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Bankruptcy System Faces Gov't Backlash

By Robert Gayda, Andrew Matott and Catherine LoTempio

Key bankruptcy issues, including the propriety of third-party releases and the so-called "Texas Two-Step," as well as determination of proper case venue, have recently drawn the attention of mainstream media, the public at large and, consequently, Congress. These issues have largely been thrust into the public eye by two high-profile and emotionally charged cases, namely Purdue Pharma and Johnson & Johnson affiliate, LTL Management LLC. There has been a bevy of related activity, which has not been easy to keep track of — a number of highly influential bankruptcy court decisions have been rendered and bankruptcy court policies changed. The related public scrutiny has also driven the desire of Congress to act to curtail what they view as abuse of the bankruptcy system. To that end, certain members of Congress have proposed legislation aimed at resolving these perceived problems, which legislation remains outstanding. The intent of this

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More Action Seen in 2nd Half of 2022

By Christopher Patalinghug

Total U.S. bankruptcy filings in April 2022 decreased 21% from the previous year, according to American Bankruptcy Institute, citing data from Epiq Bankruptcy. Total filings were 32,508 for the month of April 2022, down from 40,931 in April last year. Commercial bankruptcy filings decreased 16% in April 2022, as the 1,761 filings were down from the 2,105 commercial filings registered in April 2021, ABI says. There were 249 commercial Chapter 11 filings registered in April 2022, a decline of 15% from the 290 filings in April 2021. Small business filings, filed under Subchapter V of Chapter 11, decreased 26% to 83 in April 2022 from 112 in April 2021.

Through the first four months of 2022, bankruptcy filings continue to

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article is to level set on these issues, detailing what has occurred to date, as well as to provide some observations and thoughts on how things might evolve going forward.

Third-Party Releases

The September 2021 decision by the Honorable Robert D. Drain of the U.S. Bankruptcy Court for the Southern District of New York to confirm Purdue's Chapter 11 plan of reorganization — which included releases of the Sackler family for their role in the marketing and sale of opioids in exchange for forfeiting ownership of the company and a $4.325 billion contribution — was a touchstone of controversy. Even before Judge Drain had handed down his decision on the Purdue plan, the public outcry on the issue of third-party releases resulted in the introduction of the Nondebtor Release Prohibition Act of 2021 in the House of Representatives by Jerrold Nadler (D-N.Y.), Carolyn Maloney (D-N.Y.), David Cicilline (D-R.I.), Peter DeFazio (D-Ore.), and Katie Porter (D-Calif.). This was followed by a corresponding bill in the Senate introduced by Elizabeth Warren (D-Mass.), Richard Durbin (D-Ill.), and Richard Blumenthal (D-Conn.). The NRPA, if enacted, would add a new section 113 to the Bankruptcy Code that would prohibit bankruptcy courts from confirming a plan containing nonconsensual third-party releases of claims against non-debtors (except as provided in section 524(g) of the Bankruptcy Code with respect to asbestos claims) and limit a bankruptcy court's power to enjoin claims against non-debtors or non-debtor property. Representative Maloney described the bill as "a critical tool to prevent bad actors, like the Sacklers, from abusing a loophole in the Bankruptcy Code to escape personal responsibility for their actions." On November 3, 2021, the House Judiciary Committee voted to send the NRPA to the full House of Representatives — where it has lingered ever since.

In the month after the NRPA reached the House floor, the Honorable Colleen McMahon of the U.S. District Court for the Southern District of New York overturned Judge Drain's confirmation of Purdue's plan. The decision turned on Judge McMahon's finding that nonconsensual third-party releases against non-debtor parties were not authorized by the Bankruptcy Code. Specifically, she held that "[c]ontrary to [Judge Drain]'s conclusion, Sections 105(a) and 1123(a)(5) & (b)(6), whether read individually or together, do not provide a bankruptcy court with [statutory] authority; and there is no such thing as 'equitable authority' or 'residual authority' in a bankruptcy court untethered to some specific, substantive grant of authority in the Bankruptcy Code." Judge McMahon noted that this issue, which had "hovered over bankruptcy law," needed "a clear answer."

