THIRD CIRCUIT DISMISSES MASS TORT CHAPTER 11 FILED BY J&J SUBSIDIARY

In recent years, it has become almost commonplace for companies facing mass tort liability in the US to turn to US bankruptcy courts to provide a central forum to address present and future liabilities. Purdue Pharma, Boy Scouts of America, Imerys Talc, Aearo Technologies (a 3M subsidiary) and others have sought such protection because, among other reasons, the US Bankruptcy Code offers powerful tools that can be used to stay litigation, negotiate global settlements, bind holdouts and future claimants and estimate current and future liabilities. In contrast to what some consider an overburdened and unfair tort system, US bankruptcy courts may be able to efficiently and equitably resolve matters that otherwise could languish for years and result in vast inequities amongst claimants, although some critics have argued that Chapter 11 should not be used as a means to displace tort claimants' "day in court."

In the midst of this debate, on January 30, the Third Circuit Court of Appeals in Philadelphia issued a much-awaited opinion holding that a debtor must be experiencing "financial distress" in order to invoke the protections of the US Bankruptcy Code and ordered the dismissal of the Chapter 11 case filed by a division of Johnson & Johnson ("J&J") that was spun off in 2021 to deal with the company's talc-related tort liabilities. While the decision is at odds with the holdings of certain other circuit courts of appeals as to the Bankruptcy Code's dismissal standard, it does suggest that at least some debtors seeking to use bankruptcy to address mass tort liabilities may consider filing outside of the Third Circuit despite the fact that the Third Circuit – which includes the "magnet" District of Delaware bankruptcy court – is often considered a favored venue by Chapter 11 debtors.

As recounted by the Third Circuit, prior to the bankruptcy filing, Johnson & Johnson Consumer Inc. ("Old JJCI") was facing at least 38,000 lawsuits over claims that talc in the company's products caused ovarian cancer, with thousands more suits expected to be filed and one court in Missouri having awarded $2.24 billion in damages to ovarian cancer plaintiffs. In order to preserve the significant value of Old JJCI – estimated at $61.5 billion excluding future talc liabilities – the company undertook a series of transactions known colloquially as a "Texas two-step" to segregate the profitable portions of the enterprise from its substantial talc liabilities. In substance, Old JJCI effectuated a "divisional merger" under Texas law, splitting itself into two new entities: LTL Management, LLC ("LTL"), which assumed all of Old JJCI's talc liabilities, and "New JJCI," which retained all of Old

JJCI's profitable businesses excluding those liabilities. J&J and New JJCI then agreed to fund LTL's talc liabilities in cash up to the value of New JJCI (i.e., $61.5 billion), and LTL (but not J&J or New JJCI) promptly filed for Chapter 11.

On appeal of the bankruptcy court's order denying a motion to dismiss LTL's Chapter 11 case, the Third Circuit reversed, holding that as LTL was not in "financial distress," LTL lacked the requisite good faith to commence a Chapter 11 case. The court noted, among other things, that J&J – which was supporting LTL's talc liabilities through the funding agreement – had an "exceptionally strong" balance sheet, including "well over" $400 billion in equity value, a AAA credit rating and $31 billion in cash and marketable securities, and that it had distributed over $13 billion to shareholders in each of 2020 and 2021. On the other hand, J&J valued the probable and reasonably estimable contingent loss for talc and other products liability litigation at just $2.4 billion. Pre-bankruptcy, Old JJCI also had success either settling or obtaining dismissal of products liability claims and, aside from the single award from a Missouri court, no ovarian cancer plaintiffs had won an award at trial that withstood appeal. Given those facts and the funding backstop by the "highly creditworthy" J&J and New JJCI, the court was "confident[]" that LTL was not in financial distress at the time of the bankruptcy filing. Accordingly, the court held that LTL could not show that the filing "served a valid bankruptcy purpose and was filed in good faith" and therefore directed that the bankruptcy case be dismissed.

Although the court focused on the particular facts of LTL's financial condition and declined to hold that a transaction like Old JJCI's Texas two-step could establish bad faith per se, the decision could have far-reaching implications in mass-tort and other bankruptcies where a well-capitalized debtor's motivation for pursuing bankruptcy relief may revolve around contingent future liabilities rather than more near term liabilities or other obvious signs of imminent financial distress. The opinion leaves open the door for creditors of companies seeking proactively to address future liabilities through a Chapter 11 in the Third Circuit to argue that the company's financial distress is not "apparent . . . [and] immediate enough to justify a filing." It remains to be seen whether the opinion will also incentivize creditors of other types of debtors to seek dismissal of their Chapter 11 cases based upon lack of financial distress.

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