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The Texas Two-Step: How Corporate Debtors Manipulate Chapter 11 Reorganizations to Dance Around Mass Tort Liability

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THE TEXAS TWO-STEP: HOW CORPORATE DEBTORS MANIPULATE CHAPTER 11 REORGANIZATIONS TO DANCE AROUND MASS TORT LIABILITY

ABSTRACT

The purpose of the bankruptcy system is to grant a “fresh start” to the honest but unfortunate debtor, while the purpose of the tort system is to make injured parties “whole” again. As a result, these systems inevitably clash when a business debtor files for bankruptcy while there are pending tort claims against it. The tension between these systems has reached a whole new level following the emergence of a new strategy deemed the “Texas Two-Step.”

A Texas statute leaves open a loophole for otherwise solvent companies to dodge mass tort liabilities and protect their assets, leaving injured plaintiffs with little hope of adequate recovery. The acceptance of such a maneuver into widespread bankruptcy practice will allow culpable companies to escape accountability and, more devastatingly, call into question the integrity of the bankruptcy and tort systems. Johnson & Johnson, a multinational conglomerate known for producing some of the most famous household products, is one of many companies using the Two-Step strategy to resolve injury claims related to its talc-based baby powder. Though many questions remain about the Two-Step’s durability, the Third Circuit issued an opinion in the J&J case which could prove detrimental for the Two-Step’s survival.

*Because the Two-Step is a product of state law that engages with federal bankruptcy law, the solution requires striking a delicate balance between honoring state sovereignty while still effectively preventing putative debtors from seeking chapter 11 protection for reasons beyond the Code’s intent. This Comment proposes a combination of judicial and legislative reforms that would prevent the Texas Two-Step from becoming the “norm” for companies facing mass tort liability. More specifically, this Comment advocates for reform of state and federal laws that currently allow the Texas Two-Step to proceed, in addition to encouraging courts to follow the Third Circuit’s approach from *In re LTL Management* regarding bad faith.*

TABLE OF CONTENTS

INTRODUCTION	587
I. CHAPTER 11 REORGANIZATIONS	590
A. <i>Chapter 11 Reorganization & Creditors' Committees</i>	590
B. <i>Treatment of Tort Claims after Chapter 11 Reorganization</i>	592
C. <i>The "Good-Faith" Filing Requirement</i>	595
II. WHAT'S THE DEAL WITH TEXAS?	596
A. <i>"Divisive Mergers" under Texas Law</i>	596
B. <i>Creditors' Rights</i>	598
III. THE TEXAS TWO-STEP IN PRACTICE	601
A. <i>The Rise of Asbestos Lawsuits</i>	601
B. <i>Georgia-Pacific and CertainTeed Bankruptcies</i>	604
C. <i>The Johnson & Johnson Dilemma</i>	606
D. <i>Dangers of the Dance</i>	611
IV. CUT THE MUSIC: AVENUES FOR JUDICIAL & LEGISLATIVE REFORM	613
A. <i>Judicial Attack: Closing the Statutory Loophole</i>	613
B. <i>Judicial Attack: Adopting the Third Circuit's "Bad Faith"</i> <i>Analysis</i>	615
C. <i>Legislative Reform: Strengthening Tort Creditors'</i> <i>Clawback Powers</i>	616
D. <i>Legislative Reform: Banning Forum Shopping in Texas</i> <i>Two-Step Cases</i>	621
CONCLUSION	625

INTRODUCTION

The principal purpose of the bankruptcy system is to grant a “fresh start” to the “honest but unfortunate debtor.”¹ A business debtor may achieve a fresh start by filing for a chapter 11 reorganization under the Bankruptcy Code (the “Code”). Under chapter 11, an insolvent business may reorganize its debts according to a plan of reorganization while still carrying out normal business functions. Because the business continues to operate after filing under chapter 11, the debtor is able to maximize its recoverable assets to pay off creditors.² Chapter 11 reorganizations ultimately assist “the financially distressed business enterprise by providing it with breathing space in which to return to a viable state.”³ In other words, chapter 11 is specifically reserved for businesses facing genuine financial turmoil.⁴

Once a debtor files for bankruptcy, creditors—including tort creditors—are automatically barred from collecting on a prepetition debt or claim.⁵ The primary purpose of tort law is “to give compensation, indemnity, or restitution for harms” inflicted upon the plaintiff.⁶ Courts grant compensatory damages as an attempt to put the injured party in the same position as she would have been had the tort not been committed, thus making her “whole” again.⁷ The costs of litigation, in turn, deter manufacturers from producing, selling, and marketing defective or hazardous products.⁸ When a plaintiff files a tort claim against a business for harms caused by a defective or hazardous product, and that business later files for bankruptcy protection, the purposes of these two systems begin to clash.

The relationship between bankruptcy and tort law has faced greater tension in recent years, largely due to the discovery of a loophole in one of Texas’s business statutes. The Texas Legislature substantially amended the Texas

¹ *Grogan v. Garner*, 498 U.S. 279, 286–87 (1991) (quoting *Loc. Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)).

² *See Canadian Pac. Forest Prods. v. J.D. Irving, Ltd. (In re Gibson Grp., Inc.)*, 66 F.3d 1436, 1442 (6th Cir. 1995).

³ *C-TC 9th Ave. P’ship v. Norton Co. (In re C-TC 9th Ave. P’ship)*, 113 F.3d 1304, 1310 (2d Cir. 1997).

⁴ *See Grogan*, 498 U.S. at 287–88 (“But in the same breath that we have invoked this ‘fresh start’ policy, we have been careful to explain that the Act limits the opportunity for a completely unencumbered new beginning to the ‘honest but unfortunate debtor.’”).

⁵ *See* 11 U.S.C. § 362(a) (implementing the automatic stay).

⁶ Jill Wieber Lens, *Honest Confusion: The Purpose of Compensatory Damages in Tort and Fraudulent Misrepresentation*, 59 KAN. L. REV. 231, 235 (2011).

⁷ *E.g., Lovelace Med. Ctr. v. Mendez*, 805 P.2d 603, 616 (N.M. 1991).

⁸ Jill Wieber Lens, *Tort Law’s Deterrent Effect and Procedural Due Process*, 50 TULSA L. REV. 115, 116–18 (2014) (noting that by placing manufacturers in a position where they are always vulnerable to lawsuits and potentially having to pay damages, tort law “indirectly regulates conduct” and tightens quality control).

Business Corporation Act (“TBCA”) in 1989 to modernize its merger provisions and attract businesses to incorporate in the state.⁹ One amendment created the “divisive merger,” which effectively allows corporations to split the company in two through a plan of merger.¹⁰ An essential element of the merger plan, and its most compelling implication for bankruptcy relief, is how the corporation chooses to allocate its assets and liabilities among the two entities.¹¹ In anticipation of creditors’ concerns over this practice, the Texas Legislature noted that “[c]reditors’ rights would not be adversely affected by the proposed amendment, and creditors would continue to have protection afforded by the Uniform Fraudulent Transfer Act and other existing statutes that protect the rights of creditors.”¹² Unfortunately, the legislature failed to anticipate the emergence of the Texas Two-Step.¹³

The Texas Two-Step is a mechanism by which a company¹⁴ first splits into two entities, transferring all of its assets to Subsidiary A and all of its liabilities to Subsidiary B, and then plunges Subsidiary B into bankruptcy.¹⁵ This strategy, if employed successfully by a company facing mass liabilities, would substantially limit compensation for injured plaintiffs and bring an “indefinite halt” to all related trials being heard in state and federal courts.¹⁶ Major companies, including Georgia-Pacific and CertainTeed, previously adopted this strategy to deal with liabilities arising from mass asbestos exposure claims.¹⁷ However, “[t]he largest Two-Step” to date is currently being attempted by Johnson & Johnson Consumer Inc. (“J&J”), a wholly owned subsidiary of Johnson & Johnson.¹⁸ After plaintiffs in New Jersey and Missouri unsuccessfully tried to bar the company from undergoing a divisional merger,¹⁹

⁹ Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY’S L.J. 109, 110 (1989).

¹⁰ *Id.* at 110–11.

¹¹ *Id.* at 118.

¹² *Id.* at 122 (quoting H. COMM. BUS. & COM., BILL ANALYSIS, H.B. 472, 71st Reg. Sess., at 23 (Tex. 1989)).

¹³ See generally Michael A. Francus, *Texas Two-Stepping out of Bankruptcy*, 120 MICH. L. REV. 38, 39–41 (2022).

¹⁴ More precisely, a corporation, partnership, or LLC.

¹⁵ Beasley Allen Law Firm, *Battle Against Johnson & Johnson “Texas Two-Step” Ploy Moves to New Jersey*, PR NEWSWIRE (Sept. 2, 2021, 4:07 PM), <https://www.prnewswire.com/news-releases/battle-against-johnson-johnson-johnson-texas-two-step-ploy-moves-to-new-jersey-301368796.html>.

¹⁶ *Id.*

¹⁷ E.g., Adam Levitin, *The Texas Two-Step: The New Fad in Fraudulent Transfers*, CREDIT SLIPS (July 19, 2021, 10:50 AM), <https://www.creditslips.org/creditslips/2021/07/the-texas-two-step.html>.

¹⁸ Francus, *supra* note 13, at 42.

¹⁹ See, e.g., *N.J. Judge Denies J&J ‘Texas Two-Step’ Injunction Sought by Talc Claimants*, REORG (Sept. 20, 2021, 6:31 PM), <https://reorg.com/johnson-johnson-texas-two-step/>; Cara Salvatore, *J&J May Court*

J&J underwent the Texas Two-Step in 2021 as an attempt to shield itself “from almost 40,000 claims that its baby talcum powder caused cancers.”²⁰

The Texas Two-Step greatly threatens the integrity of both the bankruptcy and tort systems. Though the fresh start policy is supposed to be reserved for the honest but unfortunate debtor, companies that have undergone the Two-Step have attempted to manipulate the bankruptcy system to delay or deny justice for people harmed by their dangerous products.²¹ The Two-Step creates room for otherwise solvent business debtors to shield themselves from the consequences of their wrongful conduct in direct violation of the policy underlying the Code.²²

The Texas Two-Step also prevents an injured plaintiff from having their chance to be made “whole” again.²³ When a company moves its liabilities to a new entity with insufficient assets and keeps its remaining assets out of reach, injured plaintiffs cannot be adequately compensated.²⁴ Instead of having their day in court, an injured plaintiff merely becomes just another creditor tied up in bankruptcy proceedings.²⁵ And the parent company—the one actually liable for these injuries—is left untouched and unstigmatized by the bankruptcy proceedings.²⁶ Because of these potentially devastating consequences, the Texas Two-Step dilemma requires prompt resolution before it becomes the norm for companies facing mass tort and related liabilities.

Section I of this Comment describes the role of creditors’ committees in a chapter 11 reorganization before detailing how tort creditors in bankruptcy already face strong headwinds, even without the Two-Step. It concludes with a brief discussion of the implicit good faith filing requirement in chapter 11 cases. Section II explores the Texas statute more in depth and examines how it affects

Trouble with ‘Texas Two-Step’ Talc Gambit, LAW360 (Sept. 20, 2021, 10:26 PM), <https://www.law360.com/articles/1423468>.

²⁰ Jamie Smyth, *‘Texas Two-Step’: The US Legal Move Letting Corporations off the Hook*, FIN. TIMES (Oct. 25, 2022), <https://www.ft.com/content/82ee5808-716e-47ae-acfb-2aba4b3d1502>.

²¹ Will Maddox, *The Texas Two-Step and How Corporations May Use It to Avoid Bankruptcy*, D MAG. (Sept. 13, 2021, 3:00 PM), <https://www.dmagazine.com/healthcare-business/2021/09/the-texas-two-step-and-how-corporations-may-use-it-to-avoid-bankruptcy/>.

²² See *Henri v. Wheeler (In re Wheeler)*, 511 B.R. 240, 51 (Bankr. N.D.N.Y. 2014) (explaining that “bankruptcy was never intended to shield a debtor from the justifiable consequences of her own wrongful acts”).

²³ Maddox, *supra* note 21.

²⁴ As explained in Section II(B), tort creditors can only seek relief from the liability-ridden entity, even though most or all the assets are in the parent company. See Huff, *supra* note 9, at 122–23; Byron F. Egan, *Choice of Entity Decision Tree*, presented at 14TH ANN. COURSE ON CHOICE, GOVERNANCE & ACQUISITION OF ENTITIES, at 17 (May 20, 2016), available at <https://www.jw.com/wp-content/uploads/2016/05/2147.pdf>.

²⁵ Maddox, *supra* note 21.

²⁶ *Id.*

the rights of creditors. Section III evaluates the Texas Two-Step in practice by chronicling how Georgia-Pacific and CertainTeed's chapter 11 bankruptcy proceedings paved the way for J&J to replicate this strategy in 2022. This section also discusses the Third Circuit's January 2023 decision to dismiss LTL Management's bankruptcy petition²⁷ and what it means for J&J moving forward. It concludes with a brief discussion of the immediate problems that the Texas Two-Step poses for future consumers. Finally, Section IV proposes four solutions—based on judicial construction, bad faith, creditor clawback power, and venue shopping—to curb the Two-Step's momentum.

I. CHAPTER 11 REORGANIZATIONS

This section provides general background information on the peculiarities of chapter 11 bankruptcy, how tort litigants fit into chapter 11, and the good faith filing requirement.

A. Chapter 11 Reorganization & Creditors' Committees

A chapter 11 restructuring involves the reorganization of a debtor's business affairs, debts, and assets. Chapter 11 is unique in that the debtor remains in control of the business's normal operations as the debtor in possession ("DIP")²⁸ and is afforded nearly all of the rights, duties, and obligations of a traditional trustee.²⁹ The debtor may use these powers to modify its obligations to and the rights of creditors through the plan of reorganization.³⁰ The statutory goal under chapter 11 is to create a plan of reorganization that the debtor, creditors, and the court agree upon.³¹ The process, in a nutshell, is as follows: (1) formulation, (2) solicitation of creditors' votes, (3) confirmation, and (4) implementation.³²

²⁷ See generally *LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (In re LTL Mgmt., LLC)*, 64 F.4th 84 (3d Cir. 2023).

²⁸ ASA S. HERZOG & JOSEPH SAMET, § 7:1 *Overview of Chapter 11*, in HERZOG'S BANKRUPTCY FORMS AND PRACTICE (9th ed. 2022) [hereinafter HERZOG & SAMET, *Overview of Chapter 11*]; 11 U.S.C. § 1107(a).

²⁹ For example, a debtor in possession can obtain unsecured credit and incur unsecured debt in the ordinary course of business; assume, assign, or reject executory contracts and leases; and recover preferences, fraudulent transfers, or exercise the trustee's avoidance powers. 5 NORTON BANKRUPTCY LAW AND PRACTICE § 93:2 (3d ed. 2022).

³⁰ Corinne McCarthy, Comment, *Creditors' Committees: Giving Tort Claimants a Voice in Chapter 11 Bankruptcy Cases*, 31 EMORY BANKR. DEV. J. 431, 436 n.24 (2015).

³¹ See 11 U.S.C. §§ 1126, 1129.

³² See generally *Chapter 11 Bankruptcy Basics*, U.S. CTS., <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics> (last visited Feb. 8, 2023).

