DIRTY DANCING: IS THE TEXAS TWO-STEP A BAD FAITH FILING?

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The Texas Two-Step is both a style of line dancing and a legal maneuver used by several large, profitable companies to enable a newly created entity to access the bankruptcy system and, thus, discharge the tort liabilities of its predecessor. This type of filing has been criticized by some as a tool used by healthy companies to evade responsibility for their tortious conduct and lauded by others as an efficient means to achieve a global resolution of crushing mass tort liability. Whether Texas Two-Step filings may properly access the bankruptcy courts is a question governed by § 1112(b) of the U.S. Bankruptcy Code. Section 1112(b) provides grounds to dismiss filings "for cause," a standard that courts have long interpreted to impose a good faith requirement on all bankruptcy filings.

But this backstop may no longer be effective. In fact, although there have been five Texas Two-Step filings to date, only one has been dismissed for bad faith. Instead, in most cases, savvy practitioners have structured such filings around existing "good faith" case law to avoid dismissal. This Note argues that Texas Two-Step filings may well be "bad faith" filings that can be dismissed under § 1112(b). However, courts considering them have applied historic good faith filing standards too narrowly by ignoring the good or bad faith of the debtor's predecessor—the entity initially responsible for the allegedly tortious conduct and the transactions leading to a Texas Two-Step filing.

Good faith standards have been developed by judges in response to three types of cases: the single-asset real estate debtor, the healthy debtor seeking a litigation advantage provided by bankruptcy, and the nearly insolvent mass tort defendant seeking to discharge crippling liability. Because each of these is distinctly different from the Texas Two-Step debtor, this Note argues that Texas Two-Step transactions require a broader good faith analysis that considers the circumstances and conduct of both the debtor and the debtor's predecessor. It then

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proposes an expanded test for good faith filings under § 1112(b) of the Bankruptcy Code to address future Texas Two-Step filings precisely because they are strategically engineered to satisfy the letter but not the spirit of the traditional good faith filing test.

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INTRODUCTION

Mesothelioma is a form of cancer that is caused by only one thing: exposure to asbestos.[1] To develop mesothelioma, individuals must be regularly exposed to asbestos over a significant period—usually, this happens at work.[2]

Because asbestos fibers are resistant to heat, fire, and chemicals, and do not conduct electricity, asbestos was widely used for insulation and piping.[3] Perhaps surprisingly, until recently, it was also found in Johnson & Johnson's baby powder, which is made from talcum powder.[4]

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1. *Asbestos Cancer*, PENN MED., https://www.pennmedicine.org/cancer/types-of-cancer/mesothelioma/asbestos-cancer [https://perma.cc/M2EM-F5MZ] (last visited Apr. 3, 2023).

2. *See Causes of Mesothelioma*, PENN MED., https://www.pennmedicine.org/cancer/types-of-cancer/mesothelioma/causes [https://perma.cc/QAC9-PNSW] (last visited Apr. 3, 2023).

3. *See Asbestos Cancer*, *supra* note 1.

4. Brian Mann, *J&J Tried to Block Lawsuits from 40,000 Cancer Patients. A Court Wants Answers*, NPR (Sept. 27, 2022, 2:51 PM), https://www.npr.org/2022/09/19/1123567606/johnson-baby-powder-bankruptcy-lawsuits [https://perma.cc/C3CC-WHNK].

In early 2022, a mother of seven and long-term user of Johnson & Johnson's baby powder, Kimberly Naranjo, was diagnosed with mesothelioma and given twelve to sixteen months to live.[5] As a counselor, Ms. Naranjo had not been exposed to asbestos in the workplace.[6] Her only exposure to asbestos was through Johnson & Johnson's baby powder, which she used for years when her children were young.[7]

When she was diagnosed, Ms. Naranjo had started a new job and purchased a home where she was living with her two youngest children, aged fourteen and nine.[8] However, because of aggressive treatment for mesothelioma, she had to stop working and sell her home.[9] She was, understandably, concerned about how to provide financial security for her young children.[10]

Ordinarily, when a company makes a harmful product, victims like Ms. Naranjo can file a products liability or wrongful death suit to seek compensation from the company that harmed them.[11] The Seventh Amendment to the U.S. Constitution gives such victims the right to have a jury decide the merits of their claim.[12] However, Johnson & Johnson's victims may no longer be able to exercise this right.[13]

In October 2021, the subsidiary of Johnson & Johnson that held the baby powder business, worth billions of dollars, completed a corporate restructuring under Texas state law.[14] As a result, the original company "divisively merged" into two new companies.[15] The first, also called Johnson & Johnson, was given almost all of the original subsidiary's assets and liabilities.[16] The second, called LTL Management, was allocated a single royalty revenue stream and all the asbestos claims pending against Johnson & Johnson.[17]

Two days later, LTL Management filed for bankruptcy, seeking to enjoin all pending and future civil suits against itself and Johnson & Johnson.[18]

5. *Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy: Hearing Before the Subcomm. on Fed. Cts., Oversight, Agency Action & Fed. Rts. of the S. Comm. on the Judiciary*, 117th Cong. 2 (2022) (testimony of Kimberly A. Naranjo).

6. *Id.* at 3.

7. *Id.* at 3–4.

8. *Id.* at 2–3.

9. *Id.* at 3.

10. *Id.* at 4.

11. *Id.*

12. *Id.*; *see also* U.S. CONST amend. VII.

13. *See Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy: Hearing Before the Subcomm. on Fed. Cts., Oversight, Agency Action & Fed. Rts. of the S. Comm. on the Judiciary*, *supra* note 5, at 4 (testimony of Kimberly A. Naranjo).

14. *See* Mann, *supra* note 4.

15. *Id.*

16. *See* Jeffrey R. Gleit & Matthew R. Bentley, *The Texas Two-Step: A Problematic Reframing of the Bankruptcy Code Toolkit or an Equitable Solution for Productive Conglomerates and Their Mass Tort Claimants?*, 31 NORTON J. BANKR. L. & PRAC. 149, 151 (2022).

17. *Id.*

18. *See* Mann, *supra* note 4.

Now, victims like Ms. Naranjo and thousands more who will be diagnosed with mesothelioma in the future may not be able to bring suit at all.[19] If LTL Management succeeds in confirming the plan of reorganization that it has proposed, these individuals will be able to assert a claim against a trust with limited funds that will be created through the bankruptcy process—a process that may take years.[20]

This transaction—unevenly dividing the assets and liabilities of a company facing extensive tort claims between two new companies, and then filing the liability-laden entity for bankruptcy—has become known as the Texas Two-Step because it depends on a unique Texas state law.[21] Johnson & Johnson is the fifth company to employ a Texas Two-Step as a means of accessing the bankruptcy system to resolve asbestos claims globally and finally.[22]

Johnson & Johnson contends that its proposed bankruptcy resolution of asbestos claims is fairer for both Johnson & Johnson and tort claimants.[23] However, in the cases considering Texas Two-Steps, the transaction generally had no business purpose other than to separate the great majority of a solvent corporation's assets from specified contingent liabilities.[24] This allows both the specially created subsidiary and Johnson & Johnson to access powerful provisions of the U.S. Bankruptcy Code—which was designed to rehabilitate debtors—to help force a resolution of specific liabilities without exposing most of the assets of Johnson & Johnson to bankruptcy.[25]

Section 1112 of the Bankruptcy Code grants federal bankruptcy courts the power to dismiss abusive filings at the outset of a Chapter 11 case as bad

19. *See Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy: Hearing Before the Subcomm. on Fed. Cts., Oversight, Agency Action & Fed. Rts. of the S. Comm. on the Judiciary*, *supra* note 5, at 3 (testimony of Kimberly A. Naranjo). Although a panel for the U.S. Court of Appeals for the Third Circuit dismissed LTL Management's filing as a bad faith filing in January 2023, LTL Management has refiled for bankruptcy, proposing an $8.9-billion-dollar settlement to talc plaintiffs. Dietrich Knauth & Mike Spector, *J&J Unit Files for Second Bankruptcy to Pursue $8.9 Billion Talc Settlement*, REUTERS (Apr. 5, 2023, 7:47 AM), https://www.reuters.com/legal/jj-unit-goes-bankrupt-second-time-pursue-89-bln-talc-settlement-2023-04-04/ [https://perma.cc/RG4H-WTLH].

20. *See* Gleit & Bentley, *supra* note 16, at 151–52.

21. *See* Mann, *supra* note 4 (describing how a Texas Two-Step works).

22. *See* Michael A. Francus, *Texas Two-Stepping Out of Bankruptcy*, 120 MICH. L. REV. ONLINE 38, 41–42 (2022) (describing five Texas Two-Step bankruptcies).

23. Brief for Debtor-Appellee at 2–3, *In re* LTL Management, LLC, Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011 (3d Cir. May 27, 2022), BL-89 (arguing that bankruptcy resolution is more equitable than resolutions that arise from class actions and multidistrict litigation).

24. *See* Samir D. Parikh, *Mass Exploitation*, 170 U. PA. L. REV. ONLINE 53, 59 (2022) (noting the purpose of a "divisive merger" is to keep assets out of victims' reach).

25. *See id.* at 57, 59.

faith filings.[26] Dismissal is an extreme remedy that is used sparingly.[27] In fact, asbestos claimants have twice sought to dismiss Texas Two-Step filings for bad faith.[28] Only one has succeeded.[29] And these motions have garnered extensive attention from legal scholars.[30]

Although there are strong arguments supporting dismissal in these cases, courts have, for the most part, too narrowly applied historic good faith filing standards to Texas Two-Step filings by applying traditional good faith filing tests to only the new, debtor entity. In doing so, they have ignored the objectives and actions of the debtor's predecessor, the entity that is responsible for both the allegedly tortious conduct and execution of the Texas Two-Step transaction. This Note argues that a broader good faith analysis should be applied in future Texas Two-Step cases. This broader test would require courts to look beyond the debtor's conduct and consider the intent and conduct of the debtor's predecessor.

This Note proceeds in three parts. Part I provides background on corporate efforts to separate assets from mass tort liabilities and discusses the features of bankruptcy that corporations find attractive for discharging those liabilities. It then outlines certain limitations on corporations' ability to access bankruptcy, namely the good faith filing requirement. Part II explains key features of the Texas Two-Step and analyzes how courts have applied the good faith test to Texas Two-Step filings, as well as Texas Two-Step debtors' responses to those decisions. Finally, Part III argues that courts' applications of the good faith filing requirement in these cases have been too narrow and proposes that courts look at both the financial distress of the predecessor entity and the business purpose for conducting the Texas Two-Step.

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26. *See* 11 U.S.C. § 1112(b) ("[T]he court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause . . . ."); *see also* Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1072 (5th Cir. 1986); Phoenix Piccadilly, Ltd. v. Life Ins. Co. of Va. (*In re* Phoenix Piccadilly, Ltd.), 849 F.2d 1393 (11th Cir. 1988); Carolin Corp. v. Miller, 886 F.2d 693, 698 (4th Cir. 1989).

27. *See Carolin*, 886 F.2d at 700.

28. *See In re* LTL Mgmt., LLC, 637 B.R. 396, 399–400 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023) (denying motion to dismiss for bad faith); *In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019) (same).

29. In January, the LTL Management filing was found to be made in bad faith. *In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir.) (dismissing LTL Management's filing), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

30. *Compare Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy: Hearing Before the Subcomm. on Fed. Cts., Oversight, Agency Action & Fed. Rts. of the S. Comm. on the Judiciary*, *supra* note 5 (statement of Samir D. Parikh) (arguing against invalidating Two-Step per se), *with* Jared A. Ellias, *Texas Two-Step and the Future of Mass Tort Bankruptcy Series: Upending the Traditional Chapter 11 Bargain*, HARV. L SCH. BANKR. ROUNDTABLE (June 21, 2022), http://blogs.harvard.edu/bankruptcyroundtable/2022/06/21/texas-two-step-and-the-future-of-mass-tort-bankruptcy-series-upending-the-traditional-chapter-11-bargain/ [https://perma.cc/GRY2-ZXX3] (arguing Two-Step technique is improper).

I. TEXAS TWO-STEP BANKRUPTCIES AND THE GOOD FAITH REQUIREMENT

Although the Texas Two-Step has emerged relatively recently,[31] corporations have been seeking to manage mass tort or other large contingent liabilities for decades.[32] The first part of this Note explains the historical origins of the Texas Two-Step, as well as the bankruptcy concepts that underlie it. Part I.A explains a prior corporate effort to separate corporate assets from mass tort liabilities and the way in which the failure of that effort has led to the use of the Texas Two-Step. Part I.B explains why mass tort defendants view bankruptcy as an attractive method for resolving tort claims. Part I.C explains the good faith requirement for bankruptcy filings and surrounding case law, as well as the potential limitations it places on Texas Two-Step debtors' efforts to access bankruptcy.

A. Isolating Liabilities Through a Divisive Merger

Large, diverse corporations are sometimes subject to substantial contingent liabilities.[33] Through their operations, enterprises may become subject to mass tort, products liability, environmental, or other types of claims.[34] These claims arise in a variety of contexts[35] and diminish the enterprise value of these companies.[36] As a result, sophisticated companies with large contingent liabilities have sought creative ways to separate these liabilities and maintain the enterprise value of the company.[37] One method that otherwise healthy companies have used to isolate large contingent liabilities is known as a corporate spin-off.[38]

Broadly, in a spin-off, an existing corporation creates a new, separate corporation that is owned by the same equity holders, and then contributes assets and liabilities from the predecessor entity to the new entity.[39] After the transaction, the same equity holders own the same net assets, which are now divided into two corporations rather than one.[40] If the assets and

31. *See In re Bestwall*, 605 B.R. at 46 (noting Bestwall filed in 2017).

32. *See* David F. Larcker, Brian Tayan & Andrew C. Baker, *Environmental Spinoffs: The Attempt to Dump Liability Through Spin and Bankruptcy*, HARV. L. SCH. F. CORP. GOVERNANCE (Nov. 27, 2020), https://corpgov.law.harvard.edu/2020/11/27/environmental-spinoffs-the-attempt-to-dump-liability-through-spin-and-bankruptcy/ [https://perma.cc/4DBK-9JM5] (describing efforts to isolate environmental liabilities).

33. *See id.*; *see also* Caroline Banton, *Contingent Liability: What Is It, and What Are Some Examples?*, INVESTOPEDIA (July 12, 2022), https://www.investopedia.com/terms/c/contingentliability.asp [https://perma.cc/HCB7-W2HX] ("A contingent liability is a liability that may occur depending on the outcome of an uncertain future event.").

34. *See* Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 1154, 1164–65 (2022).

35. *See id.* at 1164.

36. *See id.* at 1165 (stating that mass tort liability may eventually threaten a company's survival).

37. *See* Gleit & Bentley, *supra* note 16, at 153; Tronox Inc. v. Kerr McGee Corp. (*In re* Tronox Inc.), 503 B.R. 239, 252–55 (Bankr. S.D.N.Y. 2013) (using a spin-off transaction to shed liabilities).

38. *See, e.g.*, *In re Tronox*, 503 B.R. 239.

39. *See* Gleit & Bentley, *supra* note 16, at 148 (describing spin-off).

