new entity on the eve of bankruptcy, saddling it with liabilities and denying it any employees, operations, or meaningful assets. The entity then immediately files for bankruptcy. That pattern should draw a motion to dismiss for lack of good faith and, following the doctrine, should result in a dismissal (or at least denial of a stay).

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*Circuits Shorted? Good Faith and Chapter 11 Bankruptcy Petitions*, 67 AM. BANKR. L.J. 401, 401–03 (1993).

49. See *supra* Section I.B. (noting that Aldrich Pump, DBMP, Bestwall, and Johnson & Johnson all filed in the Western District of North Carolina).

50. Coordes, *supra* note 25, at 388–90.

51. Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 922–23 (1991).

52. For various taxonomies, see *id.* at 927 (one-asset debtor, strategic use of bankruptcy-specific power, litigation tactic); Robert L. Ordin, *The Good Faith Principle in the Bankruptcy Code: A Case Study*, 38 BUS. LAW. 1795, 1797–1838 (1983) (giving a series of "fact patterns" of bad faith); Daniel J. Tyukody, Jr., *Good Faith Inquiries Under the Bankruptcy Code: Treating the Symptom, Not the Cause*, 52 U. CHI. L. REV. 795, 803 (1985) (listing eve-of-bankruptcy transfers, infeasible reorganization, and instances where the creditors would not benefit from collective proceeding).

53. Ordin, *supra* note 52, at 1813; Ponoroff & Knippenberg, *supra* note 51, at 927.

54. Ordin, *supra* note 52, at 1813; Ponoroff & Knippenberg, *supra* note 51, at 927.

55. Ordin, *supra* note 52, at 1813.

56. *Id.*

57. *Id.* at 1813–17 (giving a series of examples). Others agree. Tyukody, *supra* note 52, at 804–06 (describing the same fact pattern and decisions in a series of cases); Ponoroff & Knippenberg, *supra* note 51, at 927–30.



### B. *Improper Bankruptcy Purpose*

Another line of good faith cases centers on whether the filing aims to effect a valid bankruptcy purpose or instead is used as a litigation tactic.<sup>58</sup> This too suggests that the Texas Two-Step is a bad faith filing.

Take one classic case, *In re Integrated Telecom Express, Inc.*, as an example.<sup>59</sup> There, Integrated Telecom, a broadband equipment supplier, was not in financial distress. When it filed for bankruptcy, Integrated Telecom had \$105.4 million in cash and \$1.5 million in other assets; its liabilities consisted of a \$26 million lease and miscellaneous liabilities under half a million dollars.<sup>60</sup> Integrated Telecom filed to reduce its lease obligations, exploiting section 502(b)(6) of the Code, which caps landlords' claims and would have reduced Integrated Telecom's obligation to its landlord from \$26 million to \$4.3 million.<sup>61</sup> In short, Integrated Telecom had more than enough cash on hand to pay its debts and filed for bankruptcy solely to save \$21.7 million.

Assisted by an amicus brief of leading bankruptcy scholars, the Third Circuit rejected Integrated Telecom's maneuver as a bad faith bankruptcy.<sup>62</sup> The court explained that such a filing could not be in good faith because it does not "serve a valid bankruptcy purpose"—that is, preserving going-concern value or maximizing a debtor's estate value—but was instead designed "to obtain a tactical litigation advantage," namely, forcing the landlord to reduce Integrated Telecom's rent obligations.<sup>63</sup>

This doctrine likewise describes the Texas Two-Step. Johnson & Johnson, for example, is likely solvent. Its main motivation for filing for bankruptcy is to diminish its talc liabilities, and the bankruptcy filing is a litigation tactic to extract settlement value from talc claimants. This too sounds in bad faith and should result in a court dismissing the LTL Management bankruptcy as a bad faith filing.