Additionally, section 1102 of the Code allows the United States trustee to appoint an unsecured creditors' committee,³³ generally consisting of the seven largest unsecured creditors.³⁴ This committee functions as a "watchdog on behalf of the larger body of creditors which it represents" by monitoring the debtor's operations, activities, and compliance with Code requirements.³⁵ Creditors' committees are expected to protect their constituents' interests and have a duty to act in the best interests of the creditors whom they represent; therefore, committees must exercise the statutory powers granted under section 1103 of the Code "if doing so is necessary to protect their constituents' interests."³⁶

The Code also grants the United States trustee the authority to appoint "additional committees of creditors or of equity security holders if necessary to assure adequate representation."³⁷ In theory, this provision might enable tort claimants to have a voice in the case. In practice, however, courts are generally reluctant to form creditors' committees exclusively made up of tort claimants.³⁸ When courts fail to do so, the interests of tort claimants are usually outweighed by the majority financial interests of commercial creditors:

In *In re Chrysler*, tort claimants were appointed to an official creditors' committee. However, other unsecured creditors made up most of the creditors' committee. These other unsecured creditors were interested in selling Chrysler's assets free and clear of tort claims to Chrysler's successor because their own claims would be satisfied through the sales transaction [The] tort claimants were unable to oppose the sale and received nothing because the sales price was insufficient to repay all of the creditors.³⁹

³³ 11 U.S.C. § 1102; PATRICK A. MURPHY ET AL., § 16:6 *Committees of Creditors*, in CREDITORS' RIGHTS IN BANKRUPTCY (2d ed. 2022).

³⁴ The United States trustee may also use discretion to balance the committee. See 11 U.S.C. § 1102(a)(1)–(2).

³⁵ 5 NORTON BANKRUPTCY LAW AND PRACTICE § 98:1 (3d ed. 2022). See also McCarthy, *supra* note 30, at 438–39 (noting that the statutory powers of the creditors' committee include the ability to employ professionals, such as attorneys or accountants, to represent or serve the committee, and to participate in the formulation of a reorganization plan).

³⁶ See McCarthy, *supra* note 30, at 431.

³⁷ 11 U.S.C. § 1102(a)(2).

³⁸ McCarthy, *supra* note 30, at 431.

³⁹ *Id.* at 455.

Creditors' committees have a duty to protect the interests of all unsecured creditors.⁴⁰ However, unsecured creditors' committees often do not adequately represent the voices of tort creditors.⁴¹ The reason for this phenomenon lies in the fact that different groups of creditors represented by the committee "have dissimilar goals, yet must bargain with the debtor as a single monolith."⁴² When tort creditors are underrepresented—or their interests are neglected—they are left injured, unprotected, and disenfranchised.⁴³

B. *Treatment of Tort Claims after Chapter 11 Reorganization*

Scholars generally agree that tort creditors are systematically undercompensated in bankruptcy proceedings.⁴⁴ There are four main reasons for this conclusion. First, under the Code, tort claimants are defined as "unsecured creditors," meaning that they do not have a lien on their claim and are entitled only to a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."⁴⁵ Secured creditors are treated with the highest priority in any bankruptcy case and must be paid in full before any unsecured creditors receive payment.⁴⁶ After all secured creditors have been paid in full, unsecured creditors, including tort claimants, share the remaining assets pro rata.⁴⁷ Because of this embedded hierarchy, "tort creditors'

⁴⁰ U.S. TRUSTEE PROGRAM, *Official Committee of Unsecured Creditors Info Sheet*, DEP'T OF JUST., https://www.justice.gov/ust-regions-r11/file/ch11_mtl_ofcl_cmte_info_sheet_chicago.pdf/download (last visited Apr. 29, 2023); see also McCarthy, *supra* note 30, at 431, 438.

⁴¹ Ella Epstein, *The Need for Dignitary Justice for Tort Creditors in Chapter 11 Bankruptcy*, 2 COLUM. BUS. L. REV. 943, 971–72 (2022).

⁴² *Id.* at 972.

⁴³ See McCarthy, *supra* note 30, at 455–56.

⁴⁴ See, e.g., Vincent S.J. Buccola & Joshua C. Macey, *Claim Durability and Bankruptcy's Tort Problem*, 38 YALE J. ON REGUL. 766, 773 (2021) ("The bankruptcy process systematically undercompensates tort creditors."); Note, *Switching Priorities: Elevating the Status of Tort Claims in Bankruptcy in Pursuit of Optimal Deterrence*, 116 HARV. L. REV. 2541, 2541–42 (2003) ("In recent years, many firms have resorted to bankruptcy liquidation or reorganization in the face of massive tort litigation, often resulting in tort claimants' recovering less than they would have under the normal operation of the tort system.").

⁴⁵ 11 U.S.C. § 101(5)(A); see also Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1049 (1984).

⁴⁶ Secured creditors, unlike unsecured creditors, also have a lien on the debtor's property, which cannot readily be discharged through bankruptcy. See 11 U.S.C. § 506; 1129(b)(2)(A); see also Cara O'Neill, *Types of Creditor Claims in Bankruptcy*, NOLO, <https://www.nolo.com/legal-encyclopedia/types-creditor-claims-bankruptcy-secured-unsecured-priority.html> (last visited Apr. 29, 2023).

⁴⁷ Despite this theoretical pro rata rule, tort claimants are in a weak position to bargain because "almost by definition, they have nothing to offer a reorganizing enterprise." Buccola & Macey, *supra* note 44, at 774. For this reason, tort creditors recover even less than other unsecured creditors, such as vendors or employees, who have greater leverage. *Id.* at 774–75; see also Painter, *supra* note 45, at 1049.

compensation generally comes from whatever value remains after secured claims have been paid,” which is usually marginal or nonexistent.⁴⁸

Second, unlike commercial creditors, who voluntarily enter a contract with the business, a tort creditor does not consent to being injured by the debtor.⁴⁹ Commercial creditors are granted all of the rights, protections, and remedies afforded by contract law.⁵⁰ Tort creditors, on the other hand, do not agree to the harm that a debtor inflicts upon them and are not in any sort of contractual relationship with the debtor.⁵¹ A commercial creditor can anticipate a potential breach of contract and proactively obtain a security agreement, but a tort creditor does not know that she needs security until after she is injured.⁵² Further, a commercial creditor knows exactly whom she is entering into the agreement with and on what terms, whereas a tort creditor will not know who the tortfeasor is, or the extent of her injury, until after she is injured.⁵³ Tort creditors find themselves at a significant disadvantage as compared to commercial creditors because they are not afforded the same degree of knowledge and security in forming a legal claim.

Third, the concept of shareholder limited liability prevents tort creditors from recovering from the debtor’s shareholders.⁵⁴ Shareholders of a corporation enjoy the protection of limited liability, absent any contractual or judicial exception.⁵⁵ As a result of this protection, wealthy investors (i.e., shareholders) of a corporation are not liable to injured persons when they are harmed by an act of the corporation. Contract creditors are protected by their bargaining position as lenders⁵⁶ but tort creditors lack such protection and are often not compensated

⁴⁸ Buccola & Macey, *supra* note 44, at 774 (2021); *see also* Painter, *supra* note 45, at 1050.

⁴⁹ *See* Margaret I. Lyle, *Mass Tort Claims and the Corporate Tortfeasor: Bankruptcy Reorganization and Legislative Compensation Versus the Common-Law Tort System*, 61 TEX. L. REV. 1297, 1304–05 (1983).

⁵⁰ *See id.* at 1303–04.

⁵¹ *Id.* at 1304.

⁵² *Id.* at 1305.

⁵³ *See id.* at 1304–05.

⁵⁴ Buccola & Macey, *supra* note 44, at 774.

⁵⁵ Shareholders can be liable for the acts or debts of a corporation if, for instance they (a) made a personal guarantee or (b) pierced the corporate veil. Rush Nigut, *Exceptions to Limited Liability for Corporations and LLCs*, RUSH ON BUS. (Aug 26, 2006), <https://www.rushonbusiness.com/2006/08/articles/incorporation-and-llc-formation/exceptions-to-limited-liability-for-corporations-and-limited-liability-companies/>. The principle of piercing the corporate veil, which is the principal judicial exception, is notoriously unpredictable and only available with small close corporations—it has never been used in the context of a publicly traded corporation. *See* Kyle D. Wuepper, *Piercing the Corporate Veil*, 68 OR. L. REV. 347, 350 (1999).

⁵⁶ “Borrowers and lenders can contract around the limited liability rule” by, for instance, demanding personal guarantees from corporations. Frederick Tung, *Limited Liability and Creditors’ Rights: The Limits of Risk Shifting to Creditors*, 34 GA. L. REV. 547, 553 (2000).

after businesses become insolvent or go out of business. Since tort creditors must recover from the corporation itself and cannot go after individual shareholders,⁵⁷ the limited liability rule greatly reduces an injured party's potential to be "made whole" again.

Fourth, the automatic stay effectively freezes all claims against the debtor at the filing of the petition, including those that arise from tort lawsuits.⁵⁸ Under section 362 of the Code, all actions against the debtor, the debtor's property, or the property of the estate are stayed, and creditors may not enforce or collect on any prepetition debt.⁵⁹ The stay commences automatically upon filing of the suit; a creditor's knowledge of the case's filing or the stay's existence is irrelevant.⁶⁰ Once a company files for a chapter 11 bankruptcy, a tort claimant with a prepetition claim may not "proceed with service, discovery, litigation, trial, enforcement of judgments, and perfection of liens" without court permission and absent any of the Code's exceptions.⁶¹ Creditors may file a motion for relief from the automatic stay. However, because the Code is silent in this regard, judges have full discretion over whether to grant the motion.⁶²

Tort creditors are placed in a relatively poor position as compared to other creditors in any bankruptcy proceeding. Between their position as unsecured creditors and the concept of shareholder limited liability,⁶³ the potential for injured tort claimants to be made "whole" narrows significantly once a corporation files for a chapter 11 bankruptcy, even without the presence of a

⁵⁷ See Sorin Borlolan, *Conceptualizing Shareholder Limited Liability in Corporations*, 4 WAYNE ST. U. J. BUS. L. 1–5 (2021).

⁵⁸ See Lawrence D. Hirsch, *Tort Claims and Automatic Stay*, PARKER SCHWARTZ PLLC, <https://www.parkerschwartzlaw.com/wp-content/uploads/bsk-pdf-manager/2019/02/Tort-Claims-and-Automatic-Stay-1.pdf> (last visited Apr. 29, 2023).

⁵⁹ See 11 U.S.C. § 362(a); HERZOG & SAMET, *Overview of Chapter 11*, *supra* note 28.

⁶⁰ HERZOG & SAMET, *Overview of Chapter 11*, *supra* note 28.

⁶¹ See *How a Bankruptcy Filing Affects Personal Injury Claims*, L. OFFS. OF CHARLES CLAPP, <https://bankruptcylawyeratlantageorgia.com/resources/how-bankruptcy-filing-affects-personal-injury-claims/> (last visited Apr. 29, 2023); see also Norma Duenas, *The Domestic Relations Exceptions to the Automatic Stay*, S. CAL. L. ADVOCS., P.C. (Nov. 27, 2019), <https://www.socaladvocates.com/2994/domestic-relations-exceptions-to-automatic-stay/> (discussing a number of exceptions that are not covered by the automatic stay, including criminal proceedings against the debtor and most actions to enforce a domestic support obligation).

⁶² See *Sonnax Indus., Inc. v. Tri Component Prods. Corp. (In re Sonnax Indus., Inc.)*, 907 F.2d 1280, 1285–86 (2d Cir. 1990) (affirming denial of contract creditors' motion to lift automatic stay based on bankruptcy court's discretionary evaluation of four factors: (1) whether the state court proceeding is connected to or might interfere with the bankruptcy case; (2) whether the bankruptcy petition was filed in bad faith; (3) the balance of harms; and (4) the interests of judicial economy).

⁶³ Buccola & Macey, *supra* note 44, at 774.

fraudulent transfer. The Texas Two-Step maneuver further exploits this imbalance of power and leaves injured claimants wholly unprotected.

C. The “Good-Faith” Filing Requirement

A court may dismiss a bankruptcy petition “for cause” under Code section 1112(b).⁶⁴ Though a lack of good faith does not fall under one of the statutory examples of “cause,”⁶⁵ “all of the circuits recognize that bad faith is grounds for dismissal of a bankruptcy petition.”⁶⁶ The good faith filing requirement aligns with the purpose of bankruptcy because “only the ‘honest but unfortunate debtor’ is eligible to avail itself of the protections afforded” by the Code.⁶⁷ Though all courts have expressly acknowledged the good faith filing requirement, each circuit has developed its own different standard for evaluating good faith under section 1112(b).⁶⁸ The underlying goal in all of these standards, however, is to figure out whether the debtor is using bankruptcy protection for its intended purpose, and nearly all federal appellate courts follow a “totality of the circumstances” approach.⁶⁹

Two inquiries are especially important in determining good faith: “(1) whether the petition serves a valid bankruptcy purpose, and (2) whether the

⁶⁴ 11 U.S.C. § 1112(b).

⁶⁵ 11 U.S.C. § 1112(b)(4).

⁶⁶ Kathleen Mullins, *Bad Faith Constitutes Cause for Dismissal of a Bankruptcy Case*, AM. BANKR. INST. BLOG, https://www.abi.org/member-resources/blog/bad-faith-constitutes-cause-for-dismissal-of-a-bankruptcy-case#_edn15 (last visited Apr. 29, 2023). A non-exhaustive list of cases where courts have recognized the good faith doctrine include *Marsch v. Marsch* (*In re Marsch*), 36 F.3d 825, 828 (9th Cir. 1994); *In re Jer Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 297 (Bankr. D. Del. 2011); *In re Liberate Techs.*, 314 B.R. 206, 211 (N.D. Cal. 2004); *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc.* (*In re Integrated Telecom Express, Inc.*), 384 F.3d 108, 118 (3d Cir. 2004).

⁶⁷ *Jer Jameson Mezz Borrower II*, 461 B.R. at 297 (quoting *Grogan v. Garner*, 498 U.S. 279, 287 (1991)).

⁶⁸ Mullins, *supra* note 66.

⁶⁹ 15375 Mem’l Corp. v. BEPCO, Inc (*In re 15375 Mem’l Corp.*), 589 F.3d 605, 618 n.7 (3d Cir. 2009); *see also, e.g., Marsch*, 36 F.3d at 828 (test is “whether a debtor is attempting to unreasonably deter and harass creditors or attempting to effect a speedy, efficient reorganization on a feasible basis”); *Off. Comm. of Unsecured Creditors v. Nucor Corp.* (*In re SGL Carbon Corp.*), 200 F.3d 154, 163 (3d Cir. 1999) (test is whether the petition has a “valid reorganizational purpose”); *Laguna Assocs. Ltd. P’ship v. Aetna Cas. & Sur. Co.* (*In re Laguna Assocs. Ltd. P’ship*), 30 F.3d 734, 738 (6th Cir. 1994) (The following factors are significant: “(1) the debtor has one asset; (2) the pre-petition conduct of the debtor has been improper; (3) there are only a few unsecured creditors; (4) the debtor’s property has been posted for foreclosure, and the debtor has been unsuccessful in defending against foreclosure in state court; (5) the debtor and one creditor have proceeded to a standstill in state court litigation, and the debtor has lost or has been required to post a bond which it cannot afford; (6) the filing of the petition effectively allows the debtor to evade court orders; (7) the debtor has no ongoing business or employees; and (8) the lack of possibility of reorganization.”).

petition is filed merely to obtain a tactical litigation advantage.”⁷⁰ The Fourth Circuit and the Eleventh Circuit represent opposite ends of the spectrum regarding bad faith dismissals.⁷¹ For a bankruptcy petition to be dismissed in the Fourth Circuit, there must be proof of (1) subjective bad faith and (2) objective futility.⁷² The Eleventh Circuit, on the other hand, does not even inquire into the objective futility of the debtor’s case.⁷³ This split in authority has generated criticism of the good faith doctrine for its lack of “reasonable certainty” in application.⁷⁴ The good faith filing requirement may nonetheless play a particularly important role in curbing the Texas Two-Step, as further discussed in Section IV.