Purdue promptly appealed the decision to the Second Circuit. On March 3, 2022, however, a settlement was reached whereby the Sacklers would increase consideration under the plan by $1.175 billion in total committed cash and up to an additional $500 million of cash consideration in exchange for the objectors agreeing to be consensually bound by the third-party releases in question. Judge Drain approved the settlement agreement on March 9, 2022. According to Purdue, the Second Circuit appeal "therefore no longer presents the question of whether claims brought by states against third parties can be non-consensually released in bankruptcy, either generally or under the facts of this case." Other case constituents, however, seem to disagree, putting the issue front and center in their filings with the Second Circuit, which was scheduled to hear oral arguments on April 29, 2022.

Another impactful decision on the non-consensual third-party releases was issued by the U.S. District Court for the Eastern District of Virginia on January 13, 2022, while the drama in Purdue was unfolding. The District Court there overturned the decision by the U.S. Bankruptcy Court for the Eastern District of Virginia, Richmond Division, confirming the plan in the Ascena Retail Group, Inc. bankruptcy cases. The Ascena plan contained third-party releases that protected officers who had stopped working for the company prior to the petition date and were not contributing value under the plan. Although the District Court stopped short of finding that nonconsensual third-party releases are never permitted, it stressed that such releases should be granted only cautiously and infrequently, and after meaningful fact finding. The District Court also criticized the routine approval of third-party releases in

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the Richmond Division, going so far as to order that the remanded case be reassigned to a bankruptcy judge in another division.

Texas Two-Step

Although J&J may have brought the Texas Two-Step into the public spotlight, it was hardly the first distressed company to utilize the maneuver. In 2017, Georgia-Pacific effectuated a divisive merger that created a new Texas entity, Bestwall LLC, to which it assigned $175 million in assets as well as massive liabilities related to asbestos claims against the company. Bestwall LLC then changed its domicile and filed for Chapter 11 relief in the U.S. Bankruptcy Court for the Western District of North Carolina, where it sought to establish a trust that would deal with asbestos claims under section 524(g) of the Bankruptcy Code. The bankruptcy filing was challenged as a sham by creditors. Motions to dismiss the bankruptcy case, however, were denied for lack of cause. The bankruptcy court ultimately approved a settlement whereby Georgia-Pacific agreed to fund a section 524(g) trust with $1 billion to resolve the claims at issue.

After Georgia-Pacific, CertainTeed Corp., a manufacturer of construction materials that contained asbestos, also converted into a Texas LLC and effected a divisive merger that created two entities: CertainTeed LLC, which retained 97% of the company's assets and non-asbestos liabilities, and DBMP LLC, which inherited the company's asbestos liabilities and agreed to indemnify CertainTeed LLC for any future asbestos liability in exchange for funding an asbestos trust. DBMP LLC subsequently converted to a North Carolina LLC and filed for Chapter 11 relief in the U.S. Bankruptcy Court for the Western District of North Carolina in January 2020. Various parties have sought to substantively consolidate the debtor's estate with the assets of CertainTeed, which could effectively unwind the merger and create liability for parties that received pre-petition payments from CertainTeed. That litigation remains pending.

Cases like *Bestwall* and *CertainTeed* appear to be one of the driving forces behind introduction of the NRPA in 2021, which, in addition to the prohibition of releases described above, would provide creditors with a tool to challenge the Texas Two-Step. Specifically, the NRPA proposes to amend the Bankruptcy Code to provide that:

> [o]n a request of a party in interest, and after notice and a hearing, the court shall dismiss a [chapter 11] case . . . if the debtor or a predecessor of the debtor was the subject of, or was formed or organized in connection with a divisional merger or equivalent transaction or restructuring that — (1) had the intent or foreseeable effect of — (A) separating material assets from material liabilities of an entity eligible to be a debtor under this title; and (B) assigning or allocating all or a substantial portion of those liabilities to the debtor, or the debtor assuming or retaining all or a substantial portion of those liabilities; and (2) occurred during the 10-year period preceding the date of the filing of the petition.