40. *Id.*

liabilities are not distributed equitably, however, the transaction may harm creditors.[41]

For example, when a corporation is faced with extensive pending liabilities, spin-offs have been used to separate the bulk of a corporation's assets from its contingent liabilities.[42] After such a spin-off, the unburdened predecessor company may be sold at a profit, while the company holding the liabilities has many fewer assets available to satisfy creditor claims.[43] For this reason, bankruptcy courts have previously rejected spin-offs like this.[44]

Despite the prior rejection of liability-shedding spin-offs, the Texas Two-Step is similarly designed to separate assets from liabilities.[45] In fact, the Texas Business Organizations Code (TBOC) provides a statutory avenue for companies to effect an economically identical transaction.[46]

The TBOC allows Texas corporations to implement a "divisive merger," through which a corporation divides itself into separate corporations and allocates its assets between the separated entities, in much the same way that a spin-off might be designed to isolate corporate liabilities.[47]

As Part II explains in more detail, several corporations—all subject to asbestos mass tort claims—have taken advantage of the TBOC to divide their assets and liabilities, allocating the lion's share of their assets to one successor and their mass tort liabilities to another.[48] The entity holding the mass tort liabilities then files under Chapter 11, enjoys the benefit of the automatic stay—which pauses all litigation against them (and may even be

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41. *Id.* at 153–54.

42. *See, e.g.*, *In re Tronox*, 503 B.R. at 252–55.

43. *See, e.g.*, *id.* at 248 (selling spin-off for eighteen billion dollars).

44. *See id.* at 239 (holding spin-off constituted a fraudulent transfer); Gleit & Bentley, *supra* note 16, at 153 (describing rejection of uneven spin-offs as well-settled case law). These uneven spin-offs have been successfully challenged as fraudulent transfers. *In re Tronox*, 503 B.R. at 282, 295. Section 548 of the Bankruptcy Code deems that a transfer of assets within two years of a filing is actually fraudulent if it is made with "intent to hinder, delay or defraud creditors." 11 U.S.C. § 548. A transfer may also be constructively fraudulent if it is made without the debtor receiving something reasonably equivalent in value and renders the debtor insolvent. *Id.* In either case, the court can void the transfer and reclaim the transferred assets to satisfy bankruptcy creditors' claims. *See id.* § 550.

45. *See* Gleit & Bentley, *supra* note 16, at 153.

46. *Id.* at 154. The primary difference between a spin-off under most state laws and a divisive merger under the TBOC is that the TBOC deems this division to take place "without . . . any transfer or assignment having occurred." *See* TEX. BUS. ORGS. CODE ANN. § 10.008 (West 2021). Because a fraudulent conveyance requires a "transfer," this statue may create an obstacle to creditors' efforts to challenge the transaction. Parikh, *supra* note 24, at 59.

47. *See* BUS. ORGS. § 10.002. Whether the "divisive mergers" under the TBOC will result in successful fraudulent transfer challenges is disputed but beyond the scope of this Note. Even still, whether a transaction is arguably fraudulent bears on the good faith inquiry.

48. *See* Parikh, *supra* note 24, at 58. *See generally In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019); DBMP LLC v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021); Aldrich Pump LLC v. Does 1–1000 (*In re* Aldrich Pump LLC), No. 20-30608, 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021); *In re* LTL Mgmt., LLC, 637 B.R. 396 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

extended to the nonfiling entity)[49]—and eventually proposes a plan of reorganization containing a channeling injunction[50] that effectively blocks suits against itself and the nonfiling entity while pushing all present and future tort claims to a yet-to-be established trust.[51]

B. Companies Attempt to Discharge Tort Claims Through Bankruptcy

The second step in a Texas Two-Step transaction is for the liability-burdened successor to file for bankruptcy.[52] In bankruptcy, tort claims can be resolved finally in a single proceeding, and thus, it may be an efficient and cheaper alternative to defending suits in the tort system, which can take years.[53] In fact, for this reason, large companies that are also mass tort defendants are increasingly using a novel, bankruptcy-based approach to resolve these claims on a final and global basis.[54] This part will describe the provisions of the Bankruptcy Code that mass tort defendants use to discharge tort liabilities, which are thus important for understanding the motivations of Texas Two-Step debtors.

Chapter 11 is the reorganization-focused chapter of the Bankruptcy Code.[55] Under it, the debtor attempts to negotiate with its creditors and proposes a plan of reorganization to those creditors, who then vote on it, before it is presented to the bankruptcy court for approval.[56]

When the debtor is subject to mass tort or other large contingent liabilities, several aspects of the Bankruptcy Code become prominent.[57] Most notably, the automatic stay allows the mass tort debtor to pause all litigation pending against it.[58] Similarly, so long as a resolution can be reached with a sufficient number of creditors, and the other requirements of Bankruptcy Code § 1129

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49. *See* 11 U.S.C. § 362(a)(1); *see also infra* note 58 and accompanying text.

50. *See* 11 U.S.C. § 524(g)(1)(B); *see also infra* notes 61–63 and accompanying text.

51. *See* Gleit & Bentley, *supra* note 16, at 151–52; Parikh, *supra* note 24, at 59. Section 524(g) of the Bankruptcy Code allows debtors to discharge asbestos claims through a trust if several statutory requirements are met. *See* 11 U.S.C. § 524(g)(1)–(2). As a result, the court can enjoin all present and future claims against the debtor (and in some cases, no debtors) and require those claims to be paid out through the trust. *Id.* § 524(g)(4)(A)(2).

52. *See supra* notes 49–51 and accompanying text.

53. *See Abusing Chapter 11: Corporate Efforts to Side-Step Accountability Through Bankruptcy: Hearing Before the Subcomm. on Fed. Cts., Oversight, Agency Action & Fed. Rts. of the S. Comm. on the Judiciary*, *supra* note 5 (statement of Samir D. Parikh) (describing the efficiency benefits of resolving mass tort claims in bankruptcy).

54. *See* Simon, *supra* note 34, at 1165–66. For example, Purdue Pharma, a large pharmaceutical company, filed for bankruptcy to resolve widespread litigation regarding aggressive opioid sales techniques. *See generally In re* Purdue Pharma, L.P., 635 B.R. 26 (S.D.N.Y. 2021). USA Gymnastics also successfully resolved hundreds of sexual assault claims in bankruptcy court. *See* Alex Wolf, *USA Gymnastics' $380 Million Bankruptcy Plan Gets Approval*, BLOOMBERG L. (Dec. 13, 2021, 4:36 PM), https://news.bloomberglaw.com/bankruptcy-law/usa-gymnastics-380-million-bankruptcy-plan-set-for-approval [https://perma.cc/V78U-EXJJ].

55. *See* Czyzewski v. Jevic Holding Corp., 580 U.S. 451, 454–55 (2017).

56. *Id.*

57. *See generally* Edward J. Janger, *Aggregation and Abuse: Mass Torts in Bankruptcy*, 91 FORDHAM L. REV. 361, 368–69 (2022); Simon, *supra* note 34 (describing features).

58. 11 U.S.C. § 362(a)(1).

are satisfied,[59] the debtor may be able to use the plan confirmation process to force a settlement on dissenting tort claimants and other creditors.[60]

Finally, when a mass tort defendant is subject to asbestos claims, as all Texas Two-Step debtors are, the code allows the debtor to channel those claims into a trust.[61] In these cases, if the confirmed plan for contributions meets several stiff statutory requirements,[62] the court may issue an injunction, known as a channeling injunction, that channels all present and future claims against the debtor, and also specified nondebtors, to the trust.[63]

C. Eligibility for Bankruptcy: The Good Faith Requirement

Although bankruptcy provides debtors with powerful tools to assist in a reorganization, it places important restrictions on their use to prevent their abuse.[64] One of these restrictions is the requirement that bankruptcy filings be made in good faith.[65] This part describes § 1112(b) of the code and the surrounding case law, which allow courts to dismiss bad faith filings at the outset of a bankruptcy case.

The Bankruptcy Code is designed to allow debtors to reorganize, repay creditors, and enjoy a fresh start, unburdened by existing debts.[66] It is structured to provide open access to debtors seeking to reorganize.[67]

However, Bankruptcy Code § 1112(b) authorizes the bankruptcy court to "dismiss a case under this chapter . . . for cause" and lists several nonexclusive factors that the court may consider in this analysis.[68] Although not expressly listed under § 1112(b), bankruptcy courts have imposed a good faith requirement on debtors filing bankruptcy petitions.[69] In other words, if a debtor files for Chapter 11 protection in bad faith, that constitutes "cause"

59. *Id.* § 1129(b) (listing requirements).

60. *See* Janger, *supra* note 57, at 369; *see also* 11 U.S.C. § 1129.

61. *See* 11 U.S.C. § 524(g)(1)(B).

62. *See id.* § 524(g)(2)(A)–(B).

63. *See id.* § 524(g)(4)(A)(2).

64. *See* Janger, *supra* note 57, at 368–70.

65. 11 U.S.C. § 1112; *see also* Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1072 (5th Cir. 1986); Phoenix Piccadilly, Ltd. v. Life Ins. Co. of Va. (*In re* Phoenix Piccadilly, Ltd.), 849 F.2d 1393, 1394 (11th Cir. 1988); Carolin Corp. v. Miller, 886 F.2d 693, 698 (4th Cir. 1989) (interpreting § 1112 to impose a good faith requirement).

66. Grogan v. Garner, 498 U.S. 279, 287 (1991).

67. *See In re* Johns-Manville Corp., 36 B.R. 727, 736 (Bankr. S.D.N.Y. 1984) ("A 'principal goal' of the Bankruptcy Code is to provide 'open access' to the 'bankruptcy process.'").

68. *See* 11 U.S.C. § 1112(b) ("[T]he court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause . . . .").

69. *Id.*; *see also Carolin*, 886 F.2d at 698. The bankruptcy court evaluates whether the debtor is proceeding in good faith at two points during the proceeding. If the court does not dismiss for bad faith, to confirm a plan, the court must still find that it has been proposed in good faith. *See* 11 U.S.C. § 1129(a)(3). In fact, § 1129(a)(3) of the Bankruptcy Code, which allows the court to confirm the plan "only if . . . [it] has been proposed in good faith and not by any means forbidden by law," is the only provision of the code that explicitly requires good faith. *See id.*

to dismiss the filing.[70] There is, however, no uniform standard for what constitutes good faith.[71] Rather, the good faith requirement, as developed by courts, is somewhat amorphous and varies among circuits and different types of filings.[72]

The existing standards, which have been applied by courts to Texas Two-Step cases in two instances, are discussed below. First, Part I.C.1 describes the U.S. Court of Appeals for the Fourth Circuit's standard for dismissal, which is more stringent than the other circuits' standards. As a result, and perhaps unsurprisingly, all Texas Two-Step debtors have filed in the Fourth Circuit. Next, Part I.C.2 analyzes the highly fact-dependent inquiry used by all other circuits, particularly the emphasis placed on the debtor's financial distress and reorganizational purpose as relevant to a finding of good faith.

1. The Fourth Circuit Standard

The Fourth Circuit has applied the most stringent standard for dismissal, requiring both a showing of (1) subjective bad faith on the part of the debtor and (2) objective futility of restructuring efforts.[73] In the case that adopted this standard, *Carolin Corp. v. Miller*,[74] the Fourth Circuit held that the debtor had filed in bad faith because it filed its Chapter 11 proceeding solely to interfere with pending litigation and, importantly, did not have the objective ability to reorganize.[75] There, the debtor was a newly created holding company whose sole asset was a heavily encumbered property with only one secured creditor.[76] When the debtor defaulted, the secured creditor sought to foreclose.[77] On the eve of foreclosure, a newly incorporated company bought all of the debtor's stock and then filed for bankruptcy.[78] The court reasoned that dismissing a case for bad faith, especially "before an ongoing proceeding has even begun to develop the shape of the debtor's situation," is a drastic measure and should be exercised sparingly.[79] Nevertheless, it found that the debtor had filed only to halt the foreclosure

70. *See, e.g.*, Mich. Nat'l Bank v. Charfoos (*In re* Charfoos), 979 F.2d 390, 393–94 (6th Cir. 1992); *In re Phoenix Piccadilly*, 849 F.2d at 1394; *Carolin*, 886 F.2d at 698; *In re Little Creek*, 779 F.2d at 1072; Meadowbrook Investors' Grp. v. Thirtieth Place, Inc. (*In re* Thirtieth Place, Inc.), 30 B.R. 503, 504–05 (B.A.P. 9th Cir. 1983).

71. *See In re* SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999) ("Courts have not been unanimous about what constitutes 'good faith' in the Chapter 11 filing context.").

72. *See* Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 944 (1991) (describing standards as "ill-defined and obscure").

73. *Carolin*, 886 F.2d at 700–01 (requiring objective futility and subjective bad faith).

74. 886 F.2d 693 (4th Cir. 1989).

75. *See id.* at 701 (finding objective futility); *id.* at 702 (finding subjective bad faith when debtor is seeking the benefit of the automatic stay but has no plans to reorganize).

76. *Id.* at 695–96.

77. *Id.* at 695.

78. *Id.* at 696.

79. *Id.* at 700.

and had "no going concern to preserve" and no ability or plans to reorganize.[80]

2. Other Circuits Consider the Totality of the Circumstances

In contrast to the Fourth Circuit, other circuits recognize that evaluating the debtor's good faith involves a fact-specific inquiry, and they therefore review the totality of the circumstances of each case.[81] Courts examine an amalgam of factors, all focused on the debtor's condition and conduct, to determine whether a filing is made in bad faith, including whether

- The debtor is financially distressed;[82]
- The debtor has only one asset;
- The pre-petition conduct of the debtor was improper;
- The debtor has no ongoing business or employees;
- The debtor has few unsecured creditors whose claims are small; and
- The debtor and one creditor have arrived at a standstill in state court litigation.[83]

No one factor is decisive, but bankruptcy courts have frequently emphasized the debtor's financial distress[84] and its reorganizational purpose in assessing the propriety of a bankruptcy filing,[85] both of which are discussed below. Because the predecessor entity—as opposed to the manufactured debtor—in a Texas Two-Step filing is usually clearly solvent, Part I.C.2.a focuses on case law holding that a debtor's financial distress is necessary to establish whether a filing has been made in good faith. Part I.C.2.b describes the inquiry made by courts into a debtor's reorganizational purpose.

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80. *Id.* at 705.

81. *See* Meadowbrook Investors' Grp. v. Thirtieth Place, Inc. (*In re* Thirtieth Place, Inc.), 30 B.R. 503, 505 (B.A.P. 9th Cir. 1983); Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1072 (5th Cir. 1986); Phoenix Piccadilly, Ltd. v. Life Ins. Co. of Va. (*In re* Phoenix Piccadilly, Ltd.), 849 F.2d 1393, 1394 (11th Cir. 1988); Mich. Nat'l Bank v. Charfoos (*In re* Charfoos), 979 F.2d 390, 393–94 (6th Cir. 1992); Udall v. FDIC (*In re* Nursery Land Dev., Inc.), 91 F.3d 1414, 1416 (10th Cir. 1996); Cedar Shore Resort, Inc. v. Mueller (*In re* Cedar Shore Resort, Inc.), 235 F.3d 375, 379 (8th Cir. 2000) (looking at many factors indicating bad faith).