II. WHAT’S THE DEAL WITH TEXAS?

The Texas Two-Step is made possible due to the specific language that Texas legislators used in crafting the state’s business code.⁷⁵ This section first explores the language and effect of a divisive merger under Texas law, and then discusses how these provisions fit in with the state statutes governing fraudulent transfers.

A. “Divisive Mergers” under Texas Law

The Texas Legislature reformed the merger provisions of the Texas Business Corporation Act in 1989 primarily to simplify the complex processes that businesses previously had to undergo to divide their assets and liabilities.⁷⁶ The Texas Business Organizations Code (“TBOC”) now authorizes a corporation, partnership, or LLC to undergo a “divisive merger.”⁷⁷ Contrary to the common

⁷⁰ *In re Nat’l Rifle Ass’n of Am.*, 628 B.R. 262, 280 (N.D. Tex. 2021) (citing *15375 Mem’l Corp.*, 589 F.3d at 618).

⁷¹ Mullins, *supra* note 66.

⁷² “Objective futility” in this context refers to the debtor’s objective possibility of reorganizing. See *Carolin Corp. v. Miller*, 886 F.2d 693, 708 (4th Cir. 1989).

⁷³ See *In re Phx. Piccadilly, Ltd.*, 849 F.2d 1393 (11th Cir. 1988).

⁷⁴ Robert J. Kreach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, AM. BANKR. INST. J., Dec/Jan 2004-05, at 37.

⁷⁵ TEX. BUS. ORGS. CODE § 1.002(55)(A); Jamie Smyth, “Texas Two-Step”: The US Legal Move Letting Corporations off the Hook, FIN. TIMES (Oct. 25, 2022), <https://www.ft.com/content/82ee5808-716e-47ae-acfb-2aba4b3d1502>.

⁷⁶ Huff, *supra* note 9, at 115–16. In 2010, the Texas Business Organizations Code consolidated all of Texas’s former business statutes, including the Texas Business Corporation Act, and placed them into a single code. See *Business Organizations Code FAQs*, TEX. SEC’Y STATE, <https://www.sos.state.tx.us/corp/bocfaqs.shtml#boc1> (last visited Apr. 29, 2023).

⁷⁷ TEX. BUS. ORGS. CODE § 1.002(55)(A); Egan, *supra* note 24, at 16.

law meaning of “merger,”⁷⁸ this statute allows the corporation to split itself in two and divide its assets and liabilities between the new entity and the original entity.⁷⁹ The statute specifies, however, that a transfer does not occur when a merger takes effect. When a divisive merger occurs:

- (1) The separate existence of each domestic entity that is a party to the merger, other than a surviving or new domestic entity, ceases;
- (2) All rights, titles, and interests to all real estate and other property owned by each organization that is a party to the merger is allocated to and vested, subject to any existing liens or other encumbrances on the property, in one or more of the surviving or new organizations as provided in the plan of merger *without*:
 - a. Reversion or impairment;
 - b. Any further act or deed; or
 - c. *Any transfer or assignment having occurred.*⁸⁰

The approval and documentation process for a divisive merger parallels the process for a traditional merger: the company negotiates how the assets, liabilities, and equity interests will be divided; obtains approval from management and owners; formulates a plan of merger; and files a divisional merger certificate with the Texas Secretary of State.⁸¹ Rather than having to make these transactions through asset conveyances or shareholder distributions, corporations and their shareholders can now complete these transactions directly through statutory mergers, effectively providing the most efficient, flexible, and desirable means for restructuring.⁸² The new merger provisions allow what would traditionally take multiple steps to be achieved in just one.⁸³

⁷⁸ The common law conception of a merger is defined as the “blending of one corporation into another, whereby the latter swallows up the properties and franchises of the first.” Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 36 GA. L. REV. 1523, 1529 (2000).

⁷⁹ Egan, *supra* note 24, at 16. For instance, in its opinion, the Third Circuit refers to pre-merger J&J as “Old Consumer” and post-merger J&J as “New Consumer,” though the two are technically the same entity, “Johnson & Johnson Consumer Inc.” See *LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (In re LTL Mgmt., LLC)*, 64 F.4th 84, 92–93 (3d Cir. 2023). This Comment similarly adopts that convention, and refers to “Old J&J” and “New J&J” throughout.

⁸⁰ TEX. BUS. ORGS. CODE § 10.008(a)(1)–(2) (emphasis added).

⁸¹ Joseph R. Struble, *Strategic Use of the Divisive Merger in Texas*, MONDAQ (Jan. 18, 2018), <https://www.mondaq.com/unitedstates/maprivate-equity/561212/strategic-use-of-the-divisive-merger-in-texas>.

⁸² Huff, *supra* note 9, at 116.

⁸³ *Id.* (“The TBCA amendments also eliminate the need for creating artificial structures and unnecessary steps in order to accomplish transactions within historical forms designed for a significantly different business and economic environment.”).

There are at least two legitimate reasons why a company might choose to carry out a divisive merger. First, a divisive merger can be a useful tool where a company wants to “transfer a business line, contracts, real estate[,] or certain assets into a new company to isolate risk or as a restructuring step in the sale of all or a portion of the business.”⁸⁴ Second, unless the parties agree that the merger specifically violates an anti-assignment provision, a company can use a divisive merger when it wants to transfer a contract that would otherwise be unassignable.⁸⁵ However, “if a company engages in a divisive merger as a means to avoid creditors or allocates liabilities in such a way that triggers insolvency, then the divisive merger’s segregation of assets and liabilities could be characterized as a fraudulent transfer and voided.”⁸⁶ This is precisely the line that companies come dangerously close to crossing when employing the Texas Two-Step.

B. Creditors’ Rights

The most important part of the merger plan for the purposes of the Texas Two-Step is “its allocation of assets and liabilities among the surviving or new corporations and other entities in the merger.”⁸⁷ Creditors’ rights are materially and adversely affected by TBOC section 10.008(a), despite the Texas legislature’s intent to protect creditors’ rights.⁸⁸ Once a company splits off some of its assets through a divisive merger, creditors are only allowed to go after the assets of the entity that has filed for bankruptcy.⁸⁹ Therefore, creditors will only have access to whatever assets the non-bankrupt entity chooses to funnel into the bankrupt entity.⁹⁰ This can drastically change or reduce the pool of assets that a creditor may seek for repayment.⁹¹

⁸⁴ Struble, *supra* note 81.

⁸⁵ TXO Prod. Co. v. M.D. Mark, Inc., 999 S.W.2d 137, 143 (Tex. Ct. App. 1999).

⁸⁶ Struble, *supra* note 81; *see also* Hahn v. Love, 321 S.W.3d 517, 525–26 (Tex. Ct. App. 2009) (“The actual intent to defraud is shown, among other things, by evidence that the transfer was made to an insider, including a relative; the transfer was concealed; the debtor was sued or threatened with suit before the transfer and the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred; the debtor was insolvent; and the transfer occurred shortly before or after a substantial debt was incurred.”).

⁸⁷ Huff, *supra* note 9, at 118; TEX. BUS. ORGS. CODE §10.002(a)(5).

⁸⁸ Huff, *supra* note 9, at 122 (quoting H. COMM. BUS. & COM., BILL ANALYSIS, H.B. 472, 71st Reg. Sess., at 23 (Tex. 1989)).

⁸⁹ *J&J Tries the ‘Texas Two-Step,’* NAT’L PUB. RADIO, at 6:36 (Jan. 5, 2022), <https://www.npr.org/2022/01/05/1070765481/j-j-tries-the-texas-two-step>.

⁹⁰ *Id.*

⁹¹ Huff, *supra* note 9, at 122; Egan, *supra* note 24, at 17.

Consider the following example: Corporation A undergoes a divisive merger and splits into Corporation A and Corporation B. All the assets are legally allocated into Corporation A and all the liabilities, including the creditor's claim, are legally allocated into Corporation B. Now, because the creditor's claim is allocated into Corporation B, the creditor can only recover from Corporation B even though Corporation A survives with all of the assets.⁹² The justification for this phenomenon is that creditors still possess all the rights available to them under law and contract,⁹³ including those provided under the Uniform Voidable Transactions Act ("UVTA")⁹⁴ and the Code.⁹⁵

If a company engages in a divisive merger to avoid paying out creditors, or allocates liabilities in a way that triggers insolvency, then the divisive merger's separation of assets and liabilities could be characterized as a fraudulent transfer and voided under the UVTA or the Code.⁹⁶ A transfer will be considered fraudulent under these laws generally in three ways⁹⁷: (1) "if the debtor transfers assets or incurs an obligation with the intent to 'hinder, delay, or defraud' creditors[;]"⁹⁸ (2) "if the debtor transfers assets or incurs an obligation without receiving 'reasonably equivalent value' and the debtor was (a) engaged or about to engage in a transaction for which its remaining assets were unreasonably small in relationship to the business conducted or (b) intended to incur or

⁹² See Huff, *supra* note 9, at 122–23; Egan, *supra* note 24, at 17.

⁹³ Huff, *supra* note 9, at 124.

⁹⁴ The Uniform Law Commission promulgated the UFTA in 1984 to prevent debtors from transferring assets while claims are pending against them, thus putting them out of creditors' reach. Forty-five states have enacted the UFTA as of 2015. The Uniform Law Commission amended the UFTA in 2015 and renamed it the UVTA to clarify the purpose of the Act. The UVTA amendments, among other changes, added choice-of-law rules for claims governed by the Act, uniform rules allocating the burden of proof for claims under the Act, and refined a few narrow provisions. The transition from the UFTA to UVTA did not change any material provisions as they relate to the purpose of this paper. As of the writing of this comment, twenty-two states have enacted the UVTA, three have introduced the UVTA, and twenty-five still follow the original UFTA version. See *Voidable Transactions Act*, UNIF. L. COMM'N, <https://www.uniformlaws.org/committees/community-home?CommunityKey=64ee1ccc-a3ae-4a5e-a18f-a5ba8206bf49> (last visited Apr. 29, 2023).

⁹⁵ If the petition is filed in Maryland, then the Uniform Fraudulent Conveyance Act governs. Maryland is the only state where the UFCA remains in force. See UNIF. FRAUDULENT CONVEYANCE ACT § 1 (UNIF. L. COMM'N 1918); MD. CODE, COM. LAW § 15–201.

⁹⁶ Huff, *supra* note 9, at 126–28.

⁹⁷ As of the writing of this comment, the Texas Business and Commerce Code, which governs all commercial transactions within the state, still follows the language of the former UFTA as it pertains to fraudulent transfers and has not yet enacted the updated UVTA. See TEX. BUS. COMM. CODE §24.005(a); *Voidable Transactions Act*, UNIFORM LAW COMMISSION, <https://www.uniformlaws.org/committees/community-home?CommunityKey=64ee1ccc-a3ae-4a5e-a18f-a5ba8206bf49> (last visited Apr. 29, 2023).

⁹⁸ Huff, *supra* note 9, at 126–27 (discussing UFTA).

believed it would incur debts beyond its ability to pay as they become due[;]”⁹⁹ and (3) “if the transfer of assets by the debtor or incurrence of the obligation by the debtor was made without ‘reasonably equivalent value’” and the debtor was insolvent.¹⁰⁰ When a fraudulent transfer occurs, a creditor may seek various remedies, such as avoidance of the transfer.¹⁰¹ At first glance, it seems that the Two-Step issue can simply be resolved through the judicial application of statutory tests; a tort claimant creditor can sue Corporation A for fraudulent transfer and, if successful, can avoid the transfer. However, the specific language of the Texas merger statute has created a loophole that appears to obviate this possibility.

The Code defines “transfer” as “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property.”¹⁰² The UVTA adopts a similar definition.¹⁰³ As previously noted, however, the TBOC explicitly states that a merger occurs “without . . . any transfer or assignment having occurred.”¹⁰⁴ In cases involving traditional mergers, Texas courts have generally adhered to the basic rule that a merger does not trigger an anti-transfer clause and that the language of a contract will be interpreted to reflect this rule.¹⁰⁵ The issue then becomes: If a divisive merger in Texas occurs without any transfer or assignment, are there any adequate remedies for a tort creditor to seek when a corporate debtor undergoes the Texas Two-Step?

⁹⁹ *Id.* at 127. The UFTA does not define “reasonable equivalent value” for a transfer or obligation. A transfer for security is ordinarily for a reasonably equivalent value notwithstanding a discrepancy between the value of the asset transferred and the debt secured. *See* UNIF. FRAUDULENT TRANSFER ACT § 3 cmt. 3 (UNIF. L. COMM’N 1984).

¹⁰⁰ Huff, *supra* note 9, at 127. “[A] corporation generally will be considered insolvent if the sum of its debts is greater than all of its assets . . .” *Id.* at 127 n.63 (citations omitted).

¹⁰¹ 11 U.S.C. § 548(a).

¹⁰² 11 U.S.C. § 101(54).

¹⁰³ California, which has enacted the updated UVTA, defines “transfer” as “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease, license, and creation of a lien or other encumbrance.” *See* CAL. CIV. CODE § 3439.01(m). Texas, which still follows the prior UFTA version, defines “transfer” in the exact same way, with the caveat that “transfer” does not include a transfer under a disclaimer filed under the Texas Property Code. *See* TEX. BUS. COMM. CODE §24.002(12).

¹⁰⁴ TEX. BUS. ORGS. CODE § 10.008(a)(2).

¹⁰⁵ *See* Philip M. Haines, *The Efficient Merger: When and Why Courts Interpret Business Transactions to Trigger Anti-Assignment and Anti-Transfer Provisions*, 61 BAYLOR L. REV. 683, 694 (2009); *see also* TXO Prod. Co. v. M.D. Mark, Inc., 999 S.W.2d 137, 143 (Tex. Ct. App. 1999).

III. THE TEXAS TWO-STEP IN PRACTICE

Attorney Greg Gordon¹⁰⁶ is credited with pioneering the Texas Two-Step strategy.¹⁰⁷ Gordon, who coined the term “Texas Two-Step,” considers it “the greatest innovation in the history of bankruptcy.”¹⁰⁸ Four companies have attempted the Texas Two-Step to date,¹⁰⁹ all of which have been represented by Gordon.¹¹⁰ As of February 2023, Gordon’s firm has collected more than \$107 million in Two-Step fees.¹¹¹

A. *The Rise of Asbestos Lawsuits*

Asbestos is a naturally occurring mineral fiber found in rock and soil, previously used in a variety of construction materials. Because asbestos-related diseases do not surface until years after exposure, the health risks of exposure did not receive widespread attention until the 1960s and 1970s.¹¹² Since then, though there is no general ban on the use of asbestos, policymakers have made many attempts to regulate its use in various industries.