Congressional disdain for the Texas Two-Step has only grown as a result of the J&J cases. J&J filed for bankruptcy in October 2021 in the U.S. Bankruptcy Court for the Western District of North Carolina to resolve talc-related claims stemming from J&J products without subjecting the parent company, which is solvent, to bankruptcy. Two days before the filing, Johnson and Johnson Consumer Inc. ("Old JJCI"), a subsidiary, completed a divisive merger under Texas law whereby Old JJCI was dissolved and two Texas limited liability companies were created: Johnson & Johnson Consumer Inc. ("New JJCI") and LTL Management LLC, which then converted into a North Carolina LLC. LTL Management LLC was assigned all talc-related liabilities of Old JJCI, along with certain assets, including approximately $6 million in cash, royalties with an estimated value of over $367 million, and rights under a funding agreement with the parent company. J&J planned to establish a qualified settlement fund to pay current and future talc-related claims, which the parent company and New JJCI would fund with $2 billion. From the onset, however, the Honorable Craig Whitley of the U.S. Bankruptcy Court for the Western District of North Carolina raised concerns as to whether the Western District of North Carolina was the proper venue for the bankruptcy proceedings and, on his own motion, ordered J&J to show cause why the case should not be transferred to a more appropriate venue. In November 2021, Judge Whitley

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transferred the LTL bankruptcy case to the Bankruptcy Court for the District of New Jersey — where J&J has its headquarters as well as its principal assets and operations.

On February 8, 2022, the Senate Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights held a hearing on the "Texas Two-Step." During the hearing, which featured panelists that advocated both for and against the maneuver, Senator Sheldon Whitehouse (D-RI) signaled that he planned to pursue legislative action to remedy what he perceived as an abuse of the bankruptcy process. A week after the hearing, Senate Majority Whip and Chair of the Senate Judiciary Committee Dick Durbin delivered a speech from the Senate floor criticizing J&J for taking advantage of the Texas Two-Step to limit consumer liability.

Meanwhile, upon the J&J case arriving in the Garden State, certain parties moved to dismiss the case on the basis it was not filed in good faith. On February 25, 2022, the Honorable Michael Kaplan of the U.S. Bankruptcy Court for the District of New Jersey denied the motions to dismiss, finding "[t]here is nothing to fear in the migration of tort litigation out of the tort system and into the bankruptcy system." He also found that there is "nothing inherently improper" in the use of the Texas Two-Step: "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" and there is "nothing inherently unlawful or improper with application of the Texas divisional merger scheme in a manner which would facilitate a chapter 11 filing for one of the resulting new entities."

After Judge Kaplan's decision, Senator Whitehouse issued a press release doubling-down on his concerns and asserting "[t]he Texas Two-Step is a blot on our legal system that's neither efficient nor fair for victims. We need to find a sensible fix." The NRPA, however, has not gained momentum in the Senate, where the Senate Judiciary Committee has yet to take it up for a vote. Meanwhile, certain parties appealed Judge Kaplan's decision and sought direct review by the U.S. Court of Appeals for the Third Circuit. The Honorable Freda Wolfson, Chief Judge of the District Court for the District of New Jersey, has issued a stay of the proceedings until the Third Circuit rules on the request for direct review.

