Candice Kline, Esq.
Partner
Saul Ewing Arnstein & Lehr LLP

Editor's Note: Since Candice Kline wrote extensively about third-party releases CLW Vol. 35, Issue 3 (July/August/September 2021), the interaction, or some would say conflict, between bankruptcy courts and tort litigants has continued to draw attention. Candice now provides Part 3 in what may be a long-running feature spotlighting developments in high profile cases involving mass tort defendants in bankruptcy.

THIRD-PARTY RELEASES, FORUM SHOPPING AND THE TEXAS TWO-STEP:

An update in the continuing battle between Bankruptcy and "The Tort System"

Nonconsensual third-party releases have been focal issues in two pharmaceutical company bankruptcy cases, *Purdue Pharma* and *Mallinckrodt* in the opioid crisis. These cases are typically referred to as mass tort liability cases. Other recent bankruptcy cases in the mass tort context that have attracted scrutiny are *Boy Scouts of America*, *USA Gymnastics*, and the Catholic diocese cases. The newest entrant in the field is the bankruptcy of LTL Management, an affiliate of Johnson & Johnson (J&J) relating to liability claims for J&J talc products. *LTL Management* has not gotten to the stage where there will be fights over releases, but has drawn public outcry for the tactic used by J&J to create the company, pour the talc liabilities into the new company, and then promptly have LTL file bankruptcy. Those maneuvers are then followed by obtaining a litigation stay for and, subsequently, nonconsensual third-party releases of J&J and others not filing bankruptcy themselves.

Reacting to the *LTL Management* bankruptcy filing to seemingly brush off J&J's talc liabilities, on February 8, 2022, the Senate Subcommittee on Federal Courts, Oversight, Agency Action, and Federal Rights held a hearing. Longtime CLLA member Hon. Judith K. Fitzgerald (ret.) was a witness at the hearing.

The hearing explored the "Texas Two-Step" strategy used by J&J to protect itself (and potentially other third parties) from mass tort liability by forcing the talc-related litigation into bankruptcy. J&J formed *LTL Management* in Texas using that state's controversial corporate statute authorizing a "divisive merger" in which a company divides itself into BadCo (LTL) which has no operational business but takes on the talc liabilities while the remaining GoodCo (J&J) holds on to the lion's share of the assets and maintains the operations of the business. LTL then filed for chapter 11 protection in North Carolina only two days after formation. After venue in North Carolina was opposed, the bankruptcy case was transferred to New Jersey, which recently retained the case, a decision prompting multiple appeals.

Following the hearing, Senator Dick Durbin (D-IL) criticized J&J's divisive merger as a "shell game" to avoid accountability to 38,000 cancer victims claiming that company's talc products caused their illness. Senator Durbin seeks a bipartisan bill to eliminate such maneuvers, which he characterized as "bankruptcy abuse." Unfortunately, this is not the first time that phrase has been used in the halls of Congress this session. The Nondebtor Release Prohibition Act of 2021 (see H.R. 4777 and S. 2497) already aims to prohibit both nonconsensual third-party releases (while raising the bar on what constitutes consent for such releases as well) and Congress is now looking at ways to address the "Texas Two-Step" as well.

All of the various strategies that have been discussed in this series are interconnected. The "Texas Two-Step" creates a vehicle to insulate the operational revenue and hard assets of the tort-feasor from liability. The company then forum shops its bankruptcy filing to find a jurisdiction favorable to its strategy for a reorganization that minimizes the losses. And then the Badco bankruptcy plan is coupled with nonconsensual third-party releases to protect GoodCo and other third parties. In this way, GoodCo and other non-debtor stakeholders get all the claims resolved and discharged while the assets remain outside the reach of the court and the claimants, all the benefit of bankruptcy without the burdens.