Three of the major health effects associated with asbestos exposure are lung cancer, mesothelioma, and asbestosis, all of which damage a person’s pulmonary system. Asbestos exposure occurs when microscopic fibers become airborne, which happens when asbestos-containing products start to deteriorate

¹⁰⁶ Greg Gordon is a partner at Jones Day, one of the largest multinational law firms in the United States. He specializes in “complex, high-profile chapter 11 cases and corporate restructurings.” See *Gregory M. Gordon*, JONES DAY, <https://www.jonesday.com/en/lawyers/g/gregory-gordon?tab=overview> (last visited Apr. 29, 2023).

¹⁰⁷ Dan Levine & Mike Spector, *How a Bankruptcy ‘Innovation’ Halted Thousands of Lawsuits from Sick Plaintiffs*, REUTERS (Jan. 26, 2023), <https://www.reuters.com/investigates/special-report/bankruptcy-tactics-two-step/>.

¹⁰⁸ *Id.*

¹⁰⁹ These four companies are Georgia Pacific (Bestwall), CertainTeed (DBMP), Trane Technologies (Aldrich Pump and Murray Boiler), and Johnson & Johnson (LTL Management). See Jamie Smyth, *Koch Industries’ Texas Two-Step Bankruptcy Move Challenged*, FIN. TIMES (Feb. 18, 2023), <https://www.ft.com/content/b1d80321-5ccd-4ddc-908c-8efaa7fa84b0>; Daniel Gill, *Trane Technologies’ Bankrupt Spinoffs Ask to Curb Committee Power*, BLOOMBERG L. (Mar. 2, 2022, 3:43 PM), <https://news.bloomberglaw.com/bankruptcy-law/trane-technologies-bankrupt-spinoffs-ask-to-curb-committee-power>.

¹¹⁰ Kathryn Rubino, *Jones Day Took Home over \$300 Million Thanks to a Controversial Bankruptcy Tactic*, ABOVE THE L. (Feb. 14, 2023, 11:43 AM), <https://abovethelaw.com/2023/02/jones-day-100-million-controversial-bankruptcy-texas-two-step/>.

¹¹¹ *Id.*

¹¹² Joe Lahav, *National Asbestos Legislation*, MESOTHELIOMA CTR., <https://www.asbestos.com/mesothelioma-lawyer/legislation/> (last updated Mar. 23, 2023).

or are cut, sanded, drilled, or otherwise disturbed.¹¹³ People working in the construction industry, in the shipbuilding industry, in home and commercial renovation, and in factories faced a high risk of exposure before government regulations were enforced.¹¹⁴

Congress identified asbestos as a hazardous air pollutant under the Clean Air Act of 1970.¹¹⁵ The Clean Air Act also gave the Environmental Protection Agency (“EPA”) the authority to regulate the use and disposal of asbestos.¹¹⁶ A few years later, Congress passed the Toxic Substances Control Act of 1976 to give the EPA power to regulate both new and existing commercial materials that posed unreasonable health and environmental risks, including asbestos.¹¹⁷ The EPA attempted to use such authority in 1989 by banning most asbestos-containing products under the “Asbestos Ban and Phase-Out Rule,” but corporations lobbied against it and successfully challenged the rule in court.¹¹⁸ Some products, including, after 1989, those making new uses of asbestos, were banned, but most remained legal. In 2019, the EPA issued a “Significant New Use Rule,” which requires manufacturers to provide notice to the agency before certain discontinued asbestos products are used.¹¹⁹ To this day, however, there is no comprehensive federal ban on the use of asbestos in the United States,¹²⁰ and thousands of people continue to die each year from diseases related to asbestos exposure.¹²¹

The prolonged manifestation period of asbestos-related diseases has caused asbestos litigation to crowd American court dockets for nearly fifty years. Johns Manville (“Manville”) is an American corporation that manufactures insulating materials. Manville was the nation’s leading asbestos producer in the early 1980s, making it a target for the growing number of asbestos-related products

¹¹³ See Michelle Whitmer, *Asbestos Exposure*, MESOTHELIOMA CTR., <https://www.asbestos.com/exposure/> (last updated Mar. 13, 2023).

¹¹⁴ See *Asbestos Exposure and Cancer Risk*, NAT’L CANCER INST., <https://www.cancer.gov/about-cancer/causes-prevention/risk/substances/asbestos/asbestos-fact-sheet> (last visited Apr. 29, 2023).

¹¹⁵ See *Initial List of Hazardous Air Pollutants with Modifications*, EPA, <https://www.epa.gov/haps/initial-list-hazardous-air-pollutants-modifications> (last visited Apr 29, 2023).

¹¹⁶ Clean Air Act, Pub. L. No. 91–604, sec. 113, 84 Stat. 1676, 1686 (1970) (codified as amended at 42 U.S.C. § 7412).

¹¹⁷ Toxic Substances Control Act of 1976, Pub. L. No. 94–469, 90 Stat. 2003; Lahav, *supra* note 112.

¹¹⁸ Lahav, *supra* note 112.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ Rebecca Hersher, *Asbestos Deaths Remain a Public Health Concern, CDC Finds*, NAT’L PUB. RADIO (Apr. 11, 2017, 1:56 PM), <https://www.npr.org/sections/health-shots/2017/04/11/523277735/asbestos-deaths-remain-a-public-health-concern-cdc-finds>.

liability lawsuits.¹²² By the 1980s, “Manville had been named in approximately 12,500 such suits brought on behalf of over 16,000 claimants” and nearly 425 new suits were being filed each month.¹²³ It was projected that 50,000 to 100,000 more suits would be filed in the future and that the company would be potentially liable for an estimated two billion dollars.¹²⁴ Manville filed for a chapter 11 reorganization in 1982, marking one of the first times an otherwise solvent company sought relief from the bankruptcy system to deal with mass tort liabilities.¹²⁵

After four years of negotiation, Manville, the Asbestos Health Committee (representing personal injury claimants), the Equity Security Holders’ Committee, and other interested groups developed a plan of reorganization.¹²⁶ The plan included the Asbestos Health Trust, “a mechanism designed to satisfy the claims of all asbestos health victims, both present and future.”¹²⁷ The terms of the trust require that individual plaintiffs first try to settle their claims with trust representatives before pursuing mediation, arbitration, or litigation.¹²⁸ As a condition precedent to the plan’s confirmation, the parties agreed that the bankruptcy court would issue an injunction protecting Manville, its other operating entities, and its insurers from further asbestos-related lawsuits, and would channel all of the asbestos claims to the trust.¹²⁹ Within the first year of the trust’s operations, it spent nearly \$550 million settling over 12,600 claims and compensating 1,200 claimants.¹³⁰ As claims continued to rise,¹³¹ however, the trust realized that it was underfunded and had to lower its payout percentages accordingly.¹³²

¹²² A *History of Asbestos and the Manville Trust Fund*, WASH. POST (Nov. 20, 1990), <https://www.washingtonpost.com/archive/business/1990/11/20/a-history-of-asbestos-and-the-manville-trust-fund/fb60ed34-2a94-4570-9648-9e2efb8167f0/>.

¹²³ *Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 843 F.2d 636, 639 (2d Cir. 1988).

¹²⁴ *Id.*

¹²⁵ Note, *The Manville Bankruptcy: Treating Mass Tort Claims in Chapter 11 Proceedings*, 96 HARV. L. REV. 1121, 1121–22 (1983).

¹²⁶ *Johns-Manville Corp.*, 843 F.2d at 640.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ Tara Strand, *Johns-Manville*, MESOTHELIOMA.COM, <https://www.mesothelioma.com/asbestos-exposure/companies/johns-manville/> (last visited Apr. 29, 2023).

¹³¹ Within the first four years of the trust’s operation, there were more than 190,000 claims against the trust. *Id.*

¹³² The trust initially paid out 100% of claims in a first-in, first-out order. As of 2019, the payout percentage was lowered to 5.1%. See *Johns-Manville*, MESOTHELIOMAFUND.COM, <https://www.mesotheliomafund.com/asbestos-trusts/johns-manville/> (last visited Apr. 29, 2023); Strand, *supra* note 130.

Because the procedures for handling these claims through settlement and chapter 11 reorganization are mostly administrative rather than adversarial, the trust significantly reduced Manville's transactional costs as compared to what it would have spent to litigate.¹³³ Though the money is paid out more efficiently through the trust's procedures, these savings come at the expense of the injured claimants themselves. Funds available to the these trusts are limited, meaning that the compensation available for an individual claimant is much less than it could have been in litigation.¹³⁴ Furthermore, most trusts do not limit attorney's fees.¹³⁵ Unlike commercial creditors, tort creditors may not be familiar with the Code or how to protect themselves throughout proceedings, making them all the more reliant on professionals to protect and advocate for their interests.¹³⁶ Issues that arose in the Manville case demonstrate how the bankruptcy system and tort system have been struggling to strike a proper balance long before the emergence of the Texas Two-Step.

B. Georgia-Pacific and CertainTeed Bankruptcies

Like Manville, Georgia-Pacific and CertainTeed were major manufacturers of asbestos-containing products that gave rise to hundreds of thousands of asbestos-related claims. Facing mass tort liability, Georgia-Pacific underwent the Texas Two-Step in 2017.¹³⁷ Georgia-Pacific incorporated in Texas and then, pursuant to the divisive merger statute, broke itself into two entities: Georgia-Pacific and Bestwall, LLC.¹³⁸ Georgia-Pacific retained all of the original company's valuable assets and operations, while Bestwall absorbed the over 60,000 asbestos claims.¹³⁹ Bestwall then filed for a chapter 11 bankruptcy that

¹³³ Stephen J. Carroll et al., *Asbestos Litigation Costs and Compensation: An Interim Report*, RAND INST. FOR CIV. JUST. 62 (2002), available at https://www.rand.org/content/dam/rand/pubs/documented_briefings/2005/DB397.pdf.

¹³⁴ *Id.* See generally Robert J. Boumis, *Nearly a Century After First Asbestos Lawsuit, Litigation Continues*, TOP CLASS ACTIONS (Dec. 10, 2013), <https://topclassactions.com/lawsuit-settlements/lawsuit-news/10052-nearly-century-first-asbestos-lawsuit-litigation-continues/> (discussing James Cavett, a retired boilermaker, who won \$3.8 million in a civil suit against the asbestos industry in 1982, which marked a turning point in asbestos litigation).

¹³⁵ The Manville Trust is an exception: attorneys representing claimants may not charge a fee greater than 25%. Carroll et al., *supra* note 133.

¹³⁶ See McCarthy, *supra* note 30, at 445.

¹³⁷ Levine & Spector, *supra* note 107.

¹³⁸ Steven Church & Jeremy Hill, *Georgia-Pacific, Purdue Spats Give J&J Bankruptcy Options*, BLOOMBERG L. (Aug. 26, 2021, 11:46 AM), <https://news.bloomberglaw.com/product-liability-and-toxics-law/sackler-immunity-and-a-texas-two-step-tilt-bankruptcy-scales>.

¹³⁹ *Id.*

same year and has since pledged one billion dollars to fund an asbestos trust.¹⁴⁰ A couple years later, CertainTeed replicated this strategy and divided itself into two entities under the same Texas statute: CertainTeed, LLC and DBMP, LLC.¹⁴¹ CertainTeed retained all of the original company's employees, assets and operations, and non-asbestos creditors, while DBMP absorbed 100% of the asbestos liabilities with no employees, no operations, and few assets.¹⁴²

Bankruptcy courts have expressed concern that the Texas Two-Step may result in fraudulent transfers.¹⁴³ In *In re DBMP*, the Official Committee of Asbestos Personal Injury Claimants (“ACC”) in CertainTeed’s chapter 11 case moved to lift the automatic stay to allow the tort system to deal with the asbestos claims against DBMP.¹⁴⁴ Although the court ultimately denied the ACC’s stay relief motion, it found that CertainTeed’s restructuring “appears materially prejudicial to the rights of asbestos claimants” and is “subject to legal challenge.”¹⁴⁵ The court noted that because the ACC and related representatives did not pursue an action of fraudulent transfer against the bankruptcy estate, the issue was not for the court to decide at that point.¹⁴⁶ However, the court still pointed out that the rights of the asbestos claimants were materially affected by the divisive merger:

Before the Corporate Restructuring, Old CertainTeed’s asbestos creditors had the same ability and rights to access Old CertainTeed’s considerable assets as did its other unsecured (non-asbestos) creditors. As a result of the Corporate Restructuring, asbestos creditors were placed one step beyond those assets and made dependent on the DBMP’s willingness to press its rights . . . by DBMP acting through seconded SGC employees, not by the asbestos claimants Apart from the Funding Agreement, DBMP lacks the ability to pay asbestos claims.¹⁴⁷

¹⁴⁰ See Alex Wolf, *Georgia-Pacific Puts up \$1 Billion to Fund Asbestos Trust*, BLOOMBERG L. (Aug. 13, 2020, 6:39 PM), <https://news.bloomberglaw.com/bankruptcy-law/georgia-pacific-puts-up-1-billion-to-fund-asbestos-trust>.

¹⁴¹ *DBMP, LLC v. Those Parties Listed on Appendix A to Complaint (In re DBMP, LLC)*, No. 20-30080, 2021 WL 3552350, at *6 (Bankr. W.D.N.C. Aug. 10, 2021).

¹⁴² *Id.* at *6–7.

¹⁴³ See *Bestwall v. Those Parties Listed on Appendix A (In re Bestwall LLC)*, 606 B.R. 243, 252 (Bankr. W.D.N.C. 2019) (asserting that because Texas has adopted the UFTA and fraudulent transfer law is embedded in the Code, “[i]f a debtor used the Texas statute to commit a fraudulent transfer . . . such law would be available to address such acts.”).

¹⁴⁴ *DBMP, LLC*, 2021 WL 3552350, at *9.

¹⁴⁵ *Id.* at *22.

¹⁴⁶ *Id.* at *23.

¹⁴⁷ *Id.* at *26.

Although the ACC was ultimately unsuccessful, the court's evaluation of CertainTeed's actions lends credence to the fear that companies undergo the Texas Two-Step to defraud creditors.

C. *The Johnson & Johnson Dilemma*

Prior to 2020, J&J had sold Johnson's Baby Powder for almost 130 years.¹⁴⁸ The U.S. Food and Drug Administration ("FDA") discovered asbestos in several of J&J's talc-containing products in October 2019, including Johnson's Baby Powder.¹⁴⁹ In response to these studies, J&J "recalled a single lot of Johnson's Baby Powder" that same month.¹⁵⁰ However, by April 2020, J&J was already facing thousands of lawsuits alleging that exposure to the talc-based baby powder was causing diseases.¹⁵¹ The company announced in 2020 that it would stop selling its talc-based baby powder in the U.S. or Canada, but that the product would remain available on the global market until 2023.¹⁵²

Most of the plaintiffs in these cases are women suffering from mesothelioma or ovarian cancers.¹⁵³ Plaintiffs allege that J&J was aware that their talc products contained asbestos and failed to warn consumers of the risks, but J&J vehemently denies liability.¹⁵⁴ The company goes so far as to say that "talc-based Johnson's baby powder is safe, does not contain asbestos, and does not cause cancer."¹⁵⁵ J&J's decision to remove its talc baby powder from shelves in the United States was in response to a fall in demand from "misinformation" about the product's safety amid these lawsuits.¹⁵⁶

¹⁴⁸ Peter Hoskins, *Johnson & Johnson to Replace Talc-Based Powder with Cornstarch*, BBC NEWS (Aug. 12, 2022), <https://www.bbc.com/news/business-62514263>.