82. *See In re* SGL Carbon Corp., 200 F.3d 154, 164 (3d Cir. 1999) (discussing financial distress as a prerequisite for accessing the bankruptcy system).

83. *See In re Little Creek*, 779 F.2d at 1072–73.

84. *Compare In re SGL Carbon*, 200 F.3d at 163–64, *with In re* Johns-Manville Corp., 36 B.R. 727, 730 (Bankr. S.D.N.Y. 1984).

85. *See In re SGL Carbon*, 200 F.3d at 165 (noting that several cases have held a filing must serve a reorganizational purpose).

a. Financial or Operational Distress Is Usually Required to Sustain a Filing

The Bankruptcy Code does not expressly require a debtor to be insolvent.[86] Proof of insolvency, however, tends to suggest financial distress and therefore the existence of a valid reorganizational purpose.[87] Evidence of solvency, on the other hand, does the opposite, suggesting financial health and the absence of a valid reorganizational purpose.[88]

In *In re SGL Carbon Corp.*,[89] the debtor, SGL Carbon, was a defendant in multiple antitrust actions with an estimated liability of $240 million, $135 million of which was paid by its corporate parent after the filing.[90] It filed for bankruptcy with a proposed plan of reorganization providing for all creditors to be paid in full except for the litigation's plaintiffs, who would receive credits against future purchases, and further providing the debtor and its affiliates with a release of the antitrust claims.[91] The debtor asserted that the bankruptcy filing was required because the plaintiffs had proven to be intractable.[92] By filing, it hoped to change the negotiating dynamic and increase pressure on the plaintiffs to settle.[93]

The U.S. Court of Appeals for the Third Circuit found that the debtor's assets exceeded its liabilities by $124 million, that it was not struggling to pay its debts as they came due, and that it had no trouble accessing capital markets.[94] In addition, although future antitrust judgments might have threatened the company, none had been entered yet.[95] Similarly, although the litigation had distracted management somewhat, the debtor had continued to meet its financial and operational targets.[96] The debtor acknowledged its financial health, noting only that it was just beginning to lose market share as a result of the suits.[97] The Third Circuit held that the debtor had not established a basis to file when it did.[98] Although the court held that proof of insolvency was not required to sustain a bankruptcy filing, the debtor was nonetheless required to show a present "serious threat to the companies'

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86. *See In re Johns-Manville*, 36 B.R. at 730 (noting that Chapter 11 has no insolvency requirement); *see also* 11 U.S.C. § 109(a) (no requirement that the debtor be insolvent).

87. *See In re Johns-Manville*, 36 B.R. at 738 (noting that a company with real debt may access bankruptcy system).

88. *See In re SGL Carbon*, 200 F.3d at 164 (holding that ability to meet debts means filing does not serve a valid purpose).

89. 200 F.3d 154 (3d Cir. 1999).

90. *Id.* at 157, 163.

91. *Id.* at 157.

92. *Id.*

93. *Id.* at 157–58.

94. *Id.* at 166.

95. *Id.* at 163.

96. *Id.* at 162.

97. *Id.* at 158. The *In re SGL Carbon* court and others found it relevant that the debtor itself outwardly projected its financial health despite the bankruptcy filing. *See id.* at 166 (finding that issuing a statement that pending suits are without merit undercuts a finding of financial distress).

98. *Id.* at 163 (finding Chapter 11 filing was "premature").

long-term viability."[99] This required proof of "serious financial and/or managerial difficulties at the time of filing."[100] Because SGL Carbon had not alleged anything approaching these conditions—indeed, it had claimed just the opposite—the court dismissed the petition as having been filed in bad faith.[101]

In reaching this conclusion, the Third Circuit relied on earlier cases finding that "financially distressed"—but not insolvent—debtors may access bankruptcy to reorganize and repay creditors.[102] At the time of their filing, these other debtors were experiencing substantial business problems that, unless addressed, would lead to the collapse of the business,[103] thus distinguishing these good faith filings from the *SGL Carbon* filing.[104]

One such company, Johns-Manville Corporation, a *Fortune* 500 company that manufactured asbestos, booked a $1.9 billion reserve for asbestos liabilities, then filed for bankruptcy in 1982.[105] It claimed that the sole reason for the filing was a "mammoth problem of uncontrolled proliferation of asbestos health suits."[106] Four creditor groups filed motions to dismiss the filing for lack of good faith.[107] The bankruptcy court denied them all.[108]

In so ruling, the court rejected the creditors' arguments that Manville had manufactured evidence of financial distress.[109] Although the Bankruptcy Code does not require a debtor to be insolvent at the time of filing, Manville had demonstrated that it was subject to a massive number of suits, with thousands more reasonably expected to be filed.[110] The liabilities associated with these suits, as well as other obligations of the company, exceeded Manville's liquid assets, and its insurance carriers had denied coverage.[111] Thus, "[t]he economic reality of Manville's highly precarious financial

99. *Id.* at 164.

100. *Id.* In fact, even the fact that a company was "losing a lot of money" and had indeed gone out of business will not establish the kind of financial distress necessary to sustain a Chapter 11 petition. *See* NMSBPCSLDHB v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 115–16 (3d Cir. 2004). There, Integrated filed for bankruptcy and pointed to the fact that the company had sustained thirty-six million dollars in losses in the year preceding the filing and had in fact gone out of business as evidence of financial distress. *Id.* at 112–13. The court rejected this evidence and found instead that for bankruptcy relief to be proper, the financial distress of the company must have some relation to the debt owed by that company. *Id.* at 122.

101. *In re SGL Carbon*, 200 F.3d at 169.

102. *Id.* at 164.

103. *Id.*

104. *Id. See generally In re* Johns-Manville Corp., 36 B.R. 727 (Bankr. S.D.N.Y. 1984); *In re* Continental Airlines Corp., 38 B.R. 67 (Bankr. S.D. Tex. 1984).

105. *See In re Johns-Manville*, 36 B.R. at 729–30.

106. *See id.* at 729. At the time, the company was facing 16,000 suits filed by individuals harmed by the company's asbestos products. *Id.*

107. *Id.*

108. *Id.* at 743.

109. *Id.* at 734–35.

110. *Id.* at 738–40.

111. *Id.*

position due to massive debt sustains its eligibility and candidacy for reorganization" at the time that it filed.[112]

Moreover, the court specifically found that Manville's filing was not an attempt to improperly expand the bankruptcy court's jurisdiction.[113] Unlike cases in which the debtor never operated legitimately or was formed for the sole purpose of filing for bankruptcy, there was no basis to question that Manville had a substantial business with real creditors and real claims.[114] When a once-viable business like Manville is later burdened by massive liabilities that threaten its ongoing business, "there is no sham or hoax perpetrated on the Court," and the filing is made in good faith.[115]

The Third Circuit has emphasized, however, that business distress alone is not sufficient to establish the debtor's financial distress.[116] For example, Integrated Telecom Express, Inc., although no longer operating, had over $105 million in cash and was solvent at the time of its filing for bankruptcy.[117] The Third Circuit rejected arguments that because Integrated had closed its doors, it necessarily was in financial distress, particularly because its collapse was unrelated to any debt owed by the company.[118] Integrated claimed that it was filing to cap liability for lease obligations under § 502(b)(6) of the Bankruptcy Code,[119] a section that Integrated acknowledged made bankruptcy a "favorable forum for the consideration and resolution of . . . the Landlord's claim."[120] The Third Circuit held that this argument put the cart before the horse.[121] The fact that bankruptcy would provide financial benefit to the debtor did not establish the debtor's financial distress or entitlement to access the benefits of bankruptcy.[122] Access to bankruptcy is limited to debtors in financial distress, and the court dismissed the case for bad faith.[123]

b. The Filing Must Still Serve a Valid Reorganizational Purpose

Even if a debtor is experiencing significant financial and managerial difficulties at the time of filing, courts also require proof that a Chapter 11 filing would serve a valid reorganizational purpose before concluding that a

112. *Id.* at 740.
113. *Id.* at 738.
114. *Id.*
115. *Id.*
116. *See* NMSBPCSLDHB v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 122–24 (3d Cir. 2004) (finding financial distress must be related to debts owed).
117. *Id.* at 123–24.
118. *Id.* at 122.
119. *Id.* at 122–23. Prior to filing, Integrated threatened the landlord with a bankruptcy filing to gain leverage and offered to settle the lease obligations outside of bankruptcy. *Id.* at 112.
120. *Id.* at 127.
121. *Id.* at 127–28.
122. *Id.* at 128 ("The question of good faith is therefore antecedent to the operation of § 502(b)(6).").
123. *Id.* at 128–30.

filing was made in good faith.[124] Generally, this means that a bankruptcy proceeding will maximize the value of the estate available to satisfy creditors' claims or preserve some value that would otherwise be lost outside of bankruptcy.[125]

This is not the case when the debtor has little or no business to reorganize.[126] For example, it is common for certain real estate debtors to have only one asset, always a heavily burdened property, and few, if any employees, unsecured creditors, customers, or inventory.[127] Many such cases are also filed on the eve of foreclosure, transparently seeking to stay the impending loss of title.[128] In these circumstances, courts infer that the debtor's true objective for seeking Chapter 11 protection was to gain a tactical advantage in a two-party litigation and that there is little in the way of other claims or assets to support a reorganization.[129]

The creation of a "new debtor" for the purpose of filing also suggests bad faith.[130] In fact, "new debtor syndrome," or a debtor that has revitalized or created a one-asset entity on the eve of foreclosure, "exemplifies . . . bad faith cases."[131] A bad faith debtor generally has no employees, no cash flow, and no sources of income to sustain a plan of reorganization.[132]

For example, in *Meadowbrook Investors' Group v. Thirtieth Place, Inc. (In re Thirtieth Place)*,[133] the court held that the creation of a corporation for the purpose of filing for bankruptcy was evidence that the resulting filing was made in bad faith.[134] The debtor in that case was created on the eve of foreclosure by partners who owned interest in a condominium development project.[135] The owners, who had defaulted on payments on the property, were facing a foreclosure sale.[136] On the eve of that sale, they formed a new entity called Thirtieth Place, Inc., assigned their interests in the property to it, and filed it for bankruptcy.[137] The court dismissed the filing because the conveyance of the property interest to the debtor was unnecessary for any

124. *See, e.g.*, *In re* SGL Carbon Corp., 200 F.3d 154, 164 (3d Cir. 1999) (citing courts that have looked at reorganizational purpose); Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994).

125. *See In re Integrated Telecom*, 384 F.3d at 120.

126. *See* Ponoroff & Knippenberg, *supra* note 72, at 929.

127. *See id.* at 928–29 (discussing single-asset cases).

128. *Id.* at 927. *See generally* Carolin Corp. v. Miller, 886 F.2d 693, 695–96 (4th Cir. 1989); Meadowbrook Investors' Grp. v. Thirtieth Place, Inc. (*In re* Thirtieth Place, Inc.), 30 B.R. 503, 505–06 (B.A.P. 9th Cir. 1983).

129. *See* Ponoroff & Knippenberg, *supra* note 72, at 929. *See generally Carolin*, 886 F.2d at 703; *In re Thirtieth Place*, 30 B.R. at 505.

130. *See In re Thirtieth Place*, 30 B.R. at 505 ("The transfer of one's assets to a new debtor on the eve of a Chapter 11 filing . . . will be scrutinized with great care."); Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1073 (5th Cir. 1986).

131. *In re Little Creek*, 779 F.2d at 1073.

132. *Id.* at 1074.

133. 30 B.R. 503 (B.A.P. 9th Cir. 1983).

134. *Id.* at 506.

135. *Id.* at 504.

136. *Id.*

137. *Id.*

business purpose and intended only to allow the debtor to file for bankruptcy.[138] It reasoned that the debtor was created for the purpose of obtaining protection under the automatic stay to prevent foreclosure on the property.[139] In making this determination, the court emphasized that the new debtor had no plan for the infusion of capital, no gain in managerial expertise, no history of past business conduct, and no employees or current business.[140]

A filing also may not serve a valid reorganizational purpose if it is undertaken solely to secure a litigation advantage.[141] In SGL Carbon's case, after concluding that the debtor's filing was premature, the Third Circuit considered whether the totality of the circumstances indicated that SGL Carbon's filing served a valid reorganizational purpose[142] and concluded that it did not.[143] Again, the court found that SGL Carbon's financial health belied any reorganizational purpose that could be served through a Chapter 11 filing.[144] The court found further that the plan proposed by SGL Carbon, which provided differing treatment of the antitrust creditors as compared to other unsecured creditors, revealed that the filing was undertaken to put pressure on the litigation claimants to accept the company's proposed settlement rather than to reorganize the company.[145]

On the other hand, tactical bankruptcy filings are not conclusive evidence of bad faith, so long as the debtor demonstrates that the filing is intended to preserve an imperiled operating business.[146] Continental Airlines, because of pre-1978 regulatory requirements, was a party to several collective bargaining agreements (CBAs) and other employee-related executory contracts that led to high and allegedly unaffordable labor costs for the company.[147] After the airline industry was deregulated in 1978, new airlines that entered the market were no longer required to be party to these types of labor contracts.[148] Because these new companies had lower labor costs than Continental, they could charge lower fares for flights and still make a profit.[149] This competition caused Continental to lose $521 million in the four years preceding its Chapter 11 filing and drove them out of several markets.[150] The company had unsuccessfully attempted to renegotiate the CBAs.[151]

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138. *Id.* at 506.
139. *Id.* at 505–06.
140. *Id.*
141. *See, e.g.*, *In re* HBA E., Inc., 87 B.R. 248, 259–60 (Bankr. E.D.N.Y. 1988).
142. *In re* SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999).
143. *Id.* at 166.
144. *Id.*
145. *Id.* at 167.
146. *See generally In re* Cont'l Airlines Corp., 38 B.R. 67, 71–72 (Bankr. S.D. Tex. 1984); *In re* Johns-Manville Corp., 36 B.R. 727, 737 (Bankr. S.D.N.Y. 1984).
147. *See In re Cont'l Airlines*, 38 B.R. at 69.
148. *See id.*
149. *Id.*
150. *Id.*
151. *Id.*

Continental's filing sought leverage in labor negotiations, to be sure.[152] Immediately upon filing, Continental moved to reject all CBAs and employee-related executory contracts.[153] The unions that were parties to the CBAs filed a motion to dismiss the filing for lack of good faith.[154]

The bankruptcy court denied the motion to dismiss, however, finding that Continental had a clear financial need to file.[155] Accordingly, the court found that the purpose of the filing was to keep the company alive and functioning and that there was no other viable alternative for doing so.[156] Even though Continental rejected unprofitable contracts as part of the reorganization process, because the rejection of these contracts was not the primary purpose for the filing, Continental had filed in good faith.[157]

II. COURTS CONFRONT TEXAS TWO-STEP FILINGS

Five recent bankruptcy cases have addressed transactions based on the Texas statute allowing the Texas Two-Step.[158] To date, however, only one bad faith challenge to Texas Two-Steps has been successful.[159] This Note argues that bankruptcy courts may properly dismiss Texas Two-Step filings under § 1112(b) of the code but that the courts that have considered Texas Two-Steps have applied the standards too narrowly and have failed to address the transactions preceding Texas Two-Step filings that indicate bad faith.