### C. *Good Faith, Forum Shopping, and the Texas-Two Step*

Two-Steppers' own choices betray a concern for good faith challenges. Each case is filed in the Western District of North Carolina, not to obtain a particular judge, but to benefit from the Fourth Circuit's strict standard for dismissing a case for lack of good faith.<sup>64</sup>

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58. Ponoroff & Knippenberg, *supra* note 51, at 938–42 (describing "The Litigation Tactic Case"); Tyukody, *supra* note 52, at 811–13 (taking advantage of bankruptcy rules to hinder creditors without a valid bankruptcy purpose); Ordin, *supra* note 52, at 1801–12 (describing these as "ulterior motive" bankruptcies).

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

60. *Id.* at 112.

61. *Id.* at 114–16.

62. *Id.* at 112.

63. *Id.* at 119–20.

64. See sources cited *supra* note 25.

And while Johnson & Johnson's bankruptcy has been transferred to New Jersey, where Third Circuit precedent (including *Integrated Telecom*) makes a bad faith dismissal more likely, it is worth disentangling the Fourth Circuit's precedent. That precedent requires both subjective bad faith and objective futility before a bankruptcy court may dismiss on bad faith grounds.<sup>65</sup> Even so, the court's leading case on bad faith, *Carolin Corp.*, found bad faith because of "new debtor syndrome,"<sup>66</sup> suggesting that at least that avenue is available for tort claimants.

More generally, in a typical two-step, there is no business to reorganize and simply a lump sum of cash designed to pay off tort liability. A reorganization is therefore objectively futile—what the Fourth Circuit labeled as a case where there is "no going concern to preserve" or "no hope of rehabilitation."<sup>67</sup>

By the same token, the two-step has the hallmarks of subjective bad faith. The Fourth Circuit framed this prong as an "actual[] inten[t]" to reorganize or rehabilitate, which cannot exist when there is no business to rehabilitate.<sup>68</sup> The only business remaining is the one with the assets, which is not in bankruptcy, and thus beyond the court's consideration.

Creditors have so far raised only one such challenge in *Bestwall*.<sup>69</sup> There it failed, and since then, creditors have given up on such challenges.<sup>70</sup> But since *Bestwall*, there have been some changes in two-step designs. In *Bestwall*, the debtor received not only tort liability and a lump sum to repay it but also a separate company with a going-concern value of \$18 million per year and an approximate equity value of \$145 million on the petition date.<sup>71</sup> That allowed the debtor to claim that it legitimately sought to reorganize. But the latest Texas Two-Steps, like Johnson & Johnson's, have no business. The debtor's assets are a pile of cash that will fund a settlement trust on the debtor's terms. And, like *Carolin Corp.*, there is no going concern.<sup>72</sup> So revived claims of bad faith should stand a chance of winning dismissal even in the Fourth Circuit.

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65. *Carolin Corp. v. Miller*, 886 F.2d 693, 694 (4th Cir. 1989).

66. *Id.* at 696.

67. *Id.* at 701–02 (quoting *Little Creek Dev. Co. v. Commonwealth Mortg. Corp.* (*In re Little Creek Dev. Co.*), 779 F.2d 1068, 1073 (5th Cir. 1986)).

68. *Id.* at 702.

69. *In re DBMP L.L.C.*, No. 20-30080, 2021 WL 3552350, at \*37 & n.245 (Bankr. W.D.N.C. Aug. 11, 2021).

70. *Id.*

71. *In re Bestwall L.L.C.*, 606 B.R. 243, 248 (Bankr. W.D.N.C. 2019).

72. See *Carolin Corp. v. Miller*, 886 F.2d 693, 702–05 (4th Cir. 1989). In fact, these cases are easier than *Carolin*, because the debtor there nominally had a real estate business and was found to be a bad faith filer because it had no tenants and was not trying to find any, turning the once-extant business into a dormant one. *Id.* at 696–97.

#### D. *Good Faith, Fraudulent Transfers, and the Bankruptcy Process*

The primary advantage for tort claimants of a good faith challenge is its speed. Fraudulent transfer litigation in bankruptcy must proceed in an adversary proceeding.<sup>73</sup> By contrast, good faith challenges may be raised on a motion to dismiss, which requires no such trial court trappings as the adversary proceeding.<sup>74</sup> This difference means a resolution is possible before two-steps can use delay tactics to extract settlement value.