In mass tort cases, all claims are funneled into bankruptcy for compensation under a plan, without regard for the volume and nature of the claims, allegedly harmful products or tortious individuals. The idea is a debtor- and insider-protective bankruptcy used to shield assets and third parties from the tort litigation as part of the settlement of claims addressed in the Chapter 11 plan. Third parties, such as the Sackler family members, pay some amount of money into the bankruptcy settlement, in exchange for releases; in some cases, such releases are so broadly drawn that they protect thousands of people with no direct contact with the bankruptcy. Proponents see bankruptcy as being good for the mass tort victims because (they perceive) bankruptcy is a more efficient vehicle for resolution of thousands of claims than "the tort system." The proponents contend that bankruptcy proceedings will get money to victims more quickly and more equitably than conventional litigation. They grimace at the lottery-like race to the courthouse involving thousands of claimants and their individual claims. Critics raise concerns about access and due process and question the divestment of plaintiffs' right to be heard and to seek compensation through litigation against the debtor and recently against the third parties who have not filed bankruptcy themselves.

The large bankruptcy cases are expensive and perhaps not as efficient as billed, yet proponents argue that they remain less costly than "the tort system." Many members of the bankruptcy bench and bar support the use of bankruptcy courts to handle these claims. Reasons include confidence in bankruptcy as a collective proceeding and as an ideal forum to settle financial claims. A recent example of a strong pro voice is Judge Kaplan's opinion denying claimants' motions to dismiss in *LTL Management*. The issue before the judge was whether the case was filed in bad faith, as that term is defined in the Bankruptcy Code, but Judge Kaplan took the opportunity to respond to the wider arguments regarding the propriety of using the bankruptcy courts to address mass tort cases. In his opinion, the Judge stated that a chapter 11 case would provide a "more beneficial and equitable path toward resolving Debtor's ongoing talc-related liabilities" than subjecting the company to thousands of lawsuits. The judge also issued an order to extend an injunction protecting a number of third parties, including J&J, from any talc-related litigation.

A key feature of chapter 11 plans in the mass tort cases is to shuffle the tort litigation into one claims-made process, usually characterized by mandatory mediation, and a plan that limits the money available to claimants. Proponents believe this approach is fair and efficient for both the claimants and the debtor, but it is not clear how well it genuinely protects the best interests of the tort claimants. The *Purdue Pharma* plan proponents argued that the $4.5 billion being paid as a claim settlement fund was fair for all parties, but the subsequent jump to a $6 billion plan after a successful appeal suggests that the original plan was not as well designed to maximize plan contributions as its proponents had claimed.

The bankruptcy approach instead may promote low-ball, "legally sufficient" settlement offers because debtors in many jurisdictions may tap nonconsensual third-party releases to enforce such plans against objecting creditors. While several circuits have rejected the use of third-party releases, bankruptcy practitioners know well that there are means of getting the debtor into in a more favorable forum through venue or judge shopping. This has been a major criticism of the mass tort cases in *Purdue Pharma* (judge shopping) and *J&J/LTL Management* (venue shopping).

Mass tort cases seem to strain the legal basis for the mandatory bankruptcy process. Following the path-breaking *Johns-Manville* asbestos-liability chapter 11 case, Congress modified the Bankruptcy Code to add section 524(g) to allow the imposition of a channeling injunction and creation of a liquidating trust for asbestos claims. Over time, this asbestos-focused provision has been extended through other sections, such as the catch-all general relief section 105(a), to apply in non-asbestos cases. Not all circuits have found that there is statutory authority for such channeling injunctions and trusts outside the asbestos cases to permit the nonconsensual third-party releases sought in the plans. Recently the battleground has been the district courts, where even though the Second and Fourth Circuit precedent permit the use of nonconsensual releases, the district courts questioned the constitutional basis for widespread use of these releases, focusing on the limited jurisdiction of bankruptcy courts and due process rights.

For many bankruptcy attorneys, particularly in the Commercial Law League, these issues may not be relevant to the daily practice. But experience has shown that whenever a creative strategy is developed in high-dollar bankruptcy cases, it will soon filter down to the rest of the bankruptcy bar. Just as liquidation trusts and litigation trusts have become commonplace in bankruptcy cases that don't generate headlines, third-party releases and divisive mergers will likely start being used in the smaller commercial bankruptcies as well. ■

The CLLA's Bankruptcy Section's legislative committee has appointed a subcommittee to recommend a position for the League. Members of this subcommittee and Judge Fitzgerald (ret.), who testified at the February 8, 2022 hearing, will present on this topic at the National Conference. If you would like more information about the League's position, please contact Dawn.Federico@clla.org.