¹⁴⁹ See Shelby Simon, *Talcum Powder Lawsuit Update November 2022*, FORBES (Sept. 15, 2022, 7:05 AM), <https://www.forbes.com/advisor/legal/product-liability/talcum-powder-update/>.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*; Hoskins, *supra* note 148.

¹⁵³ Brian Mann, *J&J Tried to Block Lawsuits from 40,000 Cancer Patients*, NAT'L PUB. RADIO (Sept. 27, 2022, 2:51 PM), <https://www.npr.org/2022/09/19/1123567606/johnson-baby-powder-bankruptcy-lawsuits>.

¹⁵⁴ See Hoskins, *supra* note 148.

¹⁵⁵ *Id.* (quoting Media Statement, Johnson & Johnson, Johnson & Johnson Consumer Health to Transition Baby Powder Portfolio to Cornstarch (Aug. 11, 2022), available at <https://www.jnj.com/johnson-johnson-consumer-health-to-transition-global-baby-powder-portfolio-to-cornstarch>).

¹⁵⁶ *Id.* (quoting *Johnson & Johnson Consumer Health Announces Discontinuation of Talc-Based Johnson's Baby Powder in U.S. and Canada*, JOHNSON & JOHNSON (May 19, 2020), <https://www.jnj.com/our-company/johnson-johnson-consumer-health-announces-discontinuation-of-talc-based-johnsons-baby-powder-in-u-s-and-canada>).

J&J's talc supplier, Imerys Talc America, Inc., is named as a codefendant in these lawsuits. Imerys filed for bankruptcy protection in 2019, sold its core business out of chapter 11, and proposed a bankruptcy plan to resolve its share of liability on current and future talc-related claims.¹⁵⁷ Administrators from Imerys pressed for indemnification from J&J for the litigation and settlement costs associated with these lawsuits to fund compensation for Imerys's own claimants.¹⁵⁸ The claimant committee appointed in Imerys's bankruptcy was concerned that if J&J underwent a divisive merger, Imerys would be delayed from collecting that reimbursement.¹⁵⁹

In response, lawyers for the J&J plaintiffs filed a motion in the Imerys bankruptcy case to prevent J&J from separating its talc liabilities from other assets pursuant to the Texas Two-Step strategy.¹⁶⁰ The bankruptcy judge presiding over the Imerys case refused to grant the motion, reasoning that it would be improper to "legally bar J&J from undertaking a hypothetical future restructuring."¹⁶¹ In October 2021, as the plaintiffs had feared, J&J underwent the Texas Two-Step: The company created a new subsidiary under Texas law, split into two, and placed all of its talc liabilities into one subsidiary, LTL Management ("LTL").¹⁶² J&J retained virtually all of the company's "productive business assets, including its valuable consumer products . . ."¹⁶³ LTL then moved to North Carolina¹⁶⁴ and filed for chapter 11 bankruptcy,

¹⁵⁷ Andrew Scurria & Becky Yerak, *J&J Injury Claimants Fail to Prevent Potential Talc Bankruptcy*, WALL ST. J. (Aug. 26, 2021, 6:57 PM), <https://www.wsj.com/articles/j-j-injury-claimants-fail-to-prevent-potential-talc-bankruptcy-11630010528>; see Eric Sagonowsky, *Staggering Under Load of Talc Litigation, J&J Supplier Imerys America Seeks Shelter in Bankruptcy*, FIERCE PHARMA (Feb. 14, 2019, 8:50 AM), <https://www.fiercepharma.com/pharma/three-units-j-j-talc-supplier-imerys-file-for-bankruptcy-amid-talc-litigation>.

¹⁵⁸ Scurria & Yerak, *supra* note 157.

¹⁵⁹ *Id.*

¹⁶⁰ Mike Spector & Maria Chutchian, *U.S. Judge Declines to Stop J&J from Splitting Talc Liabilities from Main Business*, REUTERS (Aug. 26, 2021, 9:22 PM), <https://www.reuters.com/legal/transactional/judge-allows-johnson-johnson-split-talc-liabilities-main-business-2021-08-26/>.

¹⁶¹ *Id.*

¹⁶² Jamie Smyth, *Johnson & Johnson's 'Texas Two-Step' Sparks Outcry over U.S. Bankruptcy Regime*, FIN. TIMES (Oct. 28, 2021), <https://www.ft.com/content/de13b1ec-9b4a-4a27-ae63-c8ea38ffc683>. Old J&J also funneled a funding support agreement from LTL's corporate parents to LTL, which gave LTL the ability to cause New J&J to jointly and severally satisfy any talc-related costs outside of bankruptcy. See *LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (In re LTL Mgmt., LLC)*, 64 F.4th 84, 106 (3d Cir. 2023).

¹⁶³ *LTL Mgmt.*, 64 F.4th at 93.

¹⁶⁴ The Western District of North Carolina is considered a favorable venue for the Texas Two-Step because it falls within the Fourth Circuit, which applies a higher, two-prong standard for dismissing bankruptcy cases on the basis of bad faith. *Id.* at 98 n.8 (citing *Carolin Corp. v. Miller*, 886 F.2d 693, 694 (4th Cir. 1989)). As the court notes, within the past decade, four similar cases have been filed in the Western District of North Carolina.

requesting that the judge suspend all talc cases against both LTL and J&J.¹⁶⁵ At this point, J&J had been named in over 38,000 asbestos and/or ovarian cancer-related cases.¹⁶⁶ General counsel for J&J stated that “resolving this matter as quickly and efficiently as possible is in the best interests of the [company] and all stakeholders.”¹⁶⁷

In response to this decision, Congressional Democrats issued a press release condemning J&J’s declaration of bankruptcy in this case.¹⁶⁸ The U.S. Senate Judiciary Committee later sent a letter to J&J urging it to “immediately reverse course so that tens of thousands of consumers can have their fair day in court,”¹⁶⁹ and individual legislators continue to emphasize the growing and urgent need for bankruptcy reform to prevent this type of maneuver.¹⁷⁰ In November 2021, the Western District of North Carolina approved a temporary sixty-day delay of the 38,000 asbestos-related lawsuits against J&J.¹⁷¹ The court also transferred the case to New Jersey, where J&J is headquartered, instead of keeping it in

See In re Bestwall, LLC, No. 17-31795, 2022 U.S. Dist. LEXIS 160285 (Bankr. W.D.N.C. Sept. 6, 2022); *DBMP, LLC v. Those Parties Listed on Appendix A to Complaint (In re DBMP, LLC)*, No. 20-30080, 2021 Bankr. LEXIS 2194 (Bankr. W.D.N.C. Aug. 10, 2021); *Aldrich Pump, LLC v. Those Parties to Actions Listed on Appendix A to Complaint (In re Aldrich Pump, LLC)*, No. 20-30608, 2021 WL 3729335 (Bankr. W.D.N.C. Aug. 23, 2021); Voluntary Petition Under Chapter 11, *In re Murray Boiler LLC*, No. 20-30609 (Bankr. W.D.N.C. June 18, 2020), ECF No. 4.

¹⁶⁵ Jamie Smyth, *Johnson & Johnson’s ‘Texas Two-Step’ Sparks Outcry over U.S. Bankruptcy Regime*, FIN. TIMES (Oct. 28, 2021), <https://www.ft.com/content/de13b1ec-9b4a-4a27-ae63-c8ea38ffc683>.

¹⁶⁶ Simon, *supra* note 149.

¹⁶⁷ Mike Spector & Dan Levine, *J&J Puts Talc Liabilities into Bankruptcy*, REUTERS (Oct. 15, 2021), <https://www.reuters.com/business/healthcare-pharmaceuticals/jj-unit-manage-talc-claims-files-bankruptcy-protection-2021-10-14/> (quoting Press Release, Johnson & Johnson, Johnson & Johnson Takes Steps to Equitably Resolve All Current and Future Talc Claims (Oct 14, 2021), *available at* <https://www.jnj.com/johnson-johnson-takes-steps-to-equitably-resolve-all-current-and-future-talc-claims>).

¹⁶⁸ Press Release, House Committee on Oversight & Accountability (Democrats), Congressional Democrats Condemn Johnson & Johnson’s Declaration of Bankruptcy to Evade Accountability Over Talc Claims (Oct. 15, 2021), *available at* <https://oversightdemocrats.house.gov/news/press-releases/congressional-democrats-condemn-johnson-johnsons-declaration-of-bankruptcy-to>.

¹⁶⁹ Mann, *supra* note 153 (quoting Letter from Sen. Richard J. Durbin, Sen. Elizabeth Warren, Sen. Richard Blumenthal, Rep. Carolyn B. Maloney, & Rep. Raja Krishnamoorthi to Alex Gorsky, Chairman & CEO, Johnson & Johnson (Nov. 10, 2021), <https://www.durbin.senate.gov/imo/media/doc/2021-11-10%20Letter%20from%20Senators%20and%20Members%20of%20Congress%20to%20Mr.%20Gorsky.pdf>).

¹⁷⁰ For example, Senator Warren tweeted “Another giant corporation is abusing our bankruptcy system to shield its assets and evade liability for the harm it has caused people across the country.” Elizabeth Warren (@SenWarren), TWITTER, (Oct. 15, 2021, 10:42 AM), <https://twitter.com/SenWarren/status/1449022835222061057>.

¹⁷¹ Mann, *supra* note 153.

North Carolina,¹⁷² giving the Official Committee of Talc Claimants a revived sense of hope for dismissal.¹⁷³

To the plaintiffs' dismay, the District of New Jersey approved the company's use of the Texas Two-Step in February 2022.¹⁷⁴ Chief Judge Michael B. Kaplan rejected plaintiffs' arguments that J&J's tactic was an abuse of chapter 11 and concluded that it was "'unquestionably' proper."¹⁷⁵ J&J, valued at more than \$400 billion, pledged that LTL would set aside at least two billion dollars to settle these talc claims.¹⁷⁶ Attorneys for the plaintiffs immediately appealed this "rotten to the core ruling."¹⁷⁷

On appeal to the Third Circuit, the plaintiffs argued that J&J's bankruptcy filing "was built on a foundation of bad faith."¹⁷⁸ Because J&J—the highest-grossing firm in the biopharma sector in 2022¹⁷⁹—was not actually in financial distress at the time that it underwent the divisive merger and that LTL filed for chapter 11 protection, the plaintiffs contended that J&J should not be entitled to the benefits of the automatic stay.¹⁸⁰ Plaintiffs, during the course of these proceedings, have been forced to wait, becoming more desperate "as they face medical expenses and come closer to their own deaths."¹⁸¹ Some of the plaintiffs

¹⁷² One of the plaintiffs' attorneys in this case, Andy Birchfield, thinks this is an appropriate decision because more than 30,000 affected victims filed lawsuits in New Jersey. *Id.*

¹⁷³ The Third Circuit, where New Jersey sits, applies a less stringent test for bad faith than does the Fourth Circuit, which means that, all else being equal, the New Jersey bankruptcy court may be more willing to throw the case out on bad faith grounds than the Bankruptcy Court for the Western District North Carolina would have been. See Jason G. Cohen et al., *LTL Management Texas Two Steps into New Jersey Bankruptcy Court*, NAT'L L. REV. (Dec. 8, 2021), <https://www.natlawreview.com/article/ltl-management-texas-two-steps-new-jersey-bankruptcy-court>.

¹⁷⁴ Dietrich Knauth & Tom Hals, *Judge Greenlights J&J Strategy to Resolve Talc Lawsuits in Bankruptcy Court*, REUTERS (Feb. 25, 2022, 5:14 PM), <https://www.reuters.com/legal/transactional/judge-allows-johnson-johnson-talc-unit-remain-bankruptcy-court-2022-02-25/>.

¹⁷⁵ *In re LTL Mgmt., LLC*, 637 B.R. 396, 408 (Bankr. D.N.J. 2022) ("Let's be clear, the filing of a chapter 11 case with the expressed aim of addressing the present and future liabilities associated with ongoing global personal injury claims to preserve corporate value is unquestionably a proper purpose under the Bankruptcy Code.").

¹⁷⁶ Knauth & Hals, *supra* note 174.

¹⁷⁷ *Id.*

¹⁷⁸ Kevin Dunleavy, *Johnson & Johnson Defends Bankruptcy Play in Appeals Court, but Plaintiffs Call It a "Bad Faith" Move*, FIERCE PHARMA (Sept. 20, 2022, 11:19 AM), <https://www.fiercepharma.com/pharma/johnson-johnson-argues-appeals-court-it-should-be-allowed-use-bankruptcy-play>.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ See Mann, *supra* note 153.

have since died, never able to get any form of relief from the company who caused their harm.¹⁸²

The Third Circuit issued its groundbreaking decision on January 30, 2023, dismissing LTL’s chapter 11 petition.¹⁸³ The court rejected J&J’s argument that chapter 11 was the best way to resolve the thousands of talc claims “equitably” and “efficiently”:

But here J&J’s belief that this bankruptcy creates the best of all possible worlds for it and the talc claimants is not enough, no matter how sincerely held. Nor is the Bankruptcy Court’s commendable effort to resolve a more-than-thorny problem. *These cannot displace the rule that resort to Chapter 11 is appropriate only for entities facing financial distress. This safeguard ensures that claimants’ pre-bankruptcy remedies—here, the chance to prove to a jury of their peers injuries claimed to be caused by a consumer product—are disrupted only when necessary.*¹⁸⁴

In determining LTL’s financial condition, the court paid considerable attention to the Funding Agreement that J&J had vested in LTL through the divisive merger.¹⁸⁵ The Funding Agreement, which gave LTL the right to cause J&J “to pay it cash up to [an estimated \$61.5 billion] to satisfy any talc-related costs,” provided the allegedly-insolvent LTL “a right to cash that was very valuable, likely to grow, and minimally conditional.”¹⁸⁶ The court inferred from these facts that LTL was “highly solvent” at the time it filed under chapter 11 and could comfortably cover its future liabilities.¹⁸⁷ Without proof of financial distress, the court ruled that LTL “cannot show its petition served a valid bankruptcy purpose” and therefore was not filed in good faith under section 1112(b).¹⁸⁸

A couple weeks after the court issued its opinion, LTL requested that the Third Circuit reconsider, which effectively put the petition’s dismissal on

¹⁸² Hanna Wilt, a plaintiff who spoke out over the delay in her lawsuit against J&J, died in 2022 at age twenty-seven from mesothelioma. *See id.*

¹⁸³ LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (*In re* LTL Mgmt., LLC), 64 F.4th 84, 111 (3d Cir. 2023).