Other contexts have shown as much. For example, Matthew Bruckner identifies the same phenomenon in debtors' 363 sales. Those sales are often met with a challenge by discontented parties, who request an adversary proceeding to approve the sale.<sup>75</sup> The intent is the same as the Texas Two-Step—drag out the sale and extract settlement value—and proves effective, as sales tend to require fast consummation.<sup>76</sup>

Alan White finds the same effect for individual debtors stripping junior mortgages, a benefit available to homeowners whose home value is less than the amount owed on a senior mortgage.<sup>77</sup> In some jurisdictions, the debtors may proceed by motion to remove and discharge the junior mortgage entirely; other jurisdictions require an adversary proceeding to achieve the same.<sup>78</sup> And debtors are more likely to exercise their mortgage-stripping right where judges permit a proceeding by motion.<sup>79</sup>

In the same vein, consider the latest high-profile example of a bad faith bankruptcy: the National Rifle Association. It filed for bankruptcy on January 15, 2021.<sup>80</sup> Within one month, creditors brought a motion to dismiss for bad faith on the grounds that the Association had no valid bankruptcy purpose and merely filed to escape an ongoing investigation by New York's attorney general.<sup>81</sup> By May 11, 2021, the court granted the motion to dismiss, ending the bankruptcy.<sup>82</sup> Total time in bankruptcy: fewer than four months.

#### CONCLUSION

The Texas Two-Step is the latest clever maneuver for debtors seeking to curtail their tort liabilities. And it no doubt provides shareholders with leverage in settlement negotiations and an opportunity to shift value away from

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73. FED. R. BANKR. P. 7001(1).

74. See FED. R. BANKR. P. 7001.

75. Matthew A. Bruckner, *Improving Bankruptcy Sales by Raising the Bar: Imposing a Preliminary Injunction Standard for Objections to § 363 Sales*, 62 CATH. U. L. REV. 1, 3–5 (2013).

76. *Id.* at 14–16.

77. Alan M. White, *Does Bankruptcy Save Homes? A Further Look*, 92 AM. BANKR. L.J. 363, 369–71 (2018) (noting this as a major factor in whether debtors strip off junior mortgages).

78. *Id.* at 369–71.

79. *Id.* at 384.

80. *In re Nat'l Rifle Ass'n of Am.*, 628 B.R. 262, 268 (Bankr. N.D. Tex. 2021).

81. *Id.*

82. *Id.* at 264, 279.

tort claimants. This is especially true when the two-step is analyzed (or litigated) as a fraudulent transfer, with the attendant delays and costs that favor the debtor. But the two-step also fits the mold of a bad faith bankruptcy filing. Two strands of that doctrine—“new debtor syndrome” and “no valid bankruptcy purpose”—suffice to merit dismissal. That dismissal, in turn, offers tort claimants a cheap, quick mechanism for defeating the two-step and ensures them a better opportunity for vindicating their rights.

These doctrinal and practical points have implications beyond the bankruptcy courts hearing two-step cases. Indeed, the Texas Two-Step sheds light on two prominent areas of concern within bankruptcy law: forum shopping and common law’s continuing role in bankruptcy’s statutory system.

On forum shopping, recent uses of bankruptcy’s liberal venue rules have sparked a backlash among practitioners and academics.<sup>83</sup> The focus of that backlash has been primarily on the use of local rules to allow debtors to pick their judges.<sup>84</sup> But the two-step shows that forum shopping happens not only at the judge level but at the precedent level. And bankruptcy venue rules make it possible for businesses from all over the country to pick their law, which, as the two-step shows, can be as important as picking their judges.<sup>85</sup> A Delaware corporation operating exclusively in New York can, easily enough, move to Texas, undergo a divisive merger, reincorporate the liability-laden spinoff in North Carolina, and have the spinoff file for bankruptcy to obtain the benefits of Fourth Circuit precedent. Such precedent-based forum shopping can give short shrift to tort claimants just like picking a debtor-friendly judge can.