Part II.A describes the relevant facts of the Texas Two-Step transactions that indicate the bad faith of these filings. Then, Part II.B analyzes the good faith challenges that were brought by asbestos claimants in the *In re Bestwall LLC*[160] and *In re LTL Management, LLC*[161] cases.

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152. *Id.* at 71.

153. *Id.* at 69; *see also* 11 U.S.C. § 365(a) (allowing debtors to assume or reject executory contracts).

154. *In re Cont'l Airlines*, 38 B.R. at 69.

155. *Id.* at 71. Because of the losses, Continental was forced to sell assets to pay debts. *Id.* at 70. Further, at the time of the filing, Continental had exhausted all forms of capital and was not paying obligations in a timely manner. *Id.*

156. *Id.* at 71. The court specifically noted that the unions had not demonstrated any reasonable alternative. *Id.*

157. *Id.*

158. *See In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019); DBMP LLC v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021); Aldrich Pump LLC v. Does 1–1000 (*In re* Aldrich Pump LLC), No. 20-30608, 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021). *Compare In re* LTL Mgmt., LLC, 637 B.R. 396 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023), *with In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

159. *In re LTL Mgmt.*, 58 F.4th at 746 (dismissing as bad faith filing).

160. 605 B.R. 43 (Bankr. W.D.N.C. 2019).

161. 637 B.R. 396 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

A. Five Companies Have Filed for Bankruptcy After Undergoing Divisive Mergers

Since 2017, there have been five Texas Two-Step filings.[162] Generally, these transactions take the following form.[163] A solvent corporation having significant contingent liabilities reincorporates itself in Texas from another state.[164] It then files a "divisive" plan of merger, allocating most of its assets into one entity ("AssetCo"), while allocating the contingent liabilities, together with far fewer assets, to a separate entity ("DebtorCo").[165] Promptly after the "merger"—in some cases within a matter of hours—both entities reincorporate in states other than Texas.[166] Shortly thereafter, DebtorCo files for protection under Chapter 11, seeking to discharge the contingent liabilities.[167] Viewed in these terms, such filings do not suggest good faith on the part of the debtor and accordingly raise the prospect of dismissal for lack of good faith under § 1112(b) of the Bankruptcy Code.[168]

The first case to address a Texas Two-Step was *In re Bestwall LLC*.[169] After *In re Bestwall*, four other companies have executed divisive mergers under Texas law and shortly thereafter had DebtorCo file for Chapter 11.[170] The transactions at issue in each of the cases—*In re Bestwall LLC*,[171] *Aldrich Pump LLC v. Does 1–1000 (In re Aldrich Pump LLC)*,[172] *DBMP v. Does 1–1000 (In re DBMP LLC)*,[173] and *In re LTL Management, LLC*[174]—share numerous common features that suggest that these filings may be bad faith filings. Because these features are necessary to understanding the way in which courts have evaluated these challenges, each is discussed below in turn.

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162. *See supra* notes 158–59 and accompanying text.

163. *See infra* notes 164–67 and accompanying text.

164. *See* Gleit & Bentley, *supra* note 16, at 150–51.

165. *Id.*

166. *Id.*

167. *Id.*

168. *See supra* notes 68–70 and accompanying text.

169. In 2017, Georgia Pacific Company ("Old GP") underwent a divisive merger and created Georgia Pacific ("New GP") and Bestwall. *In re* Bestwall LLC, 605 B.R. 43, 47 (Bankr. W.D.N.C. 2019).

170. See Francus, *supra* note 22, at 41–42 (describing timeline of Texas Two-Step bankruptcies).

171. *See supra* note 169 and accompanying text.

172. No. 20-30608, 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021). In 2017, two related companies IRNJ ("Old IRNJ") and Trane U.S. Inc. ("Old Trane") underwent divisive mergers. Old IRNJ became two new companies—Trane Technologies Company, LLC ("New TTC") and Aldrich, LLC ("Aldrich"). Old Trane became two new companies—Trane U.S. Inc. ("New Trane") and Murray Boiler, LLC ("Murray"). *See id.* at *10.

173. No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021). In 2019, CertainTeed Corporation ("Old CT") underwent a divisive merger and was replaced by two new companies—CertainTeed, LLC ("New CT") and DBMP LLC ("DBMP"). *See id.* at *1.

174. Most recently, Johnson & Johnson Consumer Inc. ("Old JJCI") underwent a divisive merger and became Johnson & Johnson Consumer Inc. ("New JJCI") and LTL Management, LLC. *In re* LTL Mgmt., LLC, 637 B.R. 396, 402 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

1. The Predecessor Companies Were Subject to Tort Liabilities but Were Solvent at the Time of the Divisive Merger

In each case, the predecessor companies were subject to multiple, substantial products liability suits that had led to inconsistent outcomes in the tort system.[175] For example, plaintiffs had filed 38,000 claims against Johnson & Johnson Consumer—the predecessor company in the *In re LTL Management* case—alleging that their baby powder contained asbestos that caused ovarian cancer and mesothelioma.[176] Although the company had largely been successful in defending against these suits,[177] it lost one suit that resulted in an almost five billion dollar verdict against it.[178] Similarly, the predecessor companies in the *In re Bestwall*, *In re Aldrich Pump*, and *In re DBMP* cases were all subject to substantial asbestos personal injury claims.[179]

Still, each of these predecessor companies had assets that exceeded the amount of their tort liabilities.[180] For example, in July 2021, just three months before its 2021 corporate restructuring, Johnson & Johnson's Form 10-Q reported \$176.4 billion in assets and only \$106.9 billion in total liabilities (of which only a portion were talc-related liabilities).[181]

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175. *See infra* notes 176–79 and accompanying text.

176. *See In re LTL Mgmt.*, 637 B.R. at 400–01.

177. *See* Johnson & Johnson, Quarterly Report (Form 10-Q) (July 29, 2021) (noting it had successfully defended many suits and reversed many plaintiff verdicts on appeal).

178. Tiffany Hsu, *Johnson & Johnson Told to Pay \$4.7 Billion in Baby Powder Lawsuit*, N.Y. TIMES (July 12, 2018), https://www.nytimes.com/2018/07/12/business/johnson-johnson-talcum-powder.html [https://perma.cc.656W-UU6S]. This loss caused Johnson & Johnson's stock to fall by 1.4 percent. *See id.* The verdict was reduced to just over two billion dollars on appeal. *See* Johnson & Johnson, *supra* note 177.

179. *See In re* Bestwall LLC, 605 B.R. 43, 47 (Bankr. W.D.N.C. 2019) (noting that Old GP was facing litigation that would last through 2050); Aldrich Pump LLC v. Does 1–1000 (*In re* Aldrich Pump LLC), No. 20-30608, 2021 WL 3729335, at *7 (Bankr. W.D.N.C. Aug. 23, 2021) (stating nearly 90,000 asbestos claims were pending against Old IRNJ and Old Trane); DBMP LLC v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350, at *6 (Bankr. W.D.N.C. Aug. 11, 2021) (noting Old CT had spent two billion dollars defending 300,000 suits). Further, CertainTeed complained that the tort system was an unfair forum to adjudicate these disputes that forced the companies to settle potentially fabricated or embellished claims because the cost of investigating each claim was too high. *See* Debtor's Reply to Informational Brief of Official Committee of Asbestos Personal Injury Claimants at 40–41, DBMP LLC v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021), ECF No. 1208; *see also* Informational Brief of Aldrich Pump LLC and Murray Boiler LLC at 20–21, Aldrich Pump LLC v. Does 1–1000 (*In re* Aldrich Pump LLC), No. 20-30608, 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021), ECF No. 5 (identifying plaintiff practices that lead to inconsistent tort results).

180. *See infra* note 181 and accompanying text.

181. *See* Johnson & Johnson, *supra* note 177. Old GP, Old IRNJ, Old Trane, and Old CT were all solvent. *See* Motion of the Official Committee of Asbestos Claimants to (I) Dismiss the Debtor's Chapter 11 Case for Cause as a Bad Faith Filing Pursuant to 11 U.S.C. § 1112(b), or Alternatively, (II) Transfer Venue in the Interest of Justice and for the Convenience of the Parties Pursuant to 28 U.S.C. § 1412 at 4, *In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019) (No. 17-31795), ECF No. 495 [hereinafter *Bestwall Motion to Dismiss*] (stating that Old GP could pay debts as they came due); *In re Aldrich Pump*, 2021 WL 3729335, at *8 (noting that Old IRNJ's and Old Trane's assets far outweighed their liabilities); *In re DBMP*, 2021 WL 3552350, at *8 (noting Old CertainTeed's assets outweighed its liabilities).

2. An Affiliate Was Created with No Operating Business, Few Employees, and More Liabilities than Its Assets Can Support

In each of these Texas Two-Step cases, the "divisive merger" resulted in DebtorCo receiving virtually all of the predecessor company's relevant tort liabilities but only limited additional assets, while AssetCo received virtually all of the predecessor's businesses and operating assets.[182] For example, in *DBMP*, the divisive merger of "Old CertainTeed" allocated 97 percent of Old CertainTeed's assets to "New CertainTeed," while DBMP received all of Old CertainTeed's asbestos liabilities and only 3 percent of Old CertainTeed's assets.[183] These assets included twenty-five million dollars in cash, equity in a newly created company called Millwork & Panel (which owned siding plants), and Old CertainTeed's contracts related to asbestos litigation.[184] These minimal assets proved insufficient to support the liabilities assigned to them, and it therefore could file for bankruptcy.[185]

In each case, DebtorCo received minor operating businesses in the merger.[186] For example, Millwork & Panel, the DBMP debtor's subsidiary, is projected to generate only fifteen million dollars in EBITDA annually for the next five years.[187] More strikingly, these operating assets were often created the day before the merger.[188] For example, Millwork & Panel Co.

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182. *See infra* note 183 and accompanying text.

183. 2021 WL 3552350, at *9. Similarly, Bestwall received all of the asbestos-related liabilities and limited assets related to the original Bestwall gypsum business, "Old GP." *See In re Bestwall*, 606 B.R. at 50. These assets included thirty-two million dollars in cash, all contracts of Old GP relating to its asbestos litigation (including insurance policies), real estate in North Carolina, and equity in a subsidiary of Old GP, PlasterCo, that generates eighteen million dollars in annual revenue each year. *Id.* Likewise, when "Old IRNJ" underwent a divisive merger, "New TTC" received 99 percent of Old IRNJ's assets, and Aldrich received all the asbestos-related liabilities and only 1 percent of the assets, including twenty-six million dollars in cash, rights to Old IRNJ's asbestos insurance policies, and equity interest in property. *See In re Aldrich Pump*, 2021 WL 3729335, at *9. In the division of "Old Trane," "New Trane" received 98 percent of Old Trane's assets. Murray received all the asbestos-related liability and only 2 percent of Old Trane's assets—sixteen million dollars in cash, rights to Old Trane's asbestos insurance policies, and equity interest in a subsidiary. *See id.* at *10. Finally, in the division of "Old Johnson & Johnson," LTL Management was assigned responsibility for Old Johnson & Johnson's talc liability and Royalty A&M, a North Carolina company worth $367 million that owns revenue streams based on third-party sales of various Johnson & Johnson drugs. *See In re* LTL Mgmt., LLC, 637 B.R. 396, 402 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

184. *See In re DBMP*, 2021 WL 3552350, at *9.

185. *See id.* at *1; *see also In re Aldrich Pump*, 2021 WL 3729335, at *11 (finding Aldrich's and Murray's assets could not satisfy their liabilities).

186. *See In re Bestwall*, 606 B.R. at 50 (describing PlasterCo, Bestwall's operating asset); *In re Aldrich Pump*, 2021 WL 3729335, at *9 (describing operating assets received by Aldrich and Murray); *In re DBMP*, 2021 WL 3552350, at *9 (noting that Millwork & Panel Co. was received by DBMP); *In re LTL Mgmt.*, 637 B.R. at 402 (noting that LTL Management received Royalty A&M).

187. Declaration of Robert J. Panaro in Support of First Day Pleadings at 8, DBMP LLC v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021), ECF No. 24.

188. *See infra* notes 189–91 and accompanying text.

was created the day before restructuring.[189] In fact, DBMP stands for "Doing Business as Millwork & Panel."[190] Likewise, Climate Labs, which was the only operating business assigned to Murray, one DebtorCo in the *Aldrich Pump* case, was created the day before the predecessor company, Old Trane, reincorporated in Texas.[191]

Finally, each newly created DebtorCo has few if any employees or staff,[192] and its board of directors is made up of the same individuals as the AssetCo board.[193] In fact, the evidence in each case disclosed no independent business purpose for the transaction other than isolating the tort liabilities from the assets of the predecessor.[194]

3. Insolvent Entities Are Provided with Funding Agreements Obligating the Asset-Rich Entity to Fund a Bankruptcy

Likely the most valuable "asset" assigned to DebtorCo is not an operating asset at all.[195] In each case, DebtorCo enters into a contract with AssetCo, obligating AssetCo to fund the costs and expenses of DebtorCo in bankruptcy to the extent that its limited assets cannot cover them.[196] It further obligates AssetCo to contribute to a fund for tort claimants.[197] In all instances, the amount of funding is payable only if DebtorCo has exhausted its cash and is limited to the value of the predecessor company.[198]

These agreements are not loans, however, as DebtorCo has no repayment obligations.[199] Rather, they allow Texas Two-Step debtors to argue that they are not underfunded and that they have "the same ability to resolve and pay

189. *See In re DBMP*, 2021 WL 3552350, at *9; *see also In re LTL Mgmt.*, 637 B.R. at 402 (finding that Royalty A&M was assigned to Old JJCI the day prior).

190. *See* Appendix to Informational Brief of the Official Committee of Asbestos Personal Injury Claimants of DBMP LLC at A-000011, DBMP LLC v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350 (Bankr. W.D.N.C. Aug. 11, 2021), ECF No. 1003-1 (deposition testimony of Eric Placidet).

191. *See In re Aldrich Pump*, 2021 WL 3729335, at *10.

192. *See id.* at *16 (noting that debtors have three seconded employees); *In re DBMP*, 2021 WL 3552350, at *13 (noting that debtor has five seconded employees); *In re LTL Mgmt.*, 637 B.R. at 404 (finding that debtor's employees are seconded from Johnson & Johnson).

193. *See In re DBMP*, 2021 WL 3552350, at *14; *In re LTL Mgmt.*, 637 B.R. at 404 (finding that all of LTL Management's board members also work at Johnson & Johnson).

194. *See In re DBMP*, 2021 WL 3552350, at *13 ("DBMP was created with . . . [a] single purpose: the Debtor was a vessel designed to ferry Old CertainTeed's asbestos liabilities into bankruptcy."); *In re Aldrich Pump*, 2021 WL 3729335, at *16 (noting that DBMP's business was limited to managing asbestos liabilities).

195. *See infra* notes 196–204 and accompanying text.

196. *In re* Bestwall LLC, 605 B.R. 43, 47–48 (Bankr. W.D.N.C. 2019); *see also* Francus, *supra* note 22, at 40–41 (describing funding agreements as common to all Texas Two-Steps).