Venue Reform

Calls for venue reform are nothing new, typically occurring once every several years since New York and Delaware became "magnet" jurisdictions pre-Enron. The purported issue stems from the flexibility of 28 U.S.C. § 1408, which provides alternative bases to establish proper venue, allowing several possible jurisdictions where a debtor may file for bankruptcy. As practitioners are aware, a debtor is authorized to file in any district (1) in which the domicile (i.e., place of incorporation), residence, principal place of business, or principal assets of the debtor have been located for the 180 days prior to filing or (2) in which the debtor's affiliate, general partner, or partnership has a pending case. The 40-plus year-old venue debate has been reignited by J&J, Purdue and Ascena, and their alleged forum shopping. Critics point to J&J's decision to file LTL's bankruptcy in the Western District of North Carolina, where prior Texas Two-Step cases have been successful. *Purdue* is cited because the Purdue debtors filed in the White Plains division of the Southern District of New York. At the time that they filed, this meant that the case would draw Judge Drain, who has deep experience in presiding over "mega-cases." In *Ascena*, the debtors supposedly sought the debtor-friendly (and third-party release friendly) jurisdiction of the Eastern District of Virginia.

As a result of these filings, in June 2021, Representatives Zoe Lofgren (D-Calif.) and Ken Buck (R-Colo.) introduced the Bankruptcy Venue Reform Act of 2021 in the House of Representatives, which was followed by a Senate counterpart introduced by Senators Warren and John Cornyn (R-Texas) on September 23, 2021. The BVRA would, among other things, require companies to file in the judicial district where their principal assets or place of business is located and prohibit them from commencing a bankruptcy in a district simply because an affiliate filed there. Additionally, the BVRA would restrict companies from filing in a jurisdiction where, within one year of the filing, they take an action to transfer their principal place of business for the purpose of establishing venue — including through divisional mergers.

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The BVRA has yet to make it out of committee in either the House or the Senate. Of course, even if the BVRA was passed by both houses of Congress, it would still need to be signed by the President, who has stymied prior reform efforts during his tenure as a Senator for Delaware (a popular venue for prospective debtors).

Observations

Non-consensual third-party releases, the Texas Two-Step and bankruptcy venue raise a host of questions that are far from easy to answer. Granting broad releases to non-debtors that have not contributed to a bankruptcy case and which are not vital to the success of the reorganized debtor seem inappropriate in most circumstances. On the other hand, almost every complex bankruptcy implicates non-debtors, the release of which may be required to achieve the bankruptcy goal of rehabilitation. The Texas Two-Step appears to prejudice creditors by limiting their recourse to one entity which may have limited assets contributed by a solvent parent, but could resolving litigation claims through a bankruptcy lead to a better result than piecemeal litigation elsewhere (as Judge Kaplan suggested)? And does allowing a prospective debtor leeway in deciding where to file bankruptcy prejudice "local" creditors given advances in technology and access?

Reasonable minds can differ on how to approach these difficult issues. Notably, the judiciary has already been able to provide some answers. In Purdue, the appellate system has already provided a remedy to aggrieved creditors impacted by third-party releases. Moreover, the Southern District of New York and the Eastern District of Virginia have implemented new protocols in assigning cases to judges to combat the perceived inequity of "judge shopping." In LTL, the North Carolina bankruptcy court raised the prospect of venue transfer itself, and case constituents have challenged the propriety of the Texas Two-Step before the bankruptcy court and, currently, before the appellate courts. Despite these measures, a bigger fix may still be in order. Any larger solution, however, should be informed, well-reasoned and deliberate, rather than emotional and based on the evaluation of one or two high-profile cases. Misconceptions certainly exist and must be remedied.

Robert Gayda

For example, not all non-consensual third-party releases are inappropriate, and the ability to bind dissenting stakeholders is critical to the success of the bankruptcy system. Proponents of venue reform may have some valid concerns, but they do not legitimately include creditor disenfranchisement simply based on distance from the courthouse. Hopefully the debate over these issues continues to be lively and workable resolutions can be achieved. Given the status of the NRPA and the BVRA in Congress, it seems as though there will be ample time for discussion. ¤

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