¹⁸⁴ *Id.* (emphasis added).

¹⁸⁵ *Id.* at 106.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 108.

¹⁸⁸ *Id.* at 110.

hold.¹⁸⁹ The Third Circuit has not yet ruled on this request as of March 2023. If the court refuses a rehearing, it is likely that LTL will seek to further delay its dismissal by appealing to the Supreme Court of the United States.¹⁹⁰

D. *Dangers of the Dance*

There are at least three negative consequences that would arise should the Texas Two Step become widely accepted and/or legitimized, such as through a ruling in favor of LTL from the Supreme Court. First, it will become harder for injured plaintiffs to receive adequate compensation for their injuries. Because tort debt is classified as “general unsecured debt” in any chapter 11 case¹⁹¹ and has low priority in the payout scheme,¹⁹² tort creditors typically recover “less than one hundred cents on the dollar” and relatively less than commercial claimants and other unsecured creditors.¹⁹³ The bankruptcy system has faced strong criticism for notoriously undercompensating tort creditors, long before the Texas Two-Step emerged, and scholars have proposed various solutions over the past half-century: elevating the priority of tort creditors’ claims;¹⁹⁴ amending the Code to make personal injury tort claims nondischargeable in chapter 11 filings;¹⁹⁵ and allowing tort claims to follow a debtor’s assets beyond chapter 11 and reattach to the reorganized debtor.¹⁹⁶

The Texas Two-Step also makes it harder—if not impossible—for tort litigants to have their day in court.¹⁹⁷ Tort litigants often file lawsuits for reasons beyond monetary relief, such as “to protect others, to seek answers, to demand apologies,” and to be heard by the defendant who caused their harm.¹⁹⁸ The impersonal nature of a chapter 11 bankruptcy proceeding funnels tort litigants into the broader pool of unsecured creditors and forces them to fight for adequate representation in the creditors’ committee.¹⁹⁹ Their individual voice becomes

¹⁸⁹ Mike Spector, *Judge Indicates Intention to Dismiss J&J Talc Unit Bankruptcy*, REUTERS (Feb. 14, 2023, 11:20 AM), <https://www.reuters.com/legal/jj-talc-unit-faces-bankruptcy-judge-after-tactic-rejected-2023-02-14/>.

¹⁹⁰ *Id.*

¹⁹¹ See *supra* Section I(B).

¹⁹² See Note, *supra* note 44, at 2549.

¹⁹³ Buccola & Macey, *supra* note 44, at 773.

¹⁹⁴ See Painter, *supra* note 45, at 1076.

¹⁹⁵ See Lyle, *supra* note 49, at 1356.

¹⁹⁶ See Buccola & Macey, *supra* note 44, at 770 (proposing a “super-durability” norm for tort claims, which would allow tort claims to follow a debtor’s assets beyond chapter 11 and attach to the reorganized debtor).

¹⁹⁷ Epstein, *supra* note 41, at 966–67.

¹⁹⁸ *Id.* at 965.

¹⁹⁹ *Id.* at 971–72.

one of many, and their interests likely do not align with the interests of other unsecured creditors.²⁰⁰

Second, companies will no longer be incentivized to produce safe, non-defective products at the same risk-benefit calculation. Chapter 11 reorganizations allow the insolvent business to continue operating as a going concern,²⁰¹ which largely benefits society by protecting the economic health of a bankrupt business and the jobs it produces.²⁰² Tort liability is rooted in an incentive structure that encourages businesses to “weigh the cost of tort injuries produced by the unsafe product against the increased production and research costs associated with the safer alternatives.”²⁰³ The theory underlying tort deterrence is that companies will “compute, ex ante, the possibility of ex post liability” from a business decision and proceed accordingly.²⁰⁴

A problem arises when the bankruptcy system allows a business to externalize its tort liability.²⁰⁵ Internalization incentivizes adequate and appropriate caution, so tort deterrence only functions properly when a business internalizes the costs of its accidents or defects.²⁰⁶ Bankruptcy provides a loophole for companies to avoid bearing the social (and actual monetary) costs of their behavior.²⁰⁷ When a business discovers that reorganizing under chapter 11 would partially insulate the company from bearing the cost of product liabilities, any incentive for the corporation to invest into producing safer products is diminished.²⁰⁸

This is true for any chapter 11 business reorganization, not just those that execute the Two-Step; however, the Texas Two-Step adds yet another shield to the debtor facing tort liability, so the concerns of moral hazard are particularly acute. For example, because J&J allocated all its liabilities into a separate entity, the well-known megacorporation is now technically not liable itself. Therefore,

²⁰⁰ *Id.*

²⁰¹ *See also* United Mine Works of Am. Combined Benefit Fund v. Toffel (*In re* Walter Energy, Inc.), 911 F.3d 1121, 1152 (2018).

²⁰² *See* Lyle, *supra* note 49, at 1318.

²⁰³ *Id.*

²⁰⁴ Note, *supra* note 44, at 2545.

²⁰⁵ *Id.* at 2545.

²⁰⁶ *Id.* at 2546.

²⁰⁷ Buccola & Macey, *supra* note 44, at 769.

²⁰⁸ *See* Lyle, *supra* note 49, at 1318–19. *See generally* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 32 (“To the extent that a firm knows that it will not have to fully compensate its future tort victims, it has too little incentive to take care to prevent accidents in the first instance.”).

J&J will potentially be less incentivized to produce safe products in the future if it does not have to bear the costs now. Closing the Texas Two-Step loophole is necessary to properly align incentives for companies to take necessary precautions and allow mass tort victims to obtain adequate compensation.

Third, acceptance of the Texas Two-Step will encourage bad faith filing. Bankruptcy law intends to reserve the fresh start to honest debtors alone.²⁰⁹ While there is no explicit statutory requirement of good faith in the Code, all federal circuit courts have acknowledged an implicit good faith filing requirement.²¹⁰ The Code is not meant to be used as a “shield” to protect dishonest debtors from the consequences of their own actions.²¹¹ As explored further below, a finding of good faith typically requires proof that the debtor was in financial distress at the time they filed under chapter 11.²¹² Though financial distress is not necessarily synonymous with insolvency, the debtor must still be facing “the kinds of problems that justify Chapter 11 relief.”²¹³ Conglomerate businesses similar to J&J will continue to try to use chapter 11 protection, despite having the resources to pay off liabilities outside of bankruptcy, thus disrupting the Code’s intent to protect only honest debtors.

IV. CUT THE MUSIC: AVENUES FOR JUDICIAL & LEGISLATIVE REFORM

The Texas Two-Step presents a grave threat to the integrity of the U.S. bankruptcy and tort systems. Both the federal judiciary and federal legislature must act fast before the Two-Step becomes the norm for corporations facing mass tort liabilities. This section will briefly discuss four separate reform mechanisms that would deter companies from using the Two-Step strategy in the future. Ultimately, the greatest chance of successfully curbing the Two-Step lies in a combination of all four proposals.

A. *Judicial Attack: Closing the Statutory Loophole*

The source of the Texas Two-Step loophole lies in the state’s contradictory definition of “transfer” under the Texas Business and Commerce Code

²⁰⁹ Grogan v. Garner, 498 U.S. 279, 287 (1991).

²¹⁰ Mullins, *supra* note 66.

²¹¹ Eastern Diversified Distributions, Inc. v. Matus (*In re Matus*), 303 B.R. 660, 670 (Bankr. N.D. Ga. 2004); Henri v. Wheeler (*In re Wheeler*), 511 B.R. 240, 250–51 (Bankr. N.D.N.Y. 2014).

²¹² See, e.g., *In re Rent-A-Wreck of Am., Inc.*, 580 B.R. 364, 374 (Bankr. D. Del. 2018); 1500 Mineral Spring Assoc., LP v. Gencarelli, 353 B.R. 771, 781 (Bankr. D.R.I. 2006).

²¹³ Derek Baker, *Impending Financial Distress is Critical Fact in Good Faith Finding for Chapter 11*, JD SUPRA (Mar. 10, 2023), <https://www.jdsupra.com/legalnews/impending-financial-distress-is-7190236/>.

(“TBCC”) and the legal effect of a divisive merger under the TBOC.²¹⁴ The TBCC defines “transfer” as “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset.”²¹⁵ A “merger” is evidently a way to dispose of or part with an asset or an interest in an asset;²¹⁶ however, under the TBOC, a merger occurs without causing a transfer or assignment.²¹⁷ Despite appearing similar to a fraudulent transfer on paper, the specific language of these statutes allows companies to circumvent fraudulent transfer law.²¹⁸

Under the TBCC, like the UVTA, a “fraudulent transfer” includes any “transfer made or obligation incurred by a debtor” in an effort to avoid debt:

*A transfer made or obligation incurred by a debtor is fraudulent as to a creditor . . . if the debtor made the transfer or incurred the obligation: with actual intent to hinder, delay, or defraud any creditor of the debtor; or without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor’s ability to pay as they became due.*²¹⁹

The TBCC further outlines factors that a court may consider in evaluating a debtor’s “actual intent,” including: whether the debtor had been sued or threatened with a suit before the transfer was made or obligation was incurred; whether the transfer was of substantially all the debtor’s assets; and whether the debtor became insolvent shortly after the transfer was made or the obligation was incurred.²²⁰

The inclusion of “transfer made *or* obligation incurred” suggests that the Texas legislature intended these words to be distinct from one another. Under this theory, a debtor could *incur an obligation* through a divisive merger and perhaps be liable under fraudulent transfer law. One of the potential ways a court can get around this statutory loophole is by focusing on the term “obligation”

²¹⁴ Haines, *supra* note 105, at 714.

²¹⁵ TEX. BUS. & COM. CODE § 24.002(12).

²¹⁶ Haines, *supra* note 105, at 714.

²¹⁷ TEX. BUS. ORGS. CODE §10.008(a)(2).

²¹⁸ See Francus, *supra* note 13, at 43.

²¹⁹ TEX. BUS. & COM. CODE § 24.005(a) (emphasis added).

²²⁰ TEX. BUS. & COM. CODE § 24.005(b)(4), (5), (9).

rather than “transfer.”²²¹ For example, the District of New Jersey could have determined that LTL “incurred an obligation to pay debts without receiving reasonably equivalent value and knew it could not pay the debts as they became due” after J&J split its assets and liabilities between the two entities, thus triggering the TBCC provision on fraudulent transfers.²²² The court could then determine whether LTL had actual intent to defraud.²²³ Unfortunately, courts and individual judges have ultimate discretion over how they interpret a statute, and without any formal enforcement mechanism, the chances for this to be applied uniformly are low.

B. Judicial Attack: Adopting the Third Circuit’s “Bad Faith” Analysis

As explored in Section II, most courts acknowledge a good faith filing requirement for chapter 11 cases.²²⁴ However, because the Code and the Supreme Court have not yet provided any guidance, federal circuit courts do not uniformly apply the same standards. For this reason, certain circuits—especially the Fourth Circuit—have become known for applying a stricter standard for dismissing a case for lack of good faith.²²⁵ The Fourth Circuit requires evidence of two factors to dismiss a case for bad faith: (1) “subjective bad faith” and (2) “objective futility of any possible reorganization.”²²⁶ Because this two-pronged test is considered to be more stringent than the test applied in the Third Circuit, the Western District of North Carolina speculated that LTL’s decision to file for bankruptcy in that venue was an effort to “manufacture venue” and was insufficient to justify keeping the case out of New Jersey.²²⁷

Perhaps the most effective strategy that the judiciary can employ to prevent the Texas Two-Step from becoming the norm is adopting the Third Circuit’s analysis in *In re LTL Management, LLC*. In reaching its conclusion, the Third Circuit heavily relied on the fact that LTL was protected by the massive “safety net” of its parent company which shielded all foreseeable talc liability.²²⁸ LTL had “a roughly \$61.5 billion payment right” against New J&J to “satisfy any

²²¹ Haines, *supra* note 105, at 716.

²²² *Id.*

²²³ See TEX. BUS. & COM. CODE § 24.005(b).

²²⁴ See *supra* Section (II).

²²⁵ *LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (In re LTL Mgmt., LLC)*, 64 F.4th 84, 98 n.8 (3d Cir. 2023).

²²⁶ *Carolin Corp. v. Miller*, 886 F.2d 693, 694 (4th Cir. 1989).

²²⁷ *LTL Mgmt.*, 64 F.4th at 97–98.

²²⁸ *Id.* at 111.

talco-related costs” at the time it filed under chapter 11.²²⁹ New J&J still had access to the profit-rich brands and products to pad LTL’s payment right at the time of filing. Moreover, through this payment right, LTL gained “direct access to J&J’s exceptionally strong balance sheet,” which included “well over \$400 billion in equity value with a AAA credit rating and \$31 billion just in cash and marketable securities.”²³⁰

Based on these and other facts relating to the economic health of J&J, the Third Circuit concluded that LTL was not in financial distress when it filed for bankruptcy protection.²³¹ The court ordered dismissal of LTL’s petition for an absence of good faith on this finding alone:

We start, and stay, with good faith. Good intentions—such as to protect the J&J brand or comprehensively resolve litigation—do not suffice alone. What counts to access the Bankruptcy Code’s safe harbor is to meet its intended purposes. *Only a putative debtor in financial distress can do so.*²³²

Though the Third Circuit’s holding is narrow—and the court says as much²³³—it may prove monumental enough to deter future solvent debtors from undertaking a similar approach, especially if the Supreme Court grants a writ of certiorari over LTL’s anticipated future appeal and affirms the Third Circuit’s analysis.

C. Legislative Reform: Strengthening Tort Creditors’ Clawback Powers

Under section 544 of the Code, the bankruptcy trustee has the power to bring an avoidance action against preferential transfers or fraudulent transfers.²³⁴ Creditors are harmed when a debtor makes a fraudulent transfer because it places the debtor’s assets “to which they would otherwise be entitled” out of the creditors’ reach.²³⁵ If the trustee provides sufficient proof that either of these actions occurred either pre- or post-filing, the act will either be undone or set

²²⁹ *Id.* at 96.

²³⁰ *Id.* at 106.

²³¹ *Id.* at 111.

²³² *Id.* at 93. (emphasis added).

²³³ *Id.* at 111. (“Some may argue any divisional merger to excise the liability and stigma of a product gone bad contradicts the principles and purposes of the Bankruptcy Code. But even that is a call that awaits another day and another case.”).

²³⁴ 11 U.S.C. § 544; 8A C.J.S. *Bankruptcy* § 745 (2022) (“Trustee’s Right to Bring Action to Avoid Fraudulent Transfers”).