197. *See In re Bestwall*, 605 B.R. at 47–48; *In re Aldrich Pump*, 2021 WL 3729335, at *12; *In re DBMP*, 2021 WL 3552350, at *11; *In re LTL Mgmt.*, 637 B.R. at 402 (describing funding agreements).

198. *See In re Bestwall*, 605 B.R. at 47–48; *In re Aldrich Pump*, 2021 WL 3729335, at *13; *In re DBMP*, 2021 WL 3552350, at *11; *In re LTL Mgmt.*, 637 B.R. at 402.

199. *See In re Bestwall*, 605 B.R. at 47–48; *In re Aldrich Pump*, 2021 WL 3729335, at *13; *In re DBMP*, 2021 WL 3552350, at *11; *In re LTL Mgmt.*, 637 B.R. at 402.

valid current and future asbestos-related claims [as the predecessor companies did] . . . before the restructurings."[200]

The funding agreements are not unconditional, however.[201] The agreements are made between the two companies; no agreement is made with creditors.[202] As a result, only DebtorCo can enforce the funding agreement.[203] Because executives at DebtorCo are the same individuals as the executives at AssetCo, the *Aldrich Pump* court noted that this might lead to a situation in which the funding agreement is enforced only if AssetCo approves of the Chapter 11 plan.[204]

4. The Companies Remain in Texas for Less than a Day Before Reincorporating in North Carolina

Each of the predecessor companies was incorporated outside the state of Texas (and had been for many years).[205] In each case, the predecessor company reincorporated in Texas and immediately implemented a divisive merger under the TBOC.[206]

Then, neither company created in the divisive merger—AssetCo or DebtorCo—remains a Texas corporation.[207] Rather, each Texas Two-Step debtor has remained incorporated in Texas for less than a day—just long enough to undergo a divisive merger.[208]

Further, in all cases, DebtorCo has reincorporated in the Fourth Circuit, and specifically North Carolina, which has the most favorable good faith standards for debtors.[209] As discussed above, the Fourth Circuit is the court most unlikely to dismiss a bankruptcy in the early stages for any reason, even if it was filed for an improper purpose.[210]

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200. *See In re Aldrich Pump*, 2021 WL 3729335, at *12.

201. *See id.* at *13 (finding that funding agreements require contributions only in an amount over what the debtor's assets, after liquidation, can cover).

202. *Id.*

203. *Id.*

204. *See id.* at *13 (finding that confirmation of reorganization plan requires New Trane and New TTC approval).

205. Old GP was incorporated in Delaware in 2006. *See Bestwall Motion to Dismiss*, *supra* note 181, at 6. Old JJCI had been a New Jersey corporation since 1970. *See In re* LTL Mgmt., LLC, 638 B.R. 291, 297 (Bankr. D.N.J. 2022). Old IRNJ and Old Trane were New Jersey companies prior to the restructuring. *See In re Aldrich Pump*, 2021 WL 3729335, at *1.

206. *See infra* note 208 and accompanying text.

207. *See infra* note 208 and accompanying text.

208. DBMP and New CertainTeed were Texas corporations for less than four hours. DBMP v. Does 1–1000 (*In re* DBMP LLC), No. 20-30080, 2021 WL 3552350, at *10 (Bankr. W.D.N.C. Aug. 11, 2021). Old CertainTeed became a Texas Corporation at 9:00 AM then underwent a divisive merger. *Id.* At 10:00 AM, New CertainTeed reincorporated in Delaware. At 12:49 PM, DMBP became a North Carolina company. *Id.*; *see also In re Aldrich Pump*, 2021 WL 3729335, at *10 (noting both newly formed companies left Texas within twenty-four hours); *In re LTL Mgmt.*, 637 B.R. at 402–03 (same).

209. *See* Francus, *supra* note 22, at 41–42 (stating that each Texas Two-Step debtor has reincorporated in North Carolina).

210. *See supra* Part I.C.1.

Finally, the newly created DebtorCo usually files for bankruptcy shortly after "moving out" of Texas.[211] In the process, DebtorCo files a motion for a temporary restraining order, which extends the automatic stay to a list of "protected parties" that includes AssetCo.[212]

B. *Courts Are Reluctant to Dismiss a Texas Two-Step Filing for Bad Faith*

On these facts, it appears that solvent companies rely on the Texas Two-Step as a means to access the bankruptcy courts for the tactical advantage of discharging pending tort actions against them.[213] And in fact, the companies have admitted as much.[214] All Texas Two-Step bankruptcy filings were the result of years of research and planning of a corporate restructuring to efficiently discharge tort liabilities.[215] In fact, when the executives at "Old IRNJ" and "Old Trane" found the *In re Bestwall* decision and thus learned about the Texas Two-Step, they emailed each other that they "hit the data information jackpot."[216]

Still, until recently, no good faith challenge to a Texas Two-Step filing had been successful.[217] In fact, in January 2023—six years after the first Texas Two-Step filing in 2017—the Third Circuit became the first court to dismiss a Texas Two-Step filing for bad faith.[218] This part of the Note describes both courts' good faith decisions in previous Texas Two-Step cases. Specifically,

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211. *See Bestwall Motion to Dismiss*, *supra* note 181, at 3 (stating Bestwall filed three months after the divisive merger); *In re Aldrich Pump*, 2021 WL 3729335, at *17 (noting that Aldrich and Murray filed for Chapter 11 forty-nine days after the merger); *In re DBMP*, 2021 WL 3552350, at *15 (noting DBMP filed ninety-one days after creation); *In re LTL Mgmt.*, 637 B.R. at 402–03 (noting that LTL Management filed three days after the merger).

212. *See In re Aldrich Pump*, 2021 WL 3729335, at *10; *In re DBMP*, 2021 WL 3552350, at *2. *See generally In re* LTL Mgmt., LLC, 638 B.R. 291 (Bankr. D.N.J. 2022) (extending stay to nondebtors).

213. The court in *In re Aldrich Pump* found that the spin-offs, Aldrich and Murray, were created with purposefully limited assets and all of the asbestos liability so that they could file for bankruptcy. 2021 WL 3729335, at *9.

214. *See infra* notes 215–16 and accompanying text.

215. The planning of the restructuring of Old IRNJ and Old Trane, called Project Omega, spanned a year. *See In re Aldrich Pump*, 2021 WL 3729335, at *8–9 (noting that planning began in 2019 and that the restructuring occurred in 2020). The plan to restructure Old CertainTeed was called Project Horizon and began in 2018. *See In re DBMP*, 2021 WL 3552350, at *6–7. In both cases, these projects were highly secretive with only a small select team that was privileged to work on them. *In re Aldrich Pump*, 2021 WL 3729335, at *8; *In re DBMP*, 2021 WL 3552350, at *6–7.

216. *In re Aldrich Pump*, 2021 WL 3729335, at *9.

217. In 2019, the U.S. Bankruptcy Court for the Western District of North Carolina refused to dismiss the *In re Bestwall* case for bad faith. *See In re* Bestwall LLC, 605 B.R. 43, 50–51 (Bankr. W.D.N.C. 2019) (denying motion to dismiss for bad faith). Three years later, the U.S. Bankruptcy Court for the District of New Jersey found that LTL Management had also filed in good faith. *In re* LTL Mgmt., LLC, 637 B.R. 396, 406 (Bankr. D.N.J. 2022) (denying motion to dismiss for bad faith), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

218. *In re* LTL Mgmt., LLC, 58 F.4th 738, 746 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).

it will focus on the creditors' arguments and the courts' application of current good faith law to those arguments.

Part II.B.1 analyzes the *In re Bestwall* decision, which was filed in the U.S. District Court for the Western District of North Carolina, an uncommon bankruptcy venue located in the Fourth Circuit. The court denied the motion to dismiss based on the stringent Fourth Circuit standard.[219]

Then, Part II.B.2 describes the recent Third Circuit opinion in the *LTL Management* case, in which the court held that LTL Management was not experiencing financial distress and thus had filed in bad faith.[220]

1. The Bankruptcy Court in the Western District of North Carolina Did Not Dismiss the *In re Bestwall* Filing

Bestwall filed with material assets, including thirty-two million dollars in cash, an operating business expected to generate eighteen million dollars in revenue each year, and a funding agreement with "New GP" under which New GP agreed, on an unsecured basis, to fund its bankruptcy case and any asbestos liabilities.[221]

The bankruptcy court focused on one portion of the Fourth Circuit's test, which barred dismissal if Bestwall's filing was not objectively futile—or having no chance at a successful reorganization.[222] Applying this analysis, the court concluded that Bestwall had the ability to reorganize and thus denied the motion.[223]

The court found that Bestwall was not a "defunct company" incapable of reorganization.[224] Additionally, because Bestwall owned substantial assets, including its own active business, it had a going concern to preserve.[225] More importantly, the court found that because Bestwall had an indirect claim to New GP's assets through the funding agreement, it would be able to meet all of its obligations, and thus had a hope of successful rehabilitation.[226]

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219. *In re Bestwall*, 605 B.R. at 50–51. Perhaps as a result, bad faith challenges were not brought in either the *In re DMBP* or *In re Aldrich Pump* cases, which were also filed in the Fourth Circuit. *See In re DBMP*, 2021 WL 3552350, at *4 (finding that there is no pending motion to dismiss, likely because of the *In re Bestwall* decision). In fact, a good faith challenge to the *In re LTL Management* filing was only brought after that case was transferred to the District of New Jersey from the Western District of North Carolina. *See In re LTL Mgmt.*, 637 B.R. at 399–400.

220. *In re LTL Mgmt.*, 58 F.4th at 754–56.

221. *See In re Bestwall*, 605 B.R. at 47–48.

222. *See id.* at 50 ("[T]he court concludes that this case is not objectively futile . . . ."). As an initial matter, the court held it had jurisdiction over the case because attempting to resolve asbestos claims through a § 524(g) trust demonstrated a valid reorganizational purpose. *Id.* at 49. Additionally, the volume of claims currently filed and to be filed against Bestwall in the future constituted financial distress and allowed the company to take advantage of the Bankruptcy Code. *Id.*

223. *See id.* at 50.

224. *Id.*

225. *Id.*

226. *Id.* at 49.

The court rejected creditors' arguments that it should disregard the funding agreement,[227] finding that the agreement was an enforceable, nonillusory contractual asset of Bestwall.[228] Because the court found that New GP had thus far acted in full compliance with the funding agreement and had repeatedly reaffirmed it, it found that any concerns that New GP might seek to evade performance at a later date were insufficient for dismissal.[229] The court further noted that Bestwall was not required under Bankruptcy Code § 524 to fund a trust entirely from its own assets.[230] In fact, § 524(g)(2)(B)(i)(II) specifically contemplates that a trust may be funded "in whole *or in part* by the securities of 1 or more debtors involved in such [a] plan."[231]

Finally, the court held that the bankruptcy filing did not cause any delay to the claims of creditors, which would indicate bad faith, by removing them from the tort system, because the court found that those claims could be fairly adjudicated through a § 524(g) trust.[232]

Because it concluded that Bestwall could be reorganized, the court did not consider whether the debtor had acted in subjective good faith in filing the case.[233] In particular, it did not consider the facts surrounding the purpose of the divisive merger—specifically, the timing of the divisive merger, the lack of business history, and the lack of employees assigned to Bestwall, all of which would tend to indicate that it was a sham entity created for the purpose of filing.[234]

2. The Third Circuit Reversed the Bankruptcy Court and Dismissed the *LTL Management* Filing for Bad Faith

In January 2023, the Third Circuit, reversing an earlier bankruptcy court decision,[235] dismissed the *LTL Management* filing as made in bad faith.[236] That decision is discussed below.

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227. *See id.* The creditors argued that the court should disregard the agreement because without it, Bestwall was unable to reorganize. *Id.*

228. *See id.*

229. *Id.* at 50 (noting any issues arising under the agreement can be addressed at plan confirmation).

230. *Id.* at 49.

231. *Id.*

232. *Id.* at 50.

233. *Id.* at 50–51.

234. *See In re* Johns-Manville Corp., 36 B.R. 727, 737 (Bankr. S.D.N.Y. 1984) ("[I]n the case of a filing by a viable and legitimate company with real creditors not formed as a sham solely for the purpose 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."). *See generally In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019) (failing to discuss timing of the Two-Step or the number of employees working at the debtor).

235. *In re* LTL Mgmt., LLC, 637 B.R. 396 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

236. *In re* LTL Mgmt., LLC, 58 F.4th 738, 746 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).

In addition, in response to the decision, Johnson & Johnson made changes to its corporate structure and entered into revised funding agreements.[237] Based on these changes, LTL Management filed a second bankruptcy on the same day that the first was dismissed.[238] That filing is also discussed below.

a. The Third Circuit Decision

The Third Circuit evaluated the totality of the circumstances surrounding LTL Management's filing—specifically whether its petition served a valid bankruptcy purpose or was filed merely to obtain a litigation advantage.[239]

Relying heavily on *In re SGL Carbon* and *In re Integrated Telecom*, the court found that because LTL Management was not experiencing sufficient financial distress, the filing did not serve a valid bankruptcy purpose, and dismissed it.[240] In reaching this conclusion, the court emphasized that to serve a valid bankruptcy purpose, the debtor's financial distress must not only be apparent, but also "immediate enough to justify a filing."[241] Chapter 11, it noted, arms debtors with powerful tools like the automatic stay, the use of which can only be justified when a debtor is experiencing immediate and significant financial distress.[242]

Unlike the bankruptcy court, the Third Circuit found that a desire to resolve talc liability using a § 524(g) trust could not, on its own, establish a proper bankruptcy purpose.[243] Rather, for bankruptcy to be an appropriate forum to address tort liabilities, the debtor must be experiencing bona fide financial distress.[244] In support of this conclusion, the court relied on *In re Johns-Manville*, in which the debtor had recorded a $1.9 billion reserve for asbestos liabilities and demonstrated a "compelling need . . . to reorganize in order to meet" its obligations in the short term.[245]

237. *See infra* Part II.B.2.b.

238. Declaration of John K. Kim in Support of First Day Pleadings at 24, *In re* LTL Mgmt., LLC, No. 23-12825 (Bankr. D.N.J. Apr. 4, 2023), ECF No. 4 (noting the case was dismissed on April 4, 2023).

239. *In re* LTL Mgmt., LLC, 58 F.4th 738, 754 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).

240. *Id.* at 754–56, 759.

241. *Id.* at 755.

242. *Id.* at 754–56.

243. *Id.* at 757. The bankruptcy court had found that filing a Chapter 11 petition with the aim of resolving current and future tort liabilities while preserving corporate value is "unquestionably a proper [bankruptcy] purpose." *In re* LTL Mgmt., LLC, 637 B.R. 396, 408 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023). In support of its decision, the court went on at length to describe certain features of the system that it thought more efficient and advantageous in resolving talc-related claims than the tort system and contrasted these with perceived weaknesses in the tort system, such as the limited availability of class actions and the alleged inefficiency of the pending multidistrict litigation that had generated a backlog of claims. *Id.* at 412–16.

244. *In re LTL Mgmt.*, 58 F.4th at 757.