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83. For in-depth work on forum shopping, see Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WISC. L. REV. 11. Others have identified similar judge-based reasons for forum shopping, including judicial experience with bankruptcy, judicial predictability, and pro-debtor bias. *E.g.*, Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 970–71 (1999); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1360–61 (2000); Marcus Cole, “*Delaware Is Not a State*”: *Are We Witnessing Jurisdictional Competition in Bankruptcy*, 55 VAND. L. REV. 1845, 1908–09 (2002); Kenneth M. Ayotte & David A. Skeel, Jr., *Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy* (May 21, 2003) (unpublished manuscript), [https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1019&context=faculty\\_scholarship](https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1019&context=faculty_scholarship) [perma.cc/K7A4-MAWF]; Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119, 145–46 (2018).

84. *Oversight of the Bankruptcy Code, Part I: Confronting Abuses of the Chapter 11 System: Hearing Before the Comm. on the Judiciary; Subcomm. on Antitrust, Com., & Admin. Law; U.S. House of Representatives*, 117th Cong. 9–12 (2021) (statement of Adam J. Levitin, Professor of Law, Georgetown University Law Center).

85. Earlier scholarship on forum shopping, which noted a similar phenomenon of circuit level shopping, still found that such shopping was directed at judges more than circuit precedent. The focus was on circuits that were seen as having expertise in large bankruptcies and favoring debtors generally. Coordes, *supra* note 25, at 389. Some work has highlighted precedent-based shopping, in particular for third-party releases, one of the most contentious debtor tactics. *E.g.*, Anthony J. Casey & Joshua C. Macey, *Bankruptcy Shopping: Domestic Venue Races and Global Forum Wars*, 37 EMORY BANKR. DEVS. J. 463, 478–79 (2021) (describing precedent-based forum shopping in the Caesar’s bankruptcy).

The Texas Two-Step also reveals the role that common law continues to play in a Code-based bankruptcy regime.<sup>86</sup> For the two-step, the good faith challenge serves as a common law gatekeeping mechanism,<sup>87</sup> separating the legitimate mass tort bankruptcy from the illegitimate one. That matters, as bankruptcy can be a legitimate forum for resolving mass torts or an illegitimate one.

Imagine, for example, Purdue Pharma without bankruptcy. Opioid victims would file suits and begin levying on Purdue's assets. Purdue would drag out litigation. Those who won judgments quickly would reach the assets first, simply by virtue of speedy trials. Other equally deserving victims would be left with nothing, through no fault of their own. Bankruptcy convenes these mass torts in a single forum, providing an orderly process and distribution of Purdue's assets to its tort creditors. That saves tort claimants litigation time and expense. And from the debtor's perspective, it provides certainty, confining liability to the amount determined in the bankruptcy.

Conversely, in the Texas Two-Step, the mass tort debtor does not angle to convene claims for the purpose of orderly distribution of its assets. The debtor decides what price tag it wishes to put on tort claims and aims to foist that dollar value upon the tort claimants. Weak indemnification agreements, the threat of delaying fraudulent transfer litigation, and third-party protections all undercut the orderliness, speed, and certainty valued by claimants, debtors, and the bankruptcy system.

Using these distinctions, bankruptcy courts can, and do, draw common law, good faith challenges, distinguishing between appropriate uses of mass tort bankruptcy and inappropriate ones. And it is these distinctions that will become increasingly important in response to the ever-innovative debtors who turn to the Code.

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86. See Douglas G. Baird, *The Fraudulent Conveyance Origins of Chapter 11: An Essay on the Unwritten Law of Corporate Reorganizations*, 36 EMORY BANKR. DEVS. J. 699, 700–01, 717–18 (2020); Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 431–33 (arguing for the benefits of such a common law approach).

87. See *supra* notes 51–52 and accompanying text.