²³⁵ *Balaber-Strauss v. Murphy (In re Murphy)*, 331 B.R. 107, 124 (Bankr. S.D.N.Y. 2005).

aside.²³⁶ The trustee has the lesser of two years after the entry of the order for relief, or the time the case is closed or dismissed.²³⁷ As previously discussed, chapter 11 bankruptcies are unique because the debtor in possession has the traditional powers of a trustee, including avoidance powers. If the debtor in possession fails to bring an avoidance action in a chapter 11 case after it has been requested, the court can authorize an individual creditor or committee of creditors to bring it instead.²³⁸

More specifically, under section 544(b)(1) of the Code, a trustee may recover certain transfers that are avoidable by some unsecured creditors under applicable state law.²³⁹ The Code's fraudulent transfer statute and Texas's fraudulent transfer statute are fairly analogous; both statutes similarly distinguish between actual fraudulent transfers and constructively fraudulent transfers.²⁴⁰ Actual fraudulent transfers are made, or fraudulent obligations occur, when a debtor attempts to "hinder, delay, or defraud" creditors.²⁴¹ A court may consider a variety of factors to determine whether a debtor had actual intent, including: whether the debtor had been sued or threatened with suit before the transfer was made,²⁴² whether the transfer was of substantially all the debtor's assets;²⁴³ and whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.²⁴⁴

Alternatively, courts have often found a constructively fraudulent transfer where a debtor received less than reasonably equivalent value in the transaction and became insolvent as a result of the transfer.²⁴⁵ The trustee can undo pre-petition gifts as constructively fraudulent transfers because a debtor does not receive reasonably equivalent value when it makes a gift; therefore, if the debtor

²³⁶ 8A C.J.S. *Bankruptcy* § 664 (2022) ("Avoidance and Related Powers of Trustee, Debtor-in-Possession, or Others for Benefit of Estate Generally").

²³⁷ 11 U.S.C. § 546.

²³⁸ 8A C.J.S. *Bankruptcy* §§ 746, 748 (2022) ("Creditors' Committee's Right to Bring Action to Avoid Fraudulent Transfers," and "Individual Creditor's Right to Bring Action to Avoid Fraudulent Transfers—Chapter 11 Cases").

²³⁹ 11 U.S.C. § 544(b)(1).

²⁴⁰ Compare 11 U.S.C. § 544, with TEX. BUS. & COM. CODE § 24.005.

²⁴¹ TEX. BUS. & COM. CODE § 24.005(a)(1); see also 8A C.J.S. *Bankruptcy* § 693 (2022) ("Avoidance of Actual Fraudulent Transfers").

²⁴² TEX. BUS. & COM. CODE § 24.005(b)(4).

²⁴³ TEX. BUS. & COM. CODE § 24.005(b)(5).

²⁴⁴ TEX. BUS. & COM. CODE § 24.005(b)(9).

²⁴⁵ See, e.g., *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 B.R. 430, 435–36 (N.D. Ohio 1988); *Wheatly v. Johnson (In re Johnson)*, 579 B.R. 796, 802 (W.D. Ky. 2017). A charitable contribution is not considered a transfer under this provision if it meets certain criteria. 8A C.J.S. *Bankruptcy* § 694 (2022) ("Avoidance of Transfers Constructively Fraudulent").

later becomes insolvent, the creditor may have to surrender the gift.²⁴⁶ Texas and other states cap a creditor's recovery "to the extent necessary to satisfy the creditor's claim."²⁴⁷ However, there is a lack of consensus across federal courts about whether the amount recoverable by a trustee, or DIP for chapter 11 cases, should be capped at "the total amount of unsecured claims against the estate" in fraudulent transfer avoidance litigation.²⁴⁸

At least one court agrees with the Texas law and has held that recovery under section 550 of the Code should be limited to the extent necessary to satisfy the creditor's claims to prevent a potential windfall.²⁴⁹ The Southern District of New York believes a cap is appropriate because fraudulent transfer laws are remedial rather than punitive.²⁵⁰ At least two other courts, however, have held otherwise.²⁵¹ For example, in 2017, a Delaware bankruptcy court ruled that section 550 of the Code does not impose any limitation on the estate's recovery against the transferor, unlike most state fraudulent transfer laws.²⁵² In *In re Physiotherapy Holdings, Inc.*, Court Square Capital Partners II, L.P., acquired Physiotherapy Holdings, Inc., through a leveraged buyout transaction financed partially by "a \$100 million term loan secured by Physiotherapy's assets"; \$210 million in senior notes that Physiotherapy assumed post-merger; a \$313.3 million equity investment by Court Square; a \$3.9 million management equity rollover; and "a minority third party investment."²⁵³ Physiotherapy's prior owners, who were named as defendants in this case, received \$248.6 million for their interests as a part of this transaction.²⁵⁴ Physiotherapy filed for a chapter

²⁴⁶ In cases of constructive fraud, intent is irrelevant and "reasonably equivalent value" is the only test. See Jason Freeman, *Fraudulent Conveyances*, JD SUPRA (Oct. 29, 2020), <https://www.jdsupra.com/legalnews/fraudulent-conveyances-41765/>.

²⁴⁷ TEX. BUS. & COM. CODE § 24.008(a)(1).

²⁴⁸ *Fraudulent Transfer Avoidance Recovery Not Limited to Total Amount of Creditor Claims*, JONES DAY: INSIGHTS (Jan.-Feb. 2018), <https://www.jonesday.com/en/insights/2018/02/fraudulent-transfer-avoidance-recovery-not-limited>.

²⁴⁹ See Balaber-Strauss v. Murphy (*In re Murphy*), 331 B.R. 107, 125 (Bankr. S.D.N.Y. 2005).

²⁵⁰ *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248.

²⁵¹ See, e.g., *Gunsalus v. Ontario Cnty. (In re Gunsalus)*, 613 B.R. 1, 10 (Bankr. W.D.N.Y. 2020) (holding that the recovery cap is inapplicable in this case); *Pah Litig. Tr., v. Water St. Healthcare Partners (In re Physiotherapy Holdings, Inc.)*, No. 13-12965, 2017 WL 5054308, at *7 (Bankr. D. Del. Nov. 1, 2017) ("Were the Court to rule otherwise, it would mean that if Defendants are in fact liable for the fraudulent transfer, they would keep most if not all of the transferred money. The Court cannot countenance such an inequitable result if liability exists.").

²⁵² See *Pah Litig. Tr.*, 2017 WL 5054308, at *1; see also *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248.

²⁵³ *Pah Litig. Tr.*, 2017 WL 5054308, at *1.

²⁵⁴ *Id.*; *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248.

11 bankruptcy in 2013 and later confirmed a plan of reorganization which established a litigation trust.²⁵⁵

The litigation trustee sued Physiotherapy's prior owners in 2015 to avoid and recover the \$248.6 million pre-petition payments under theories of both actual and constructive fraud.²⁵⁶ The following year, Select Medical Corporation acquired the reorganized Physiotherapy for \$421 million in cash, exchanging \$282 million of it to noteholders for their equity interests.²⁵⁷ The defendants moved to dismiss the complaint and argued that by receiving this \$282 million, noteholders were barred from recovering under section 550 of the Code and Pennsylvania's UFTA.²⁵⁸ In response, the litigation trustee asserted that "the value of the debt the noteholders agreed to release under the terms of the plan in exchange for new equity and litigation recoveries" far exceeded \$282 million.²⁵⁹ Since the parties could not agree on potential damages, the case was at a standstill and the bankruptcy court had to step in.

The bankruptcy court ruled that section 550 of the Code does not limit an estate's avoidance recovery, unlike most state fraudulent transfer laws.²⁶⁰ This

²⁵⁵ *Pah Litig. Tr.*, 2017 WL 5054308, at *2; *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248.

²⁵⁶ *Pah Litig. Tr.*, 2017 WL 5054308, at *3; *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248; Lee Harrington, *Delaware Bankruptcy Court Limits the Scope of Bankruptcy Safe Harbor for Settlement Payments in Connection with a Securities Contract Under Section 546(e)*, NIXON PEABODY: BANKR. ALERT (July 1, 2016), https://www.nixonpeabody.com/-/media/Files/Alerts/184174_in-re-physiotherapy-holdings-bankruptcy-alert.ashx.

²⁵⁷ *Pah Litig. Tr.*, 2017 WL 5054308, at *3; *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248.

²⁵⁸ *Pah Litig. Tr.*, 2017 WL 5054308, at *3; *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248. Pennsylvania's UFTA was renamed to the Pennsylvania Uniform Voidable Transactions Act ("PUVTA") after this case was decided in 2018. The UVTA still defines a "voidable transfer" analogously to the Texas's definition of "fraudulent transfer." *Compare* 12 PA. C.S. COM. AND TRADE § 5105(a) ("A transfer made or obligation incurred by a debtor is voidable as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation."), *with* TEX. BUS. COMM. CODE § 24.005(a) ("A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or within a reasonable time after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: (A) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (B) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.").

²⁵⁹ *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248.

²⁶⁰ *See id.*

ruling reinforces the differences between the state and federal system when it comes to avoidance recovery: State law is supposed to be limited to “the amount necessary to make an injured creditor whole,” while federal bankruptcy law must consider the entire bankruptcy estate, including interests of both creditors and other stakeholders.²⁶¹

As previously discussed, a simple solution to eliminating the Texas Two-Step is to reform the existing definition of “merger” under Texas law. However, because the Texas legislature intentionally redefined “merger” to attract more businesses and maintain its competitiveness,²⁶² this drastic solution would likely receive pushback from the Texas business community. To reduce the chance of receiving such pushback, another solution is to add to the divisive merger statute a clawback provision which activates if Corporation B files for chapter 11 bankruptcy protection. By adding a clawback provision, tort creditors would be able to challenge Corporation A’s fraudulent obligation of mass tort liabilities under state law without needing court authorization. If successful in avoiding Corporation A’s fraudulent obligation, and essentially “undoing” its allocation of liabilities into Corporation B, the estate may recover under section 544(b)(1) of the Code without limitation and put Corporation A’s assets back in reach of creditors. In extreme cases, the court may even award punitive damages if it finds the actual harm inflicted by the defendant-debtor severe enough.²⁶³

However, this solution relies on the Texas legislature’s willingness to change the divisive merger statute to include a clawback provision.²⁶⁴ Additionally, section 548(c) of the Code provides a good faith defense to avoidance of fraudulent transfers.²⁶⁵ Under section 548(c), a transferee or obligee “of such a transfer or obligation that takes for value and in good faith . . . may retain any interest transferred or may enforce any obligation incurred,” so long as the transferee or obligee exchanged reasonably equivalent value.²⁶⁶ This could

²⁶¹ *Id.*

²⁶² Huff, *supra* note 9, at 110.

²⁶³ See, e.g., Jay Adkisson, *Eleventh Circuit Affirms Punitive Damages for a Fraudulent Transfer and Rejects Constructive Notice in Judkins*, FORBES (Oct. 20, 2020, 11:39 AM), <https://www.forbes.com/sites/jayadkisson/2020/10/20/eleventh-circuit-affirms-punitive-damages-for-a-fraudulent-transfer-and-rejects-constructive-notice-in-judkins/?sh=6169694c45a0>.

²⁶⁴ A clawback provision is a contractual clause most commonly used in employment contracts “whereby money already paid to an employee must be returned to an employer” in responses to instances of “misconduct, scandals, poor performance, or a drop in company profits.” See Will Kenton, *Clawback: Definition, Meaning, How it Works, and Example*, INVESTOPEdia, <https://www.investopedia.com/terms/c/clawback.asp> (last updated May 13, 2021).

²⁶⁵ 11 U.S.C. § 548(c).

²⁶⁶ *Id.*

prove problematic in two ways. First, neither “good faith” nor “reasonably equivalent value” is defined in the Code, leaving the courts with broad discretion to determine an appropriate standard.²⁶⁷ Second, companies attempting the Texas Two-Step in the future may replicate J&J’s strategy by allocating certain royalty revenue streams or other equivalent value to its subsidiary, which may be sufficient to meet the exchange standard.²⁶⁸

D. Legislative Reform: Banning Forum Shopping in Texas Two-Step Cases

Bankruptcy venue is governed by 28 U.S.C. § 1408, which provides that corporations may file for chapter 11 bankruptcy in any district “in which the domicile, residence, principal place of business in the United States, or principal assets in the United States” have been located during most of the preceding 180-day period, or in any district where an affiliate, general partner, or partnership has filed.²⁶⁹ Because the law gives corporations multiple venue options, a company may partake in “forum shopping” and strategically file in a jurisdiction that is likely favorable to their case.²⁷⁰ Forum shopping has long been recognized as a significant issue in chapter 11 bankruptcy cases.²⁷¹ Critics of the current law fear that owners of bankrupt businesses can avoid unsavory outcomes by filing in a “pro-business” district, or with a “pro-business judge,” regardless of the debtor’s connections with that state.²⁷²

Forum shopping has proven problematic in Texas Two-Step cases, as demonstrated through J&J’s attempt to file its subsidiary’s bankruptcy case in North Carolina.²⁷³ The Western District of North Carolina is one of a few

²⁶⁷ *Fraudulent Transfer Avoidance Recovery Not Limited*, *supra* note 248; 8A C.J.S. *Bankruptcy* § 695 (2022) (“Avoidance of Transfers for Less Than Reasonably Equivalent Value”).

²⁶⁸ Press Release, Johnson & Johnson, Johnson & Johnson Takes Steps to Equitably Resolve All Current and Future Talc Claims (Oct. 14, 2021), *available at* <https://www.jnj.com/johnson-johnson-takes-steps-to-equitably-resolve-all-current-and-future-talc-claims>.

²⁶⁹ 28 U.S.C. § 1408.

²⁷⁰ Mark A. Salzberg & Kyle F. Arendsen, *Bankruptcy Venue “Reform”—What Are the Odds This Time?*, NAT’L L. REV. (Oct. 5, 2021), <https://www.natlawreview.com/article/bankruptcy-venue-reform-what-are-odds-time>.

²⁷¹ Unlike in civil cases, bankruptcy debtors are not limited by the strict principles of personal jurisdiction. Joan Feeney, Adam Levitin, Steven Rhodes & Jay Westbrook, *Now is the Time for Bankruptcy Venue Reform*, THE HILL (Aug. 6, 2021, 6:30 PM), <https://thehill.com/blogs/congress-blog/judicial/566729-now-is-the-time-for-bankruptcy-venue-reform?rl=1>. *See generally* Int’l Shoe v. Washington, 326 U.S. 310 (1945) (holding personal jurisdiction to be constitutional when a defendant has minimum contacts with the state where a lawsuit is brought such that notions of fair play and substantial justice would not be offended).

²⁷² Feeney, Levitin, Rhodes & Westbrook, *supra* note 271.

²⁷³ Other divisive merger cases that have been filed in North Carolina include DBMP, Aldrich Pump, and Bestwall. Charles Beckham et al., *Texas-Two Step: Part Two—Stepping into Other Jurisdictions*, HAYNES &

jurisdictions whose bankruptcy judges have heard cases invoking Texas's divisive merger statute and is known to apply a relatively stringent test when it comes to proving a bad faith filing.²⁷⁴ LTL and its representatives likely chose to file in North Carolina in hopes of preventing dismissal, especially since LTL was established in North Carolina only two days before it filed for bankruptcy.²⁷⁵ Judge Whitley shared these suspicions and transferred the LTL case to New Jersey: the forum where J&J's headquarters, employees, and principal assets are already located, and where a substantial amount of the litigation is already pending.²⁷⁶

Forum shopping poses two major issues in bankruptcy proceedings. First, when businesses file in a venue that is geographically far from their headquarters, creditors, and other affected parties are forced to travel to and defend themselves in a remote forum, oftentimes by hiring local counsel.²⁷⁷ These additional obstacles can significantly increase the cost of defense.²⁷⁸ Second, forum shopping leads the public to question the integrity of the bankruptcy system because many perceive it as "unfairly advantaging large corporations."²⁷⁹

Bankruptcy venue reform has garnered some bipartisan congressional support over the past few years: Senators Elizabeth Warren (D-Massachusetts) and John Cornyn (R-Texas) introduced the Bankruptcy Venue Reform Act (the "BVRA") in September 2021, which would require businesses to file bankruptcy either where their headquarters or significant assets are located.²⁸⁰ In urging support for this bill, the senators noted that the Act would "crack down on this corporate abuse of our nation's bankruptcy laws" and tilt the playing field more

BOONE, LLP (Dec. 15, 2021), <https://www.haynesboone.com/news/alerts/texas-two-step-part-two-stepping-into-other-jurisdictions>.