245. *Id.*

At the outset, the Third Circuit determined that only the financial distress of LTL Management, and not that of "Old JJCI," was relevant in a good faith analysis.[246] Specifically, it found that the condition of Old JJCI, which no longer existed, was irrelevant to the "availability of Chapter 11 to the only entity subject to it," LTL Management.[247] In addition, the court thought that there was no clear way to limit the scope of such a historical analysis and that authorizing one would create uncertainty regarding how far back and to which other entities a court should look to in evaluating the financial distress of the debtor.[248] The court did not seek to square this holding with the new debtor cases allowing courts to consider the mindset of the transferor when assets are transferred on the eve of bankruptcy.[249]

Looking only at LTL Management, the Third Circuit concluded that, although subject to talc claims, neither the nature nor the immediacy of its financial distress justified resort to Chapter 11.[250] Rather, the court found that LTL Management's rights under the funding agreement precluded a finding that the company was in financial distress at the time it filed.[251] According to the court, the funding agreement, which it somewhat curiously likened to an ATM, allowed LTL Management to force Johnson & Johnson and "New JJCI" to pay it up to $61.5 billion (the value of New JJCI on the date of the Chapter 11 petition).[252] Therefore, LTL Management could draw funds under the agreement to pay liabilities "without any disruption to its business."[253] In other words, the funding agreement "provided LTL a right to cash that was very valuable . . . and minimally conditional" and thus acted as a funding backstop.[254]

Further, the court found that the funding agreement was a credible source of funds because New JJCI and Johnson & Johnson were profitable, credit-worthy companies.[255] New JJCI had inherited Old JJCI's cash-flowing brands in the divisive merger, all of which were experiencing consistent growth in the last several years.[256] Likewise, Johnson & Johnson had over $400 billion in equity value and a AAA credit rating.[257] For these reasons, the court concluded that there was no circumstance in which New JJCI and Johnson & Johnson could not perform their duties under the funding agreement.[258] As a result, it concluded that, far from being distressed, LTL

246. *Id.* at 758.
247. *Id.* at 759.
248. *Id.*
249. *Id.* at 758–59; *see also supra* notes 127–32 and accompanying text.
250. *In re LTL Mgmt.*, 58 F.4th at 759, 762.
251. *Id.*
252. *Id.* at 762.
253. *Id.*
254. *Id.* at 759, 762.
255. *Id.* at 759.
256. *Id.* at 759–60.
257. *Id.*
258. *Id.* at 762.

Management was highly solvent, with access to cash that was sufficient to satisfy its liabilities at the time it filed for bankruptcy.[259]

The court also found that LTL Management had not demonstrated that it was experiencing "serious financial and/or managerial difficulties" during the three days it operated outside of bankruptcy.[260]

Finally, the court found that the pending talc litigation facing LTL Management was not immediate enough to justify a Chapter 11 filing in the short term.[261] It reasoned that although LTL Management was subject to significant talc liability, it "did not have any likely need in the present or the near-term . . . to exhaust its funding rights" to pay those liabilities.[262] Rather, the bankruptcy court's findings to the contrary were based on inflated extrapolations of "hypothetical worst-case scenarios" that ignored LTL Management's previous success in defending talc litigation and the possibility of settling other cases in the future.[263] The Third Circuit held that if those worst-case projections eventually came to fruition, then LTL Management could file for Chapter 11.[264] Until then, however, any such filing was at best premature.[265]

Importantly, in concluding that LTL Management was not experiencing financial distress sufficient to justify a bankruptcy filing, the Third Circuit resisted "attempt[ing to hand down] a tidy definition of financial distress" to be applied in all cases.[266] As such, it did not provide guidance regarding how much weight to give funding agreements that do not act as ATMs or that are guaranteed by companies less profitable and creditworthy than New JJCI and Johnson & Johnson.[267]

b. LTL Management's April 2023 Bankruptcy Filing

While the Third Circuit appeal was pending and after it was issued, the Johnson & Johnson entities conducted another corporate restructuring and revised the previous funding agreement.[268] Two months after its decision, and after the Third Circuit refused en banc review and declined to stay its mandate, LTL Management filed a second bankruptcy.[269] It asserted that the new restructuring and revised funding arrangements demonstrate that it is in financial distress and therefore, the new filing is made in good faith.[270]

259. *Id.* at 761.
260. *Id.* at 762.
261. *Id.* at 760–63.
262. *Id.* at 761.
263. *Id.*
264. *Id.* at 762.
265. *Id.*
266. *Id.* at 763.
267. *See id.*
268. *See* Declaration of John K. Kim in Support of First Day Pleadings, *supra* note 238, at 8–9, 26–29.
269. *Id.* at 24.
270. *Id.* at 28–29.

First, in December 2022, New JJCI changed its name to Johnson & Johnson HoldCo.[271] Then, in January 2023, HoldCo transferred its most profitable business segment and a substantial portion of its assets to Johnson & Johnson.[272] The filings do not reveal whether Johnson & Johnson provided consideration for this transfer.[273]

Second, the parties terminated the original funding agreement provided to LTL Management and replaced it with a new funding agreement.[274] In the new funding agreement, only HoldCo agreed to fund LTL Management.[275] By its terms, the new funding agreement applies both in and outside of bankruptcy.[276]

In addition to the new funding agreement, HoldCo and Johnson & Johnson entered into a second agreement, called a support agreement, under which Johnson & Johnson agreed to provide further funding to LTL Management if HoldCo could or did not fund, among other things, the expense of LTL Management's talc-related liabilities.[277] Importantly, the support agreement applies only in bankruptcy.[278]

Thus, outside of bankruptcy, LTL Management has funding commitment from HoldCo, which has been stripped of substantial operating assets.[279] Only once it filed did it get access to Johnson & Johnson's balance sheet through the support agreement.[280] At the same time, LTL Management has proposed an $8.9 billion settlement that has the support of 60,000 plaintiffs.[281]

III. CONSIDERING THE CONDITION AND CONDUCT OF THE PREDECESSOR ENTITY

Section 1112(b) of the code is broad enough to address abusive Texas Two-Step filings. Consideration of the propriety of such filings at the outset of the case efficiently enables courts to protect their jurisdiction and conserve resources. Furthermore, with minor adjustments, the analysis of the good faith of Texas Two-Step filings fits within the existing framework of the good faith analysis used by most circuit courts.

Part III.A argues that it is appropriate to evaluate the good faith of a Texas Two-Step debtor at the outset of a case, rather than at plan confirmation. After establishing that the debtor's good faith should be addressed upon filing, Part III.B proposes adjustments to the standards under which these

271. *Id.* at 8.
272. *Id.*
273. *Id.* at 8–9.
274. *Id.* at 26–27.
275. *Id.* at 27.
276. *Id.*
277. *Id.* at 28. The support agreement imposes repayment obligations on HoldCo, requiring HoldCo to refund any amounts provided to LTL Management by Johnson & Johnson. *Id.*
278. *Id.*
279. *Id.* at 28–29.
280. *Id.* at 29.
281. *Id.* at 25.

filings are currently assessed, intended to make § 1112(b) more effective in addressing all Texas Two-Step filings.

A. Motion to Dismiss Is the Appropriate Stage at Which to Evaluate the Good Faith of a Texas Two-Step Debtor

Consideration of the propriety of a Texas Two-Step filing at the outset of a bankruptcy case is appropriate for several reasons. First, a Texas Two-Step filing implicates the propriety of the bankruptcy court's exercise of jurisdiction, which the *In re Johns-Manville* court found was in part protected by the § 1112(b) good faith inquiry.[282] The Bankruptcy Code arms debtors with powerful tools to assist in a bona fide reorganization, but those tools are not available to all entities regardless of their financial or operational condition.[283] Although an obviously healthy company like Tesla, for example, might hypothetically find the automatic stay useful to manage products liability claims against it, it cannot access such an injunction unless it demonstrates real financial or operational distress.[284] The issue of jurisdiction, moreover, should be addressed promptly, before substantial judicial and party resources are devoted to a potentially defective proceeding.

Second, deferring consideration of the issue of good faith until plan confirmation not only requires the commitment of substantial resources to a potentially defective proceeding,[285] but also unfairly tilts the bankruptcy case in favor of the Two-Step debtor and against the mass tort creditors.[286] Deferring consideration of the good faith issue until plan confirmation not only stays the tort litigation without justification,[287] but also redirects the tort claimants into the very plan negotiations that the Texas Two-Step debtor sought, aided by the additional leverage of a funding agreement that conditions financial commitments on the confirmation of a plan.[288] If the debtor succeeds in negotiating a plan with some group of creditors, it can potentially bind nonconsenting creditors (subject to satisfying the remaining requirements of § 1129).[289] Moreover, it will undoubtedly use any agreement reached in plan negotiations, no matter how limited, as evidence

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282. *In re* Johns-Manville Corp., 36 B.R. 727, 738–40 (Bankr. S.D.N.Y. 1984).

283. *See In re* SGL Carbon Corp., 200 F.3d 154, 163–64 (3d Cir. 1999); Janger, *supra* note 57, at 368–69.

284. *See In re SGL Carbon*, 200 F.3d at 164 (finding financial distress necessary).

285. *See generally* Francus, *supra* note 22, at 48 (describing good faith challenge as allowing dismissal at the outset of the proceeding).

286. *See* Ellias, *supra* note 30.

287. *See generally id.*; Janger, *supra* note 57, at 68–69 (discussing requirement of financial distress).

288. *See* Aldrich Pump LLC v. Does 1–1000 (*In re* Aldrich Pump LLC), No. 20-30608, 2021 WL 3729335, at *13 (Bankr. W.D.N.C. Aug. 23, 2021) (finding funding contributions conditional on plan approval). The problem is amplified if, like LTL Management, future Texas Two-Step debtors refile multiple times. *See* Knauth & Spector, *supra* note 19. This gives the debtor multiple attempts to confirm a favorable plan while tort claimants wait for recovery.

289. *See* 11 U.S.C. § 1129(b)(1)–(2); *see also* Adam J. Levitin, *The Constitutional Problem of Nondebtor Releases in Bankruptcy*, 91 FORDHAM L. REV. 429 (2022) (arguing that nondebtor releases are unconstitutional).

of its good faith. Dissidents seeking to challenge the bankruptcy court's jurisdiction will thus face a more difficult substantive battle not only to challenge the propriety of the filing,[290] but also to resist the considerable practical momentum toward confirmation.

Finally, requiring tort victims to rely on fraudulent transfer actions to claw back assets of the predecessor company would provide, at best, insufficient protection of their interests.[291] Although these suits may be successful,[292] fraudulent transfer actions need to be litigated separately.[293] This time-consuming and expensive litigation would require each plaintiff to file pleadings, engage in discovery, and conduct a trial, thus delaying payments to tort claimants.[294] At the same time, it is the tort claimants, not the debtor or other related entities, that will bear the risk of that delay.[295] All the while, most of the assets of the predecessor entity are operating outside of bankruptcy protection without any guarantees as to how much will be left over at the end of the process.[296]

B. All Courts Should Evaluate the Totality of the Circumstances to Make a Good Faith Determination

The totality-of-the-circumstances test, which governs whether a filing has been made in good faith, is sufficiently flexible as to allow application of the same test to Texas Two-Step cases, with discrete changes. Most courts already employ a case-specific, totality-of-the-circumstances inquiry, with one exception.[297] The Fourth Circuit alone bars dismissal if there is *any* possibility for confirmation of a plan of reorganization.[298] This standard favors the protection of debtors over protection of the bankruptcy courts from abusive filings and should be adjusted.

This Note proposes that all courts, including Fourth Circuit courts, employ a totality-of-the-circumstances approach that considers two additional factors that are explained in Part III.B.2.[299] First, Part III.B.1 explains why Fourth Circuit case law on § 1112(b) is insufficient to protect bankruptcy courts from bad faith filings in Texas Two-Step cases and argues instead that the circuit should engage in a more fact-intensive inquiry. When a bankruptcy filing is immediately preceded by a significant corporate disposition or divisive merger, Part III.B.2 proposes that courts should consider (1) the

290. *See* 11 U.S.C. § 1129(b).

291. *See* Francus, *supra* note 22, at 43–44.

292. This point is debated, but beyond the scope of this Note. *See supra* notes 46–47 and accompanying text. However, this uncertainty further indicates that fraudulent transfer actions cannot adequately protect tort victims' interests.

293. *See* Francus, *supra* note 22, at 43.

294. *Id.*; *see* Tronox Inc. v. Kerr McGee Corp. (*In re* Tronox Inc.), 503 B.R. 239, 247 (Bankr. S.D.N.Y 2013) (noting that Tronox filed four years before decision was issued).

295. *See* Francus, *supra* note 22, at 43–44.

296. *See id.* (finding delay associated with fraudulent transfer action will reduce settlement value).

297. *See supra* Part I.C.

298. *See* Carolin Corp. v. Miller, 886 F.2d 693, 700–01 (4th Cir. 1989).

299. *See infra* Part III.B.2.

financial distress of the predecessor entity[300] and (2) the business purpose for the transaction[301] as part of its § 1112(b) inquiry, which no court to date has done.

1. The Fourth Circuit Has Developed an Improper Good Faith Standard

The ability to reorganize should not be considered decisive evidence of good faith, as it is under the Fourth Circuit's existing standard.[302] Allowing the possibility of a successful reorganization on its own to bar dismissal effectively means that a Texas Two-Step filing will never be dismissed as a bad faith filing, regardless of the factual evidence suggesting bad faith.[303] Texas Two-Step debtors are designed to require restructuring,[304] and the funding agreements ensure that debtors have at least potential access to sufficient assets to support a reorganization if a plan can be confirmed.[305] Undoubtedly aware of the obstacle to dismissal that the Fourth Circuit's standard has erected, every company employing a Texas Two-Step has chosen to have the debtor entity file for bankruptcy in the Western District of North Carolina.[306]

Although an inability to reorganize may indicate that a filing was made in bad faith, it does not follow that the potential to reorganize affirmatively establishes good faith. In fact, the text of § 1112(b) itself contradicts this position.[307] Section 1112(b)(4) provides a nonexhaustive list of sixteen conditions that constitute "cause" warranting dismissal.[308] Only one of these, § 1112(b)(4)(A), relies on "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation" as providing cause for dismissal.[309] If Congress intended the potential for reorganization to foreclose dismissal of the case, the remaining fifteen bases for dismissal—which do not require that reorganization be unlikely—would not exist.[310]

Additionally, the policy rationale advanced in support of the standard is not served by allowing Texas Two-Step cases to withstand a good faith inquiry. The Fourth Circuit adopted its standard in *Carolin*, which considered a single-asset real estate debtor that was unable, as a matter of

300. *See In re* SGL Carbon Corp., 200 F.3d 154, 164 (3d Cir. 1999) (discussing financial distress requirement).
301. *See generally* Meadowbrook Investors' Grp. v. Thirtieth Place, Inc. (*In re* Thirtieth Place, Inc.), 30 B.R. 503, 505–06 (B.A.P. 9th Cir. 1983); *In re* Johns-Manville Corp., 36 B.R. 727, 738 (Bankr. S.D.N.Y. 1984) (discussing entities made for the purpose of filing).
302. *See Carolin*, 886 F.2d at 700–701 (enunciating standard).
303. *See supra* Part II.A (highlighting relevant facts indicating bad faith).
304. *See supra* notes 182–94 and accompanying text.
305. *See supra* notes 195–204 and accompanying text.
306. *See* Francus, *supra* note 22, at 47. Such obvious forum shopping tends to evidence bad faith. *See id.*
307. *See* 11 U.S.C. § 1112(b).
308. *See id.* § 1112(b)(4).
309. *See id.* § 1112 (b)(4)(A).
310. *See id.*; Freeman v. Quicken Loans, Inc., 566 U.S. 624, 635 (2012) ("[T]he canon against surplusage . . . favors that interpretation which *avoids* surplusage . . . .").

law, to implement a plan of reorganization.[311] Consequently, the court could easily find that it filed in subjective bad faith.[312] In enacting such a stringent standard, the Fourth Circuit reasoned that it was better "to risk proceeding with a wrongly motivated invocation of Chapter 11 protections whose futility is not immediately manifest than to risk cutting off even a remote chance that a reorganization effort so motivated might nevertheless yield a successful rehabilitation."[313] This makes sense in a single-asset case in which an inability to reorganize actually evidences that the filing was made only to secure a litigation advantage and thus delay foreclosure, since courts agree that strategic motives indicate bad faith.[314] In fact, for a debtor with a single encumbered asset and few creditors, the debtor's ability to reorganize strongly suggests that it had a proper reorganizational purpose and that its filing was not motivated solely to invoke the automatic stay and thus delay foreclosure.[315] But outside this context, the test is too forgiving.

Indeed, this narrow policy rationale invited sophisticated practices intended to comply with the letter but not the underlying purpose of the good faith inquiry. For example, a Texas Two-Step debtor has been created out of a solvent predecessor specifically to be reorganized so that it may shed large-scale liabilities of the predecessor without exposing the predecessor's other assets to bankruptcy.[316] The debtor has an artificial ability to reorganize based on conditional access to assets under a funding agreement guaranteed by its predecessor.[317] This nominal ability to reorganize does not establish the good faith of the pre-petition transaction.[318] Rather, such an entity may well have been created solely to access the litigation benefits of bankruptcy. But for the advantages of the Texas Two-Step, such as the automatic stay and channeling injunctions, the predecessor entity would never have engaged in the process in the first place.

Finally, as will be discussed in more detail below, barring dismissal if the debtor can reorganize subverts the requirement of financial distress, which courts—including the Third Circuit in *LTL Management*[319]—have widely acknowledged as necessary.[320] In fact, even cases that considered cash-rich

311. Carolin Corp. v. Miller, 886 F.2d 693, 701–02 (4th Cir. 1989).

312. *See id.*

313. *Id.* at 701.

314. *See In re* SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999) ("Chapter 11 petition merely to obtain tactical litigation advantages is not within 'the legitimate scope of the bankruptcy laws.'" (quoting Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994))).

315. *Carolin*, 886 F.2d at 705.

316. *See generally* Ellias, *supra* note 30.

317. *See supra* notes 195–204 and accompanying text.

318. *See supra* Part II.A.

319. *In re* LTL Mgmt., LLC, 58 F.4th 738, 754–56 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).

320. *Compare In re* SGL Carbon Corp., 200 F.3d 154, 164 (3d Cir. 1999) (dismissing filing by healthy company), *and* NMSBPCSLDHB v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 119–20 (3d Cir. 2004) (dismissing filing by company with cash sufficient to pay debt), *with In re* Johns-Manville Corp., 36 B.R. 727

entities, like *In re SGL Carbon* and *In re Integrated Telecom*, likely would not have been dismissed under the Fourth Circuit standard. Because those filings were made by healthy companies, they would have had the ability to reorganize.[321]

2. All Circuits Should Employ a Totality-of-the-Circumstances Test with Minor Changes

Most circuits apply a totality-of-the-circumstances test to determine if a filing should be dismissed under § 1112(b).[322] This majority approach, however, has so far been applied too narrowly to Texas Two-Step filings. Courts have only examined the totality of the circumstances of the debtor on the petition date and have ignored or refused to consider the broader circumstances surrounding the transaction, specifically the condition and conduct of the debtor's predecessor.[323]

This section proposes minor adjustments to the current standard. Part III.B.2.a argues that courts can appropriately consider the predecessor entity. Part III.B.2.b proposes that courts must determine whether the predecessor entity was experiencing the type of financial distress necessary to sustain a bankruptcy filing. If it was not, the court must dismiss the case for want of jurisdiction. Finally, Part III.B.2.c proposes that if jurisdiction is proper, courts should engage in a good faith inquiry. However, as part of that inquiry, the court must specifically consider whether there was a proper business purpose for the spin-off transaction or it was undertaken to improperly secure a litigation advantage in bankruptcy.

a. It Is Appropriate to Consider the Conduct and Condition of the Predecessor Entity

To properly evaluate the totality of the circumstances surrounding the bankruptcy petition, courts considering Texas Two-Step filings should specifically consider the conduct and condition of the debtor's predecessor entity. At the most basic level, it does not make sense to only consider the pre-petition conduct of the debtor, which by the nature of the Texas Two-Step has very little pre-petition conduct to consider.[324] The debtor is a holding company that is created to operate for only a few days before filing for bankruptcy.[325] Its pre-petition conduct is insignificant when compared with the pre-petition conduct of its predecessor entity—the entity that both committed the allegedly tortious acts and conducted the controversial Texas Two-Step transaction.[326]

(Bankr. S.D.N.Y. 1984) (finding filing by company with crushing debt was made in good faith).

321. *See In re SGL Carbon*, 200 F.3d at 164; *In re Integrated Telecom*, 384 F.3d at 122.
322. *See supra* Part I.C.2.
323. *See supra* Part II.B.
324. *See supra* notes 211–12 and accompanying text.
325. *Id.*
326. *Compare supra* Parts II.A.1–2, *with supra* Part II.A.4.

In Texas Two-Step cases, the decision by the predecessor company to submit only certain assets and liabilities to the jurisdiction of the bankruptcy court through a complicated series of pre-petition transactions is clearly relevant to the determination of good faith and must be considered in addition to the pre-petition conduct of the debtor.

More importantly, prior decisions have not required courts to look at the debtor in isolation or to blind themselves to the actions and intentions of a debtor's corporate predecessors.[327] Rather, courts have recognized that the pre-petition conduct of related entities is relevant to a good faith determination.[328] Specifically, in the "new debtor" cases, courts have considered the pre-petition conduct of related entities in making a good faith determination.[329] In evaluating the purpose of the transaction that created a new debtor, courts have looked not only at the new debtor entity, but also at the conduct and intent of the entity that conceived of and executed the transaction.[330] Like a new debtor, a Texas Two-Step debtor is created just days before the bankruptcy filing through a transaction designed and conducted by its predecessor entity. Therefore, to determine whether the debtor has filed in good faith, courts should look beyond the debtor entity to the motivations of its predecessor in conducting the transaction.

Courts considering Texas Two-Steps thus far have not done this.[331] In dismissing the *In re LTL Management* filing, for example, the Third Circuit explicitly refused to consider the conduct of the predecessor entity not only because it had not filed for bankruptcy and was not subject to the good faith requirement, but also because it no longer existed as a result of the Two-Step transaction.[332] It also concluded that looking beyond the debtor would lead to future courts being confused about which entities to look at in the good faith analysis.[333]

That conclusion is misplaced. First, it unnecessarily restricts the evidence that courts may consider in determining the motivations behind a bankruptcy filing in the good faith analysis. Although only the debtor is subject to the court's jurisdiction and must demonstrate the good faith of its bankruptcy filing, that does not mean that evidence of related parties' intentions or actions are irrelevant or beyond the reach of the court.[334] Although Old JJCI did not itself file for bankruptcy in *In re LTL Management*, it developed and

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327. *See supra* notes 126–39.
328. *See supra* notes 126–39 and accompanying text.
329. *See supra* notes 126–39 and accompanying text.
330. *See supra* notes 126–39 and accompanying text.
331. *See supra* Part II.B.
332. *See In re* LTL Mgmt., LLC, 58 F.4th 738, 759 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).
333. *See id.*
334. In fact, the bankruptcy court need not have jurisdiction over the predecessor entity to take discovery to determine what its objectives and motives were in conducting the Texas Two-Step transaction. Rather, the court can take discovery of the debtor and the nondebtor successor entity, which together are managed by the same individuals who chose to undertake the transaction.

implemented the strategy that led to the debtor's creation and filing.[335] In addition, the debtor itself is in fact controlled by the same individuals that controlled Old JJCI.[336] Evidence of their intentions is undoubtedly probative of LTL Management's good or bad faith.

The Texas Two-Step, by definition, involves a divisive merger immediately followed by a bankruptcy filing. As such, the entire maneuver should be viewed as one transaction. Thus, Old JJCI's motivations for conducting the transaction, and that transaction's effect on Old JJCI, are directly relevant to the good or bad faith of the subsequent filing.[337] Second, viewing the Texas Two-Step as a single transaction reduces the risk that courts will be confused about which other entities' conduct is relevant in a good faith analysis. Just as in classic new debtor cases, courts should focus on the entity that underwent the Two-Step transaction (or made the asset transfer) because that is the entity with the state of mind that is relevant to the good faith inquiry.[338]

b. The Predecessor Entity Must Have Experienced Sufficient Financial Distress to Sustain a Filing

As part of assessing the totality of circumstances surrounding the filing, courts should first look to the financial condition of the predecessor entity to establish jurisdiction over the proceeding before looking to assess whether the filing was made in good faith.

The Third Circuit in *SGL Carbon* properly concluded—and affirmed in *LTL Management*—that an otherwise healthy company may not file bankruptcy simply to create settlement leverage or obtain a litigation advantage.[339] For the same reason, if SGL Carbon filed today, it should not be able to establish good faith by divisively merging to create and then file an undercapitalized subsidiary holding its antitrust liabilities. To hold otherwise would elevate form over substance.[340] Indeed, the creditors of the newly manufactured subsidiary would potentially be in a worse position than the litigation creditors in *SGL Carbon* because the court could not exercise jurisdiction over all the assets of the enterprise.[341]

To address this concern, courts should review the condition of the Texas Two-Step debtor's predecessor to determine whether it faced the same substantial financial and operational difficulties that the *In re Johns-Manville*

335. *See supra* notes 181–93 and accompanying text.

336. *See supra* notes 191–92 and accompanying text.

337. The fact that Old JJCI no longer exists as a corporation does not change this analysis. Evidence of its actions and intentions in executing the transaction undoubtedly continues to exist in the possession of one or both of its successors.

338. *See supra* notes 126–40 and accompanying text.

339. *See In re SGL Carbon*, 200 F.3d at 164–66; *supra* notes 250–65 and accompanying text.

340. *See generally In re* Patriot Coal Corp., 482 B.R. 718, 743 (Bankr. S.D.N.Y. 2012) (looking to substance of the transaction over its form).

341. *See generally* Ellias, *supra* note 30.

and *Continental* courts identified as essential to trigger bankruptcy jurisdiction.[342]

Courts have not done this.[343] Although courts have considered the extent of litigation in determining financial distress,[344] even large judgments or defense costs are not by themselves sufficient to establish bankruptcy jurisdiction[345] because losing money, standing alone, is not sufficient to establish financial distress.[346] At a minimum, financial distress requires a showing that the debtor is incurring costs or experiencing operational difficulties that do more than threaten the profitability of the enterprise; they must threaten its continued existence in the near term.[347]

Financial distress is a fact-dependent inquiry that depends in part on the type of business operated and the economic sector of the predecessor entity, and therefore, it cannot easily be reduced into a few factors applicable in all cases. In the case of extensive pending litigation, financial distress may mean that judgments have been entered against the company that threaten its viability.[348] Short of that, courts must look for concrete indicators of adverse impact on the business of the debtor.[349] For the purposes of this Note and Texas Two-Step filings more generally, the courts' reasoning through the financial distress question in the *SGL Carbon*, *In re Johns-Manville*, and *Continental* cases is instructive for two key reasons.[350]

First, courts should consider how the predecessor company portrayed its financial health to regulators and shareholders, and in filings and public communications.[351] Indeed, the *SGL Carbon* court found that statements by company officials touting the financial health of the company weighed

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342. *See generally In re* Johns-Manville Corp., 36 B.R. 727, 734–40 (Bankr. S.D.N.Y. 1984); *In re* Cont'l Airlines Corp., 38 B.R. 67, 69–71 (Bankr. S.D. Tex. 1984).

343. Although courts currently look at the financial distress of the debtor, they have not considered the transaction that led to the creation of the debtor or the financial health of the predecessor company. *See generally In re* Bestwall LLC, 605 B.R. 43, 49 (Bankr. W.D.N.C. 2019); *In re* LTL Mgmt., LLC, 637 B.R. 396, 399–400 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023); *In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir.) (dismissing LTL Management's filing), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL2760479 (3d Cir. Mar. 31, 2023).

344. *See supra* notes 222, 250 and accompanying text.

345. *See In re Johns-Manville*, 36 B.R. at 738 (noting that costs must threaten the company's existence).

346. *See* NMSBPCSLDHB v. Integrated Telecom Express, Inc (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 115 (3d Cir. 2004).

347. *See In re Johns-Manville*, 36 B.R. at 738.

348. *See id.* at 738.

349. *See infra* notes 351–57 and accompanying text. For example, an actuarial assessment of judgments entered against the company and of pending or threatened litigation might raise real concerns regarding its economic viability.

350. *See In re* SGL Carbon Corp., 200 F.3d 154, 163–65 (3d Cir. 1999); *In re Johns-Manville*, 36 B.R. at 734–40; *In re* Cont'l Airlines Corp., 38 B.R. 67, 69–71 (Bankr. S.D. Tex. 1984).