²⁷⁴ This would mean that the plaintiffs/their committee would have a harder hurdle to overcome in getting the case thrown out on the basis of bad faith. See Cohen et al., *supra* note 173.

²⁷⁵ Maria Chutchian, *Judge in J&J Talc Liability Bankruptcy May Kick Case out of North Carolina*, REUTERS (Oct. 26, 2021, 2:54 PM), <https://www.reuters.com/legal/transactional/judge-jj-talc-liability-bankruptcy-may-kick-case-out-north-carolina-2021-10-26/>.

²⁷⁶ *Id.*

²⁷⁷ Feeney, Levitin, Rhodes & Westbrook, *supra* note 271.

²⁷⁸ Salzberg & Arendsen, *supra* note 270.

²⁷⁹ Nicolas Cordova, *Bankruptcy Venue Reform*, HARV. L. SCH. BANKR. ROUNDTABLE (May 26, 2020), <https://blogs.harvard.edu/bankruptcyroundtable/2020/05/26/bankruptcy-venue-reform/>.

²⁸⁰ Bankruptcy Venue Reform Act of 2021, H.R. 4193, 117th Cong. Among other provisions in the Act, corporate debtors would no longer be able to file solely on the basis of their state of incorporation, or solely in a district because an affiliate of the debtor has filed there. *Id.* at 4–5.

evenly towards small businesses.²⁸¹ Two congressmen from Colorado reintroduced the BVRA in February 2023.²⁸²

However, prior reform efforts have fallen flat,²⁸³ and opponents of bankruptcy venue reform argue that the aforementioned concerns are outweighed by other factors, namely that by concentrating large bankruptcy cases in certain jurisdictions, complex issues can be decided more efficiently by experienced judges.²⁸⁴ The consensus by opponents is that the BVRA drastically undermines the complexity and uniqueness of the corporate structures themselves and the bankruptcy system that these cases find themselves in.²⁸⁵ Essentially, bankruptcy venue is distinct for a reason, or else it would be subject to the traditional rules in non-bankruptcy proceedings;²⁸⁶ companies strategically incorporate in states like Delaware to reap the benefits of its well-established body of corporate law.²⁸⁷ This clash of perspectives might lead the BVRA to meet the same fate as its predecessors, which have without exception failed to pass.²⁸⁸

Because most of the parties affected by J&J's Texas Two-Step are injured tort creditors rather than commercial creditors, the consequences of forum shopping, such as the increased costs of traveling to and advocating in a remote

²⁸¹ Press Release, Elizabeth Warren, Warren, Cornyn Introduce Bill to Prevent Large Corporations From 'Forum-Shopping' in Bankruptcy Cases (Sept. 23, 2021), <https://www.warren.senate.gov/newsroom/press-releases/warren-cornyn-introduce-bill-to-prevent-large-corporations-from-forum-shopping-in-bankruptcy-cases>.

²⁸² Press Release, Ken Buck, Buck and Lofgren Reintroduce Bipartisan Legislation to End Corporate Bankruptcy Venue Shopping (Feb. 14, 2023), <https://buck.house.gov/media-center/press-releases/buck-and-lofgren-reintroduce-bipartisan-legislation-end-corporate>.

²⁸³ See, e.g., Bankruptcy Venue Reform Act of 2018, S. 2282, 115th Cong.

²⁸⁴ Another factor that has arisen since the COVID-19 pandemic is that an increasing number of bankruptcy courts have conducted hearings online or over the phone, so local creditors can stay engaged in their case without needing to travel. Salzberg & Arendsen, *supra* note 275.

²⁸⁵ For instance, proponents of the plan assume that judges in "non-magnet" districts are incapable of navigating a large, complex case. Philip Gross & Kenneth Rosen, *Bankruptcy Venue Reform Bill Needs Amending*, JD SUPRA (Oct. 13, 2021), <https://www.jdsupra.com/legalnews/bankruptcy-venue-reform-bill-needs-2513143/>.

²⁸⁶ See, e.g., 28 U.S.C. §§ 1390, 1391, 1404.

²⁸⁷ Gross & Rosen, *supra* note 285. See also Jared A. Elias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119, 119 (Jan. 2018) (finding that "the market is better at predicting the outcomes of bankruptcy cases in New York and Delaware, consistent with the hypothesis that the law there is more predictable" and against the hypothesis that these courts are biased in favor of the managers, lawyers, and senior creditors of a debtor).

²⁸⁸ It is also important to keep in mind that President Biden, a former Delaware senator and strong proponent of the present venue rules, would also have to sign the bill into law. Salzberg & Arendsen, *supra* note 270.

forum, are particularly problematic.²⁸⁹ Although general bankruptcy reform is beyond the scope of this Comment, the Texas Two-Step potentially exacerbates the problem of forum shopping if it is not regulated at the outset; in other words, if corporate debtors can get away with such drastic forum shopping in these narrow cases, that leaves room for every other chapter 11 debtor to do so in lower-profile cases. The decision to transfer the LTL case from North Carolina to New Jersey, out of concern for the interests of justice and convenience for the parties as outlined in Bankruptcy Rule 1014, provided a beacon of light to plaintiffs.²⁹⁰

One suggestion to address the Texas Two-Step while still somewhat alleviating general chapter 11 concerns is for Congress to reform its bill for this narrow set of cases. Rather than requiring businesses to file for bankruptcy in the state where their headquarters or significant assets are located, Congress should propose a bill that limits venue only in cases where a divisive merger has occurred. Rather than requiring all chapter 11 bankruptcy cases to be commenced only in the forum “in which the principal place of business or principal assets in the United States” of a business debtor are located,²⁹¹ the bill could add the caveat that “in cases where an entity, other than an individual, underwent a divisive merger within the 365 days immediately preceding such commencement.”

The BVRA might garner greater support from skeptics if it exclusively targets Texas Two-Step cases, because it would not affect all chapter 11 filings. Although the Texas Two-Step exposes a more wicked side of the bankruptcy system, the purpose of chapter 11 is for indebted businesses “to avail themselves of the flexible tools required to accomplish successful reorganization,” including the choice of venue.²⁹² A corporation that does not undergo a divisive merger would still be able to exercise its autonomy over choosing where to file and how it would carry out its plan of reorganization. The 365-day limit would reduce the chances of a business replicating J&J’s timeline, where it establishes itself in a

²⁸⁹ A lot of these tort creditors are women who have or are suffering from ovarian cancer as a result of using J&J’s products. See generally Michelle Llamas, *Talcum Powder Lawsuits*, DRUGWATCH (Dec. 21, 2021), <https://www.drugwatch.com/talcum-powder/lawsuits/>.

²⁹⁰ Under Rule 1014, cases filed in the proper district may be transferred to any other district “if the court determines that the transfer is in the interest of justice or for the convenience of the parties.” FED. R. BANKR. P. 1014(a)(1); see also Chutchian, *supra* note 270.

²⁹¹ Bankruptcy Venue Reform Act of 2021, H.R. 4193, sec. 3, 117th Cong.

²⁹² Shmuel Vasser, *New Bill Would End the ‘Texas Two-Step’ and Eliminate Non-Debtor Releases in Chapter 11*, JD SUPRA (Nov. 11, 2021), <https://www.jdsupra.com/legalnews/new-bill-would-end-the-texas-two-step-3111746/>.

particular state only days prior to filing for bankruptcy.²⁹³ Further, the new bill also forces companies that undergo divisive mergers to file in only one of two forums. For this reason, it could even disincentivize companies from using divisive mergers as a tool to avoid mass tort liability if the company is concerned with venue.

CONCLUSION

The Texas Two-Step threatens to weaken the integrity of the American bankruptcy and tort systems. By permitting otherwise solvent companies to split into two entities, allocate their tort liabilities into one, and plunge that entity into bankruptcy, the Texas Two-Step severely undermines the integrity of the bankruptcy system and allows corporate conglomerates to evade responsibility. Injured tort claimants are left undercompensated with little recourse, forcing them to abide by bankruptcy's terms instead of seeking recovery through traditional litigation.

Only a handful of companies have utilized or attempted the Texas Two-Step to date.²⁹⁴ However, if the Third Circuit's dismissal of LTL Management's petition is reversed on appeal,²⁹⁵ the Texas Two-Step could become the "norm" for major companies to deal with mass tort liabilities. J&J, with an estimated net worth of \$434 billion, is not the honest yet unfortunate debtor that the bankruptcy system seeks to protect. If this maneuver becomes accepted practice, otherwise solvent companies will replicate J&J's strategy, which would likely lead to a massive breakdown in trust between producers and consumers, and debtors and creditors alike.²⁹⁶ The implications of J&J ultimately succeeding are, as an understatement, enormous.

The difficulty in preventing a company's use of the Texas Two-Step stems (1) from the complexity of the bankruptcy system itself, and (2) from the fact

²⁹³ See Chutchian, *supra* note 270.

²⁹⁴ See, e.g., Jamie Smyth, *Koch Industries' Texas Two-Step Bankruptcy Move Challenged*, FIN. TIMES (Feb. 18, 2023), <https://www.ft.com/content/b1d80321-5ccd-4ddc-908c-8efaa7fa84b0>; Gill, *supra* note 109.

²⁹⁵ The lawyers for LTL "have already signaled a willingness to take their arguments to the US Supreme Court if needed." See Alex Wolf & James Nani, *Asbestos Bankruptcies Facing Fresh Challenges after J&J Ruling*, BLOOMBERG L. (Mar. 8, 2023, 5:04 AM), <https://news.bloomberglaw.com/bankruptcy-law/asbestos-bankruptcies-facing-fresh-challenges-after-j-j-ruling>.

²⁹⁶ Stacy Vanek Smith & Adrian Ma, *Johnson & Johnson Tests a Legal Maneuver Known as the Texas Two-Step*, NAT'L PUB. RADIO, at 3:01 (Jan. 7, 2022, 5:14 AM), <https://www.npr.org/2022/01/07/1071181199/johnson-johnson-tests-a-legal-maneuver-known-as-the-texas-two-step> ("If the deal [is one] where you lend them money and, if they feel like it, they do a Texas two-step and get rid of your claim, then no one's ever going to lend money again.").

that it is authorized by a state statute. Many of the problems associated with the Texas Two-Step are part of broader issues associated with general bankruptcy practice, such as venue shopping, making it difficult to strike the balance between judicial intervention and legislative reform being “too broad” and “too narrow.” Any grassroots reform at the state level would require the Texas legislature to support a change in the law. Nonetheless, this paper provides a few suggestions that would make the Texas Two-Step much more inconvenient and less appealing for companies to utilize.

The judiciary can attack the Texas Two-Step through statutory interpretation or findings of bad faith. Future courts can focus on the term “obligation” rather than “transfer” under Texas law to trigger a fraudulent transfer analysis. Because the Texas statute provides that a divisive merger occurs “without any transfer having occurred,” but both “transfer” and “obligation” are included in state and federal fraudulent transfer law, analyzing J&J’s allocation of assets and liabilities as an “obligation” would allow a court to get around the statute’s loophole and examine J&J’s actual intent to defraud.²⁹⁷

Future courts can also adopt the Third Circuit’s bad faith analysis to dismiss future Two-Step cases. The Third Circuit found that the fact that LTL was backed up by its parent company when it filed for chapter 11 protection meant that LTL was not in a position of financial distress and therefore did not file in good faith.²⁹⁸ Though the court noted that its ruling in LTL’s case was narrow,²⁹⁹ the opinion provides a strong framework for future courts to follow when similar cases approach the bench.

The Texas state legislature can also limit the Two-Step’s effectiveness by reforming its business statute. The Texas legislature can add a clawback provision to the divisive merger statute, to activate if the liability-riddled entity files for chapter 11 bankruptcy protection after the merger occurs. In doing so, tort creditors would be able to challenge the asset-riddled entity’s fraudulent obligation of mass tort liabilities under state law without needing court authorization. The estate may then recover under section 544(b)(1) of the Code without limitation and put assets back in reach of the creditors if they are successful in avoiding this allocation of liabilities.

²⁹⁷ Haines, *supra* note 105, at 714–16 (2010); See TEX. BUS. & COM. CODE § 24.005(b).

²⁹⁸ LTL Mgmt., LLC v. Those Parties Listed on Appendix A to Complaint (*In re* LTL Mgmt., LLC) 64 F.4th 84, 110–11 (3d Cir. 2023).

²⁹⁹ See *id.*

Finally, the loophole can be tightened by the federal legislature. Congress introduced the Bankruptcy Venue Reform Act in 2021,³⁰⁰ which was reintroduced by two representatives in 2023.³⁰¹ As the BVRA stands today, opponents fear that its provisions interfere too heavily with a business's autonomy over its chapter 11 reorganization plan and corporate decision-making more generally.³⁰² In light of the threat that the Texas Two-Step appears to pose, it is easy to lose sight of the purpose of chapter 11 bankruptcies. Rather than reaching too broadly and punishing insolvent businesses that seek chapter 11 protection for valid reasons, Congress should reform the language of its current bills to specifically address Texas Two-Step cases to prevent Two-Step debtors from intentionally filing in a favorable venue.³⁰³

The effectiveness of curbing the Texas Two-Step ultimately relies on a combination of all these proposals. Recent years will undoubtedly bring greater developments in this intersection of bankruptcy and mass torts, possibly even some guidance from the Supreme Court. Until then, incorporating any of these proposals would certainly be a “step” in the right direction.

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³⁰⁰ Bankruptcy Venue Reform Act of 2021, H.R. 4193, 117th Cong.; Nondebtor Release Prohibition Act of 2021, S. 2497, 117th Cong.

³⁰¹ Press Release, Ken Buck, Buck and Lofgren Reintroduce Bipartisan Legislation to End Corporate Bankruptcy Venue Shopping (Feb. 14, 2023), <https://buck.house.gov/media-center/press-releases/buck-and-lofgren-reintroduce-bipartisan-legislation-end-corporate>.

³⁰² See generally Gross & Rosen, *supra* note 285; Gregg M. Galardi et al., *The Way Is Shut: Nondebtor Release Legislation Proposes Mandatory Dismissal on Account of Pre-Bankruptcy Liability Transactions*, ROPES & GRAY LLP: NEWSROOM (Oct. 13, 2021), <https://www.ropesgray.com/en/newsroom/alerts/2021/October/The-Way-Is-Shut-Nondebtor-Release-Legislation-Proposes-Mandatory-Dismissal-On-Account>.

³⁰³ See *LTL Mgmt.*, 64 F.4th at 98 n.8 (citing *Carolin Corp. v. Miller*, 886 F.2d 693, 694 (4th. Cir. 1989)).

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