351. *See, e.g, In re SGL Carbon*, 200 F.3d at 164.

against a finding of financial distress and indicated that the bankruptcy court did not have jurisdiction over the case.[352]

As part of this inquiry, courts should look specifically at how the predecessor company portrayed its financial condition in financial statements[353] or reports to its board, creditors, or shareholders. For example, the court found it persuasive that Manville marked a contingent liability of $1.9 billion on their balance sheet, an amount large enough to drive the company out of business, and submitted financial estimates created by an accounting firm indicating contingent liabilities to the same extent.[354]

Second, courts may also consider how long the predecessor company could continue its business without bankruptcy.[355] Most importantly, if the predecessor company has ample liquidity to satisfy the creditor's claims against it in the short term, a bankruptcy proceeding may not be appropriate.[356] On the other hand, if the predecessor company is short on cash even after selling its free assets, as Continental Airlines was, that may be evidence that the company "could not continue its operations for very long into the future," and bankruptcy court jurisdiction may be appropriate.[357]

Although these factors are not intended to be exclusive, in the cases considering Texas Two-Steps, courts have not made any inquiry into the financial condition of the debtor's predecessor.[358] Unlike the *SGL Carbon* court, the *In re Bestwall* court found that the extensive litigation pending against the predecessor and the costs associated with defending them, standing alone, established the financial distress of the debtor.[359] It did not, however, seek to assess whether they imperiled the continued operation of the Georgia Pacific's premerger business or even whether Georgia Pacific had indicated that it was struggling.[360]

The Third Circuit found that LTL Management was not experiencing the financial distress necessary to sustain a filing.[361] But it based this finding not on the financial health of Old JJCI but almost entirely on the original funding agreement in the divisive merger.[362] However, access to the funding agreement, which had a nominal value of sixty-one billion dollars and was backed by a highly creditworthy company, is not the only reason why the *In re LTL Management* filing was improper. Rather, LTL Management's filing is improper for the same reason that Texas Two-Step filings thus far have been improper—its predecessor was not experiencing the financial or managerial distress necessary to sustain a filing. In fact, in contrast to

352. *See id.* at 163.
353. *See, e.g.*, *In re Johns-Manville*, 36 B.R. at 729.
354. *Id.* at 730.
355. *See, e.g.*, *In re Cont'l Airlines*, 38 B.R. at 70.
356. *See* NMSBPCSLDHB v. Integrated Telecom Express, Inc (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 124 (3d Cir. 2004).
357. *See In re Cont'l Airlines*, 38 B.R. at 69.
358. *See supra* Part II.B.
359. *See In re* Bestwall LLC, 605 B.R. 43, 48 (Bankr. W.D.N.C. 2019).
360. *See id.*; *supra* note 222 and accompanying text.
361. *See supra* notes 246–65 and accompanying text.
362. *See supra* notes 246–65 and accompanying text.

Manville, Johnson & Johnson acknowledged in a July 2021 10-Q Form that contingent liabilities from various products liability suits (which covered more than simply the talc-related suits) "[were] not expected to have a material adverse effect on the Company's financial position."[363]

Further, refusing to look at the predecessor company, as the Third Circuit did, not only exaggerates the importance of funding agreements in Texas Two-Step cases, but also offers an avenue for companies like Johnson & Johnson to seek to manufacture financial distress—and thus bankruptcy jurisdiction—by revising the operative funding agreement and transferring assets within the corporate structure.[364]

First, access to a funding agreement, even if unconditional, should not be confused with access to cash. The Third Circuit seemed to equate the sixty-one-billion-dollar value of the funding agreement with LTL Management itself having "ATM" access to sixty-one billion dollars to satisfy its liabilities in the short term.[365] But this is clearly not the case. Instead, the funding agreement was not even backed entirely by cash; it was backed by a variety of assets—many of them illiquid.[366]

Additionally, LTL Management could not unilaterally collect money under either the funding agreement in the same way that it could withdraw cash from its own account with a bank. Rather, the funding agreement prescribed administrative steps that LTL Management had to comply with before receiving any cash.[367] Further, any cash provided under the agreement could be used only for "permitted funding uses" approved by the New JJCI or Johnson & Johnson, whose obligations under the funding agreement only attached to the extent that LTL Management is unable to pay for its liabilities on its own.[368]

Although these conditions may not have been impossible to satisfy,[369] it is hard to conclude, as the Third Circuit did, that the funding agreement

363. Johnson & Johnson, *supra* note 177, at 29. In fact, the company included a note addressing the talc suits, specifically noting that the suits did not threaten the enterprise value of the company. *Id.*

364. *See supra* Part II.B.2.b.

365. *In re* LTL Mgmt., LLC, 58 F.4th 738, 762 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).

366. Declaration of John K. Kim in Support of First Day Pleadings, at annex 2, *In re* LTL Mgmt., LLC, 637 B.R. 396 (Bankr. D.N.J. 2022) (No. 21-30589), ECF No. 5 (stating that the funding agreement is based on the total value of New JJCI).

367. *Id.*

368. *Id.* The new funding agreement places the same restrictions on LTL Management's ability to get cash, except that HoldCo (not New JJCI or Johnson & Johnson) is the payor. *See* Declaration of John K. Kim in Support of First Day Pleadings, *supra* note 238, at annex E.

369. Rather, the funding agreement had to be minimally conditional to protect Johnson & Johnson and New JJCI from successful fraudulent transfer actions, which would void the Texas Two-Step transaction. If the agreement imposed large hurdles on the debtor's ability to receive funds, the creditors could successfully argue that the transfer of assets to AssetCo rendered DebtorCo insolvent and was made without DebtorCo receiving something reasonably equivalent in value. *See* 11 U.S.C. § 548(a)(1)(B).

established something akin to an ATM.[370] And ultimately, even if these conditions were complied with, the payor could still refuse to pay under either funding agreement[371] or, like HoldCo, choose to transfer assets away.[372]

Likely concerned with the cost and drain on judicial resources of litigating the financial condition and intentions of the predecessor entity, the Third Circuit concluded that the value of the funding agreement and the creditworthiness of New JJCI and Johnson & Johnson made it unlikely that LTL Management would be unable to meet its existing and future obligations by drawing on the funding agreement and therefore negated a finding of financial distress.[373] This approach, while practical, invited Texas Two-Step debtors to structure around the decision. Johnson & Johnson accepted this invitation, removing assets from HoldCo—thus reducing the value of the new funding agreement provided to LTL Management—while making Johnson & Johnson's obligations applicable only after a bankruptcy is filed.[374]

These transactions, viewed in context, appear to reflect an attempt to manufacture financial distress. It is not clear how LTL Management, a company that was not experiencing financial distress two months ago, can demonstrate financial distress today simply by moving assets within the corporate family and by conditioning Johnson & Johnson's obligations under the new funding agreement.[375] This is especially so when the Johnson & Johnson corporate family has not pointed to a loss in its net assets or an increase in its total liabilities.[376]

These manipulations seriously undercut any argument that either of LTL Management's filings is a good faith resort to bankruptcy relief. Rather, for financial distress to be bona fide, it must be experienced by a "real company with real debt," rather than by a "sham entity formed for the purpose of filing."[377] The ability to create the appearance of financial distress by redoing the agreements or shifting assets among affiliates certainly tends to

370. *In re* LTL Mgmt., LLC, 58 F.4th 738, 762 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31 2023).

371. The funding agreement placed little to no restrictions on Johnson & Johnson's or New JJCI's ability to draw on or dispose of these assets. It even explicitly contemplated a situation in which Johnson & Johnson might enter a merger or sell "all or substantially all of their assets," and it did not even require LTL Management's consent to such a transaction. Declaration of John K. Kim in Support of First Day Pleadings, *supra* note 366, at annex 2 (requiring only the first successor to the transaction assume the obligations under the funding agreement).

372. HoldCo transferred that business in early January 2023 while the original funding agreement was still operative. *See* Declaration of John K. Kim in Support of First Day Pleadings, *supra* note 238, at annex E.

373. *In re LTL Mgmt.*, 58 F.4th at 759–60.

374. *See supra* notes 271–81 and accompanying text.

375. *See generally* Declaration of John K. Kim in Support of First Day Pleadings, *supra* note 238.

376. *See id.*

377. *See In re* Johns-Manville Corp., 36 B.R. 727, 730, 737 (Bankr. S.D.N.Y. 1984).

indicate that this financial distress is not real.[378] Such transactions also suggest that LTL Management is a sham company and that Johnson & Johnson will continue to restructure until it can successfully file for bankruptcy.

While Johnson & Johnson's repeat restructurings make it obvious that its Texas Two-Step was designed to manufacture financial distress, the facts in the next Texas Two-Step case may not be so clear. Rather, practitioners will learn and restructure funding agreements to sidestep the Third Circuit's analysis, making it less straightforward to apply in future cases. To properly evaluate financial distress, courts should not look exclusively at the terms of the funding agreement, but rather also at the financial condition of the last "real" entity—the predecessor entity that conducted the Texas Two-Step transaction.

If the debtor cannot establish that the predecessor entity had substantial financial or operational issues under the standard set out in this Note, then the petition should be dismissed, as it would have been had the predecessor itself filed. Without concrete indicators of financial or operational distress, the predecessor company is more like the company in *SGL Carbon*, a healthy company seeking to access bankruptcy to escape burdensome state court litigation, and bankruptcy court jurisdiction is improper.

c. There Must Be a Valid Business Purpose for the Texas Two-Step Transaction

Even if the predecessor company was experiencing financial distress that would have allowed it to access bankruptcy, the court should still determine whether the filing was made in good faith. Specifically, to determine whether the filing serves a valid reorganizational purpose, the court should conduct a review of the reasons why the predecessor company pursued the Two-Step transaction instead of filing as the entire entity. In fact, in the case of a newly created company, the decision to restructure and submit only certain assets and liabilities to the bankruptcy court tends to belie a finding of good faith.[379] Neither the *In re Bestwall* court nor the *LTL Management* court even considered Georgia Pacific's or Johnson & Johnson's motivations for pursuing the Texas Two-Step.[380]

378. In fact, in LTL Management's first day filings, its chief legal officer appears to acknowledge that the purpose of these transactions was to create financial distress when there was none before. *See* Declaration of John K. Kim in Support of First Day Pleadings, *supra* note 238, at 29 ("Since then, Holdco has transferred its consumer health business. As a result, not only was [Johnson & Johnson's] balance sheet not available to the Debtor prior to this filing, but Holdco's assets [have been depleted] . . . . The Debtor believes that its pre-filing financial condition is sufficiently distressed to satisfy the standard established by the Third Circuit.").

379. *See infra* notes 381–83 and accompanying text.

380. *See generally In re* Bestwall LLC, 605 B.R. 43 (Bankr. W.D.N.C. 2019); *In re* LTL Mgmt., LLC, 58 F.4th 738, 758–59 (3d Cir.), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023).

However, the *In re Johns-Manville* court found that forming "a sham [company] solely for the purpose of filing" would constitute an improper attempt to extend the bankruptcy court's jurisdiction and would be evidence of bad faith.[381] Factors tending to indicate that a debtor is a sham company are similar to those that indicate the creation of a "new debtor," including lack of past business conduct, lack of current business, and the presence of little to no employees.[382] In these cases, because there is no business reason for the debtor to exist, courts infer that the debtor was created to access the bankruptcy system and gain a litigation advantage.[383]

Additionally, unequal treatment of creditors may provide sufficient grounds for concluding that a filing lacks a reorganizational purpose.[384] Importantly, unequal treatment of classes of creditors in a proposed plan allowed the *SGL Carbon* court to infer that a bankruptcy filing was made in bad faith.[385]

Courts considering whether Texas Two-Step cases were filed in good faith have so far ignored the disparate treatment among creditors of the predecessor company as evidence of bad faith.[386] But such concerns are real when the creditors assigned to the debtor entity are trapped for an indefinite term in bankruptcy to be paid with less than all the assets of the company, while creditors that stayed with the predecessor entity are paid in the ordinary course of business, escaping the uncertainty and cost of bankruptcy altogether.[387] This unequal treatment on its own may be evidence of bad faith in the same way that unequal treatment of classes of creditors in a proposed plan indicated that SGL Carbon's filing was made in bad faith.[388] However, at the very least, a court should consider critically whether there exists a valid business purpose for the transaction that can properly justify such unequal treatment.

No court has assessed the business purpose for the Texas Two-Step transaction using "new debtor" factors.[389] Rather, the *In re LTL Management* court held that a desire to discharge asbestos claims alone established a

381. *See In re Johns-Manville Corp.*, 36 B.R. at 737.

382. Little Creek Dev. Co. v. Commonwealth Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1073–74 (5th Cir. 1986).

383. Meadowbrooks Investors' Grp. v. Thirtieth Place, Inc. (*In re* Thirtieth Place, Inc.), 30 B.R. 503, 506–07 (B.A.P. 9th Cir. 1983).

384. *In re* SGL Carbon Corp., 200 F.3d 154, 167 (3d Cir. 1999).

385. *Id.*

386. *See generally In re* Bestwall LLC, 605 B.R. 43, 50 (Bankr. W.D.N.C. 2019); *In re* LTL Mgmt., LLC, 637 B.R. 396, 399–400 (Bankr. D.N.J. 2022), *rev'd and remanded*, 58 F.4th 738 (3d Cir. 2023), *amended by* Nos. 22-2003, 22-2004, 22-2005, 22-2006, 22-0007, 22-2008, 22-2009, 22-2010 & 22-2011, 2023 WL 2760479 (3d Cir. Mar. 31, 2023) (finding delay to creditors did not evidence bad faith).

387. Oral Argument at 35:35, *In re* LTL Mgmt., LLC, 58 F.4th 738 (3d Cir. 2023) (No. 22-2003), https://www2.ca3.uscourts.gov/oralargument/audio/22-2003etal.v.InReLTLManagementLLC.mp3 [https://perma.cc/4LLA-CT29]. Eve-of-bankruptcy transactions raise the specter of unequal treatment of creditors. *See generally id.* at 14:24.

388. *In re SGL Carbon*, 200 F.3d at 167.

389. *See generally In re Bestwall*, 605 B.R. 43; *In re LTL Mgmt.*, 58 F.4th at 758–59.

business purpose for the Texas Two-Step.[390] However, the reorganizational purpose of the debtor must be antecedent to its ability to access any particular provision of the code.[391] And just as a desire to access § 502(b)(6) could not render the filing in *In re Integrated Telecom* proper in the absence of a legitimate reorganizational purpose, the desire of solvent companies like Georgia Pacific and Johnson & Johnson to discharge costly tort liabilities should not, standing alone, establish the bankruptcy court's jurisdiction.[392]

Instead, courts should look to past business conduct and future business plans, if any, of the Texas Two-Step debtor. Because these debtors are created hours before bankruptcy and are left borderline insolvent, without any plans for the infusion of capital and little in the way of operational assets or employees,[393] courts should find that there is no valid business purpose for these types of transactions. In the absence of compelling business reasons unrelated to managing the exposure of its business and assets to bankruptcy or distancing one group of creditors from those assets, the court should either dismiss the case of the Two-Step debtor or allow it to remain in bankruptcy only if the remainder of the predecessor's business is also filed.

CONCLUSION

Texas Two-Step filings may properly be dismissed as bad faith filings under § 1112(b). These filings allow a healthy company subject to mass tort claims to discharge these liabilities in the bankruptcy system without exposing most of their valuable assets to the jurisdiction of the bankruptcy court.

Because Texas Two-Step debtors are strategically created to satisfy the letter but not the spirit of the good faith filing test, the traditional good faith analysis must be broadened to allow a critical assessment of these filings—and potentially their dismissal. Therefore, this Note argues that, in addition to evaluating the good faith of the debtor, bankruptcy courts must also specifically evaluate the predecessor company's condition and conduct as part of the good faith inquiry. It argues that courts should evaluate the predecessor entity's financial distress and the business purpose of the Texas Two-Step. Although dismissal at the outset of the case is extreme, the narrow inquiry applied to Texas Two-Step cases thus far is insufficient to protect jurisdictional abuses of the system. Courts should therefore not only examine the totality of the circumstances surrounding the debtor's condition on the petition date, but also the broader pre- and post-petition circumstances of the debtor's predecessor.

390. *In re LTL Mgmt.*, 637 B.R. at 407–08.
391. *See* NMSBPCSLDHB v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 128 (3d Cir. 2004).
392. *See id.* at 127–28.
393. *See supra* Part II.A. (discussing commonalities between cases).